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

USD 69 billion

- Student Loans
- Export credit guarantees
- Callable capital
- Housing credit
- Development aid
- Others
- Infrastructure loans and guarantees
- Pension guarantees

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 rating based approach 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

- Regular reporting to the board
- Continuous evaluation of company performance
- Regular reports to the government when applicable
- Formal internal meetings evaluating risk and progress twice a year
- Valuation of guarantees twice a year
- Monitoring of covenants
- Regular reports to the EU-Commission when applicable
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