Management of Guarantees and Lending - the Swedish Experience

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Background and Evolution of the Swedish Government Guarantee Model

Background: Public sector financial problems in the 1980´s, with large deficit and rising debt.. Most important parts of reform consisted of:

- Clearer and more stringent budget process; Fiscal rules (numerical targets); Medium-term framework; Forecasting and monitoring

The reform also included an overview of the government guarantee. The Budget Act (1996:1059) included the first fundaments of the Swedish guarantee model.

In the Budget Act (2011:203) the Swedish guarantee model was regulated more in detail. Government on-lending was also for the first time regulated and included in the same way as government guarantees.

The Swedish model – 3 principles

- Transparency
  - Risk assessment
  - Making the cost visible up-front
  - Ongoing monitoring and reporting
- Cost coverage
  - Provisioning for expected losses
  - Charging fees
- Risk management
  - Avoiding excessive and unmanageable risks

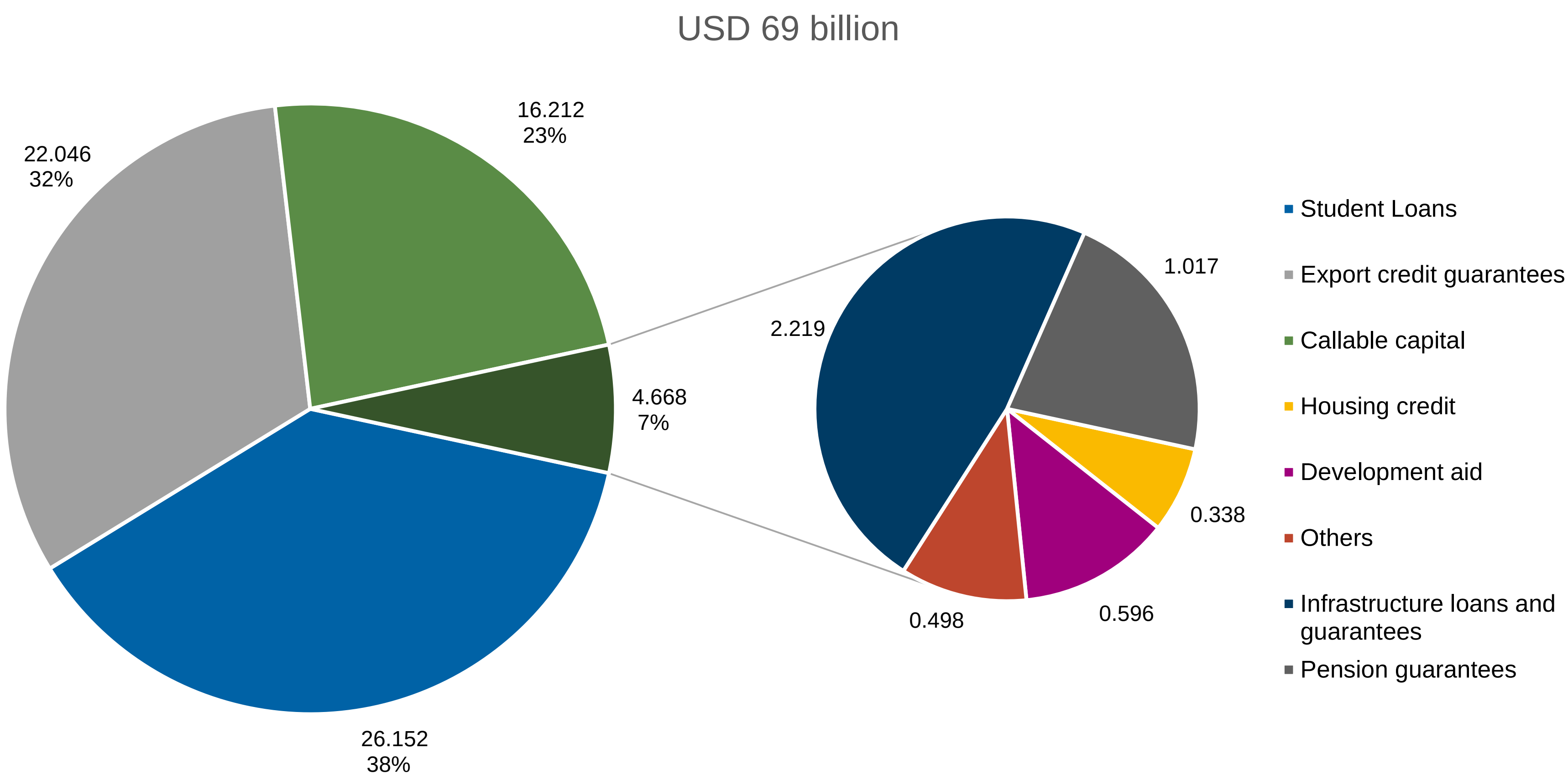
Swedish Regulatory and Institutional Framework

- Guarantees and loans approved by Parliament and commissioned by the government.
- Parliament decides on amount, purpose and instrument.
- Annual limit approved for programs, eg. student loans and export credit guarantees.
- Once approved – commissioned to relevant authority (5 major central authorities)
  - Independently responsible for: assessing the credit risk…
  - Separation of politicians and civil servants (credit risk experts)

Swedish Regulatory and Institutional Framework (continued)

- A fee is charged to cover at least the total Expected Cost of the guarantee or loan
  - Administrative fee
  - Fee covering Expected Loss
  - Fee covering funding costs (if lending)
- An amount corresponding to expected loss is transferred to notional reserve account (at SNDO)
- Losses on guarantees and loans covered by reserves. Any shortfall is financed via an unlimited credit facility.
- When EU state aid rules apply, a market based fee must be charged.
- Fee exceeding expected loss (market risk premium related to unexpected losses, liquidity premium etc.) is transferred back to the central government budget.

Guarantees and Loans



In total 14 % of GDP

Ensuring Adequate Credit Risk Profile

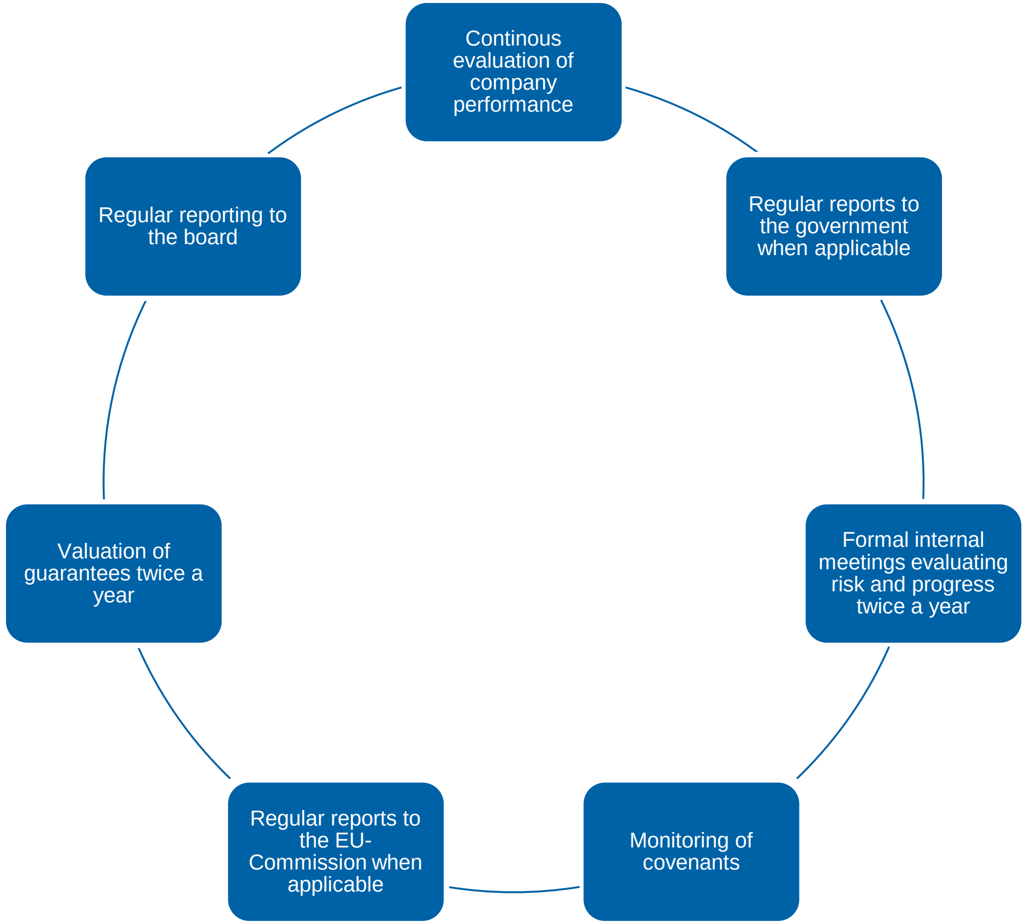
- To estimate a correct fee the credit risk must be *identifiable*, *manageable* and *measurable.*
- Ensure that the beneficiary is not in financial distress.
- Guarantees should have finite amount and maturity.
- Risk sharing aligns the incentives of the lender and the guarantor.
- Risk mitigation via legal covenants
- Collateral may be used to reduce the credit risk, especially if the credit profile of the beneficiary is weak.

Overview of Credit Risk Assessment and Pricing

- The Guarantee and Loan department at the SNDO is responsible for managing a portfolio of non-standardized guarantees and on-lending.

- Mainly corporate credit risk (single beneficiary), but some guarantees where the credit risk is on a portfolio of beneficiaries, requiring a more structured finance type approach.
- The SNDO strives for best practice in methods used.
- A <u>rating based approach</u> is preferred method for credit risk assessment.
- When a ratings based approach is not appropriate then simulation models, such as Monte-Carlo, are used for calculating expected loss

Managing a guarantee and reporting



Monitoring and Supervision

- The SNDO is responsible to the government and accountable for its guarantees

  Annual and semi annual reports according to general accrual accounting rules (financial report and performance)

- The SNDO coordinates the reporting of all government guarantees (from other specialized governmental guarantee agencies) and on-lending. This includes an annual report on the total contingent liabilities of the Swedish government, from a risk perspective.

- The coordination role also includes developing the management of guarantees and loans in collaboration with other authorities.

- The Swedish National Audit Office audits SNDO. Financial audit as well as performance audit. The Swedish NAO is a part of the central control power of the Swedish Parliament

The Swedish guarantee model - to summarize

- Legal Setting (rules and regulations) has Evolved over time
  - The model came into place against background of fiscal problems and need for firmer budget discipline (also regarding guarantees)
  - Scope - incorporation and equal treatment of On-Lending since 2011
- Continuing adaptation of Risk Assessment- and Quantification Methods, against background of :
  - Personal resources, skills/competences
  - The Characteristics/structures of Guarantee- and On-lending portfolio
  - Feed back/experience-loop
  - Evolving best practices (monitoring/networking with peers)
- The Rating Approach to pricing has served SNDO well
- Holistic approach - Risk Management System at SNDO
- Coordination role of SNDO – all Swedish Government guarantee agencies