Outline

Some Recent Trends – Fiscal Risks and CLs
The Role of the Debt Manager
Institutional Arrangements
Some Trends

East Asian financial crisis drew attention to CL exposures – Indonesia’s GDP fell by 35%

Over last 25 years governments experienced on average an adverse fiscal shock of 6% of GDP every 12 years – many finance related

DMUs have responded – often the only source of expertise – but focus on guarantees and on-lending, linked with loans and credits

But expanding sources of risk and awareness of implications (inc for fiscal policy) => development of IMF Fiscal Risk Management Framework
## The Fiscal Risks Matrix

<table>
<thead>
<tr>
<th>Contingent Liability</th>
<th>Identify and Quantify</th>
<th>Mitigate</th>
<th>Provision</th>
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<tbody>
<tr>
<td></td>
<td>Direct Controls</td>
<td>Indirect Tools (regulation and fees)</td>
<td>Risk Transfer Instruments</td>
</tr>
<tr>
<td><strong>Financial Sector</strong></td>
<td>Reduce state participation in the financial sector</td>
<td>Increase sector’s loss absorbing capacity Utilize macroprudential tools to reduce procyclicality Reduce debt bias in tax system</td>
<td>Reinsurance Catastrophe bonds Limit payouts and require deductibles for govt schemes Mandate insurance in high risk areas</td>
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<tr>
<td><strong>Natural Disasters</strong></td>
<td>Reduce footprint in risky areas</td>
<td>Tax premia in high risk areas Environmental standards Building codes Disaster preparedness strategies</td>
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<tr>
<td><strong>Guarantees</strong></td>
<td>Maintain a central registry of guarantees; assess risks at time of issue and over their life</td>
<td>Central authorizing entity Ceilings on liabilities Standard insurance criteria Conditions on access</td>
<td>Charge risk-related fees Partial guarantees Require collateral Reinsure if feasible</td>
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<tr>
<td><strong>PPP</strong></td>
<td>Maintain central registry of PPP commitments Subject projects to sensitivity analysis</td>
<td>Central authorizing entity Ministry of Finance gatekeeper role Ceilings on PPP commitments</td>
<td>Value for money checks Charge guarantee fees Risk sharing framework Limit payments linked to demand Insure retained contract risks where feasible</td>
</tr>
<tr>
<td><strong>SOEs</strong></td>
<td>Quantify explicit exposures Monitor financial performance Scenario analysis and stress testing</td>
<td>Reduce size of the SOE sector</td>
<td>Hold boards accountable for performance Reporting requirements Explicit no-bail out clauses</td>
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<tr>
<td><strong>Subnational Government</strong></td>
<td>Monitor financial performance against benchmarks</td>
<td>Fiscal rules and limits on borrowing</td>
<td>Link degree of financial autonomy to performance Reporting requirements Establish credible no-bail out clauses Retain authority to liquidate assets / appoint administrator</td>
</tr>
</tbody>
</table>

*Source: IMF 2016*
In Practice......

- IMF recommended central Fiscal Risk Units
  - Identifying, assessing, monitoring and reporting risks
  - Mitigation techniques; establishing targets
  - Buffers in fiscal path
- But FRUs are not well established outside some AEs

- DMU may still be only unit in government with developed risk management skills
- Debt manager retains
  - Lead responsibility for explicit CLs whose crystallisation directly adds to debt
  - An overview of the government’s balance sheet
- CL analysis must be integrated into debt management strategy (DMS)
The Role of the Debt Manager Today

• Contribute to general CL policy (with [Fiscal Risk Unit])
  – Design general CL policy, including guidance on analytical methodologies
  – Establish borrowing guidelines for public sector beneficiaries of guarantees on debt
  – Develop methodologies to identify and measure risks (inc to assess PPPs)
  – [Potentially] propose ceiling on guarantees for budget

• Assist [Fiscal Risk Unit] with budgeting
  – Centralising data; establishing methodology for CL cost estimation and pricing; identifying budget provisions & buffers

• Implement Risk Management – the Main Task!
Tools of Analysis, Measurement & Mitigation

**Defining Characteristics**
- Characteristics of Guarantee Portfolio
- Clear Definition of Risk Exposure
- Data availability
- Resources and capacity

**Risk Analysis**
- Analysing key risk factors of guaranteed entity using various methodologies
  - A Credit scoring; B Statistical models; C Scenario analysis; D Structural models

**Risk Quantification**
- Various target measures, e.g. Expected loss, Market value, Unexpected loss, Maximum exposure.
  - Primary approaches: Price differentials and Bottom up: estimation of default probabilities

**Risk Management and Risk Tools**
- Structuring of guarantees, incl. risk sharing;
- Setting limits, fixing fees; Provisioning for losses; Managing risk funds;
- Reporting on and monitoring risks

Based on: Bachmair 2016
Complications of PPPs

Scope for substantial benefit if risk transfer drives value for money

But extra challenges

- Ministers often see PPPs as a Free Lunch
- Financing structures are opaque
- Difficult to identify risks over a long period (up to 30 years)
- Not covered by legislation designed for guarantees

Often handled by a separate unit in MoF

- Requires different skills (contractual, corporate finance)
- Insist that DMU is able to comment, e.g. on implied cost of capital?

Some PPPs have more explicit debt-like qualities

- If government has guaranteed a regular purchase, e.g. of electricity from a build-own-operate supplier, some part will be remunerating the supplier’s capital investment
- Not very different from interest on the bond that the government might have issued had it itself constructed the plant – must take into account in DMS
CLs and the DMS

• Interaction between debt structures and economic shocks
  – Compare the CL shock in the DSA
  – Even if central government has reduced its FX liabilities, it might still be exposed to an exchange rate depreciation if SOEs are heavy external borrowers

• How will be balance sheet as a whole be affected by different shocks – central to ALM analysis
  – Exchange rate and interest rate shocks affect values of financial assets, liabilities and net worth
  – Implications for future borrowing costs
  – Impacts on discounted revenue and expenditure flows

• Scope for hedging residual risk
  – Catastrophe bonds, loss sharing, loss provisions, collateral
Strengthening Institutional Arrangements

Who has approval powers

- Parliament – open to the same problems as approval of individual debt transactions – should approve programme and policy only
- Minister/Cabinet - requires some high-level machinery (compare Public Debt Committee); must approve guidance, and major or unusual projects
- Head of DMO/FRU - on basis of delegated authority within agreed parameter
- But must not take accountability for project delivery aware from sponsor minister or agency

Disclosure requirements in legislation

Building resources, skills, capabilities

Setting Target and Ceilings – next slide
 Targets and Ceilings

• Increasing use of targets
  – Whether on flows or stocks
  – Linked with debt management or budget analysis

• Conditionality on public debt in IMF arrangements is established as a limit on “public debt and publicly guaranteed debt”
  – Subject to country circumstances
  – May exclude debt of SoEs that are able to borrow without a guarantee or that pose limited fiscal risk

• Should target be of risk-adjusted exposure, not maximum exposure?

• Time dimension
  – Identify probabilities of staying below ceiling taking account of range of shocks and average response of fiscal policy to those shocks
  – Implications for buffers
Who Does What in the DMU

**Front Office**
- Reviewing proposals,* recommendations
- Links with assessment of loans & credits
- Agree legal documentation
- Identifying cost of capital in PPPs

**Middle Office**
- Developing policy, establishing guidance
- Integration with debt management strategy
- MoUs with MDAs, macro-fiscal unit etc

**Back Office**
- Collecting fees
- Monitoring exposure, early warning
- Data and reporting

* Initial analysis should be done elsewhere
  * in SoE, line ministry or dedicated MoF unit
Legislation: Some of the Requirements parallel those in a Debt Management Law

• State has authority to accept CLs
  – Maybe in Constitution or other Statutes (eg related to deposit insurance schemes, pensions, etc)
  – For whom (private as well as public sector)?
    • Covering SoEs, PPPs, Sub-National Government…
  – Which types of obligation – guarantees or others
  – Implicit liabilities – care of moral hazard
  – Some countries allow CB to provide guarantees on Gov’s behalf (Ghana)

• Decision making: Parliament, Cabinet, Minister, Hd/DMO…
• Borrowing powers include ability to meet cost of called guarantees
• Setting quantitative limits – on flows or stocks
• Reporting and auditing requirements
Some Requirements may be less familiar...

• Powers may be needed
  – To meet cost of called guarantees etc from budget
  – To raise charges/fees for the guarantee
  – To clarify how to use/invest the fees
    • In a fund (notional or real)
    • Or through the budget
    • Managed by whom
  – To recover payments from the beneficiary

• The government must have power to scrutinise
  – Responsibility of minister to ensure skills, resources, and controls are all in place to manage risks
  – Secondary legislation to require a proper risk assessment

• Must be consistent with wider PFM legal framework

Thank You!
References


