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CABRI - Understanding and Managing Contingent Liabilities

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Course Overview

- Overview of the ALSF
- Understanding Contingent Liabilities
- Risk Assessment
- Risk Mitigation and Management Tools
- Questions and Answers

Overview of the ALSF

- International Organization hosted by the African Development Bank
- Provides legal support to African Governments on issues related to complex commercial contracts
  - Sectors:
    - Sovereign Debt
    - Infrastructure (PPP-type of arrangements, concession agreements, etc.)
    - Power
    - Natural Resources, including the Extractive Industry (Oil & Gas, Mining)
  - Types of assistance
    - Creditor Litigation
    - Advisory Services/Transactional Support
    - Capacity Building
    - Knowledge Management

Understanding CLs: Overview

- What are Contingent Liabilities
- Types of Contigent Liabilities
  - Implicit and Explicit Contingent Liabilities
    - Definitions
    - Examples
- Why Contingent Liabilities matter

What are Contingent Liabilities?

- Absence of a single definition – presence of common elements
- Typically contingent liabilities "represent **potential financial claims against the government** that have **not yet materialized**, but that **could trigger a financial obligation or liability under certain circumstances**" (Definition from the handbook *Understanding Sovereign Debt: Options and Opportunities for Africa*, *vide* References)
- Key elements of the definition:
  - Likelihood/unlikelihood of materialization
  - Uncertainty regarding amount and timing of payment
  - Fiscal cost largely invisible until the triggering event materializes – if and when it does, fical impact can be very significant

Implicit and Explicit CLs

- **Explicit CLs**
  - Legal obligations for governments to make payments if a conditional event occurs or is triggered
  - Government liability explicitly recognized by law or contract
  - Uncertainty concerning the materialization, but in some instances possible to estimate the exposure beforehand
- **Implicit CLs (including Systemic and Subnational CLs)**
  - A political or moral obligation for governments to step in
  - Government liability created by the expectation of government intervention in the event of a crisis or a disaster, linked to beliefs of the role of a state and to public/political pressures
  - Uncertainty concerning the triggering event, the extent of government exposure, and the amount of outlay that could be required

Implicit and Explicit CLs (Cont.)

- **Explicit CL – Examples:**
  - Guarantees
    - Loan guarantees
    - Export guarantees
    - Other financial guarantees – includes guarantees under PPP arrangements
  - Indemnities
  - Legal Claims agains the Government
- **Implicit CL – Examples:**
  - Bailouts of SOEs, financial institutions linked to the banking sector, subnational governments, and any other entities that are strategic to the state's political economy obligations or deemed "too big to fail"
  - Natural disaster relief

Why do Contingent Liabilities matter?

- CLs are considered **one of the largest sources of fiscal risk** – they can lead to large increases in public debt and trigger fiscal crises
- Due to their complexity, **common misconceptions about CLs include beliefs that they represent no cost because they are off-balance sheet** – in this sense, they can be deceiving and it is why they are often referred to as **"hidden deficits"**, i.e. "increases in public debt that are not explained by headline fiscal balances" (Kharas and Mishra, 2001, *Fiscal Policy, Hidden Deficits, and Currency Crises)*
- When CLs are not previously identified, captured, assessed, mitigated, or managed, **CLs can materialize without governements having taken appropriate mitigation measures and mechanisms**
- CLs tend to occur during periods of economic stress, which they potentially amplify
- CL realizations tend to occur during times of crisis, with strong correlations among the different types of CL and risk factors – all these factors compound the negative impact on the government budget – Thus the adage: ***When it rains, it pours.***

Risk Assessment: Overview

- What are the chances of the contingent liability becoming a liability?
  - Probable?
  - Possible?
  - Remote?
- How much will the materialized liability cost?
- What impact will materialization have on the overall debt position and sustainability of the country?

Risk Assessment: Guaranteed entity and project default risk

- Guaranteed entity default risk
  - What is the likelihood the SOE will repay (not default) on its obligations?
    - Credit ratings
    - Statistical models
    - Scenario analysis
- Project risk
  - What is the likelihood that the guaranteed project's revenue stream/ right to termination payment will be called?
  - Understanding the project's risk – has a balanced risk allocation been reached?

Risk Assessment: Quantifying risk

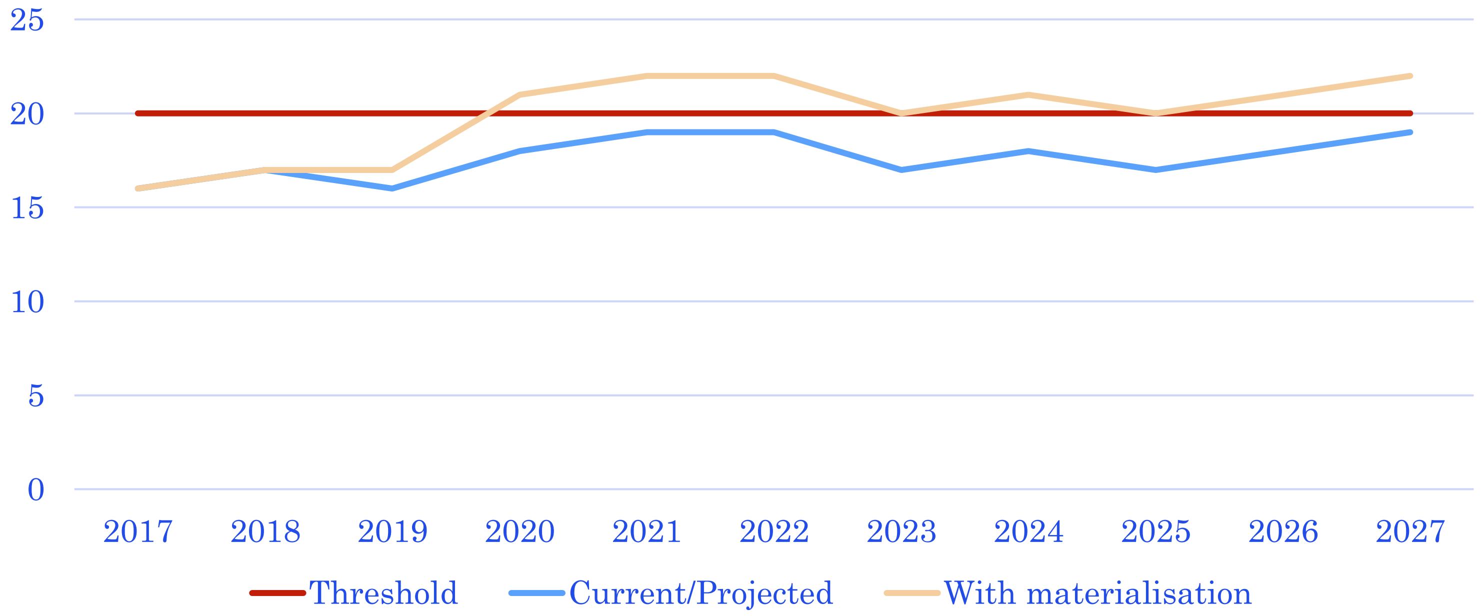
- Understanding the potential impact of a CL on the sovereign's balance sheet
  - Face value (maximum loss)
  - Expected costs
  - Market value

Risk Assessment: Understanding Impact

- Understanding the potential impact of a CL on the sovereign's fiscal health
- **Stress-testing contingent liabilities**
  - What is stress testing?: Assesses how sensitive the government's fiscal health is to the potential materialization of the CL. Whether that fiscal health can withstand the materialization.
  - When evaluating a contingent liability, one should stress test the fiscal effects of the realization/materialization risk using varying:
    - assumptions
    - scenarios
    - type/levels of guarantee
- Debt sustainability analyses (DSA)
  - What is a DSA: Assesses how a country's current and prospective debt levels impact its ability to meet its various debt servicing obligations.
    - Understanding country classifications and DSAs – LIC vs MAC

Risk Assessment: Understanding Impact

- Understanding the potential impact of a CL on the sovereign's fiscal health
- **Stress-testing contingent liabilities**
  - Debt: GDP



Risk Assessment: Understanding Impact

- Understanding the potential impact of a CL on the sovereign's fiscal health

- Stress-testing contingent liabilities
  - What is stress testing?: Assesses how sensitive the government's fiscal health is to the potential materialization of the CL. Whether that fiscal health can withstand the materialization.
  - When evaluating a guarantee, one should stress test the fiscal effects of the realization/materialization risk using varying:
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- **Debt sustainability analyses (DSA)**
  - What is a DSA: Assesses how a country's current and prospective debt levels impact its ability to meet its various debt servicing obligations.
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Risk Assessment: Cost-risk-benefit assessment

- The stage is about putting the assessment into context and performing a risk-cost-benefit analysis
- Key questions:
  1. Whether the project is necessary/ assessing the value of the project (i.e., power, roads, bridges, etc.)
  2. Is the government guarantee necessary for the project?
     a. Is the guarantee addressing a supply-side issue?
     b. Could the private sector address the need?
     c. Could an external resource such as insurance be used instead?
     d. Would direct budgetary support be preferable?

Risk Mitigation and Management Tools: Overview

- Because CLs pose a fiscal risk, measures to mitigate and manage those risks are usually presented as part of a **strategy to address fiscal risks** and an even broader debt management strategy
- Specific risk mitigation and management strategies and options may vary from country to country, but key concerns remain the same when it comes to risks arising from CLs:
  - Setting up **objective criteria and guidelines** to support the decision of **when to take on CLs and accept the associated risks**
  - Having clear guidelines on **how to allocate, transfer or share CL risks** with the private sector in order to mitigate the impact of CLs
  - **Efficiently managing risks** accepted by and remaining with the government
  - Identifying the **best practices in disclosing CLs**

Risk Mitigation and Management Tools: Fiscal Risk

- Fiscal risk refers to "the **possibility of deviations in fiscal variables** from what was expected at the time of the budget or other forecast" (Cebotari et al., *Fiscal Risks: Sources, Disclosure and Management*)
- **Individual sources of risk** such as banking crises, natural disasters, SOE bailouts, legal claims against the state, guarantees, PPP-related obligations **can all compound**, particularly in the face of **macroeconomic shocks**
- There are **guidelines** and **tools** to support countries integrating fiscal risks into their fiscal analysis and the budget process
  - *International Standards and Transparency initiatives* for general risks, including disclosure practices
  - *PPP Fiscal Risk Assessment Model (PFRAM)* – analytical tool developed by IMF and the WB to assess the potential fiscal costs and risks arising from PPP projects

Risk Mitigation and Management Tools: Contingent Liabilities

- **Mitigating risks associated with CLs**
  - Importance of dealing with risks before taking the decision to take on CLs
    - Framework for assessing risks from CLs
    - Framework for decision making on whether to take on those risks and when
  - As part of the decision-making process to take on CLs
    - Strategies to transfer risks or costs related to CLs
    - Other built-in safeguards against CL risks
- **Managing retained risk from CLs**
  - Instruments for managing the materialization of CLs taken on
    - Budget flexibility
    - Contingency reserve funds
    - Internal and external audits
- **Disclosing CLs**

Mitigating risks related to CLs

- Dealing with risks **before making the decision** to take on CLs
- Decision typically relates to explicit CLs
  - Focusing on sovereign guarantees in the context of infrastructure project development – typically, explicit CLs, unless public SOE, in which case can also be implicit CL (e.g. in the event of financial difficulties of the SOE)
  - Can also be loans, indemnities, government insurance programs, etc.
- Avoiding taking on contingent liabilities might not be feasible or desirable (cost-benefit analysis)
- Key issue is not whether to take on any CLs, but **which CLs to take on, when and why**

Legal framework for CLs

- Decisions to enter CLs should **follow a well-established process**
- Incorporated within a **clear legal and administrative framework** for fiscal management and government's exposure to fiscal risk
- Framework would guide the justification for CL and put in place safeguards against associated risks
- Objectives:
  - To enable decision-makers to **understand the nature of the risks** associated with CLs
  - **Provide guidance** on when CLs are an acceptable form of support
  - Set up a proper **record** of all decisions to take on CLs for **accountability purposes**
- PPP specific frameworks – ensure proper risk allocation

Legal Framework for CLs (Cont.)

- Institutional arrangements and the allocation of roles and responsibilities vary from country to country:
  - In some countries, there is a **central unit of government** responsible for monitoring and coordinating the management of fiscal risks, including risks associated with CLs
  - For some specific risks such as PPP-related risks or issuance of guarantees for infrastructure development projects purposes, some countries have set up **specific units (PPP Unit)** or provide for the **involvement of line ministries** (sector-specific) in the process
  - Some countries also provide for the **involvement of the supreme auditing institution** as a way to enhance scrutiny and implement some safeguards against fiscal risk
- Best practices highlight that the legal framework should be clear as to who may authorize the issuance of CLs

Other safeguards

- Parliamentary involvement in the decision to take on CLs
  - In the form of information about CLs and how they may affect the fiscal position of the country
  - In the form of direct approval
- Capping the overall budget for guarantees
- PPP-related liabilities may be limited under guarantee, debt or separate PPP ceilings
- External control over CLs – Scrutiny by national audit offices

Country highlight: Australia

- Developed **guidelines** for the issuance of guarantees and other CLs by the government
- Guidelines require, among others:
  - The **identification of an explicitly identified risk as a condition precedent** to accepting a CL
  - Confirmation that the **expected benefits objectively outweigh** the level and costs of the **risk**
  - Confirmation that there is a demonstrable need for the government to accept such risks
  - Confirmation that **alternative options for managing these risks have been fully explored** (including commercial insurance)
  - Confirmation that the price of the risk being borne by the government has been factored into the value-for-money consideration of the proposal
  - Appropriate **risk management arrangements** in place

Managing risks related to CLs

- Not all risks can be eliminated, covered by insurance, or transferred
- Risks that remain with the government need to be managed – and continuously monitored
- Mechanisms include
  - Budget flexibility
    - Contingency reserves (typically capped below 3% of total budget amount)
    - Provision to spend in excess of the budget, with clear restrictions
  - **Contingency reserve funds**
  - **Capping or ceiling CLs**
  - Insurance and hedging
  - Contingency and emergency loans

Contingency Reserve Funds: Definition and Purpose

- Earmarked reserve funds created specifically to address risks arising from the materialization of CLs
- Used to secure financing (if and) when CLs are called
- Serve as self-insurance against calls on various CLs
- Can also make the cost of the CLs more transparent
- Can be project specific (especially for large projects) or program specific (e.g. PPP program)
- Can also be set up to address risks arising from certain implicit CLs such as natural disaster relief, commodity price movements, etc.

Contingency Reserve Funds: Types

- **Actual contingency funds** – "invest resources in financial assets (usually government bond or AAA securities) and manage these assets"
- **Notional contingency funds** – "government finance accounts to which resources are paid and tracked, but which are pooled into the treasury and are therefore not invested separately"

NOTE: The choice between actual and notional funds will depend on the country's financial management practices and other relevant considerations

* Both definitions by Cebotari, *Contingent Liabilities – Issues and Practice*

Contingent Liability Caps

- One of the most common forms of risk mitigation and management tools
- Many countries set a **limit to the stock and/or issuance of CLs**
- Overall ceilings on guarantees can stimulate comparisons and trade-offs among guarantees, thus encouraging additional scrutiny and analysis
- Such ceilings can therefore be a direct and efficient tool to manage the impact of the issuance of guarantees
- **Separate ceilings can be set on the overall size of the PPP program (stocks)** and/or on the **annual PPP-related payments (flows)**, which can help limit the government's overall exposure to risks from PPPs

Disclosure practices for CLs

- Risks related to CLs can have an impact on debt sustainability and current/future fiscal position
- It is therefore important for decision-makers to have access to information on CLs – reporting practices also contribute to **enhancing transparency**
- **Trend towards increased disclosure** of information related to CLs and general fiscal risks
- **Disclosure requirements vary** depending on:
  - Accounting standards
  - Statistical reporting standards
  - International transparency initiatives and best practices

Conclusion

- CLs can pose significant **fiscal risk** to sovereigns
- Understanding the logic and mechanisms of CLs is an essential **tool for decision-making** process regarding the approval of explicit CLs such as guarantees
- Key issues include the **identification of the risk**, conducting a proper **risk assessment**, and putting in place appropriate **risk mitigation and management processes**
- Clear **legal frameworks** regarding roles and responsibilities as a primary tool for risk mitigation
- Importance of disclosing CL risks through **accounting standards and international best practices** to enhance **transparency** and strengthen the sovereign's position

Resources

- https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/635939/contingent_liability_approval_framework_guidance.pdf
- https://www.iisd.org/system/files/publications/currency-risk-project-finance-discussion-paper.pdf
- http://pubdocs.worldbank.org/en/294941565898518464/LearningandTrainingNotes-Assessing-and-Managing-Risk-from-CLs-Final-August152019.pdf
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- https://www.un.org/ipsas/Chapter15.html
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