Risk Management in Colombia: Contingent liabilities

Ministry of Finance and Public Credit
Republic of Colombia

Introduction to contingent liabilities management in Colombia

It is a fundamental component of the principles of fiscal discipline, addressing debt sustainability, reduction of fiscal risk and transparency in the administration of public resources.

- The CL management process starts with Act 448 of 1998:
  - regulated the budget management of contingent liabilities
  - established the General Directorate of Public Credit of the Ministry of Finance as responsible for the approval of valuations.

- In 2003 Law 819 established that CL of central and sub-national governments had to be included in the Medium Term Fiscal Framework – MFMP, presented annually to Economic Commissions of Congress

Contingent Liabilities

Explicit:

- Guarantees for infrastructure projects developed under Public-Private Partnership schemes.
- Public Credit Operations
- Litigation or Claims against the Nation.
- Callable Capital.

Implicit:

- Natural Disasters

Explicit Contingent Liabilities

PPP's Infrastructure projects	Public Credit Operations	Claims against the Nation	Callable Capital.
• Evaluates the fiscal impact of the contingent risk coverage agreed on for infrastructure contracts, in order to establish the contributions to the Contingency Fund.	• Estimates the contributions that government agencies with state guarantees must make to the Contingency Fund.	• Estimates the possible fiscal costs generated by negative rulings on legal disputes against the Nation.	• Possible commitments of capitalization of multilateral organisms.

Contingent Value

Contingent value with INCORA

INCORA US$ 188.46 (55% of GDP)

Other Legal Disputes US$ 49.12 (14% of GDP)

Callable Capital US$ 6.37	PPP´s US$1.01	PCO´s US$ 0.58

*Billions

Contingent value without INCORA

Cases of Illegal Ponzi Schemes US$ 19.16 (6% of GDP)

Other Legal Disputes US$ 29.96 (9% of GDP)

Callable Capital US$ 6.37 (2% of GDP)	PPP´s US$1.01	Public Credit Ops. US$ 0.58

Explicit Contingent Liabilities

PPP's Infrastructure projects	Public Credit Operations	Claims against the Nation	Callable Capital.
• Evaluates the fiscal impact of the contingent risk coverage agreed on for infrastructure contracts, in order to establish the contributions to the Contingency Fund.	• Estimates the contributions that government agencies with state warranties have to do to the Contingency Fund.	• Estimates the possible fiscal costs generated by negative rulings on legal disputes against the Nation.	• Possible commitments of capitalization of multilateral organisms.

Contingent liabilities of projects developed under PPP's scheme

Background

90's

- The state encouraged private participation in infrastructure, by offering some guarantees to concessionaires.

Fiscal problem

- The guarantees to concessionaires were not registered under the fiscal accounting.

Fiscal volatility

- Debt issuance was the funding mechanism to pay for these obligations.

Law

Law 448 of 1998	Establishes measures for the management of contingent liabilities. Creates the Contingencies Fund.
Decree 423 of 2001	Regulates Law 448 of 1998. Empowers the MHCP to establish methodologies and approve.
Law 819 of 2003	Establishes budgeting standards for accountability and fiscal transparency. Obliged to submit a statement of contingent liabilities that may affect the financial position of the Nation
CONPES 3107 and 3133	Established the guidelines of Contractual Risk Policy of the State of projects developed under PPP's scheme
Law 1508 of 2012	Establishes the legal framework for Public Private Partnerships. The PPP's must be governed in contingent liabilities issues by Law 448 of 1998.
Decree 1467 of 2012	Regulates Law 1508 of 2012. Empowers the MHCP to approve the valuations of contingent liabilities.

Contingent liabilities of projects developed under PPP's scheme

Institutional process

Sector

- Structures technical, legal and financial aspects of project.

Nat. Planning Dept.

- Reviews and advises on technical features of the project.

MHCP (MoF)

- Evaluates the financial terms in order to establish if they are convenient for the Nation
- Approves the valuation of contingent liabilities.

Contingent liabilities of projects developed under PPP's scheme

Evolution of risk allocation

1st Generation

- The government is responsible tor all the risks that the contracts derive.
- Compensation for the risk is provided by establishing a higher value for the design process, larger amounts of public works contracted, minimum traffic and toll fees.

2nd Generation

- Introduces the concept of expected income.
- Income support (for the coverage of debt service), exchange rate support, or geological risk.

3rd Generation

- It achieves the transfer of risk to the concessionaires.
- The dealer assumes the risk of land management and environmental licenses.
- Continues with the concept of expected income.

Contingent liabilities of projects developed under PPP's scheme

Assessment process

Contextualization	• It verifies that the project has met the basic provisions in the planning stage, including the recognition and allocation of risks in the minutes of the contract.
Risk Identification	• Identifies possible causes and effects of risk factors and determines which party (dealer or nation) is better able to anticipate and handle each type of risk.
Evaluation	• Qualitative assessment and risk mitigation strategies through contractual transfer.
Valuation	• Estimation of the probability of occurrence on each of the identified risks and their potential impact on project results.
Management	• Decision making on the optimal risk management strategy.

Explicit Contingent Liabilities

PPP's Infrastructure projects	Public Credit Operations	Legal Disputes against the Nation	Callable Capital.
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Claims against the Nation

Introduction

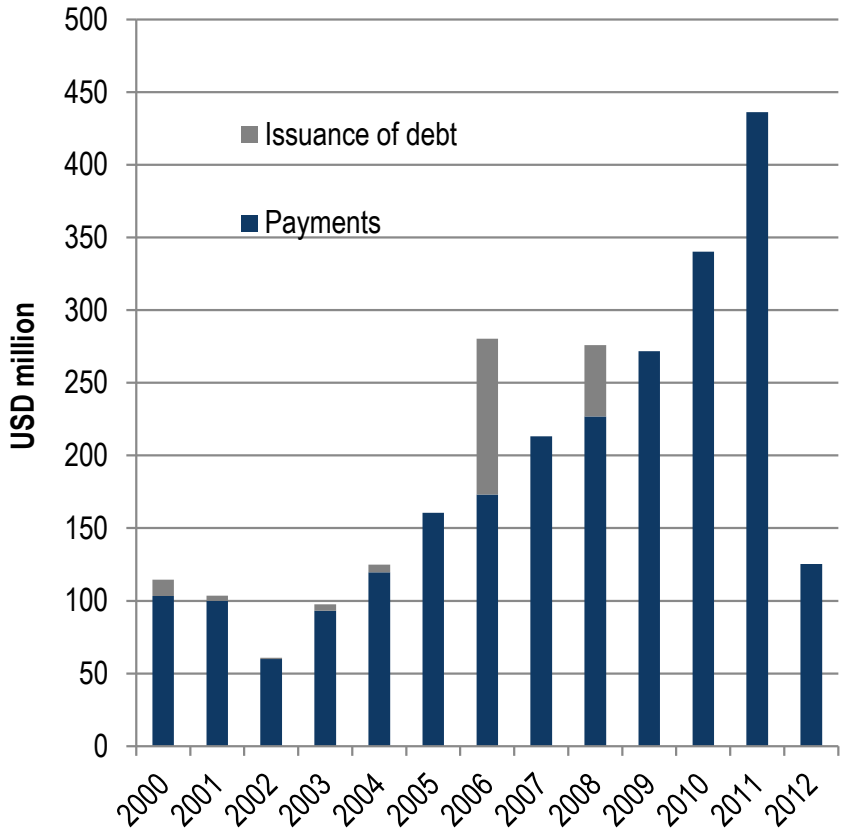
- Uncertain fiscal expenditures may derive from negative rulings that depend on future conditions.
- Each government agency under an allegation has to include in their annual budget the potential impact of a negative ruling.
- Monitoring and forecasting the results of litigations is key to transparency and fiscal responsibility.
- The developed methodology is a tool to for decision making on budget policy and management in the legal defense of state agencies.

Claims against the Nation

Law 448 of 1998	Establishes measures for the management of contingent liabilities.. Create the Contingencies Fund.
Law 812 of 2003	Strengthening policy of the unique legal defense of the nation.
Law 819 of 2003	Obliged to submit a statement of contingent liabilities that may affect the financial position of the Nation
CONPES 3250	Policies to strengthen the legal defense of the nation And valuation of contingent liabilities.
Law 1437 of 2011	Code of Administrative Jurisdiction Entities should make contributions to the Contingency Fund
Decree 4085 of 2011	Create the National Legal Defense Provides tools to MHCP for the valuation of contingent liabilities

Claims against the Nation

Background



Source: Consolidation Group General Directorate of National Budget-MHCP
* Court in April 2010

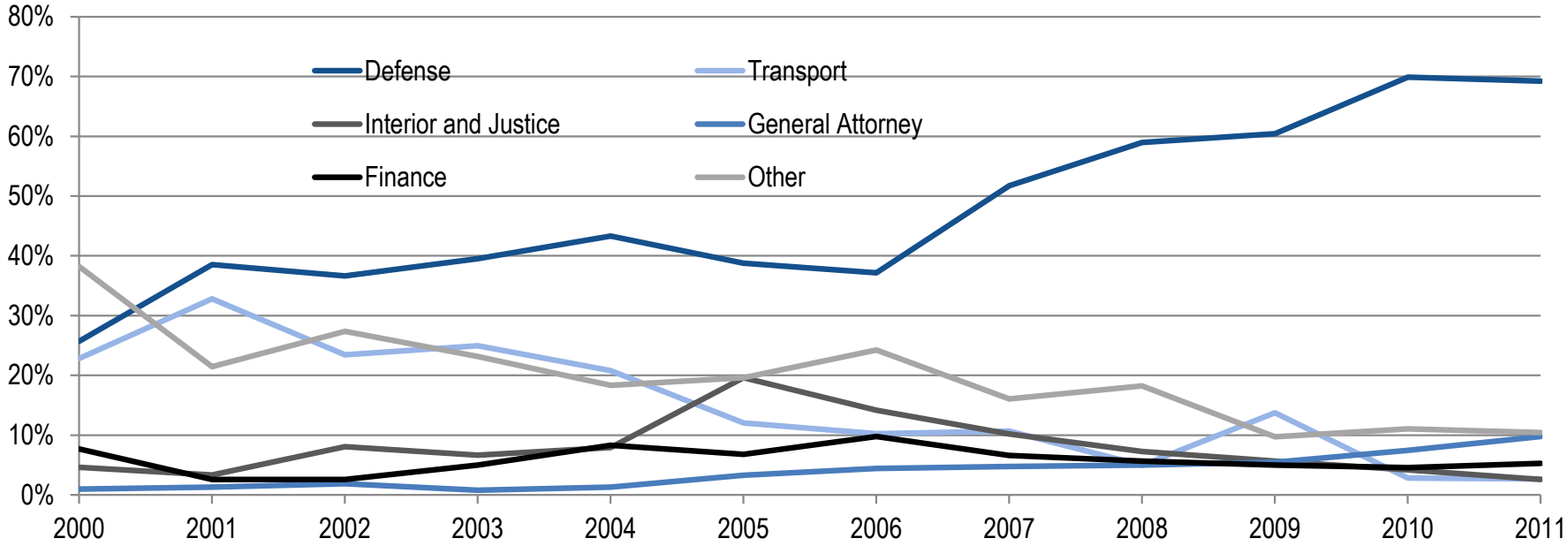
1. Since 2000 there is a growing trend of payment for judgments and settlements of the Nation.

2. This growth is the result of the increased number of claims and their value

3. Additionally, there are weaknesses in the legal defense of the State, especially those from the national defense sector

Claims against the Nation

Background

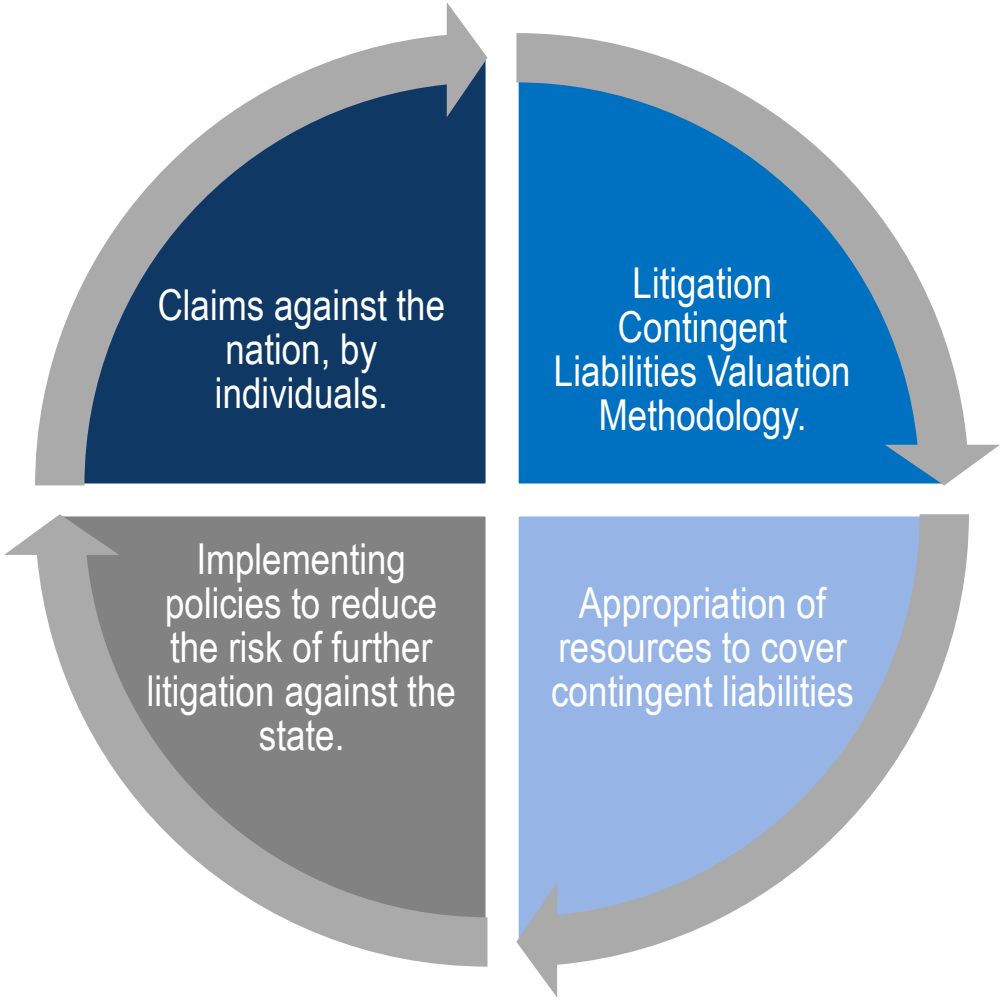


Source: Consolidation Group General Directorate of National Budget-MHCP
* Court in April 2010

1. The sector with the highest level of participation in claim payments made with resources from the national Budget is defense, with 62.24%.

Claims against the Nation

Risk Management



Claims against the Nation

Methodology and assessment of contingent liability for litigation activity

Elements of the contingent liabilities on litigation activity

1. A probabilistic tree model, which represents the dynamics of the processes against the nation.

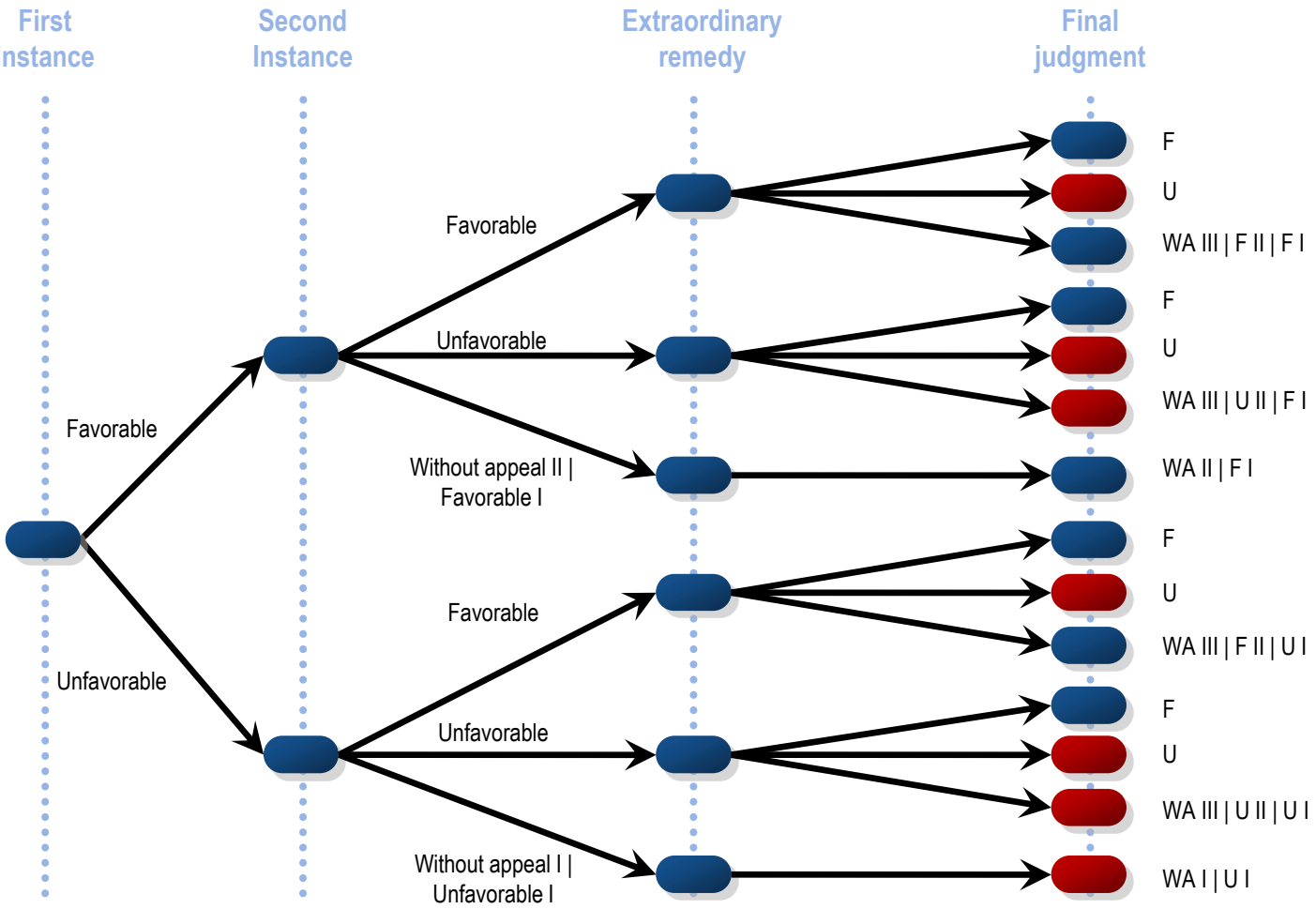
2. Qualitative information provided by the attorneys
- Strong demand
- Evidentiary strength
- Presence of procedural risks and
- Level of jurisprudence

3. Elements to compensate the subjective bias of the attorney

4. The estimated Claim/condemnation ratio

Claims against the Nation

Representation of the probabilistic tree



Claims against the Nation

Assessment of contingent liability for litigation activity.

	2012-2022 without INCORA*			
	Pretensions		Contingent	
Entity	**Billons**	**%**	**Billions**	**%**
Financing Superintendence of Colombia	28.48	34.44%	20.01	40.74%
General Attorney	7.54	9.12%	3.55	7.22%
Ministry of National Defense	5.35	6.47%	3.43	6.98%
Consejo Superior de la Judicatura	3.51	4.24%	2.25	4.57%
Autonomous Regional Corporation of Cundinamarca - Car	2.95	3.57%	1.97	4.00%
National Police	3.80	4.60%	1.49	3.04%
Ministry of Transportation	2.02	2.45%	1.21	2.47%
Ministry of Mining and Energy	2.43	2.93%	1.21	2.46%
Ministry of Finance and Public Credit	1.74	2.10%	1.14	2.33%
Ministry of Agriculture and Rural Development	1.98	2.39%	1.00	2.04%
Subtotal	**59.80**	**72.31%**	**43.47**	**88.51%**
Total	**82.70**	**100.00%**	**49.12**	**100.00%**

Claims against the Nation

Challenges

1. It is necessary to have a consolidated database of claims against the State in the short term.
2. It is important to identify possible correlations between the different processes against the state, considering that court rulings in similar processes may give way to same or similar verdicts.
3. It is necessary to create policies, guidelines and valuation methodologies for conciliations.
4. In order to avoid fiscal volatility, it is mandatory to evaluate the use of the Contingency Fund of State Agencies as a mean of mitigating contingent liabilities arising from litigation activity

Explicit Contingent Liabilities

PPP's Infrastructure projects	Public Credit Operations	Legal Disputes against the Nation	Callable Capital.
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Public credit operations

Legal Framework

Law 448 of 1998

- Establishes measures for the management of contingent liabilities.
- Create the Contingencies Fund.

Decree 2681 of 1993

- Regulates Law 448 of 1998.
- Empowers the MHCP to establish methodologies and approve.

Law 819 of 2003

- Obliged to submit a statement of contingent liabilities that may affect the financial position of the Nation

Decree 3800 of 2005

- Budgeting guideline of public credit operations and
- Contingency Fund regulations

Resolution 2818 of 2005

- Establishes the methodology of valuation of public credit operations with guarantee of the Nation

Public credit operations

Risk management mechanisms

Counter-guarantees.

- The entity agrees to pledge a revenue stream and manage it in fiduciary account
- Sufficient
- Liquid
- Easily attainable

Payments to the Contingency Fund

- All beneficiaries of the guarantee are forced to contribute to the Contingency Fund
- The methodology of resolution 2818 provides the calculation of the basic points and estimation of the Contributions Plan

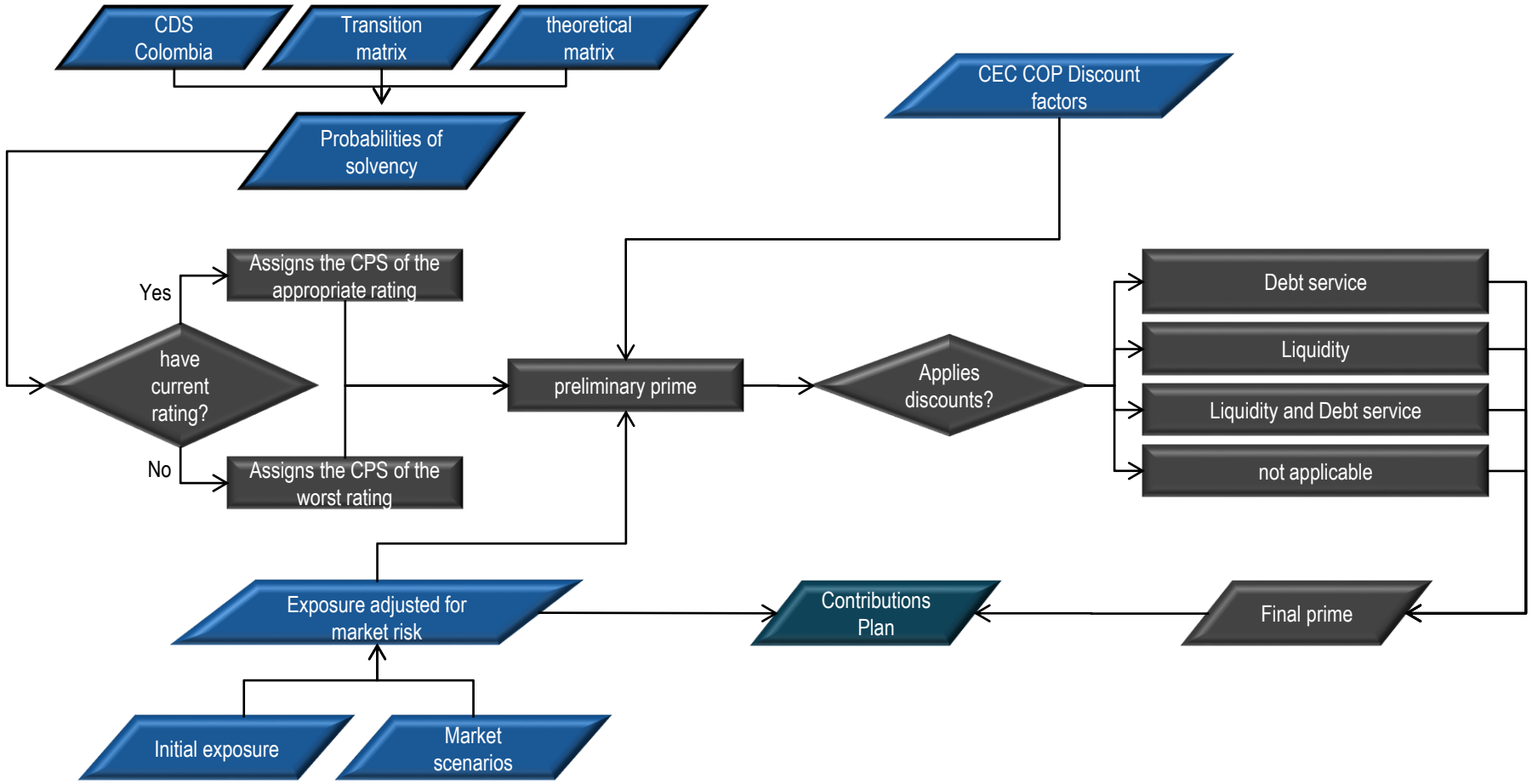
Methodology and assessment of contingent liability for public credit

The methodology consists of three components:

1. Gathering and processing the available information of ratings and sovereign risk.
2. Transition Matrix calculation.
3. Estimation of the 25 years probability curve of solvency (CPS).

Public credit operations

General outline of the methodologyoperations.



Contingent Liabilities

Explicit:

- Infrastructure projects developed under Public-Private Partnership schemes.
- Public Credit Operations.
- Legal Disputes against the Nation.
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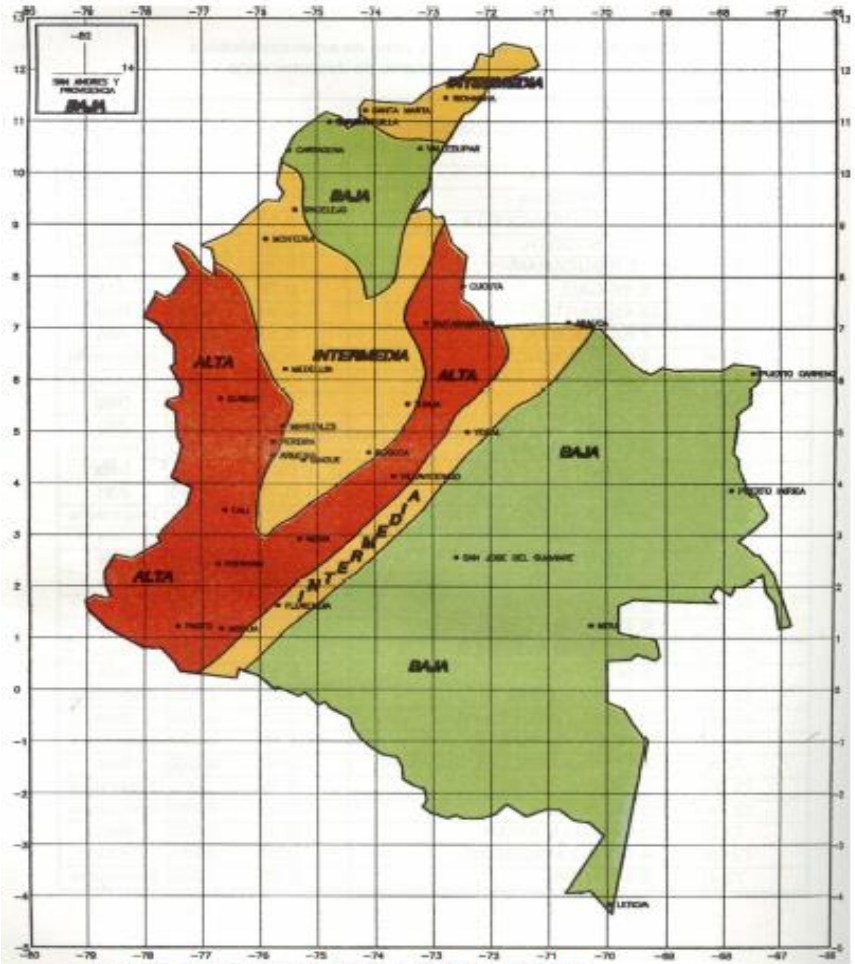
Implicit:

- Natural Disasters

Geographic Conditions

Seismic Hazard Map



Fuente: Estudio General de Amenaza Sísmica de Colombia, 1996

Comments

- The country has the highest rate of recurrent natural disasters in Latin America, with an average of over 600 reported disasters every year. (1970-2000 US4500 million)
- In the last 30 years, Colombia has suffered ten major earthquakes, two major volcanic eruptions, five major flooding and annual major landslides.
- The damage of the “Ola Invernal” exceed the most damage of the earthquake in the “Eje Cafetero” (US1590 mill).

Legal Framework

Decree 1547/84	Establishes the National Calamity Fund
Law 46/88	Establishes the System for Disaster Prevention and Attention (SNPAD)
Decree 93 of 1998	The National Plan for Prevention and Attention of Disasters (PMPAD) was adopted. It defines 4 strategies: • Risk identification and monitoring • Risk reduction • Institutional strengthening • Socialization of disaster prevention and care
CONPES 3146 of 2001	Establishes the strategy to prevent and attend disasters
Decree 4147 of 2011	Create the National Unit for Disaster Risk Management with the function of coordinating the SNPAD.

Legal Framework
National Development Plan (PND)

PND 2002 - 2006	Includes as an objective to reduce fiscal exposure
PND 2006 - 2010	Includes as an objective to reduce fiscal exposure through transfer risk mechanisms
PND 2010 - 2014	**Article 220 : MHCP should design a strategy to reduce Natural Disaster fiscal exposure. To do so, the MHCP could use resources from the National Budget to get the mechanisms to cover those events.**

Risk management public policies perspective

Institutional, political, normative, financial context

A. Risk identification

- Hazard mapping, risk modeling
- Social perception, priority settings

B. Risk reduction

- Territorial and sectorial planning, building codes
- Risk mitigation works, infrastructure retrofitting
- Education, creation of a culture prevention

C. Financial protection

- Reserve mechanism, budget planning
- Risk transfer, insurance, insurance linked securities
- Budget appropriation, execution in emergency

D. Preparedness

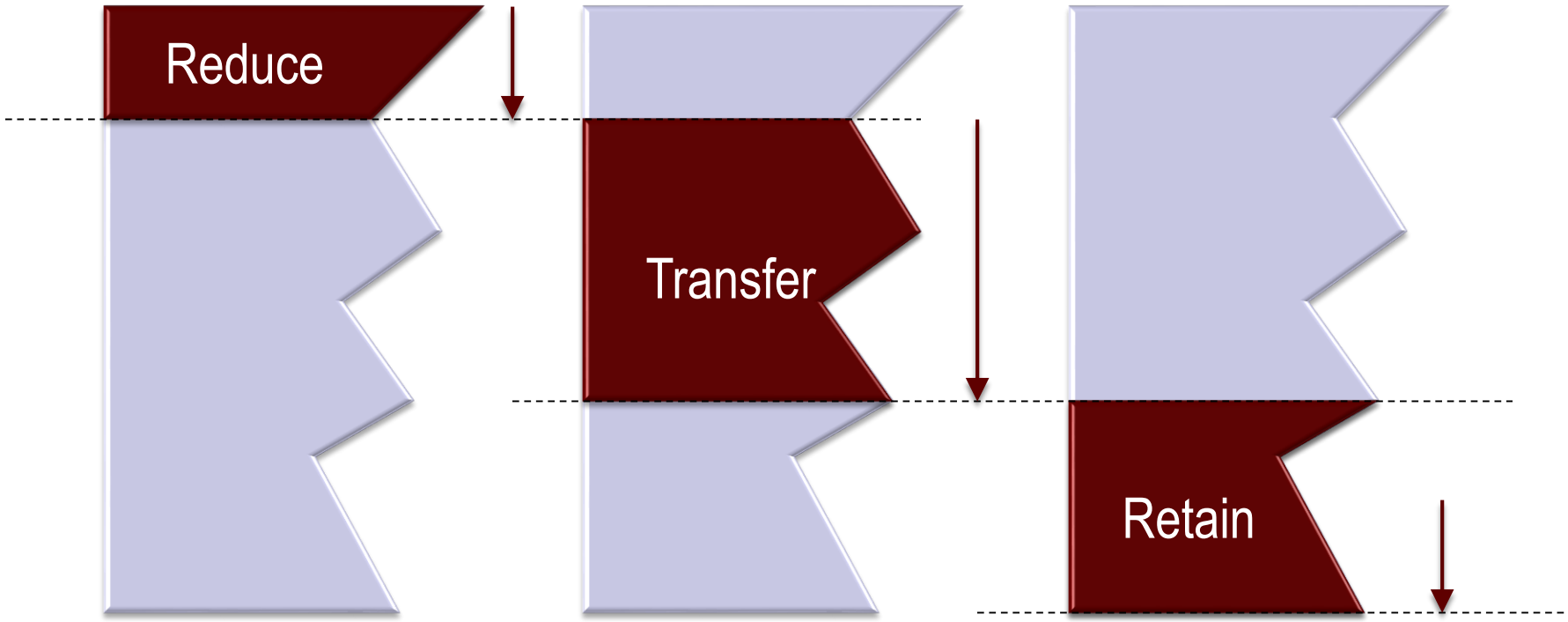
- Alert and early warning systems
- Response planning training, equipment logistics, simulations
- Response systems management

E. Post-disaster reconstruction

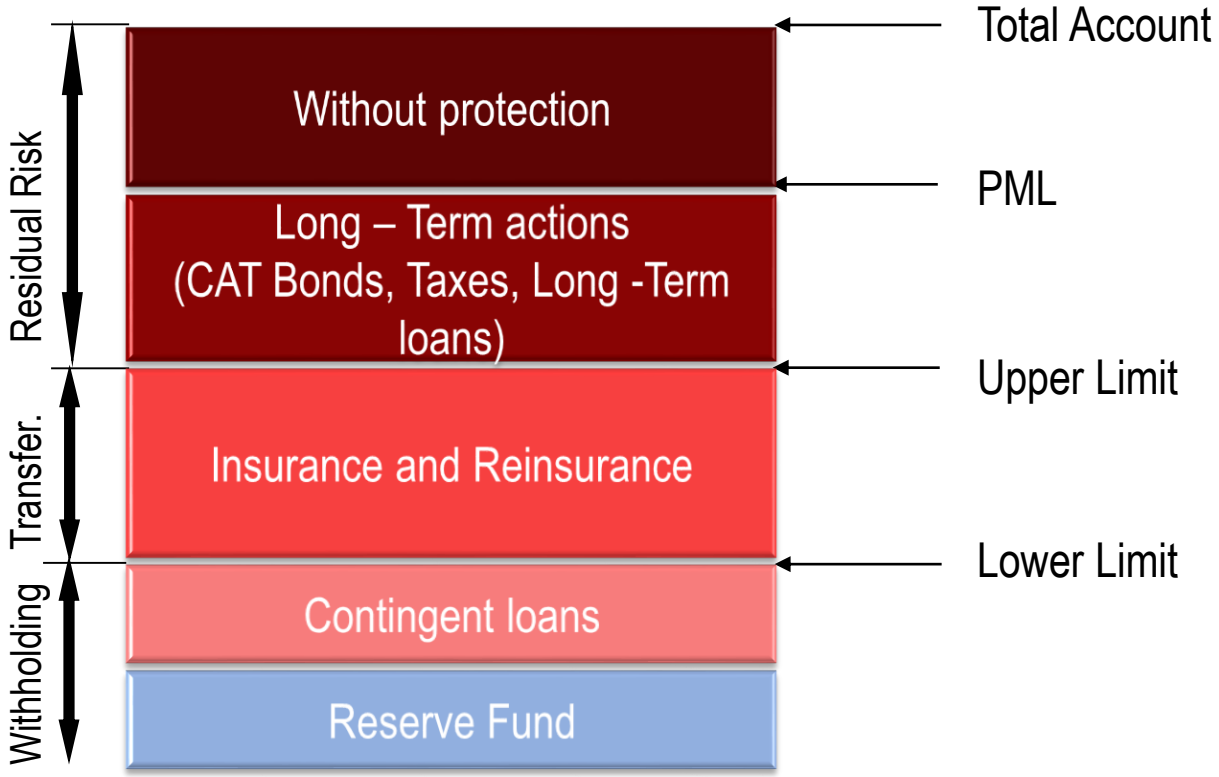
- Institutional planning, strengthening
- Recovery, planning reconstruction policies
- Rehabilitation plans

Number in Millions of USD.

Financial risk strategy

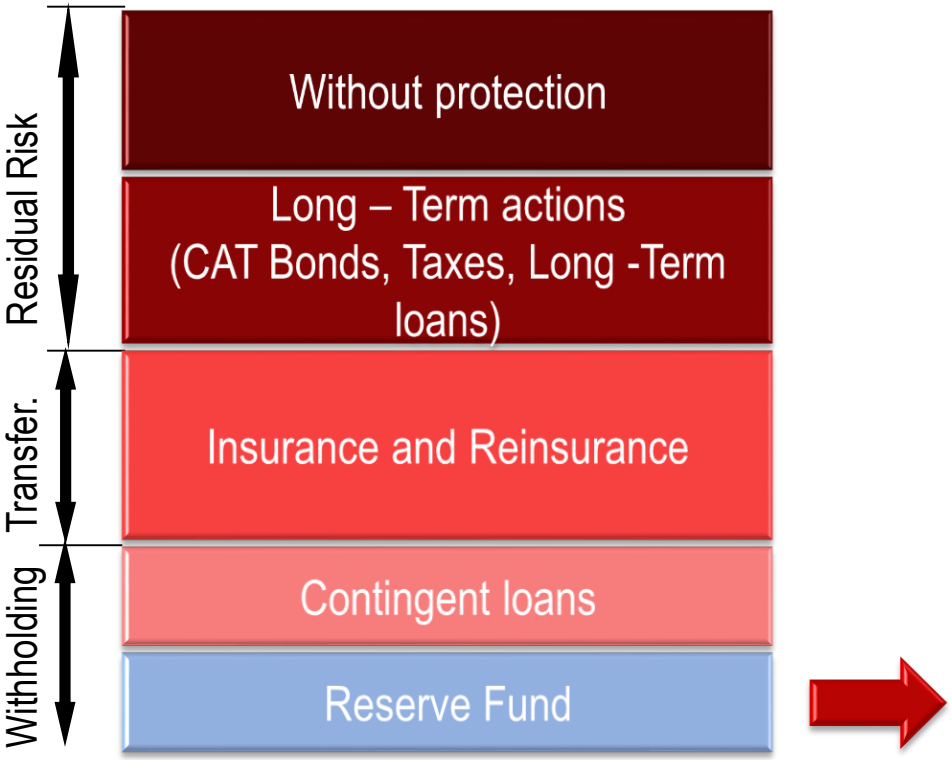


Financing Strategy - Colombia



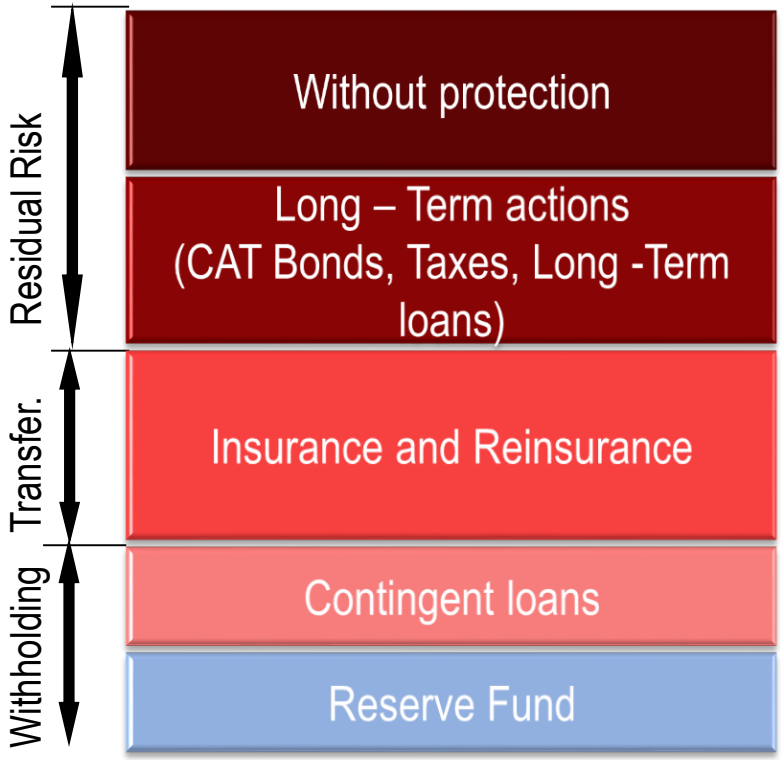
Source: Cardona (2005).

Financing strategy



- The Calamity Fund has insufficient resources.
- To modernize the legal and institutional framework.
- To establish a clear allocation of responsibilities

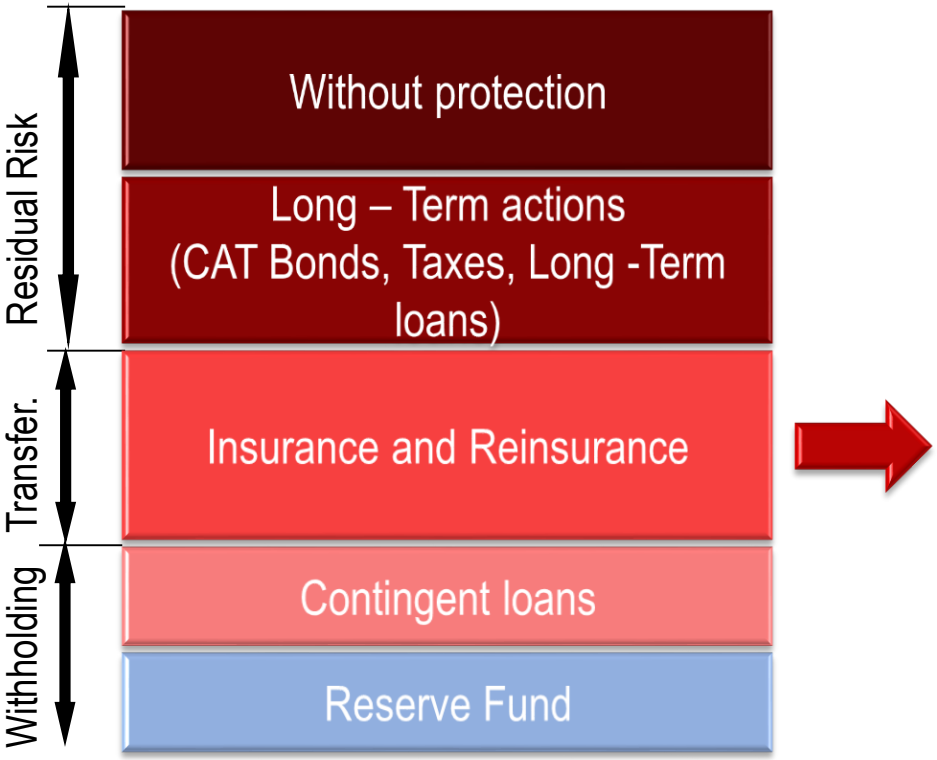
Financing strategy



- USD 150 Mill – IBDR
- From 2006 to 2011 (It was used in the flood "Fenomeno del Niño" 2011)
- Trigger Event: President's decree declaring the occurrence of the disaster, indicating magnitude, geographic area and effects.

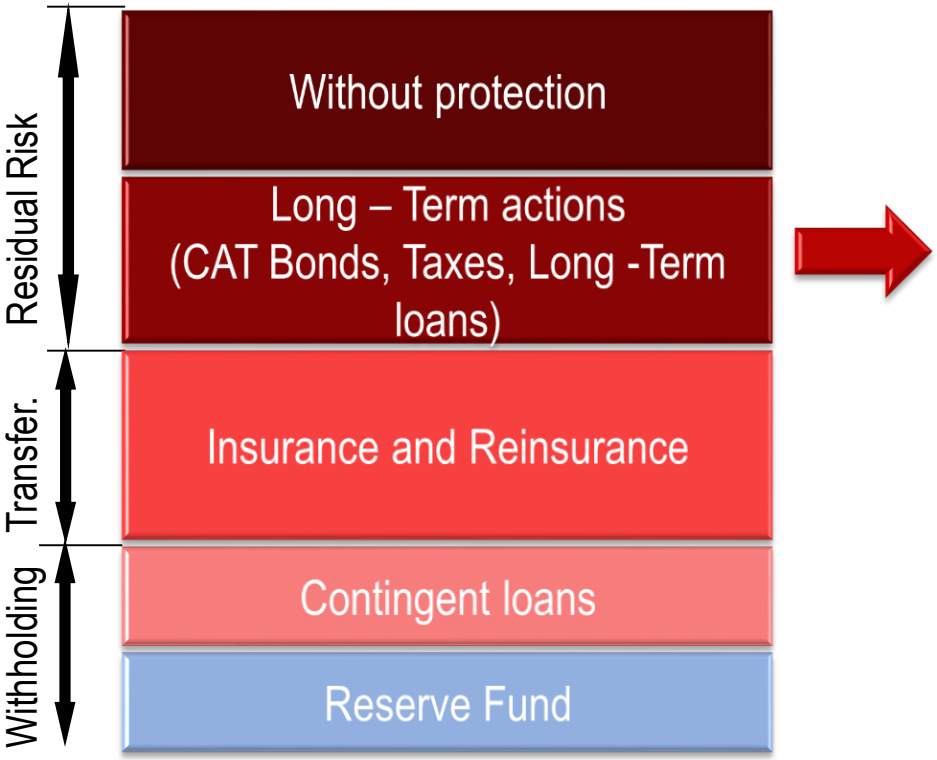
Source: Cardona (2005).

Financing strategy – Risk transfer instruments



- To implement the insurance of public infrastructure through collective insurances.
- To foster the private insuring.

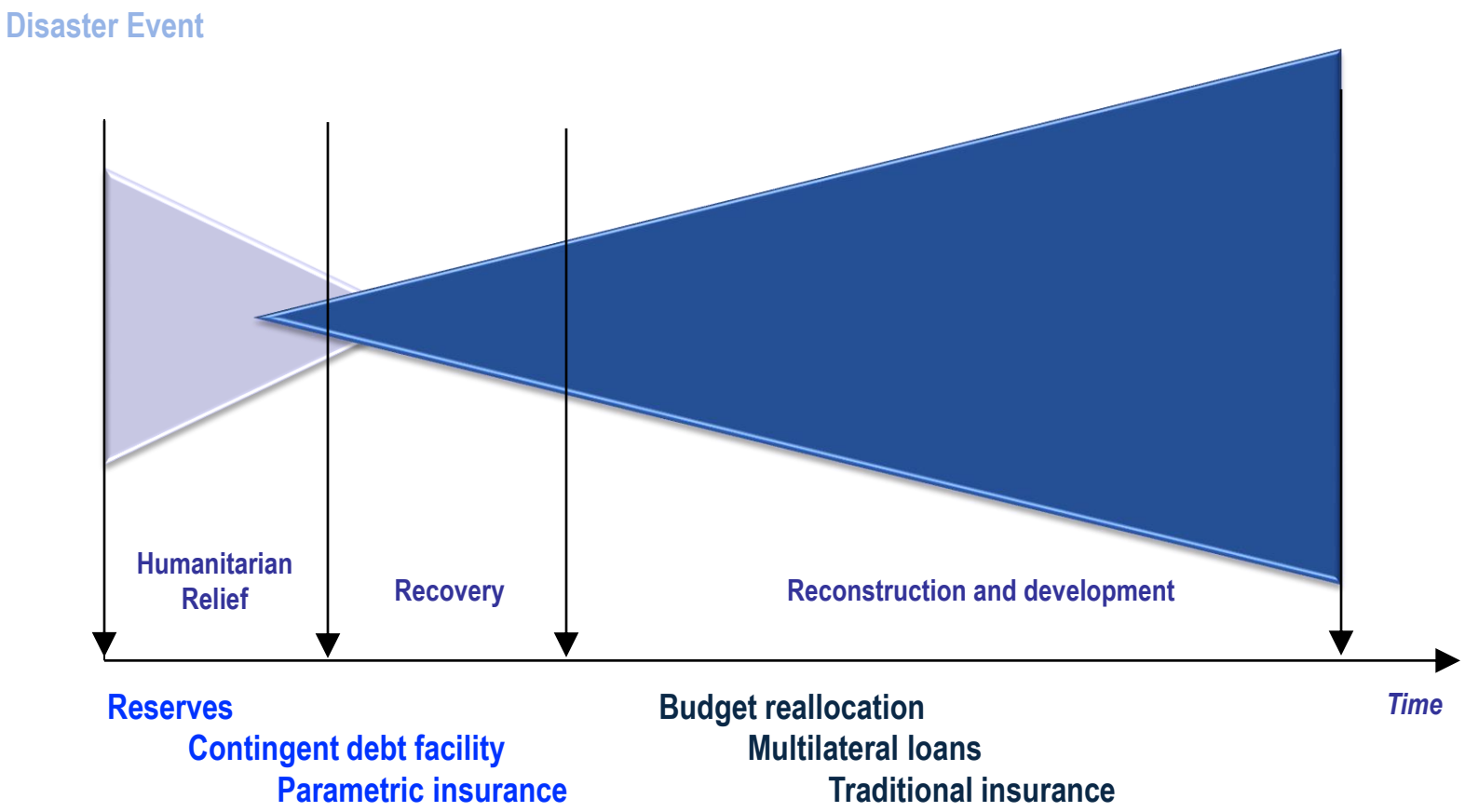
Financing strategy



- To study the feasibility instruments to cover residual risk (catastrophic Bonds).
- To develop internal procedures to face a disaster.

Source: Cardona (2005).

Time dimension



Pillars of catastrophic financing structure

Government Contingent liability assessment

Catastrophe risk financing model: exposure to natural disasters and losses associated to different events

Risk transfer promotion to competitive insurance markets

The government can reduce its contingent liability promoting private insurance

Sovereign catastrophe risk financing

Public assets insurance and mechanism to protect budget against liquidity crisis

Fuente: Cummins y Mahul (2008), Banco Mundial

Remarkable cases

Manizales

- Voluntary catastrophe insurance;
- Premiums are collected through the property taxes;
- they include a subsidy to the poorer areas.

Sabaneta

- Insurance on the assessed value of residential buildings, aimed at all the homes that have no outstanding property taxes to pay.

Bogotá

- Financial strategy of the System for Prevention and Emergency Response in Bogota. (DRAFT AGREEMENT No. 097, 2009)

Final Remarks

- Colombia has gradually developed a framework for risk management of contingent liabilities, with legal, institutional, budgetary and financial elements.
- This process has been led by the Debt Management Office (DGCPTN) in the MoF.
- The objective has been to protect government finances from potential shocks arising from contingent liabilities.