



# THE ROLE OF PUBLIC DEBT MANAGERS IN CONTINGENT LIABILITY MANAGEMENT

## SELECTED COUNTRY PRACTICES

This document is published as an annex to an OECD working paper on "The role of public debt managers in contingent liability management".<sup>1</sup> It presents the contingent liability management frameworks and practices in seven countries – Brazil, Denmark, Iceland, Mexico, South Africa, Sweden and Turkey – that are members of the OECD Task Force on Contingent Liabilities and Public Debt Management.<sup>2</sup> These country cases provide detailed information on the:

- organisational structure of the Debt Management Office (DMO)
- main sources of contingent liabilities
- role of the DMO in the area of contingent liabilities – management, measurement, monitoring and reporting.

The experiences of public debt managers in task force countries shed light on the different implementation and policy frameworks. These differences underline the difficulty of advising on a single set of roles for public debt managers.

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<sup>1</sup> "The role of public debt managers in contingent liability management", *OECD Working Papers on Sovereign Borrowing and Public Debt Management*, No. 8, OECD Publishing, Paris. DOI: <http://dx.doi.org/10.1787/93469058-en>.

<sup>2</sup> The OECD Working Party on Public Debt Management (WPDM) created a task force on Contingent Liabilities and Public Debt Management to report on country practices. The Members of the OECD task force are: Taşkın Temiz (Task Force Chair) and Fatih Kuz from the Turkish Treasury; Jose Franco Medeiros de Morais André Proite, Giovana Leivas Craveiro and Luiz Fernando Alves from the National Treasury of Brazil; Claus Johansen, Jacob Stæhr Wellendorph Ejsing and Nicolaj Hamann Christensen from Danmarks Nationalbank; Hákon Zimsen and Hafsteinn Hafsteinsson, from the Central Bank of Iceland; Jesus Ramiro Del Valle Rodriguez and Alejandro Diaz de Leon Carrillo from the Mexican Treasury; Mkhulu Maseko and Anthony Julies from the South African Treasury; Kritoffer Ekström and Eva Cassel from the Swedish National Debt Office (SNDO).

## 1. BRAZIL

The National Treasury of Brazil is one of the Secretariats within the Ministry of Finance. Its main duties are:

- execution and reporting of fiscal policy;
- public debt management;
- government asset management<sup>3</sup>;
- supervision of the accounts of subnational entities, and
- structuring and monitoring of the infrastructure projects.

There are different sources of contingent liabilities, most of which are somehow related to the activities of the National Treasury and therefore they can be closely monitored. The main source of explicit contingent liabilities is government guarantees, while implicit contingent liabilities could potentially arise from the occurrence of a variety of events, with different degrees of likelihood, such as a disruption in the banking system or a court decision against the government or a state owned company.

### **Government guarantees**

A government guarantee is a financial tool used to reduce the cost of funding for eligible borrowers and to enhance lending, since the banking sector is unwilling to be exposed to the risk of some borrowers, unless it has a government guarantee. A secondary positive effect of government guarantees is that they foster transparency and avert potential moral hazard issues, by explicitly assigning duties and responsibilities.

From an institutional standpoint, the Debt Management Department (DMD) is responsible for monitoring and reporting the government guarantees, given that they represent explicit contingent liabilities and therefore they must be incorporated into the regular process of public debt management.

There are two categories of borrowers legally eligible to apply for a government guarantee:

- state-owned companies, and
- sub-national entities (SEs), namely states and municipalities.

In order to have access to a credit guarantee, the borrower must fulfil certain conditions, most of which are related to its payment capacity and its ability to provide an asset as counter-guarantee<sup>4</sup>.

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<sup>3</sup> Assets, such as state owned companies, claims against subnational entities and funds for specific purposes.

The assessment and recommendation regarding the government guarantee is provided either by the DMD or by the States and Municipalities Department (SMD), depending on the type of borrower. Both departments are structured within the National Treasury. If the borrower is a state owned company, the DMD is responsible for the approval, while if it is a sub-national entity, the SMD plays this role. The reason for such a division of duties is the peculiar situation involving the Federal Government (FG) and the SEs, in which the former keeps permanent oversight of the accounts of the latter.

There are historical reasons for having this kind of framework, as described in Box 1.1. Since the SMD is the area of the National Treasury responsible for supervising the accounts of the SEs, it is in a better position to attest if the borrower fulfils the necessary conditions for getting a government guarantee. Despite having two separate departments providing government guarantees, there is no overlapping of duties, since the criteria for the division is very clear. Besides, there is good communication and coordination between the two departments and the process of monitoring and reporting of the government guarantees is done exclusively by the DMD.

One key aspect of the process of government guarantee provision is the legal framework, which must be clear and consistent, in order to avoid uncertainties that could potentially affect the cost of funding. The legal framework is based on Law No. 101/2000, known as the Fiscal Responsibility Law (FRL) and on Senate Resolutions No. 43/2001 and no. 48/2007<sup>5</sup>. The FRL establishes general public finance rules and practices, enforcing responsibility in fiscal management for all three levels of government, i.e. the FG, states and municipalities<sup>6</sup>. The Senate Resolution no. 43/2001 regulates credit operations of the SEs and establishes prudential ratios, while the Senate Resolution no. 48/2007 establishes prudential ratios and the limits that the FG must comply with to offer a government guarantee. The main prudential limit is that the outstanding amount of guarantee provided by the FG must not exceed 60% of its current net revenues on an annual basis. Figure 1.1 shows that this indicator is currently quite below the legal limit.

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<sup>4</sup> The counter-guarantee is not required from enterprises whose only shareholder is the government.

<sup>5</sup> There is also secondary legislation that regulates the process, including laws, decrees and resolutions.

<sup>6</sup> For each level of government; its funds, foundations and state owned companies have to comply with the FRL.

### **Box 1.1. Federal government bail-out of subnational entities**

In the 1980s and the early 1990s, most of the states and many municipalities faced rising public debt because of constant fiscal deficits. Some of the possible reasons for this fiscal imbalance were: (i) poor macroeconomic fundamentals that led to hyperinflation, (ii) the overreliance on regional state owned banks to close the fiscal gaps, and (iii) the crises on the balance of payment. Nevertheless, it is fair to state that the origin of the bad debt dynamics was the lack of an institutional framework to enhance transparency and promote practices towards fiscal responsibility.

When the non-guaranteed debt of the SEs became unsustainable, the FG stepped in to avoid any contagion to the sovereign debt and played a central role in the restructuring process. The legal framework of the process was based on Law No. 9496/1997, which established the criteria and conditions for the FG to bailout the SEs. On the one hand, the FG took over the entire outstanding amount of the debt and committed to make all the due payments to the original creditors. On the other hand, the FG became a creditor against the SEs, while offering them additional benefits, such as duration extension and debt haircut. The framework contemplated also a guarantee scheme, under the scope of the States and Municipalities Participation Fund (SMPF), funded by the so-called Constitutional transfers. If an SE defaults on any given payment, the FG has the right to use the resources from the SMPF to offset the debt.

A crucial condition for the bailout was a long term Fiscal Adjustment Program (FAP) to be undertaken by the related SE. The FAP established specific fiscal targets to be met by each SE, based on different indicators, such as *total debt/revenues*, *debt services/revenues*, *investment expenditure/total expenditure*, *primary balance* and *current expenditures*. Another feature of the FAP was the privatization program, which most SEs had to undertake in order to meet the fiscal targets.

Since then, the FG has been not only keeping permanent oversight on the accounts of the SEs, but also ranking the states and municipalities according to its credit risk. The National Treasury determines the credit risk of each SE, according to its fiscal indicators.

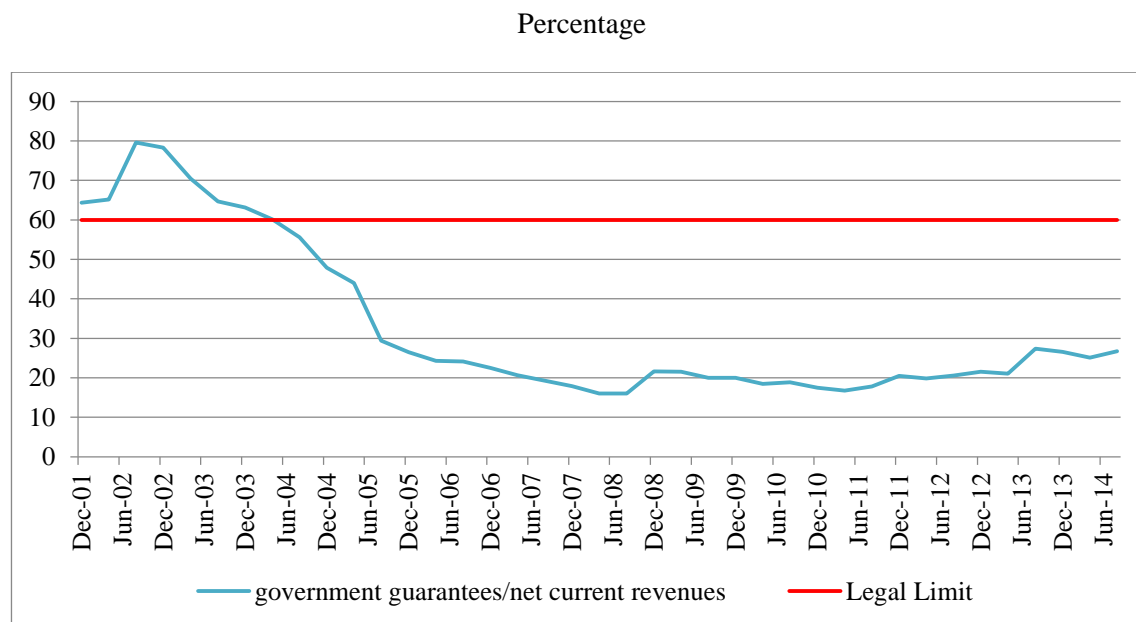
The FRL states that the SEs are eligible for a FG guarantee in either domestic or external credit operations, pursuant to the following conditions<sup>7</sup>: (a) the guarantee must be conditioned to the provision of a counter-guarantee, in an amount equal to or higher than the guarantee provided, and (b) the counter-guarantee required by the FG from the states or municipalities may consist in the earmarking of tax revenue directly collected and resulting from Brazilian Constitutional transfers. In this case, the guarantor will be authorized to retain such revenue and use the respective amount to repay the overdue debt, in case the SE defaults.

The current legal framework does not allow states and municipalities to issue bonds, although they can borrow directly from either multilateral agencies or private banks. The FG can provide a guarantee if the SE meets the following two criteria: (i) its credit rating is B- or higher according to the National Treasury methodology and (ii) resources from the SMPF is equal to or higher than the total amount of the loan, in order to be used as counter-guarantee.

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<sup>7</sup> This is a very brief summary. The complete Law in English can be found at <http://www1.worldbank.org/publicsector/pe/BudgetLaws/BRLRFEnglish.pdf>. The relevant articles concerning credit guarantees are No. 32 and No. 40.

**Figure 1.1. Federal government guarantee/current net revenue ratio**



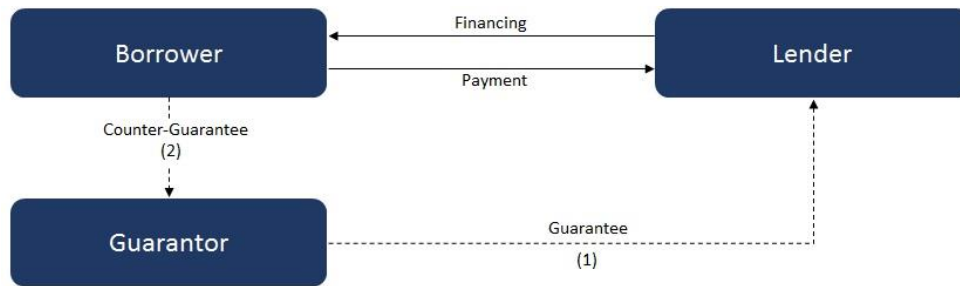
Source: National Treasury of Brazil

The counter-guarantee is a mechanism designed to align the incentives, by sharing the risks between the guarantor and the borrower. It is tied to a particular financial obligation, ensuring that at the end the borrower itself bears the credit risk, instead of the guarantor. This mechanism is particularly important, considering the fact that the government provides a full guarantee, without charging any sort of fee. From an administrative standpoint, the implication is that for each lending contract, signed by all three parts involved, i.e. the lender, the borrower and the guarantor, there is a counter-guarantee contract, signed by the borrower and the guarantor. From the standpoint of the FG, the counter-guarantee feature minimizes the need to allocate resources to monitoring and controlling the guaranteed entity. Figure 1.2 illustrates the roles played by each agent involved in the process.

In the case of the SEs, the only asset accepted as counter-guarantee is its share in the SMPF. Nevertheless, when the borrower is a state-owned company, a variety of assets and receivables could potentially be accepted as counter-guarantee. In the first case, the guarantor does not take any risk, since in case of default the FG is entitled to use the resources from the SMPF to offset the debt. In the second case, the only risk potentially taken by the guarantor is a mismatch between the value of the counter-guarantee and the stock of the guaranteed loan<sup>8</sup>. Nevertheless, under the current framework there has never been even one case of default, which indicates that the scheme works properly.

<sup>8</sup>One potential source of risk could be currency mismatch, when the loan and the counter-guarantee are linked to different currencies. In order to avoid this kind of risk, there is a margin call scheme between guarantor and the borrower.

**Figure 1.2. Credit guarantee and counter-guarantee**



In the case of a borrower's default:  
(1) The National Treasury pays the debt.  
(2) The National Treasury executes the counter-guarantee against the borrower.

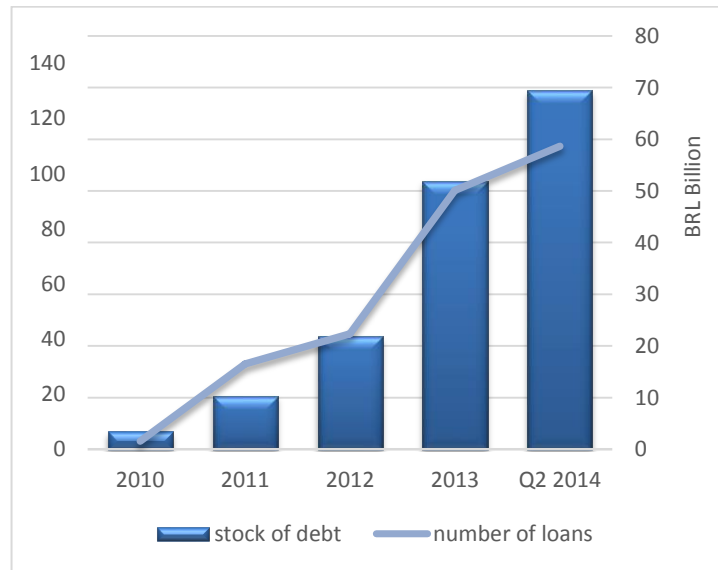
### ***Government guarantee statistics***

There is an upward trend in the outstanding amount of loans guaranteed by the FG (Figures 1.3 and 1.4). The relatively smaller increase observed between 2013 and the second quarter of 2014 is expected to grow in the following months, since a higher amount of disbursements is expected to take place in the last quarter of the year, compared to the previous years. Furthermore, a rapid growth can be observed in the domestic credit operations, whereas there has been a smaller improvement in the debit balance of external credit operations.

Figure 1.5 presents the breakdown of the government guarantees by the type of lender and borrower. The main lenders of credit operations with guarantees are federal banks (state owned banks), with almost 55%, followed by multilateral organisations, with almost 42%. In the last few years, federal banks became important players in providing credit for infrastructure projects.

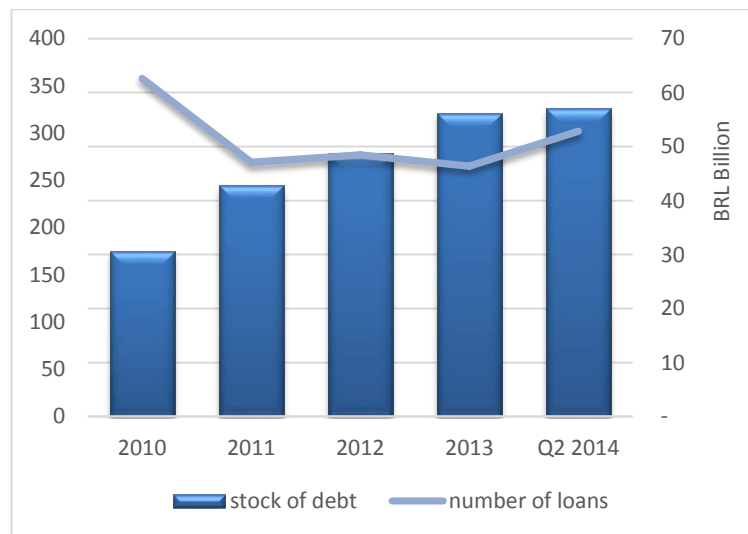
Regarding the type of borrower, the SEs accounts for 78.8% representing an outstanding amount of around BRL 100 billion. Federal banks and state owned companies, on the other hand, represent, respectively, 14.3% and 6.9% of the outstanding amount. State-owned banks can play the role of either lenders or borrowers.

**Figure 1.3. Outstanding amount of guaranteed domestic credits**



Source: National Treasury of Brazil

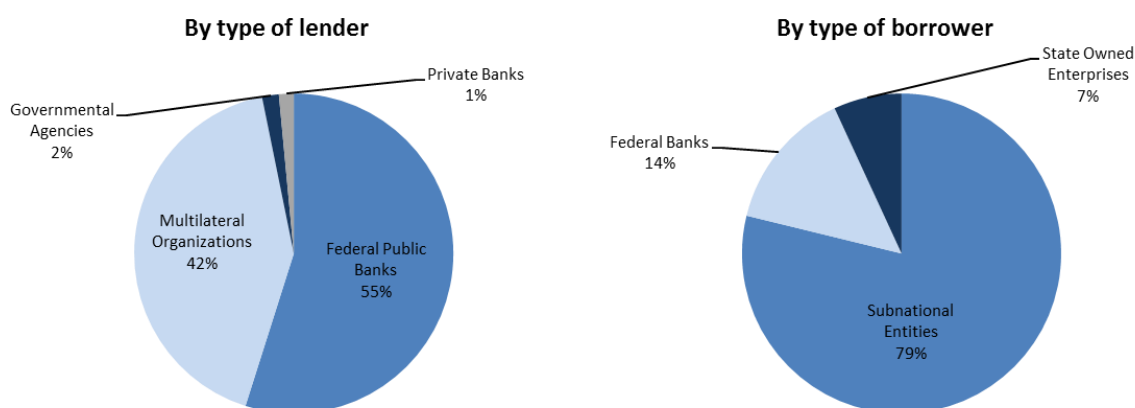
**Figure 1.4. Outstanding amount of guaranteed foreign credits**



Source: National Treasury of Brazil

**Figure 1.5. Breakdown of total guaranteed credits as of 2014**

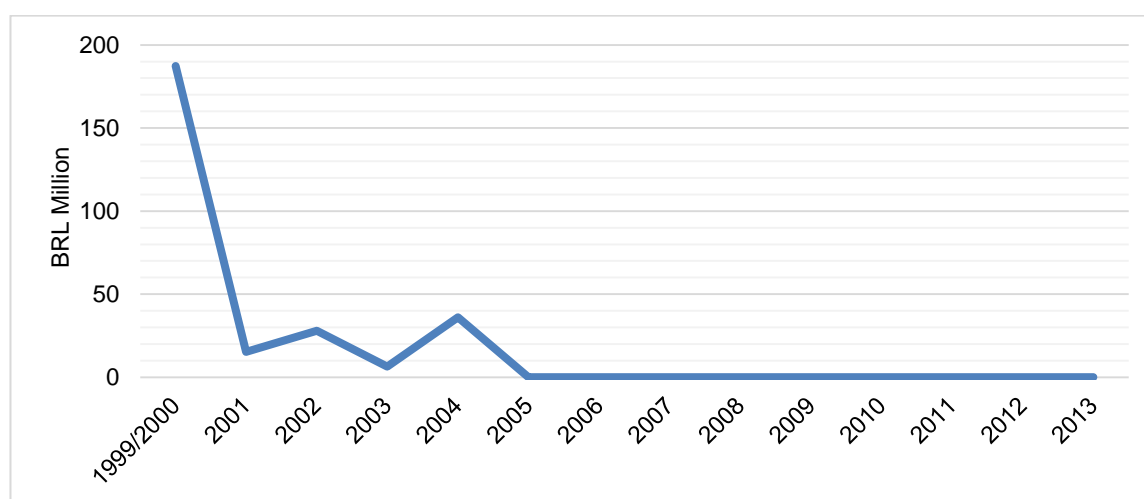
Shares of stock of debt



Source: National Treasury of Brazil

To assess the soundness of the credit guarantee scheme, it is important to verify the track record of payments from the government to the lenders, arising because of the missing payments from the borrowers. Figure 1.6 shows the historical expenses of the FG with the execution of guarantees. Since 2005, there have not been any payments related to the guaranteed loans, unlike what happened in the previous years. The main reasons for this performance are (i) the development of the FRL framework; (ii) the SEs' debt taken over by the FG, and (iii) the fiscal adjustment promoted by the SEs.

**Figure 1.6. Federal government guarantee payments**



Source: National Treasury of Brazil



## **Contingent liabilities related to the banking system**

### ***Background***

To understand the status of the Brazilian financial system and its potential sources of contingent liabilities, it is important to describe the structural changes resulting from the stabilization process occurred in the 1990s. After taming inflation in 1994, the Brazilian Central Bank (BCB) implemented an ambitious program to deal with the series of banking failures of 1995-1998. During this period, 59 banks failed and a number of other institutions were merged, privatized, liquidated, split-up or incorporated. The main reason for this process of industry consolidation is the fact that the banking system strongly benefited from the high inflation rate, since its assets yielded nominal rates, while its liabilities yielded real interest rates. Once inflation was tamed, this important source of profits disappeared, as inflationary transfers to the banking system significantly decreased and the banks' deposits growth rate became lower than the interest rate paid by the banks to its depositors. At that time, banks had two basic choices: sell their assets or make a fund transfer for their depositors. On the top of that, credit expansion suffered a boom despite the fact that it was more difficult to differentiate the quality of the borrowers.

To deal with this new over-dimensioned system, BCB had to intervene and implement a program to restructure and strengthen the financial system. Costs were very high, but the initiative prevented a generalized banking crisis and launched the basis for an extremely well regulated and capitalized financial system. Furthermore, most contingent liabilities arising from the financial sector were incorporated during the restructuring program. The fact that Brazil had already suffered from a banking stress in the mid-nineties helps to explain the cautious stance taken by the regulators since then. In fact, the banking industry in Brazil is nowadays very well capitalized, even above minimum Basel ratios.

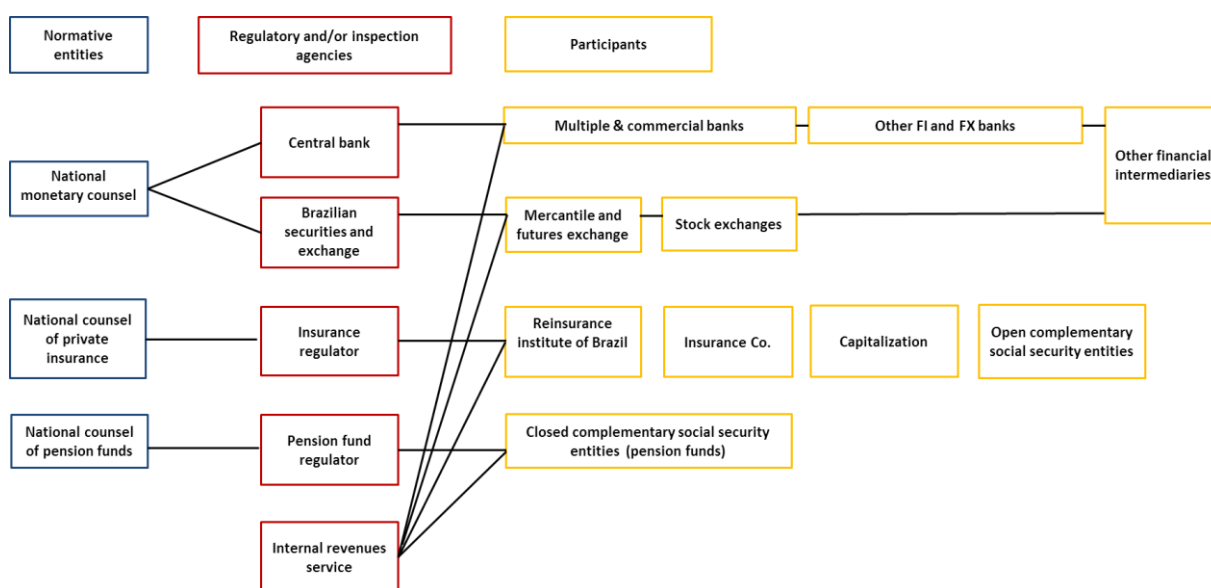
The financial system framework proved to be resilient over time, including in the aftermath of the international financial crisis in 2008. After an initial credit freeze and interbank liquidity dry-up, the system gradually recovered and became functional again. Several factors contributed to the soundness of the financial system during that period, such as (i) the fact that 95% of the banking funding was domestic; (ii) interest rates were relatively high; and (iii) reserve requirements were very high and there was plenty of room for reduction. It is important to mention that the local financing scheme in most business sectors are different from those observed in developed-economies as the public sector plays a relatively larger role in Brazil. Therefore, it is less dependent on sources of funding from private banks.

### ***Organization***

The Brazilian financial system is composed of three main sets of players: (i) normative authorities; (ii) regulatory and supervising agencies and (iii) operators. In the first set, there are the authorities in charge of creating the normative ruling, which are the National Monetary Council (CMN), the Insurance Sector Council (CNSP) and the Pension Funds Council (CGPC). In the second set, there are the supervising authorities, responsible for regulating the system. It is formed by the BCB, the Brazilian Securities and Exchange Commission (CVM), the Pension Funds Agency (Previc) and the Insurance Companies Agency (Susep). Finally, the third set is formed by the final operators and participants in general, such as financial institutions, exchanges, pension funds (open and closed regimes), and insurance companies. Amongst all types of operators, there are 1,995 authorized financial institutions as of Dec-13. Figure 1.7 presents a diagram of the structure of the financial system in Brazil.

Contingent liabilities and other risks to the public debt stemming from the financial sector are identified, measured, monitored, and reported on a regular ongoing basis, and not only under special circumstances (e.g., involving potential systemic risks arising from the financial sector). The financial system structure contributes to the assessment and an important player is the CMN, which is composed by the Central Bank Governor, the Ministry of Finance and the Ministry of Budget and Planning. At this forum, potential risks to the financial stability are shared and their implications to different areas are discussed.

**Figure 1.7. Structure of the financial system**



Source: Central Bank of Brazil website, prepared by the authors

There is also an inter-agency Financial Stability Committee (FSC), dedicated to discussing the financial sector risks. The members of the committee are the regulatory and inspection agencies. The chairperson is appointed on a rotating basis, the BCB being responsible for its secretariat. The FSC has the power to do advisory, call up for a sector discussion forum and coordinate proposals.

The BCB is responsible for recording; quantifying and reporting financial sector explicit and implicit contingent liabilities, such as the potential fiscal cost of bailing out financial institutions in the event of a crisis. The analysis is shared with the Ministry of Finance on a regular basis. The most complete public assessment of the soundness of the financial system is the Financial Stability Report (FSR), published by the Central Bank.

In the event of a financial crisis, there is no crisis resolution mechanism in place delineating each agency's responsibilities in the process. However, there is a crisis resolution mechanism plan inside the BCB. As such, several indicators are used to monitor and/or assess potential vulnerabilities in the financial sector:

- leverage ratios (risk and non-risk based ratios)

- indebtedness ratios (debt service ratios for households and corporations, credit to GDP, credit to GDP gap, etc.)
- liquidity and market risk indicators (liquidity indicator analogous to the Liquidity Coverage Ratio - LCR, built using information from trade repositories, payment systems and others)
- market indicators (interest rates, exchange rates, CDS spreads, stock market indicators, real estate prices and others)
- external vulnerability (external funding reliance, credit lines availability, capital inflows and outflows, and asset exposure to foreign countries)
- credit risk indicators (Non Performed Loans - NPL, provision, coverage ratios, write-off).

### ***Financial sector risks and public debt portfolio analysis***

Because of its size and complexity, it is important to know the structure and conditions of the financial sector and how it affects the design of the public debt management strategy. The main financial sector factors that influence public debt management include regulatory requirements, liquidity conditions, concentration and liquidity asset ratios and deepness of the government bond market.

The design of debt strategies takes into account the FG financing needs (including debt maturing in the near term), i.e., the borrowing requirements considering the expected redemptions vis-a-vis the budgetary resources earmarked for public debt payments. Besides that, the National Treasury has the prerogative to conduct net issuances (i.e. to issue debt in amount beyond its net borrowing requirements) in order to help reduce system liquidity or to minimize impact of debt payments on liquidity, what would lead the Central Bank to carry out repo operations.

Debt strategies require a baseline scenario as well as alternative scenarios, containing both macroeconomic variables (e.g. monetary policy interest rate, inflation index, foreign currency rates, economic growth, and fiscal policy variables) and financial variables (e.g. yield curve and risk premium on government bonds). Besides a baseline scenario, at least two other scenarios (an optimistic and a conservative one) are generated in order to capture the most relevant risk factors. Potential risks arising from the financial sector must be captured in those ranges of scenarios and this scheme proved to be quite efficient in recent periods of crisis.

Moreover, there are cash buffers held by the DMD, which gives more flexibility to the issuance strategy and allows the Treasury to cope with extreme market volatility.

### ***Safeguards***

There are other mechanisms to prevent the contingent liabilities arising from the financial sector. One of the most important is the Credit Guarantee Fund (FGC). It consists of a private fund capitalized by the banking system to safeguard deposits, savings accounts and credit risk for most of the private financial instruments (corporate bonds, securitized credits, time deposits, etc.). It is designed to stand up for any individual losses (retail wise) up to BRL 250,000. The FGC policy objectives are (i) to protect depositors under the financial system, (ii) to contribute to the maintenance of the stability of the national financial system, and (iii) to contribute to the prevention of systemic banking crises.

The mutual funds industry, which is very large in Brazil, is regulated by the CVM and auto-regulated by Anbima-National Financial Institutions Association. Both entities promote close monitoring and disclosure about the costs, risks and allocation towards institutional and retail clients. There has been a steady and consistent track record of robustness indicators related to the mutual funds industry. One important legal aspect is that the bank's assets do not merge with the mutual fund's assets, even if the same bank is the respective distributor. If a given bank is suffering from credit hardness, the fund's clients may change the administration of the fund to another institution.

The CVM also regulates the clearinghouses operating in the derivatives market. By far, the largest derivatives market in Brazil is related to future exchange rate and the future interest rate. BMFBOVESPA and CETIP are the most important clearinghouses and have many levels of security that are binding with the legislation designed to prevent systemic stress. As an ultimate safeguard, these operators are required to keep sizable deposits at the Central Bank in a special fund designed to protect their net worth. Since 2008, the CVM also monitors all OTC derivatives, besides those traded in organized exchanges.

### **Other sources of contingent liabilities**

The FRL established that the Annual Budgetary Guidelines Law must present, as part of its Annex of Fiscal Risks, an evaluation of contingent liabilities and other risks that may affect the fiscal budget, as well as the government balance sheet.

Contingent liabilities are possible new obligations whose foundation depends on the outcome of an uncertain future event. In addition, they may arise from the past events whose settlement is not probable or whose notional value is not measured with certainty. For instance, the aforementioned Annex includes information about lawsuits and their risks for the government balance sheet, ranked by source and by agencies responsible for their management, as following<sup>9</sup>:

- federal debt in process of acknowledgement by the National Treasury;
- credit guarantees by the National Treasury of Brazil;
- lawsuits:
  - against Federal Government Direct Administration<sup>10</sup>
  - against federal Agencies and Foundations<sup>11</sup>
  - involving tax<sup>12</sup>
  - against Federal Public Enterprises

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<sup>9</sup> The Attorneys in charge of the lawsuits are responsible for evaluating their fiscal risks and selecting the processes that will integrate the Annex.

<sup>10</sup> Monitored by the Union's General Attorney (Portuguese acronym PGU).

<sup>11</sup> Monitored by the Federal General Attorney (Portuguese acronym PGF).

<sup>12</sup> Monitored by the National Finance's General Attorney (Portuguese acronym PGFN).

- against the Central Bank of Brazil<sup>13</sup>
- other contingent liabilities.

In the set of contingent liabilities, we stand for debts that are in process of acknowledgement by the National Treasury, which can arise from three sources: (1) dissolution/ liquidation of entities and agencies of the Public Administration; (2) direct obligations of federal government, and (3) subsidies. The stock of these liabilities was estimated as BRL 107.7 billion, most of which is due to the subsidies granted in government housing policies (Table 1.1).

**Table 1.1. Other contingent liabilities**

	In BRL billions	As percentage of total
Dissolution / liquidation	9,1	8,4
Direct obligations	7,2	6,7
<i>Housing policy</i>	3,2	3,0
<i>Creation of States</i>	1,2	1,1
<i>Other</i>	2,8	2,6
Subsidies to housing policy	91,4	84,9
<i>FCVS</i>	86,2	80,0
<i>Other</i>	5,2	4,9
<b>Total amount</b>	<b>107,7</b>	<b>100</b>

Source: National Treasury of Brazil

In the group of subsidies, we highlight liabilities of the FCVS - the Portuguese acronym of “Fund for Compensation of Wage Changes”. Created in 1967, this fund aimed at providing insurance to housing loans settled in the Housing Financial System. In particular, the FCVS became responsible for reimbursing the residual balances that could still exist at the end of the contract to the funding institutions, resulting from differences between inflation (which was the indexation of the outstanding balance for the lender) and wage adjustments (which was the indexation of the reimbursements for the borrower)<sup>14</sup>.

Due to this arrangement in housing contracts, during the 80s, the economic stagnation, the hyperinflation and the high interest rates in Brazil resulted in successive subsidies to debtors, which led to an unbalance in the FCSV. As one of the measures to deal with this contingent liability, by the

<sup>13</sup> Monitored by the Central Bank’s General Attorney (Portuguese acronym PGBC).

<sup>14</sup> The FCVS sought to ensure a time limit for amortizing of the housing contracts.

mid of the 90s the FG assigned the Law Number 10.150, dated December, 21th 2000, which allowed the National Treasury conduct the novation of the FCVS obligations by means of securitization.

### **Concluding remarks**

The main source of contingent liabilities in Brazil is Government credit guarantees, which is a tool used to enhance the supply of credit to investment projects at reasonable costs. There are two types of borrowers, the SEs and the state-owned companies. To be granted a government guarantee, the borrower must provide a counter-guarantee, the amount of which must be equal to or higher than the total amount necessary to repay de entire debt. The only category of borrower exempted from providing a counter-guarantee is the enterprises whose only shareholder is the government.

The banking sector in Brazil is quite sound, due to the tight regulation implemented in the aftermath of the banking crises occurred in the nineties. Besides, the credit/GDP ratio is still low when compared to other countries. The system is well regulated and a number of safeguards are in place. Most banks maintained or improved their loans/deposits ratio after the global financial crisis, as deposits grew faster than loans. Liquidity ratios improved (declined) as banks had built up liquidity buffers. Brazilian banks generate strong net profit margins and the regulators, though vigilant, are not worrisome about meaningful contingent liabilities arising from the financial sector.

Other sources of contingent liabilities, arising from specific government programs (e.g. housing and education) or from lawsuits against the government are monitored and disclosed in the Annual Budget Law.

The frameworks for credit guarantees, the financial system and for monitoring other sources or contingent liabilities in Brazil have proved to be quite efficient, which leads to a low probability of occurrence of unanticipated fiscal risks.

## 2. DENMARK

### Introduction and the portfolio in brief<sup>15</sup>

As an agent for the Ministry of Finance, the Danish DMO at the Danmarks Nationalbank administers loan guarantees<sup>16</sup> and direct loans (on-lending) to a number of companies, the majority of which are fully government owned. In addition to the portfolio administered by the Danmarks Nationalbank, the central government has issued other guarantees, mainly related to the international development banks, the EU, export credits and social housing.

Data on the Danish central government's contingent liabilities are publicly available. Figures on the portfolio of on-lending and government guarantees managed by the Danmarks Nationalbank are published in the annual report *Danish Government Borrowing and Debt*. Other guarantees, not managed by the Danmarks Nationalbank, appear in the government accounts.

Danmarks Nationalbank manages a portfolio of guarantees and on-lending agreements corresponding to around 7% of GDP as of end-2013. On-lending constitutes around 5% of GDP and the loan guarantees the remaining 2%. The other central government guarantees - commitments to international development banks, the EU, export credits and social housing are in the order of 11% of GDP.<sup>17</sup>

### Government loan guarantees versus on-lending

Many countries use government loan guarantees and – to a lesser extent – on-lending to secure stable and cost-effective financing of certain projects. Large infrastructure projects are typical examples. Although the treatment of guarantees and on-lending in debt statistics differ to some extent, the economic implications for government exposures are essentially identical.

### *On-lending and government guarantees imply the same risk*

Under a government loan guarantee, the government guarantees a company's timely payment of interest and principal to investors. Should the company default on its obligations on a guaranteed loan, these obligations are transferred to the government. In case of on-lending, the company instead obtains a loan directly from the government. The government raises money to be on-lent through its ordinary borrowing activities (typically issuance of government bonds). The government is then exposed directly to the government entity's ability to meet its payment obligations. The two types of

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<sup>15</sup> Although “on-lending” has not been covered under the contingent liabilities throughout the report, Danish Government considers on-lending as a direct alternative to guarantees and as contingent liabilities on the grounds that on-lending and government guarantees imply the same risk. This section and OECD (2005) provides a comparative analysis of government guarantees and on-lending.

<sup>16</sup> In this section the term “loan guarantees” is used instead of “credit guarantees” in other parts of the report. The definition covers bond guarantees as well.

<sup>17</sup> As of end-2013.

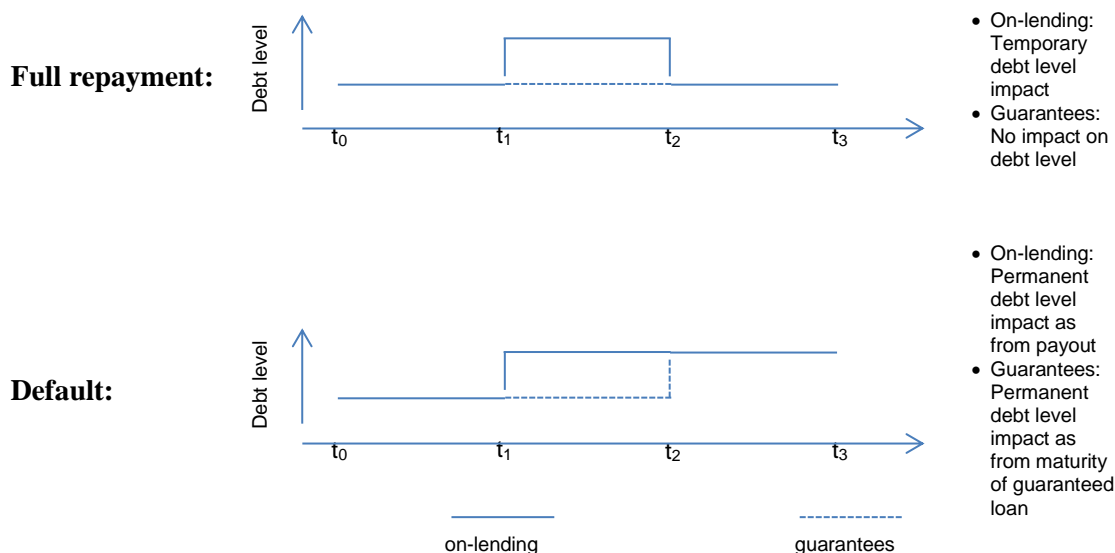
financing thus imply the same risk of losses in a credit event. As a compensation for the extra risk that the government incurs, the government entity typically pays a fee to the government.

However, on-lending and guarantees have different impact on the size of the government debt. Since guarantees are not included in the government budget before the guarantee is called, the central government debt will only be affected, in case the government entity defaults (Box 2.1). With on-lending, the government debt increases at the time, when the loan is given, since it is financed by issuing government bonds. The increase in the debt level is – as a starting point – temporary, since the government entity is expected to meet its payment obligations. In case of default, however, the debt level increase becomes permanent.

### Box 2.1. Debt impact from on-lending and guarantees

Financing of a government entity implies a risk of loss, but the risk is the same, irrespective of the choice between on-lending and government guarantees. To illustrate this symmetry between on-lending and guarantees, two cases are considered. In the first case, the government entity meets its payment obligations, and in the second case, the entity defaults.

At  $t_1$ , the government entity receives a loan via on-lending or raises a loan with a guarantee. Loans and guarantees expire at  $t_2$ . Seen over the full horizon  $t_1$  to  $t_3$ , the government debt level is unaffected by the financing model, cf. chart below. However, in the interim period, there is a difference in the debt level between the two types of financing.<sup>1</sup>



<sup>1</sup> It has been assumed that the government debt, excluding the influence from on-lending and guarantees, is constant from  $t_0$  to  $t_3$ . Interest payments are not considered.



### ***Impact on debt statistics***

In the EU, the statistical treatment of government guarantees and on-lending differs to some extent. Since on-lending is financed via issuance of government securities, it leads to a direct increase in the central government's outstanding debt. This translates into a higher EMU-debt<sup>18</sup> figure, as the government's corresponding financial asset (i.e. the claim on the company arising from on-lending agreements) is not offset against the increase in the outstanding government debt.

The statistical treatment of guarantees depends on the characteristics of the entity receiving the guarantee. Only loan guarantees to the general government sector are included in the statement of the EMU debt. However, the so-called market producers, for whom the sales of products or services cover a majority of the production costs, are not classified as being part of the general government sector.<sup>19</sup> This means that large infrastructure projects – to the extent that income from tolls is high enough to meet the 50% criterion – will be classified as public corporations, i.e. outside of the general government sector. The debt of such public corporations does therefore not add to the EMU debt.

The application of the market/non-market test leads to an asymmetry in the treatment of guarantees and on-lending. For example, by financing a toll road with government-guaranteed loans, an increase in the EMU-debt can be avoided, whereas this is not the case if on-lending is used. To the extent that a low EMU-debt figure is desirable, e.g. with a view to complying with the euro convergence criteria, this difference in statistical treatment can give governments an incentive to prefer government-guaranteed issuance over on-lending – despite the typical cost advantages of the latter.

Eurostat is currently working on a new measure of *net* government debt as a supplement to the EMU debt.<sup>20</sup> In the net government debt measure, financial assets will be deducted from the gross debt. Financial assets can take three forms:

- currency and deposits
- securities other than shares, excluding financial derivatives
- loans.

By deducting loans as financial assets, on-lending and guarantees are in effect treated symmetrically in the net government debt measure.

### **Use of guarantees and on-lending in Denmark in recent years**

In Denmark, companies have in recent years primarily been given access to on-lending instead of government guarantees. In addition, existing companies with access to both on-lending and guarantees have increasingly used on-lending. As a result, the split between outstanding amounts in on-lending and loan guarantees has shifted markedly towards on-lending over the past 10 years (Figure 2.1). In

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<sup>18</sup> The consolidated gross debt at nominal value for general government is often referred to as EMU debt.

<sup>19</sup> Cf. "[Manual on Government Deficit and Debt - Implementation of ESA10](#)", Eurostat 2014. The quantitative market/non-market test is described in Section I.2.4.3.

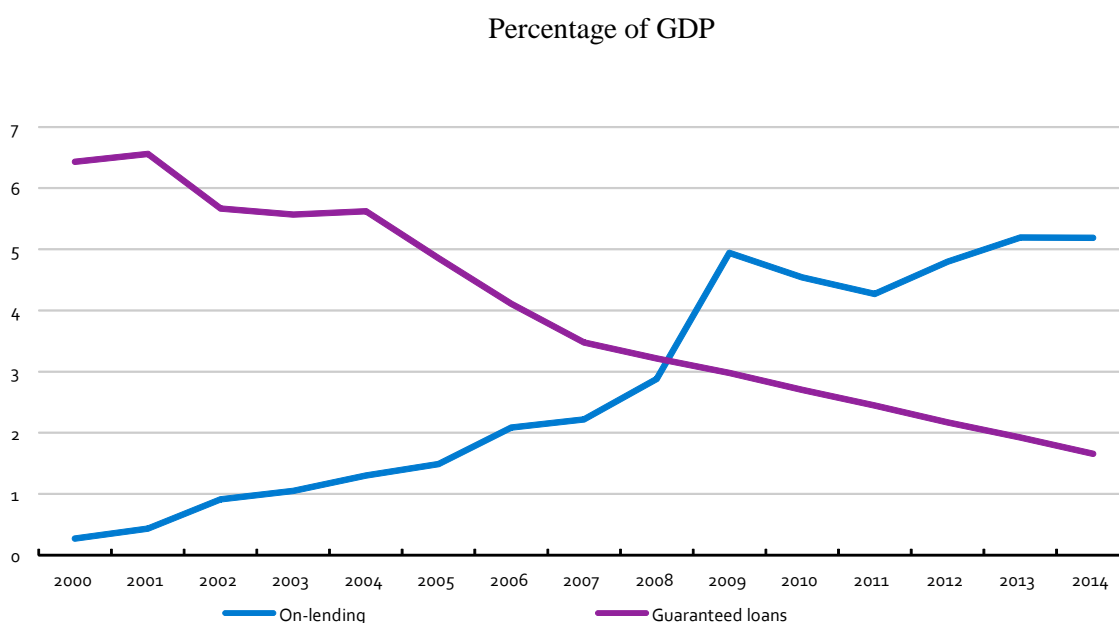
<sup>20</sup> Cf. "[Measuring net government debt: theory and practice](#)", Eurostat 2014.

total, on-lending and government guaranteed loans as a fraction of GDP, is roughly unchanged since 2000.

The shift towards on-lending mainly reflects the cost-effectiveness of on-lending. Borrowing under a government guarantee is de facto equivalent to borrowing in the government's name. The interest rate on a government-guaranteed loan therefore reflects the credit standing of the government rather than that of the issuing company itself. If the government is a highly rated issuer, the company can typically achieve a noticeably lower interest rate in the private market with the guarantee than it would otherwise be able to. Other things being equal, the interest rate will reflect the government's own borrowing rate.

However, a loan issuance issued by a single company – irrespective of the presence of any guarantee – will typically be significantly less liquid than corresponding government bonds. Hence, investors will tend to require a higher expected return on a guaranteed loan as compensation for lower liquidity, which will push the interest rate on the company's loan somewhat above the yields on comparable government debt. By relying on on-lending instead of guaranteed loans, financing costs can thus be reduced.

**Figure 2.1. On-lending and government loan guarantees**



Note: On-lending and loan guarantees administered by the Danmarks Nationalbank

Source: Danmarks Nationalbank

On-lending can also be beneficial in times of low outstanding government debt, as on-lending allows the government to keep issuing liquid bonds even if the central government temporarily has no financing needs. While guarantees and on-lending are equivalent regarding their purpose and the central government's exposures, they differ with respect to the impact on the central government's financing requirement. Guarantees have no impact on the financing requirement unless the guarantees are called, whereas financing via on-lending translates directly into a higher financing requirement. However, most market participants are aware of interchangeability between these financing models and see them as budget-neutral substitutes. This goes for both investors and rating agencies.

Denmark experienced such a period of low and falling debt during 2005-08. When Danish government debt level was at its lowest, on-lending contributed to the Denmark's continued presence as an issuer in the primary market. As the funding requirement sharply increased after the onset of the global financial crisis in 2008, the central government benefitted from its ongoing presence as a borrower in the market.

### **Guidelines for borrowing by the companies**

The boards of directors and executive boards of the companies with access to on-lending and/or loan guarantees are responsible for the companies' funding, including borrowing and risk management, etc.<sup>21</sup> Danmarks Nationalbank formulates general guidelines for borrowing by the companies. The aim is to ensure that the companies do not assume financial risks that the central government would not assume itself.

Earlier, each specific loan was evaluated by Danmarks Nationalbank, but this procedure has been replaced by a framework based on general guidelines, under which the individual company is responsible for compliance.

While compliance is the responsibility of each individual company, six companies with infrastructure-related activities have been grouped under one parent company, which takes care of several treasury functions for all companies in the group, including compliance evaluation. This allows for exploiting potential economies of scale among the government-owned companies.

The guidelines for borrowing by the companies (Box 2.2) are stated in a set of agreements comprising two main elements:

- an agreement between the individual company, the responsible ministry, the Ministry of Finance and Danmarks Nationalbank.
- a list of eligible loan types, which is specified and updated by Danmarks Nationalbank.

Once a year, the companies' auditors inform the management whether the procedures established in relation to the loan portfolio are adequate in terms of controls. The auditors must provide Danmarks Nationalbank with confirmation of this.

### **On-Lending**

This section describes the decomposition of the current on-lending portfolio in more detail. The portfolio of on-lending totals around 5% of GDP distributed on 13 companies of which the Danish Export Credit Agency and the Great Belt Bridge constitute the biggest debtors (Table 2.1). The portfolio also includes a bilateral loan to Ireland.

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<sup>21</sup> For example, a borrowing limit is set up for each company. It is the responsibility of the individual company to comply with the provided line and risk limits.

### Box 2.2. Guidelines for borrowing and risk management

The list of eligible loan types sets out the general guidelines for borrowing by the companies that have access to on-lending or government-guaranteed loans.

The guidelines are based on the companies' managing the risk on their assets and liabilities on a consolidated basis. It is the responsibility of the companies to lay down a financing strategy that contains rules for all financial transactions in relation to borrowing and risk-taking by the company.

The list of acceptable loan types is based on the following criteria:

Government loan guarantees

- Loan types must be customary, i.e. known and used in the market by reputed borrowers.
- Loans must be built up from simple elements that make them transparent (plain vanilla products).

On-lending operations

- Companies have access to on-lending on the basis of the on-lending list. As a starting point, the on-lending list comprises all fixed-rate government bonds denominated in Danish kroner in the maturity segments between two and ten years.

Risk-management requirements

- Swap counterparties are subject to minimum rating requirements.
- Swaps are only transacted with counterparties who have concluded collateral agreements (CSAs).
- The foreign currency exposure of the loan portfolio should, as a general rule, be limited to Euro.

**Table 2.1. On-lending portfolio**

Percentage of GDP

<b>Infrastructure</b>	
Energinet.dk	0.9
The Great Belt Bridge	0.8
CPH City & Port Development	0.6
Øresund Landworks	0.5
The Metro Company	0.4
Femern	0.1
Femern Landworks	0.0
Sund & Bælt Holding	0.0
<b>Other</b>	
EKF (Danish Export Credit Agency)	0.9
The Financial Stability Company	0.4
Danish Ship Finance	0.3
DR (Danish Broadcasting Corporation)	0.2
Loan to Ireland	0.2
SSI (Statens Serum Institut)	0.0
<b>Total</b>	<b>5.2</b>

Source: Danmarks Nationalbank

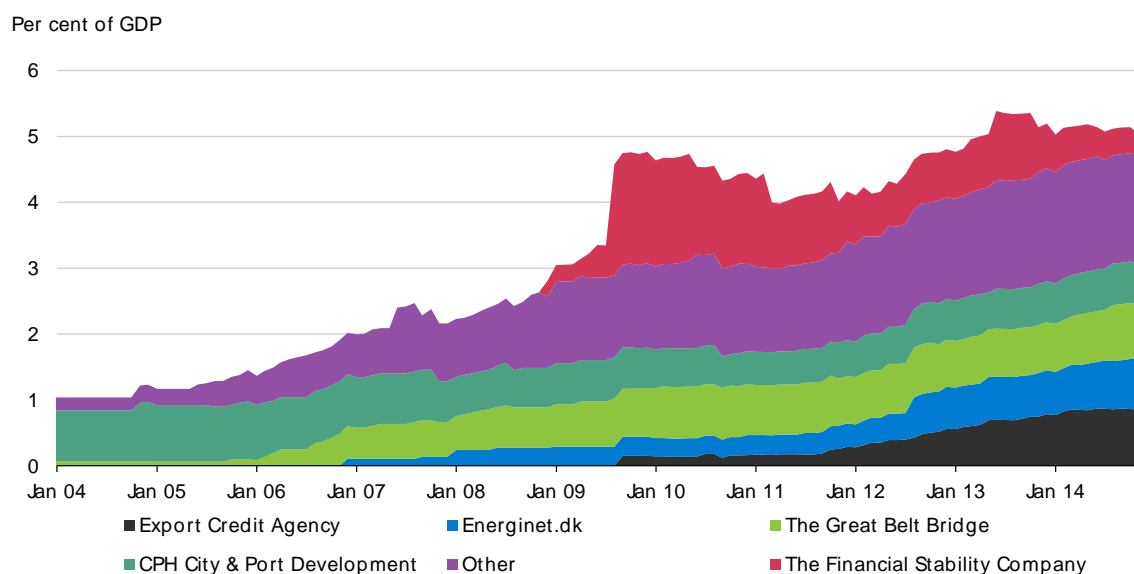
Companies with access to on-lending can obtain loans from the on-lending list. As a starting point, the on-lending list comprises all nominal fixed-rate government bonds denominated in Danish kroner in the maturity segments between two and ten years. The companies do not have access to tailor-made financing products via on-lending. Conformity between the government's outstanding debt portfolio and the on-lending products with respect to cash flows and payment dates ensures that a certain amount of the government's outstanding debt is backed one-to-one by assets in the on-lending portfolio. In that way, the central government's role differs significantly from the role of a bank, where maturity transformation is often part of the business model.

Some companies have access to on-lending based on other government securities as well. For instance, a few companies involved in projects with long investment horizons, also have access to on-lending based on the 30-year government bond. On-lending at long maturities may allow for a better match between the duration of the companies' debt portfolios and the duration on their fixed assets. In addition, some companies have access to on-lending based on the 10-year inflation-linked bond, since the income of these companies is closely linked to the price level.

When a company requests funds under the on-lending agreement, the price of the loan is fixed to match the current market price of the corresponding government bond. Since quotes on the underlying government bonds are continuously available on the MTS platform, this procedure ensures simple, transparent and market-based pricing of the loan. The proceeds of the loan are paid from the central government's account. The resulting financing requirement is met via current issuance in the government's key on-the-run issues. On-lending is included in the consolidated management of the market risk on central-government debt.

Measured net of on-lending to the Financial Stability Company, the on-lending portfolio has increased gradually from 1% of GDP in 2004 to 5% of GDP in 2014. On-lending to the Financial Stability Company caused a temporary increase during the years 2009-10 (Figure 2.2).

**Figure 2.2. On-lending**



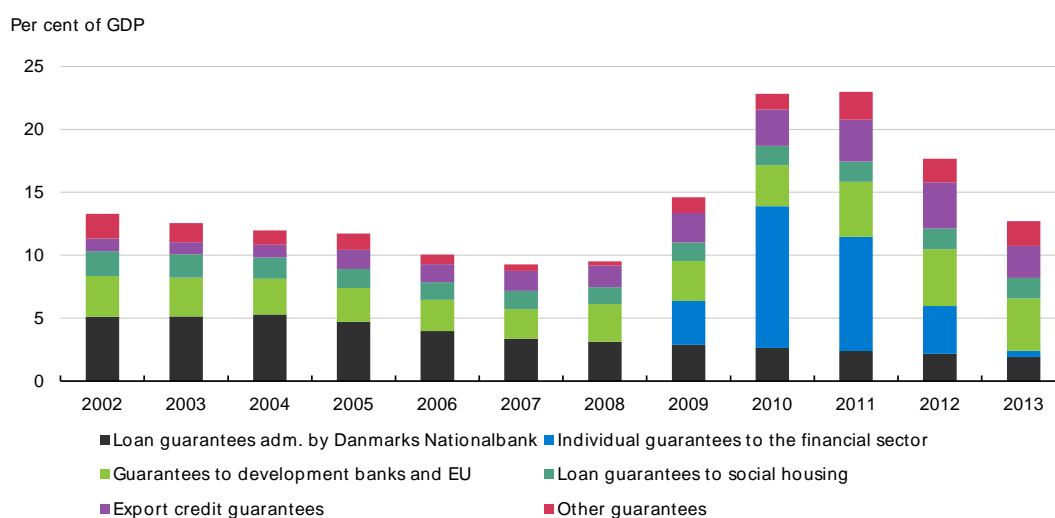
Note: End of month observations

Source: Statistics Denmark and own calculations

## Guarantee schemes

The portfolio of government guarantees consists of a group of loan guarantees, which are administered by Danmarks Nationalbank, and a group of other guarantees, which mainly consists of commitments to international development banks, EU, export credits and social housing. In total, guarantees amount to around 13 per cent of GDP, of which Danmarks Nationalbank (Figure 2.3) administers 2 percentage points.

**Figure 2.3. Central government guarantees**



Note: The numbers are exclusive of the general government guarantee to the financial sector in Bank Package 1, which was adopted in October 2008 and expired in September 2010. Compared to the government accounts, on-lending to EKF and Danish Ship Finance are not included in the numbers.

Source: Government accounts for the years 2002-13 and own calculations

### *Schemes Administered by Danmarks Nationalbank*

At end-2014, Danmarks Nationalbank administered government loan guarantees on behalf of the central government corresponding to 1.7 per cent of GDP (Table 2.2). A minor part of these guarantees is guarantees of swap agreements, in which the central government guarantees the government company's payments. The guaranteed swaps are always directly linked to a guaranteed loan.

The biggest guarantees are issued to Øresundsbro Konsortiet (the company behind the bridge between Denmark and Sweden) and the company behind the Great Belt Bridge. Guarantees to these two companies constitute 75 per cent of the total loan guarantee portfolio. Øresundsbro Konsortiet is partly owned by a Swedish governmental company and partly by a Danish governmental company. The company's debt is guaranteed by both Denmark and Sweden. The guarantee model mirrors the sharing of risk between the two central governments.

**Table 2.2. Loan guarantees administered by the DMO on behalf of the government**

Per cent of GDP	Portfolio end-2014
Øresundsbro Konsortiet	0.8
The Great Belt Bridge	0.5
The Danish State Railways	0.3
Øresund Landworks	0.0
DR (Danish Broadcasting Corporation)	0.0
Total	1.7

Note: The numbers are inclusive of guaranteed swaps.

Loans raised by Øresundsbro Konsortiet are guaranteed by the Danish and Swedish governments subject to joint and several liabilities.

Source: Government accounts and own calculations

Government guarantees may entail losses, and market participants typically factor in guarantee commitments in their assessments of sovereign credit quality. The OECD, the IMF and the World Bank have formulated best practices for managing government guarantees, e.g. that government guarantees should be published regularly in addition to conventional debt compilations.<sup>22</sup>

Danmarks Nationalbank's tasks related to the issuance of loan guarantees for Danmarks Nationalbank are primarily of a legal nature. While the legal responsibility lies with the individual company, Danmarks Nationalbank checks that the guidelines for borrowing are met before issuing the guarantee for the specific loan or swap agreement.

### *Guarantees to the Financial Sector*

During the financial crisis, a number of support packages directed at the financial sector were launched in order to safeguard financial stability.

#### *General government guarantee*

Under the Act on Financial Stability (the Bank Package) from October 2008, the Danish government provided an unlimited guarantee to all depositors and unsecured creditors against losses in Danish banking institutions until 30 September 2010.

The guarantee structure was set up with the Private Contingency Association (PCA), an entity funded by guarantee commissions paid by private banks in relation to their size, as the first line of defense. The first approximately EUR 1.3 billion of losses would be covered by the PCA, whereas losses between EUR 1.3 billion and EUR 3.4 billion would be covered by the accumulated fees paid by the private banks to the PCA. Should the total loss exceed EUR 3.4 billion, the private banks would further pay EUR 1.3 billion in fees to cover losses. Beyond this point (total losses exceeding EUR 4.7 billion) the central government would cover further losses. The total losses ended up around EUR 1.6 billion, and the government backstop was not activated.

#### *Individual government guarantees and the government capital injections*

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<sup>22</sup> Cf. "[Revised Guidelines for Public Debt Management](#)", the World Bank and IMF 2014. An overview of the guarantees managed by the Danish DMO is available in Danmarks Nationalbank's annual publication "Danish Government Borrowing and Debt".

The Credit Package from February 2009 made it possible for Danish banks and mortgage credit institutions to enter into agreements to purchase individual government guarantees for specific bond issues with maturities of up to three years. The institutions had to apply for the guarantees before the end of 2010.

As part of the Credit Package, credit institutions were also given the opportunity to apply for government capital injections for up to 5 years (additional Tier 1 capital). Only credit institutions that observed the statutory solvency requirements were able to apply. In return, the institutions had to pay the 5-year government bond yield plus a mark-up determined by the solvency of the individual institutions. In total, EUR 6 billion were injected during 2009. Overall, the central government will realize a surplus from capital injections due to the mark-up paid by the credit institutions. This surplus must, however, be seen in the context of the considerable *ex ante* risks faced by the government under this scheme.

As part of the so-called Consolidation Package (Bank Rescue Package 4), the Danish Parliament's Financial Committee in March 2012 endorsed an extension of the individual government guarantees. The Financial Stability Company could henceforth issue individual government guarantees in the context of a merger between two monetary institutions of which at least one had to be in distress or was expected to be in distress. To obtain a guarantee, the continuing institution had to be deemed viable.

Most of the individual government guarantees expired during 2012 and 2013, and only guarantees amounting to EUR 0.7 billion were still outstanding by the end of 2013. Only minor impairments amounting to EUR 0.5 billion related to the individual guarantees have occurred as of end-August 2014. These losses have fully been covered by the fees paid by the credit institutions.

#### *The resolution scheme*

In October 2010, a resolution mechanism for Danish banks was put in place, under which the central government had no contingent liabilities.<sup>23</sup> The resolution scheme was replaced by the EU Bank Recovery and Resolution Directive (BRRD) in June 2015.

#### ***Guarantees to the development banks and the EU***

Reflecting its commitment to international cooperation and development, the Danish central government has issued guarantees to a number of development banks and to the EU. In total, these guarantees amount to 4 per cent of GDP, of which the guarantee to the European Investment Bank accounts for 2 per cent (Table 2.3).

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<sup>23</sup> For a further description of the Danish resolution scheme, see [Monetary Review](#), 3<sup>rd</sup> Quarter 2011, Danmarks Nationalbank, pp. 81.



**Table 2.3. Guarantees to the development banks and the EU**

Per cent of GDP	Portfolio end-2013
European Investment Bank (EIB)	2.0
Nordic Investment Bank (NIB)	0.7
The World Bank (IBRD)	0.5
European Commission	0.5
African Development Bank (AfDB)	0.3
Asian Development Bank (AsDB)	0.2
European Bank for Reconstruction and Development (EADB)	0.1
Inter-American Development Bank (IDB)	0.1
<b>Total</b>	<b>4.3</b>

Source: Government accounts

### ***Loan Guarantees to Social Housing, Export Credits and other Guarantees***

The central government has contingent liabilities related to the social housing sector. The financing of social housing is also guaranteed by the individual municipalities.

The Danish Export Credit Agency can – on behalf of the central government – provide government guarantees to loans related to export-generating projects. As of end-2013, the outstanding export-credit guarantees amounted to EUR 6.4 billion. These government guarantees exclude the Export Credit Agency's aforementioned on-lending liabilities.

The central government has other contingent liabilities, which in total amount to 2 per cent of GDP as of end-2013. These liabilities include guarantees of retirement plans for former employees with the Danish postal service and a guarantee to insurance companies, which will take effect in case of acts of terrorism.

### **Contingent liabilities from a broader risk management perspective**

A key element of most DMOs' stated objective is to minimise long-term costs subject to an acceptable level of risk. In practice, this general formulation leaves considerable room for interpretation regarding the relevant scope of debt management. In particular, the question arises to what extent Denmark's Nationalbank should take contingent liabilities and other non-debt elements into account when formulating the overall strategy for government debt management.

In its broadest form, the ALM approach to government debt management entails taking into account all government assets and liabilities – including even those that are non-financial in nature. Under this broad view, the government's entire tax base can be regarded as an asset. Given that the return on this asset – i.e. the stream of tax revenue – is highly pro-cyclical, it is likely to have a non-trivial correlation with the amount of government guarantees being called.

However, even when the scope of debt management is more narrowly construed, such as in Denmark, and focuses primarily on the government's financial liabilities and assets, contingent

liabilities should be closely monitored. An essential prerequisite for such monitoring is, of course, that a reliable consolidated overview of contingent liabilities exists. Despite the narrower ALM approach, the government debt management strategy can still be designed with a view to make the government resilient also to broader risks. During the global financial crisis and the ensuing euro area debt crisis, the Danish DMO significantly increased the government's cash buffer to rely less on short-term borrowing. This allowed the government more room for manoeuvre should contingent liabilities turn real and tangible.

Although the size of contingent liabilities may seem manageable in many countries when viewed in isolation (e.g. as share of GDP), they have the potential to raise the government's borrowing requirements exactly at those times when the government is most under stress from dwindling tax revenues and increasing social expenditures. Hence, contingent liabilities – not least because of the partially unpredictable nature of the payments – can constitute a threat to debt sustainability if left to accumulate unchecked. The best way to avoid such accumulation is arguably to maintain a high level of transparency with respect to contingent liabilities.

### 3. ICELAND

#### Introduction

Management of central government debt, both domestic and foreign, is the responsibility of the Minister of Finance and Economic Affairs (MoFEA). However, in accordance with an agreement between the MoFEA and the Central Bank of Iceland (CBI) signed in October 2007<sup>24</sup>, the CBI will undertake the tasks of managing government debt, both domestic and foreign on behalf of the MoFEA. The Agreement specifies the distribution of responsibilities between the CBI and the MoFEA, as well as the division of work regarding the management of government debt. Moreover, the Agreement stipulates that the CBI will, on behalf of the MoFEA, manage the government guarantees and the on-lending of government funds.

Government Debt Management (GDM) is a subdivision of the Treasury and Market Operations department (TMO) of the CBI. Government guarantees are managed within the GDM by the State Guarantee Fund (SGF).

The Agreement between the MoFEA and CBI assigns the following responsibilities to the CBI as regards to the government guarantees and on-lending:

- administration of the government guarantees
- assessment of the Treasury's risk arising from the guarantees
- providing the MoFEA with opinions on the government guarantees
- issuance of government guarantees in accordance with the ministerial decisions
- levying and collecting fees charged for the government guarantees
- handling the issuance of bonds for re-lending
- monitoring the development of individual guarantees
- monitoring the total stock of guarantees
- assessing the depreciation requirements of the government guarantees
- administering the redemption of claims against the Treasury as a result of the guarantees, as well as the collection of such claims
- maintaining a special register of guarantees

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<sup>24</sup>See: <http://www.lanamal.is/Assets/Agreement%20between%20MF%20and%20Central%20Bank.pdf>.

The SGF is a separate legal entity, established by the Law on State Guarantees no. 121 enacted in 1997. The MoFEA and the SGF are responsible for managing government guarantees but most of the responsibilities of the MoFEA were transferred to the SGF by the agreement of 2007 signed between the MoFEA and the CBI.

The origin of government contingent liabilities can be traced to three main sources,

- Laws passed by the Icelandic Parliament (Alþingi)
- State-Owned Enterprises (SOE)
- Contractual obligations, e.g. government pension obligations or commitments under the PPPs.

It is the MoFEA that issues a government guarantee, but can only do it on the basis of a special legislation that must be passed by the Icelandic Parliament in each instance. However, before a bill can be presented before the Parliament, the SGF must have submitted an opinion on certain criteria regarding the proposed guarantee. Among these criteria are the creditworthiness of the borrower seeking the government guarantee, assessment of collateral offered, impact on competition in the respected field and so on. The Law on State Guarantees does not preclude any individual or legal entity from applying for government guarantee. However, applications are very rare.

Another origin of the government guarantees are the obligations of State-Owned Enterprises (SOE), as according to the Icelandic laws, the Treasury is liable for the obligations of its institutions and companies unless such liability is limited by explicit statutory provisions, or where the Treasury's liability for a limited company is restricted to its capital share contribution. Among the SOEs that fall under this category are the National Power Company (NPC) and the Housing Financing Fund (HFF).

The last source of the government guarantees is the contractual obligations of the government. Among those, pension obligations of government employees for which the Treasury is liable in a broad sense, constitute the most important part. Additionally, contingent liabilities in PPP contracts would also be placed under this category. PPP projects can involve the use of government support, as the government can bear risks which it can manage more efficiently than the private investors, to aid projects that are economically but not financially viable. The use of guarantees in such projects can provide the edge needed to ensure private investors' participation.

In Iceland, government guarantees originate mostly from the guarantees provided for the SOEs and they are almost exclusively credit guarantees. The SOEs are authorized for their borrowings with government guarantees subject to an annual budgetary ceiling. Only one SOE, the National Power Company (Landsvirkjun) has an independent legal authorization to borrow without a government guarantee.

Pension obligations weigh heavily on the total amount of outstanding government guarantees. The Actuarial status of the Pension fund for State Employees is negative regarding future commitments at yearend 2013 around 517 billion ISK, or 27,6% of GDP. That makes it the second single largest guarantee of the Treasury, second only to the Housing Financing Fund (HFF), a SOE. In recent years, the third source of government guarantees has mostly been used to commission the MoFEA to enter into PPP contracts with private enterprises/investors, apart of course from increases in pension obligations. Very few guarantees derive from the first source, i.e., by Parliamentary legislation.

## **The SGF and the operational framework for the government guarantees**

### ***The Issuance Process***

A potential new government guarantee can come about in three ways,

1. An application for a government guarantee to the MoFEA, by a non-governmental party.
2. A bill presented to the Parliament by a parliamentarian or a Government Minister.
3. Bond issuance or borrowing by an SOE, previously authorized by the National Budget.

An application for a government guarantee by a party that is not an SOE shall be sent to the MoFEA. The application shall include the following:

- A detailed report on how the borrowed funds will be used, together with a clear operational plan from the party requesting the guarantee or loan.
- A certificate of encumbrances concerning the assets to be pledged, together with other documents verifying title to them.
- Documentation concerning the mortgage liens on the property to be pledged.
- A balance sheet and profit and loss account for the party requesting the guarantee, for at least the past two years, in the form that may be requested by the SGF and with any explanatory notes and supporting documents requested by the Fund.
- Documents on insurance on the applicant's assets.
- A request for an examination and assessment.

### ***Opinion from the SGF***

Before the MoFEA can present a bill of legislation on the conferral of a government guarantee before Parliament, the SGF must have submitted an opinion on the following:

- An assessment of the creditworthiness of the borrower.
- An assessment of the need for credit provisioning for guarantees issued.
- An assessment of collateral offered for the guarantee. The MoFEA may set the hypothecation ratio by Regulation.
- The impact of the guarantee on competition in the relevant area.

Furthermore, the SGF shall assess the following in its opinion:

- The market value of the applicant's assets to be pledged as collateral.

- The estimated returns on the investments for which funds are to be loaned.
- The value of the guarantee or loan for this particular project.
- The risk taken by the Treasury.
- Whether granting the guarantee or loan is consistent with the international agreements to which Iceland is a party

The SGF is authorized by the Law on State Guarantees to engage an external party to provide the assessment or part of the assessment. The cost of the assessment shall be paid by the applicant. It is important to note that only incurred cost as a result of the assessment can be recovered from the applicant. Other cost related to the management of the SFG, is to be recovered through the fee charged for the government guarantee.

The SGF must, every time a bill is presented before the Parliament for a new government guarantee; whether it is done by the MoFEA or a parliamentarian or other Ministers of the government, submit an opinion as detailed above. The Parliament cannot pass a bill where a new government guarantee is issued without receiving first the opinion of the SGF on that particular bill.

Concerning the above-specified SGF opinion, the risk assessment must be available at the time a decision is taken on issuing the guarantee. The SGF's role is to assess risk, and the MoFEA must explain that risk to the Parliament when the bill of legislation on the conferral of the guarantee is presented. This will enable Parliament to assess, for instance, whether there is reason to provide financial subsidy instead of a guarantee. The opinion of the SGF must always accompany the bill of legislation when presented to the Parliament.

### ***The requirements for a government guarantee***

The principal requirements for the MoFEA to confer a government guarantee are:

- A government guarantee is authorized by an act of law i.e. Parliament must have passed law authorizing MoFEA to issue a government guarantee.
- The need for credit cannot be met in the general credit market and the activity in question is considered favorable.
- The guarantee recipient provides at least 20% of the total financing for the project.
- The guarantee recipient provides appropriate collateral as assessed by the SGF.
- The guarantee shall not amount to a higher proportion than 75% of the credit requirement of the project for which State guarantee is to be granted
- It is not permitted that the Treasury undertake a guarantee for a party being in default to the Treasury or the SGF.

The MoFEA is prohibited to issue a guarantee unless the above conditions are met. All these requirements must be addressed in the SGF opinion presented to the Parliament. Furthermore, it is assumed that the government guarantee shall only be granted for activities that can presumably support the service of the debt guaranteed by the Treasury.

The recipient of the guarantee must provide a collateral for the loan. That collateral must be assessed by the SGF. However, the legal opinion of the SGF is not binding except that it must have deemed the collateral provided for the government guarantee “appropriate”. Therefore, in accordance with the Law on the State Guarantees, if an applicant for a government guarantee has not provided collateral deemed sufficient by the SGF, the MoFEA is prohibited from guaranteeing the applicant’s obligations.

The collateral required shall comprise the valuables acquired with the borrowed funds for which the guarantee is issued, and the operational assets related to those valuables, as well as other assets, if deemed necessary. Furthermore, if the debtor provides real property as collateral for the payment of a debt for which the MoFEA has provided a guarantee, the liens on that property, including the government guaranteed debt, may never exceed 70% of the appraised value of the property concerned, provided that no other provisions appear in the act of law authorizing the guarantee.

In other respects, the SGF is not bound by specific requirements in its assessment of the collateral provided. Such an assessment is event-specific by its very nature, and it can be somewhat specialized. As such, it could prove necessary to engage experts in the field concerned to provide information so as to clarify the value of the collateral.

### ***Cost, incentives, pros and cons***

A government guarantee in favor of a company carries a huge advantage for the concerned party. The security that a government guarantee portrays improves the creditworthiness of a company, thereby enabling it to obtain more favourable interest rate and funding terms than it otherwise would have obtained on the market. For some companies seeking financing in foreign financial markets would be impossible without the government guarantee. Even domestic financing could in some instances be difficult without the government guarantee, e.g. the Icelandic Regional Development Institute whose purpose is to support and strengthen the local development by the provision of credit and other forms of financial support, is deemed commercially unviable by the banking system.

It is nevertheless the State that carries the risk associated with a guarantee. Therefore, this risk needs to be compensated by a payment of an appropriate premium. Otherwise the guarantee would represent an unfair advantage for the company concerned and be a violation not only of competition rules in Iceland but also a breach of state-aid rules of the EFTA Surveillance Authority (ESA).

### ***Competition and types of guarantees***

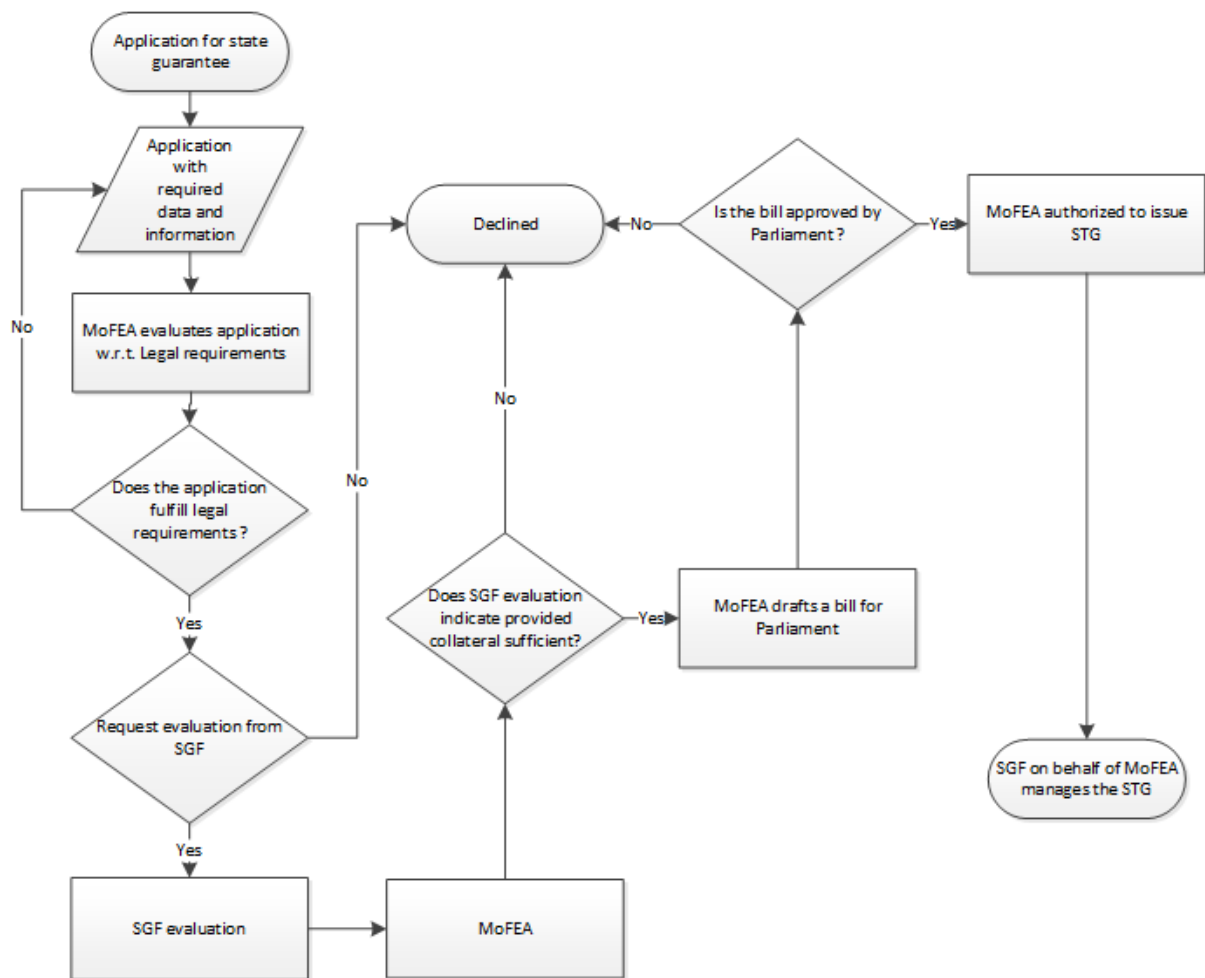
According to Icelandic law it is the responsibility of the SGF to assess the general impact of government guarantees on competition in the relevant area. Complying with the EU/EEA-rules on State Aid, the government guarantee fee shall respond fully to the concession enjoyed by the beneficiary in the form of credit terms beyond those generally available on the market and without the government guarantee. As prescribed by law, the premium paid by the beneficiary shall be determined on the basis of the assessment of an independent party of the terms with and without the government guarantee.

Managing, monitoring and reporting all government guarantees, whatever their type, is the responsibility of the SGF. Although credit guarantees are by far the most common type, other types of

guarantees<sup>25</sup> have been used and are being used for which the same system of application, opinion of the SFG and approval by the Parliament applies.

According to Icelandic law, state guarantees can only be claimed when all reasonable debt collection resources have been exhausted against the debtor (guarantee of collection), unless specifically excluded by law. Article 1 of the State Guarantee Act, states that the Treasury may not undertake a guarantee commitment unless authorized by law. The Treasury may not undertake a guarantee unless specified in the law authorizing such a guarantee. An example of this would be a state guarantee to a private company’s project financing. If the project financing would default, the lenders would have to exhaust all reasonable debt collection resources before they could collect the state guarantee.

**Figure 3.1. Process of government guarantee issuance**



Source: Government Debt Management/State Guarantee Fund

<sup>25</sup> E.g. export credit guarantees and demand guarantees.



### *On-lending*

The Law on State Guarantees shall also apply to funds re-lent by the Treasury, as applicable. However, funds may not be “on-lent” to entities other than SOEs and state owned financial institutions (SOFI) as defined by the Treasury, unless so specified in laws authorizing guarantees.

### **Risk management and risk sharing**

#### *Valuation and pricing of the government guarantees*

The Icelandic financial market is small and price formation shallow. After the financial crisis in 2008 and the collapse of all the major commercial banks representing over 90% of the banking system in Iceland, the only financial market that remained functioning was the government bond market. There is no functioning swap market or derivatives market in Iceland. Equities market exists but is very small and the price formation is unsound. Together, this makes market valuation of government guarantees problematic.

An overwhelming majority of government guarantees are credit guarantees provided for the SOEs. These guarantees are valued as the present value of the payments under the guarantee times the probability of payment, i.e. a risk neutral valuation method. This valuation method provides an assessment of the expected fiscal cost of the guarantee, i.e. it is a measure of the risk premium needed to compensate the Treasury for the risk it undertakes by issuing the guarantee.

Nonetheless, it is clear that issuing government guarantees will benefit the recipient of the guarantee unless the fee charged for issuing the guarantee is high enough to price away this potential benefit. If not, it will amount to staid-aid. According to the rules of the Agreement on the European Economic Area (EEA) on state-aid guarantees it is admissible to provide state-aid guarantee to companies. However, the benefitting companies must pay an appropriate premium for such a guarantee. The price for the state-aid guarantee should be reflected by the difference between the lending spread of a company with – and one without – the state guarantee. Therefore, in order to eliminate any incompatible aid and comply with the EEA agreement it is necessary that the SOE pay a premium that is equivalent to the difference in the interest rates obtained with and without state-aid guarantee to its owners, in proportion to the equity stake they hold, as a compensation for the guarantee.

However, calculating and applying an appropriate premium is not the only condition that guarantee scheme must meet. In order to be admissible the premium that is paid for the guarantee needs to meet the self-financing condition criteria as laid out in the EFTA Surveillance Authority (ESA) guidelines<sup>26</sup>. The self-financing condition entails that the premiums collected from SOE must be high enough to compensate for the scheme, i.e. it must be an economically viable decision to grant these guarantees.

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<sup>26</sup> See ESA guidelines for State Guarantees: <http://www.eftasurv.int/?1=1&showLinkID=15646&1=1>, section 3.4 (D).

### **Box 3.1. Finding the appropriate premium (risk charge) of a government guarantee**

A basic way of assessing an appropriate premium would be to use the difference in spreads for the guarantor and the beneficiary (stand-alone) directly. However, this is equivalent to assuming that the beneficiary with the guarantee enjoys exactly the same terms in the financial markets as the guarantor, which is not necessarily the case. In particular this would not be true for **guarantee of collection**, as is used in Iceland, as the guarantor does not simply step in honouring the obligations of the defaulting entity. Instead, creditors need to go through a collection process and evidence their real loss before receiving any payments from the guarantor. This is further reflected in the fact that credit rating agencies do not necessarily rate the beneficiary with the guarantee as high as the guarantor. For example S&P rates the National Power Company (Landsvirkjun) 2 notches below the government, despite the explicit guarantee of the latter.

For the guarantor, it is necessary to evaluate the spread of sovereign bonds of similar rating as that of the Republic of Iceland. This spread of the guarantor is compared to the spread of corporate bonds of similar rating, as beneficiary of the guarantee would have without any guarantee.

In principle there are three main steps taken while evaluating the state-aid guarantee.

#### **1. Stand-alone and relative ratings**

A requisite part of the analysis is the stand-alone rating of the beneficiary, i.e. a credit rating reflecting its creditworthiness as if the government guarantee was not in place. Stand-alone rating can either be expressed directly or referenced to the rating of the guarantor.

Having established a stand-alone rating, it must be compared to the rating of the guarantor, i.e. the Icelandic government.

#### **2. Calculation of relative spread**

It is necessary to find a benchmark that can be used to evaluate the credit spread that the beneficiary company would have obtained in the borrowing markets without guarantee. Therefore, the next step in the evaluation is to map the rating at each point in time to a relevant spread for companies of that particular rating. In the same way, a reference spread must be found for the debt of the guarantor in the relevant rating category. The difference in spread evaluated for the stand-alone rating and the spread obtained for the rating of the guarantor is an indication of the value of the state guarantee.

The spread that the guarantor obtains in the market is lower than the spread obtained by the beneficiary company with guarantee of the guarantor. This has to be taken into account when the spread difference is estimated.

#### **3. Application of relative spread to outstanding loans**

Having established a reference spread between the guarantor and the beneficiary company without a guarantee, the guarantee can be priced and the fee determined.

#### **Self-financing condition**

The self-financing condition means that premiums collected need to be at or above the sum of:

- The price associated with the risk of issuing the guarantee;
- The administrative costs of operating the scheme; and
- The remuneration of an adequate capital.

ESA guidelines on State Guarantees can be interpreted as a straightforward model for the pricing of guarantees or loans at financial institutions. This is calculated using the formula:

$$Price = Expected Loss + Cost + Risk Premium$$

Where;

$$Expected Loss = Probability of Default * Loss Given Default * Exposure at Default$$

This methodology is used in pricing government guarantees and calculating the fee charge. According to the ESA guidelines on State-Aid, the fee charged for government guarantee must be

- High enough to price away any benefit the guarantee might give the beneficiary in lower financing cost, and
- High enough to compensate the scheme, i.e. it must be an economically viable decision to grant the guarantee.

Whichever gives a higher outcome is the fee charged for the guarantee by the SGF.

### **Monitoring**

All government guarantees are monitored on a regular basis. The MoFEA is kept informed of any breach or violation of contract regarding the guarantee or if the SGF considers it likely that a beneficiary of a guarantee is likely to default on or is in any way not fulfilling his responsibilities regarding the credit guarantee.

Annually, the SGF sends the MoFEA a comprehensive report on government guarantees, where an overview is given of the prospects of each beneficiary of government guarantee, a risk assessment is made and an estimate is given on the potential loss to the Treasury of credit guarantees falling in arrears. The report also enumerates various suggestions by the SGF regarding further development in managing, monitoring and reporting on government guarantees, the aim being to improve the SGF functioning in order for it to better fulfil its purpose.

### **Risk sharing**

It is explicitly stated in the Law on Government Guarantees that government guarantee shall not exceed 75% of the credit financing needed for which the guarantee is provided. Moreover, the MoFEA may not provide a guarantee to a party that is in arrears with payments to the Treasury or the SGF. It is considered appropriate that the lender assume some risk for the loan along with the Treasury, as this will encourage the lender to consider carefully the risk attached to the loan transaction. In addition, it is required that 20% of the investment for which the guarantee is requested be equity-financed. These conditions combined ensure that the government guarantee cannot exceed 60% of the total investment.

### **Transparency**

The importance of transparency in managing government guarantees has increased highly in recent years. All new government guarantees in Iceland must be approved by the Parliament and consequently require legislation in each case. As regards to the SOEs, their borrowing requirement each year needs authorization from the Parliament in the State budget. Furthermore, it is not possible to present a bill before the Parliament for new guarantees, without the opinion and assessment of the SGF on the proposed new guarantee. Iceland's Parliamentarians should therefore be well informed about the proposed guarantee before they pass a new law authorizing it.

Every month the GDM publishes its Market Information Bulletin (Figure 3.2), where information on government guarantees is published. The government guarantees page in the bulletin is divided into 3 parts,

1. List of explicit government guarantees and a 5 year history of year-end outstanding positions, as well as a chart showing a maturity profile of the total outstanding State guarantee portfolio,
2. Comparison part, showing a chart depicting comparison between State guarantees, outstanding government debt and GDP,
3. Exposure part, with one chart showing current currency ratio, i.e. the percentage of the total guarantee portfolio in domestic currency (ISK) and proportion in other currencies, another chart showing type of lenders of credit guarantees and finally a chart showing the proportion of the total guarantee portfolio that has fixed interest rate and the proportion that has floating interest rates.

### ***Data collection***

Beneficiaries of government guarantees are obligated by law to provide any information the SGF deems necessary for the management of government guarantees. If, for any reason, a beneficiary of a guarantee does not provide the SGF with requested information, the beneficiary can be fined. The fine is levied pr. day that passes without the information requested by the SGF being delivered.

Every beneficiary of Government guarantees must, pr. end of each Quarter, deliver information on the outstanding amount and interest accrued on the debt that is guaranteed by the government. The beneficiary must also turn in annual reports or interim financial reports when published. The Housing Financing Fund (HFF) and the National Power Company (Landsvirkjun) must however hand in information of guaranteed debt at the end of every month. The reason is that these two beneficiaries of government guarantee enjoy over 90% of explicit guarantee issued by the State. Any party that requests a government guarantee on its debt must surrender all information to the SGF that SGF deems necessary to assess fully the risk to the Treasury of awarding the guarantee.

Data on every credit of every beneficiary of the guarantee is entered into a system that the SGF operates, which can calculate the position, payment schedules, various risk factors and scenarios.

Figure 3.2. Market information bulletin

## Market Information

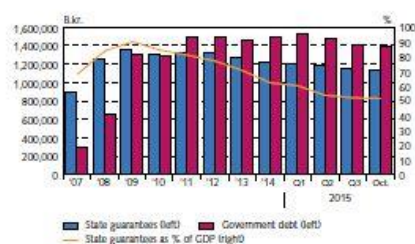


### State guarantees

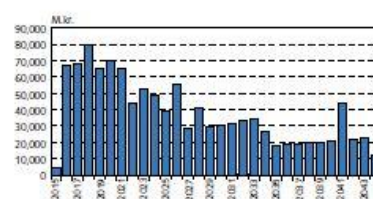
State guarantees 2010–2015

M.kr.	October	Outstanding end of year				
	2015	2014	2013	2012	2011	2010
Lending agencies	867,069	892,205	935,645	956,735	961,148	927,947
Housing Financing Fund	857,691	881,045	923,492	942,169	943,880	910,657
Regional Development Fund	9,377	11,160	12,153	14,565	16,993	17,038
Other	0	0	0	0	275	253
Co-operative and Limited Partnerships	272,212	317,940	324,844	358,920	250,744	251,455
National Power Company sf.	258,251	302,586	309,531	342,231	233,417	232,854
RARIK ehf. (Iceland State Electricity)	1,777	2,075	2,343	2,638	2,794	3,063
Farice ehf.	7,187	7,588	6,446	6,828	7,025	7,257
Isavia ehf.	1,741	2,130	2,507	2,917	3,106	3,639
RUV ehf. (National Broadcasting Service)	2,415	2,760	3,224	3,479	3,553	3,685
Other	741	801	793	828	849	857
Industries/Municipalities	2,251	2,440	3,760	3,964	5,357	5,242
Commercial Banks	0	0	0	0	1,608	1,693
NIB - Nordic Investment Bank	2,231	2,411	2,966	3,110	2,855	2,709
Other	20	29	804	854	894	840
State Guarantees total	1,141,531	1,212,585	1,264,249	1,319,619	1,217,250	1,184,644

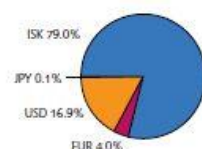
State guarantees - government debt and GDP 2007-2015



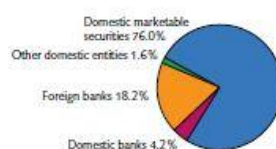
State guarantees - Maturity profile



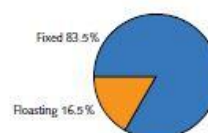
Currency ratio



Type of lenders



Interest rate type



Notes:

- Guarantees shown include accrued interest and indexation at the end of each period. Guarantees in foreign currency are shown at exchange rate. Numbers for 2015 are preliminary.
- Numbers for the Housing Financing Fund are at nominal value and include accrued interest and indexation on securities issued, except for Housing Bonds, which are at market value. Included in the position of HFF-bonds are bonds reserved for security lending contracts with Primary Dealers.
- The Treasury redeemed the contingent liabilities of the Agricultural Lending Fund, Landsbanki hf and Glitnir hf as of the end of 2010, amounting to 22.53 b. ISK.
- The Treasury redeemed the contingent liabilities of Kaupthing bank hf as of the end of 2012, amounting to 1.5 b. ISK.
- The Statement of the Icelandic Government guaranteeing domestic deposits of Icelandic banks are not included here in government guarantees.

Historically, few guarantees have been redeemed by the Treasury. However, that changed in 2010, two years after the collapse of the banking system in Iceland. In 2010, the Treasury redeemed 23.53 billion ISK due to the government guarantees awarded to the Agricultural Lending Fund and two collapsed commercial banks, Landsbanki hf and Glitnir hf. Furthermore, at year-end 2012 it was necessary to redeem 1.5 billion ISK government guarantee awarded to the commercial bank Kaupthing hf., which also collapsed in 2008. All of these redeemed state guarantees followed the privatization of the banks in 1998-2002.

The collapse of the banking system in Iceland also had serious consequences for the Housing Financing Fund (HFF), the largest beneficiary of the government guarantees in Iceland. The HFF has, since year-end 2008 received over 50 billion ISK support from the Treasury. Its asset portfolio, which mainly consists of mortgage loans to individuals, has decreased in value at the same time its debt portfolio has increased. The HFF capital adequacy ratio (CAD) has decreased steadily since 2008 and in order to keep it above the required legal minimum, it was necessary for the Treasury to inject equity capital into the HFF.

In 1970 the Icelandic Export Credit Fund (IECF) was established by law. From the beginning its operations did not go well, and the Fund suffered severe losses on its export guarantees. In 2005 the government had plans to shut down its operations but was unsuccessful. In 2007 the operations of IECF was merged with NSA Ventures, which is a Venture Capital Association established by the Government to invests directly in Icelandic seed and start-up companies with high growth potential. NSA Ventures have been dissolving the operation of the IECF and the fund is presently almost nonexistent.

### **PPPs**

PPPs are rare in Iceland. Presently only one such project is ongoing, a road tunnel through the Vadlaheidi Mountain. The Vadlaheidi project is estimated to cost approximately 9 billion ISK. The Treasury is a 42.5% owner of a limited company that is building the tunnel.

The responsibility of the GDM/SGF regarding the PPPs is substantially the same as with any other government guarantee, provided that the PPP involves a guarantee on behalf of the Treasury. The SGF must provide an opinion on the PPP contract just like it was an ordinary government guarantee. Hence, the SGF is submitted to the same kind of assessment concerning the PPP contract, like e.g. regarding risk, profitability, creditworthiness, valuation etc. A PPP contract must be submitted to the Parliament for approval before it can be entered into by the MoFEA. The PPP contract is therefore the responsibility of the MoFEA, but is managed and monitored by the SGF.

### **Government Pension Fund**

According to a report made by the Financial Supervisory Authority in Iceland (FME), the total actuarial commitments by the Pension Fund for State Employees (PFSE) were negative by 517 billion ISK at year-end 2013.

The commitments realized from 1999 in the form of excess payments to the PFSE ceased in 2008 following the financial crises. The commitment since then have only been in the form of excess premium payments from government agencies which in some cases pay 11.5% premium of total salaries instead of the legal minimum which is 8%. On top of that the employee pays 4%.

The DMO has no responsibility and is not a supervisory authority in relation to the PFSE. This is due to historical and legal reasons. Article 32 of the Act on the Government Pension Fund no. 1/1997 clearly states that the Treasury guarantees payment of pension to retired government employees through the PFSE. Public officials have historically had better pension rights than employees on the open market, accumulating 76% of average wages over a period of 40 years compared to 56% for the open market. That among other things has led to a mismatch in assets and liabilities within the Fund. MoFEA has paid this debt on an irregular basis but if this was controlled by the GDM there would have to be a specific rule to follow.

In the end, the financial responsibility is with the MoFEA, but the Board of Directors governs the Fund and takes all major decisions concerning the policies and activities of the Fund. There are eight persons on the Board of Directors, four nominated by the MoFEA, two by the Federation of State and Municipal Employees, one by the Association of Academics and one by the Icelandic Teachers' Union.

The calculated amount of contingent liabilities are based on the actuarial calculations mandatory by law, which are to be handed to the FME and published annually in each and every pension fund's Consolidated Financial Statement

The FME, which is an independent agency under the MoFEA, is responsible for the accounting of contingent liabilities related to the Government Pension Fund.

## 4. MEXICO

### Introduction

In order to understand Mexico's debt management practices, including the issuance of guarantees and reporting of the contingent liabilities, it is necessary to layout some specific roles of different government offices. In contrast to other government structures, Mexico's Treasury and Debt Management Offices (DMO) work as separate units within the Ministry of Finance.

The Treasury focuses on following cash balances, tracking and forecasting inflows and outflows throughout the year to make sure enough resources are available. It should be noted that the Treasury does not manage short-term fluctuations through credit lines but rather keeps operational cash balances as needed.<sup>27</sup> The DMO, on the other hand, focuses solely on funding the Federal Government's deficit, managing the debt profile, handling debt payment instructions and following up with investors and markets. As long as there is a sufficient cash balance at the Treasury, the DMO works independently with the purpose of being a predictable and regular issuer that does not fluctuate according to short-term cash needs, providing confidence and liquidity to the markets.

While structurally separate, both units work in close coordination. A specific area of coordination is the authorization of new credit guarantees, which have to be approved by both the Treasurer and the Head of the DMO. The Head of the DMO is the public officer through which the executive branch of government can grant new guarantees.<sup>28</sup> Guarantees are limited to projects and specific circumstances that will generate enough future value to repay the obligation backed by the full faith of the Federal Government. The Treasurer of the Federation is the public officer responsible for assessing whether the obligation supported by the guarantee leads to the creation or acquisition of sources of value that will ultimately meet the obligation.<sup>29</sup> With this condition, the Government limits the use of guarantees to support activities with potential value and ensures that they cannot be used to work around the budget approved by Congress.

Historically, the Federal Government has had five main sources of explicit contingent liabilities.

- First, most National Development Banks (NDBs or Banks) have a clause in their legal framework which states that the Federal Government backs all their liabilities.<sup>30</sup>

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<sup>27</sup> While this practice entails a cost of carry, the Treasury avoids exposure to the counterparty risk of being able to draw credit lines previously agreed with banks, allowing the DMO to follow a predictable issuance calendar and to avoid speculation by market's assessment of Government's needs by observing the cash balance.

<sup>28</sup> Article 4 of the General Law of Public Debt – "It is the responsibility of the Ministry of Finance to manage public debt, including the issuance of guarantees..."

<sup>29</sup> Article 54 of the Treasury Law. – "The Treasurer of the Federation will intervene in the guarantee granting process to make sure there are enough counter-guarantees (collateral)..."

<sup>30</sup> It should be noted that the DMO prohibits any mention of a specific Federal Government guarantee in any operation carried out by National Development Banks, making sure all new contingent liabilities come directly from the Bank's legal framework.



- Second, the *Instituto para la Protección al Ahorro Bancario (IPAB or Instituto)*, which is the Mexican bank deposit insurance corporation manages the liabilities related to the Mexican bank failure of 1995 and has a payment guarantee from the Mexican Congress in case it does not have enough resources should another bank fail.<sup>31</sup>
- Third, a specific issuance was carried with the purpose of funding a road infrastructure restructure. The securities issued for this purpose are not part of the DMO's periodic calendars.
- Fourth, there are a series of relatively small trusts related to agriculture that have the full faith of the Federal Government when they borrow from the Central Bank and one minor credit line given to a national tourism trust. It should be noted that currently most of the funding of these trusts comes from credit lines with financial institutions, not leading to additional contingent liabilities for the Federal Government.
- Fifth, in addition to the above-mentioned sources of contingent liabilities, there is the legal provision that enables the Federal Government to issue new guarantees, as long as the Head of the Debt Management Office jointly approve them and the Treasurer of the Federation observing the process previously described, hence the importance of the dual structure. Such provision exists to face specific contingencies, thus it has seldom been used given the general perception of being a last resort mechanism in case no other solution is feasible, putting also in evidence the magnitude of the problem faced.

In terms of transparency, the DMO has the mandate to issue a quarterly report for Congress where it describes the general status of public debt. As part of such mandate, all explicit contingent liabilities backed by the Federal Government have to be duly described in a specific section. In terms of valuation, all contingent liabilities are reported at notional value rather than expected value, making sure that they are fully accounted for, kept free of valuation distortions and avoiding incentives linked to using guarantees to report lower obligations.

The aforementioned guarantee structure can be separated in two classifications.

- A stock of explicit contingent liabilities that cannot grow over time because the guarantees initially given correspond to the specific past events not expected to happen on a regular basis.
- A flow of new contingent liabilities related to the way IPAB's bank deposit insurance works, by rolling over its debt over time, and to the NDBs' daily operations.

In both cases, operations backed by the Federal Government are managed by the entities that secure the obligation. Nevertheless, guarantees have specific covenants of use and periodic reporting at the DMO.

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<sup>31</sup> There was a smaller component of IPAB liabilities that was directly backed by the Federal Government. The securities that had such guarantee have been either amortized or substituted for new securities backed by IPAB's Congress guarantee, finishing the process in 2010.

The following sections thoroughly describe the operations regarding the contingent liabilities with the final purpose of highlighting some practices followed by the Mexican Government that have yielded a healthy management of the guarantee granting process.

### **The NDBs and the credit guarantees**

The NDBs are part of the Mexican financial system, focusing on specific activities according to their mandates.<sup>32</sup> Each NDB has a law that rules such mandate and establishes the way the Federal Government guarantees the NDB's liabilities.<sup>33</sup> Hence, while this guarantee is not explicitly part of a bond's indenture or a clause in a credit contract, liabilities are acknowledged as possible obligations of the Federal Government through the NDB's law. As a result of the guarantee given through NDB's law, the institutions' funding process periodically generates additional contingent liabilities for the Federal Government. Another operational consequence of this structure is that instead of approving each funding operation on a case by case basis, the Federal Government authorizes every year the total amount of domestic market operations, requiring only the registry of the legal documentation at the DMO for the purposes of keeping an updated debt record.

In case of the operations with foreign market counterparties, the process requires additional steps because the Federal Government and the NDBs share the same foreign issuance ceiling established by Congress in each year's budget. In this case the general authorization process is complemented by an engagement notice, a specific transaction approval and the final registry at the DMO. The engagement notice obliges the Bank to notify the DMO before it starts any negotiation. This gives the DMO the opportunity to support the NDB throughout the operations, providing recommendations and benchmarking financial conditions to other transactions previously registered. This also allows the DMO to coordinate Government operations to secure favourable financial conditions by making sure issuers do not overlap on capital markets or excessively use the same credit source, providing additional advice in terms of market conditions and timing. Once final terms have been agreed, the NDB asks for explicit approval of the DMO in order to coordinate compliance with the Congressional ceiling and to give an additional opportunity to review the legal documentation, ensuring it follows all requirements. Finally, legal documentation is registered at the DMO in the same way as the domestic obligations.

Even though the aforementioned structure provides NDB with the full faith of the Federal Government, these institutions tend to fund themselves at slightly higher costs than the DMO. This is mainly attributable to NDBs being less regular issuers, providing less liquidity for their securities and capitalizing smaller economies of scale in their processes. While decentralized funding operations generates a cost for the overall Government that could be avoided if the Federal Government carried out all issuance through the DMO, the current structure has a key advantage in terms of contingent liability management. When NDBs own the funding process, including all negotiation and registration requirements, they become accountable for such decisions because they have to observe market discipline in order to receive the resources they need for their daily operations. Even though they

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<sup>32</sup> Even though the Federal Government guarantee given to NDBs may raise competition concerns with other financial institutions, it should be noted that due to the specificity of their mandates, these institutions focus on customers normally not engaged by private banks due to their risk profile. Many of the NDBs' products actually cover market gaps and inefficiencies, helping private banks participate in the market.

<sup>33</sup> In few cases, this support is limited to specific operations. For example, the NDB that focuses on agriculture benefits from the Federal Government guarantee only for liabilities with other NDBs, bilateral and multilateral financial foreign institutions.

know the Federal Government backs their issuance, they are responsible for looking for the best conditions, influencing also other actions when structuring products and granting loans. Ownership of the funding process also generates competition amongst the NDBs through transparency because their decisions will directly influence their balance sheets and the results they hand in each year, allowing general public to benchmark their funding operations given that all of them have the same guarantee.

Regarding the valuation of the stock of Federal Government guarantees given to the NDBs, the DMO follows a conservative approach by reporting them at face value regardless of specific credit conditions of each NDB. Hence, there is no incentive to tamper the valuation practices in an attempt to report lower liabilities, leaving aside also the incentive of looking for Federal Government funding through the NDBs. Valuation is only taken into account in one of the measures of public debt where Federal Government guarantees given to the NDBs are still presented at their face values, but the lending activity of the NDBs is netted out as valued on its balance sheet according to the internationally accepted accounting standards, acknowledging in this way the fact that the NDBs borrow to generate credit assets.

The DMO periodically reports three measures of debt (Figure 4.1):

- Federal Government Debt,
- Public Sector Debt
- Historical Balance of Public Sector Borrowing Requirements (HBPSBR).

The first definition includes all Ministries and organisms that are directly part of the executive branch of the Federal Government. The second definition includes, in addition to the Federal Government definition, all credit liabilities of State Productive Enterprises (National Oil Company PEMEX and the National Electricity Company CFE) and the NDBs. Even though State Productive Enterprises do not have the guarantee of the Federal Government, they are accounted for as part of the Public Sector debt through this definition. The HBPSBR adds to the Public Sector definition liabilities of specific projects not accounted before and the Federal Government guarantees previously mentioned like road infrastructure restructuring, Mexican deposit insurance corporation IPAB and different trusts. It is in this last definition where the previously described valuation is taken into account.

**Figure 4.1. Three measures of debt reported by the DMO**

FEDERAL GOVERNMENT DEBT	PUBLIC SECTOR DEBT	HBPSBR
All Federal Government obligations issued to fund the deficit.	Federal Government plus National Development Banks and State Productive Enterprises.	Broadest measure of debt including all public policy tools.
Includes: <ul style="list-style-type: none"> <li>• Bank Credit</li> <li>• Issuance of Government Securities</li> <li>• Debt with International Financial Organisms</li> <li>• Export Credit Loans</li> <li>• ISSSTE Bonds (implementation of the new ISSSTE Law), social security related accounts</li> <li>• Others</li> </ul>	Includes: <ul style="list-style-type: none"> <li>• Federal Government</li> <li>• State Productive Enterprises               <ul style="list-style-type: none"> <li>- PEMEX</li> <li>- CFE</li> </ul> </li> <li>• National Development Banks               <ul style="list-style-type: none"> <li>- NAFIN</li> <li>- BANCOMEXT</li> <li>- BANSEFI</li> <li>- BANOBRAS</li> <li>- SHF</li> <li>- FINANCIERA NACIONAL</li> </ul> </li> </ul>	Includes: <ul style="list-style-type: none"> <li>• Public Sector Debt</li> <li>• IPAB's financial requirements and other programs</li> <li>• Road restructuring issuance</li> <li>• Development Funds</li> </ul>

The Federal Government benefits from the profitable operation of the NDBs. In recent years, these banks have been profitable because of the prudential credit practices and the low funding costs yield by the Federal Government guarantee. The Federal Government has the possibility to appropriate some of the residual operational value to fund its budget. While this is not an explicit fee for the guarantee availability given that it is contingent to the NDB's being profitable during a specific period, it is a direct result of its use.

Given the conservative approach of tracking government debt measures using the face value of these obligations, no specific risk management treatment is given to the NDBs' credit guarantees or others, beyond the specific operational conditions of IPAB and NDB's. As a result, the estimation of risk exposure metrics related to debt is conservative; given that contingent liabilities are fully weighted rather than reduced by an assessment on the likelihood of the guarantees being executed. The DMO periodically carries out debt sustainability analysis taking into account aggregate debt levels and their corresponding costs to assess future debt trajectories. In addition, the DMO also uses Cost at Risk (CaR) analysis over all government debt to maintain low exposure to variability of interest rates. All these metrics are available in the Annual Borrowing Plan published by the DMO.<sup>34</sup>

### **Mexican Deposit Insurance Corporation (IPAB)**

After the bank failure of 1995, the Federal Government sponsored a bill to establish the necessary mechanisms and institutions to make sure that such disruptions can be addressed in an orderly manner without destabilizing the financial system. As a result, the Congress enacted the Deposit Protection Law, which established the *Instituto para la Protección al Ahorro Bancario (IPAB or Institute)* as the official bank deposit insurance corporation. The Institute received a unique guarantee which states that

<sup>34</sup>[http://www.hacienda.gob.mx/English/public\\_credit\\_new/public\\_debt\\_policy/Documents/ANNUAL%20BORROWING%20PLAN/abp2014.pdf](http://www.hacienda.gob.mx/English/public_credit_new/public_debt_policy/Documents/ANNUAL%20BORROWING%20PLAN/abp2014.pdf)

if it cannot meet its obligations the Congress will undertake the necessary measures to fulfil any payment. Later on, the IPAB used this guarantee to carry out a different substitution program that replaced notes initially issued during the crisis with payable notes from the Institute, replacing in this way the direct guarantees given by the Federal Government with the guarantee from the Congress established in IPAB's law.

According to its law, the IPAB is a decentralized and independent government organism responsible for operating the deposit insurance system and managing liabilities that derived from the banking component of the financial crisis.<sup>35</sup> The management of such liabilities is carried out by issuing new securities to rollover payments due, while paying the real increase in value of such liabilities with budgetary resources and the fees from the insurance program operation. As a result, these liabilities have been reduced from 11.6% of GDP in 1999 to 4.96% in 2014 and are expected to reach 4% of GDP in 2020. Consequently, the stock of contingent liabilities is going to continue diminishing over time, leaving the government only with the potential obligation of a bank failure for an amount capped to 400,000 UDIS<sup>36</sup> per account, as long as the IPAB resources and issuance are not enough to cover the event.<sup>37</sup>

Even though the IPAB is an independent government entity, it works in close coordination with the DMO on different matters. First, there is the continuous communication amongst the offices to assess the investors' appetite for debt instruments with the purpose of maintaining liquid and well-functioning markets. Second, financial information is jointly disclosed through quarterly reports presented to the Congress. Third, the DMO and the IPAB also carry out joint conference calls with investors to present the issuance calendar for next quarter and provide guidance on any changes.

Like all government issuers in the domestic market, the IPAB has the obligation to register their issuance operations at the DMO for the purposes of record keeping. Its obligations derived from the bank failure of 1995 are acknowledged at face value as part of the definition of Historical Balance of Public Sector Borrowing Requirements. In the same way as the NDB credit guarantees, the IPAB total debt stock is taken into account by the DMOs sustainability analysis and risk management practices.

### **Other Federal Government credit guarantees**

Most credit guarantees explicitly granted by the Federal Government respond to specific events where intervention was deemed necessary in the past. As previously described, there are few cases when the DMO's and the Treasury's joint attribution has been used, with the conditions that led to the creation of the IPAB being one of them. The other cases where explicit credit guarantees have been granted are;

- the issuance of different instruments to fund the road infrastructure restructure process carried out in 1997,

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<sup>35</sup> Intervention from the DMO in regular operations is deemed unnecessary given the specificity of IPAB's mandate and expertise on the matter.

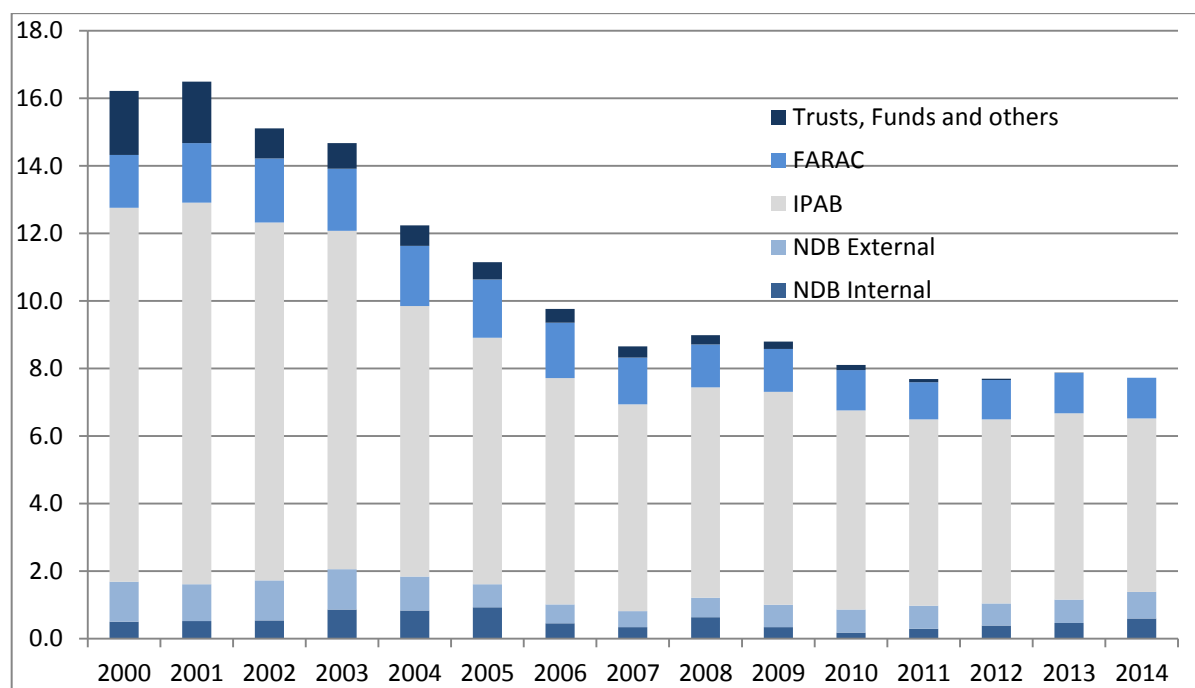
<sup>36</sup> UDIS are used as a unit to index the value of the Mexican peso to inflation. Their value is published daily by the Central Bank and at the time of this report yields a deposit account cap of approximately 2 million pesos.

<sup>37</sup> It should be noted that the system has recently faced the bank failure of a small size institution without generating volatility on markets or requiring a mechanism not foreseen in IPAB's mandate.

- the establishment of relatively small trusts related to agriculture (only when they borrow from the Central Bank),
- and one minor credit line given to a tourism trust.

Currently the balances of the agriculture and tourism trusts are zero regarding instruments with the Federal Government guarantee. As a result, the overall guaranteed credit liabilities of the Mexican Federal Government represent 7.25% of GDP.

**Figure 4.2. Stock of guarantees as percentage of GDP**



The infrastructure restructuring issuance is currently part of the liabilities of the National Infrastructure Fund, where the DMO and the Ministry of Finance have control through the different committees. As a result, this is the only credit guarantee under the DMO's direct operation spectrum. The obligations related to this issuance were treated the same way as other credit guarantees for registry purposes in the Historical Balance of Public Sector Borrowing Requirements classification at the DMO. It should be noted that the restructure carried out by the use of this guarantee has also been profitable for the Federal Government, providing resources to fund additional infrastructure projects.

## **Key practices of the Mexican contingent liability framework**

The first and most important practice in the legal framework is transparency of the process of issuing new guarantees and the periodic disclosure to the Congress and investors that such approval requires. As a result, every time a new guarantee is approved it becomes subject to public scrutiny, starting a general inquiry over the underlying reasons of its use and the characteristics of the problem being addressed. Transparency has been an effective control mechanism throughout different administrations, deeming the Federal Government guarantees as a last resort tool when all other options have been depleted. Such transparency is based on the DMO's obligation to report guarantees on a quarterly report to Congress in a specific section, making sure their use stands out and is not mixed with regular issuance. In addition, having a dual structure where no sole officer can issue new guarantees works as an additional hurdle to think of them as an alternative.

The next key practice is the legal restriction over the use of the Federal Government's guarantee. By limiting the use of this instrument to obligations that generate some asset or that back an existing asset that is currently undervalued, as in the case of the road infrastructure restructure, the Federal Government ensures that guarantees have a high possibility of not being called, leading also to an enhancement of financial resources available.

Another key practice followed within the Mexican system is the use of the face value rule for guarantee records. The conservative nature of this approach has embedded costs related to not fully leveraging the potential of using credit guarantees for specific public policy objectives; nevertheless, this also eliminates the inadequate incentive of underestimating their impact on debt levels. The approach avoids valuation distortions and registry malpractices that could obscure general debt measures leading to understating the real financial burden of the Federal Government. The conservative valuation approach combined with the centralized registry kept at the DMO represent a key component of the daily operation of the whole system.

In the specific case of the NDBs, another successful practice for contingent liability management has been to make these institutions fully responsible and accountable for the funding process. As described before, decentralized guarantee management leads to additional costs for these institutions in terms of funding their operations and accessing capital markets; nonetheless, the market discipline that such practice yields is believed to outweigh the cost of funding. In addition, the almost homogeneous guarantee given to the NDBs creates a benchmark that provides further transparency to assess whether Banks fund themselves in the best possible conditions.

Regarding the IPAB, the management strategy for obligations generated by the previous bank failure is considered a healthy practice. By paying every year the real component of its debt stock, the impact of the guarantee initially given is smoothed throughout different budgets, allowing for an easier adjustment in public finances.

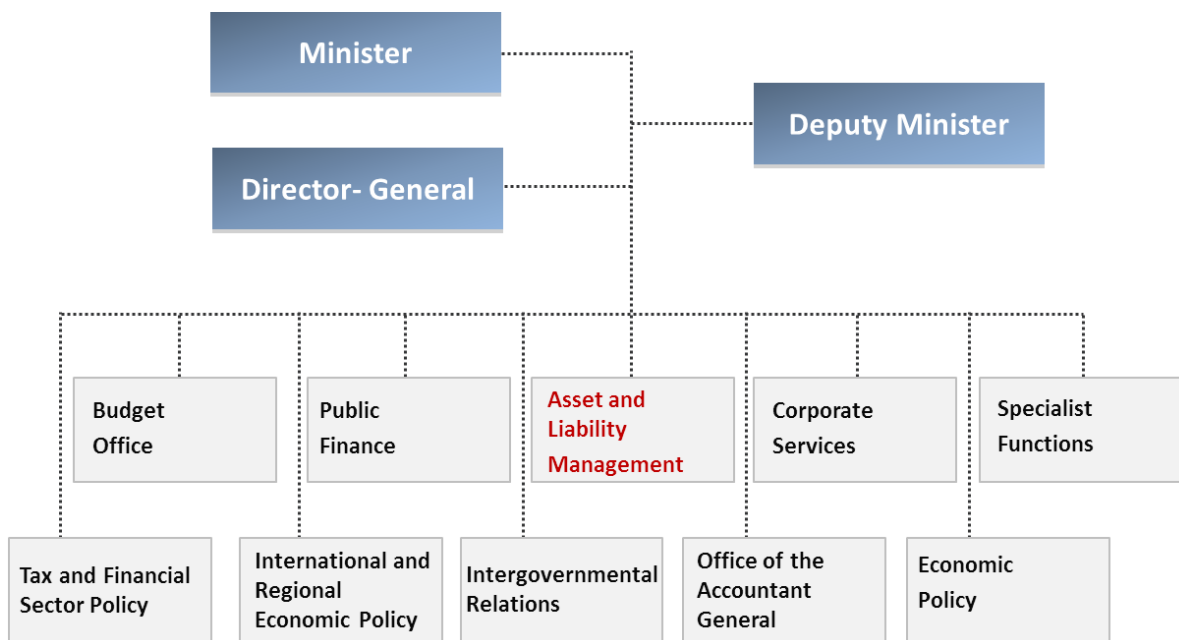
Most of Mexico's contingent liability management practices are the result of the historical process through which Mexico developed its financial system and established different institutions to access capital markets. These are highly dependent on the general government structure and the public's perception of specific actions. Thus, the recommendations hereby described are not presented as a "one type fits all" practice, but rather as a particular case that has been successful.

## 5. SOUTH AFRICA

### Introduction

South Africa’s contingent liabilities are both explicit and implicit and stem mainly from the issuance of government guarantees, obligations from the PPP contracts and state insurance schemes. The management of these contingent liabilities lies with the ALM Division within the National Treasury, which falls under the Ministry of Finance. Specifically, the Strategy and Risk Management section within the ALM Division is mandated to manage these exposures. Figure 5.1 below, illustrates the organisational structure of the National Treasury.

**Figure 5.1. National Treasury organisational structure**

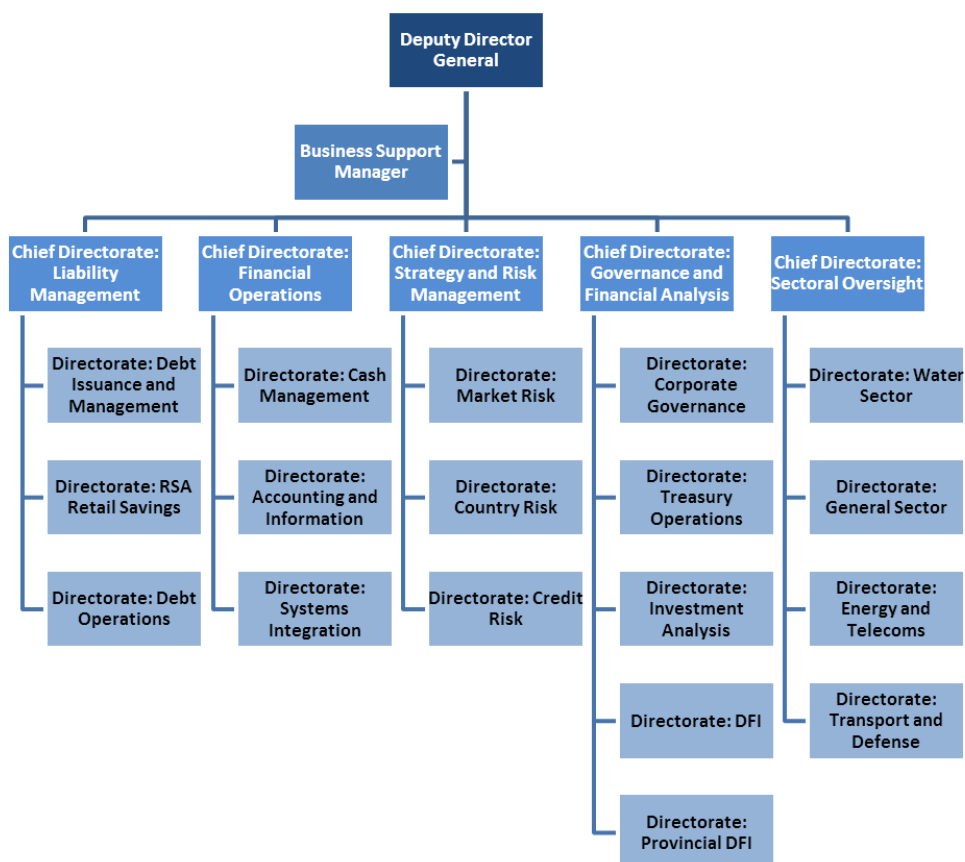


Source: National Treasury

Figure 5.2 depicts the organisational setup of the ALM Division, which performs the functions of the DMO as South Africa does not have a separate DMO. The ALM Division is responsible for determining the amount of government’s contingent liability exposure. The activities involve identification and evaluation of risks related to the portfolio as well as recommendation on mitigation strategies. Part of the activities involve the evaluation of requests for guarantees, the continuous monitoring of exposure as well as making recommendations to the Fiscal Liabilities Committee (FLC) and the Minister of Finance on whether to approve or to concur with the issuance of guarantees.



Figure 5.2. Organisational structure of the ALM division



Source: National Treasury

Government’s explicit contingent liabilities emanate from the issuance of credit guarantees to public entities. These guarantees are mainly issued with the aim of providing government support to public entities as they pursue their mandated objectives. The liability would therefore arise in the case where a public entity would be unable to service their guaranteed debt as government would have to take over the servicing of said debt.

Contingent liabilities from PPPs stem from government guaranteed debt in terms of the PPP agreement along with any expected costs for government in the event of termination of the contract. In addition, the PPP contract may stipulate a minimum revenue that have to be generated by the project, failing which, the government would provide a guaranteed top up to bring the revenue to the stipulated minimum level.

Other contingent liabilities emanate from the public or market expectation that government would support failed institutions that are deemed to be of national interest. These may include a default of a sub-sovereign, public or private entity on non-guaranteed debt and other liabilities, bank failure, investment failure of a government related pension fund, employment fund, or social security fund, central bank default on its obligations (foreign exchange contracts, currency defence, balance of payments stability) as well as residual environmental damage, disaster relief, military financing, etc.

Contingent liabilities on state insurance schemes are based on actuarial differences of the different companies, which include;

- Road Accident Fund (RAF)
- South Africa's Special Risk Insurance Association (SASRIA)
- Unemployment Insurance Fund (UIF)
- Compensation Fund (CF)
- Export Credit Insurance Corporation of South Africa SOC Limited (ECIC)

The global financial crisis has had a significant effect on the local economy and on government's fiscal position and it has also had a significant adverse impact on the quality (deterioration) and size (increase) of the contingent liability portfolio. This has necessitated that the monitoring and reporting on the portfolio be intensified while the focus on PPPs has also increased.

The Directorate Credit Risk within the Asset and Liability Management division of the National Treasury manages government's contingent liability exposure. The directorate performs the credit risk analysis on all exposure to determine and to report on the quality and volume of that exposure. The directorate coordinates its activities with the Governance and Financial Analysis as well as the Sectoral Oversight Chief Directorates who are responsible for the financial oversight of public entities.

## **Government credit guarantees**

### ***Legal Framework***

The management of the South African government's contingent liabilities is in accordance with the Public Finance Management Act, Act No 1 of 1999 (PFMA). Chapter 8 of the PFMA deals with loans, guarantees and other commitments.

Section 66 of the PFMA prescribes:

- The powers of Government and the Public Entities to borrow money, issue guarantees, indemnities and/or securities that may bind the National Revenue Fund.
- Restrictions on borrowing, guarantees and other commitments.
- That guarantees may be issued with the concurrence of the Minister of Finance subject to any conditions that the Minister may impose.

Section 70 of the PFMA stipulates:

- A Cabinet member, with the written concurrence of the Minister of Finance (subject to any conditions approved by the Minister of Finance), may issue a guarantee, indemnity or security which binds- (a) the National Revenue Fund, or (b) a National public entity.
- Any payment under a guarantee, indemnity or security issued in terms of subsection 1 (a) is a direct charge against the National Revenue Fund and in terms of subsection (b) is a direct charge against the national public entity concerned.

- A Cabinet member who seeks the Minister of Finance’s concurrence for the issuing of a guarantee, indemnity or security in terms of subsection (1)(a) or (b) must provide the Minister of Finance with all the relevant information as the Minister of Finance may require regarding the issue of such guarantee, indemnity or security and the relevant financial commitment.
- The responsible Cabinet member must at least annually report the circumstances relating to any payments under a guarantee, indemnity or security issued in terms of subsection (1)(a) or (b), to the National Assembly for tabling in the National Assembly.

### ***Policy Framework***

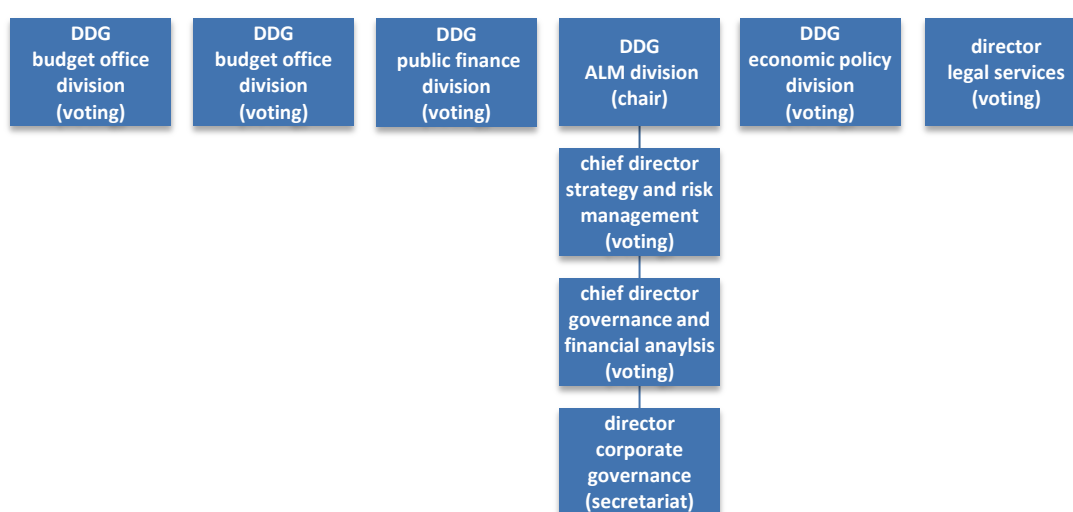
Guidelines for the issuance of government guarantees are based on the following principles:

- Government will strive to limit the issuance of guarantees to reduce its gross contingent liability obligations;
- Public entities should borrow on the strength of their balance sheets;
- In exceptional cases, guarantees may be used to support restructuring objectives;
- Guarantees will be granted to meet international agreement obligations (e.g. Lesotho Highlands Water Project);
- Guarantees may be issued if a public entity is in financial difficulties;
- Guarantees may be issued to support government’s infrastructure development program;
- Guarantees may be issued to public entities that do not operate in profit making principles in order to reduce borrowing costs; and
- Guarantee fees will be levied to equalise benefits on borrowing cost margins of public entities borrowing with a guarantee and those borrowing without guarantees.
- The South African government’s policy on guarantees is that:
  - The National Treasury will operate within an appropriate credit risk environment;
  - Credit risk inherent in all new activities must be subject to adequate controls (procedures);
  - The National Treasury must operate under a sound credit granting process;
  - An appropriate credit administration, measurement and monitoring process must be maintained;
  - The National Treasury established an independent Fiscal Liabilities Committee (FLC).

### Box 5.1. Fiscal Liabilities Committee (FLC)

The National Treasury established the FLC with the primary mandate of making recommendations to the Minister of Finance whether to approve/concur with the issuance of guarantees or not. The FLC membership, as illustrated in Figure 5.3 consists of the heads of the Economic Policy, Public Finance, Intergovernmental Relations and the ALM division (chairperson) as well as a representative of the legal division. The Director Corporate Governance in the ALM division serves as the secretariat. The Chief Directors of the Strategy and Risk Management, Sectoral Oversight and Governance and Financial Analysis units are additional members of the committee.

#### Structure of the FLC



The FLC is responsible for the optimum management of contingent liabilities and its main terms of reference include:

- Risk assessment of the counterparties' credit quality and to advise the Minister of Finance accordingly;
- Monitor concentration in contingent liability portfolio;
- Adopt a limit for total liabilities (debt plus contingent liabilities), set conditions and monitor adherence;
- Monitor performance against the benchmark of total net debt, provisions and contingent liabilities as a percentage of GDP;
- Advise the Minister of Finance on approaches/policies and provide oversight on the implementation of the contingent liability policy of the National Treasury;
- Consider applications and make appropriate recommendations;
- Determine appropriate fees and rules for non-payment;
- Monitor utilization of guarantees and adherence to conditions;
- Monitor and report claims against the state due to the non-payment by counterparties and to adopt rules to deal with non-payment; and
- Consider the introduction of a funded contingency reserve account.

FLC meetings are convened quarterly with special meetings convened when required. Each

meeting considers requests and considers the status of the portfolio as well as adherence to any conditions the Minister might have stipulated. The ALM division performs the evaluation, review and monitoring activities with recommendations submitted to the FLC.

### ***Issuance Process***

The secretariat of the FLC provides the Heads of different departments of the relevant FLC dates and the dates for submission of requests as well as the type of information that needs to be included in the requests. This is to facilitate timely submission, as the PFMA stipulates that the guarantee is issued by the responsible Minister (Executive Authority). The following steps as illustrated in Figure 5.3 would therefore be followed:

**Step 1:** The public entity will submit a request for a guarantee, indemnity or security to its executive authority/the responsible Minister. The responsible Minister would, upon his approval forward the request to the Minister of Finance to concur with the issuance of the guarantee, indemnity or security. The request must cover the following issues:

- Business profile of the applicant;
- Proposal;
- Rational;
- Financial analysis;
- Impact of activity to be supported by guarantee, indemnity or security on the public entity;
- Industry/Sector Analysis;
- Broader government imperatives such as economic development, employment and economic growth; and
- Legal implications, if any.

**Step 2:** The ALM Division will assess the application. This assessment will include an overall evaluation of the merits of the request. In addition, a credit risk analysis on the public entity would be conducted along with an analysis of the portfolio and the impact of the request on that portfolio. A submission with a recommendation from the ALM Division would then be prepared and submitted to the FLC together with any supporting documentation. A FLC meeting would be convened (one of four scheduled quarterly meetings), whereby the request would be presented and if required, the public entity would be afforded the opportunity to present and motivate in support of the request.

**Step 3:** The FLC would evaluate and deliberate all requests. The status of the portfolio would also be presented detailing the level and the quality of the exposure. After deliberations, the FLC would then make a decision on whether to support or reject the application. A memorandum is then prepared and sent to the Minister of Finance with a recommendation of whether to concur with the issuance or not.

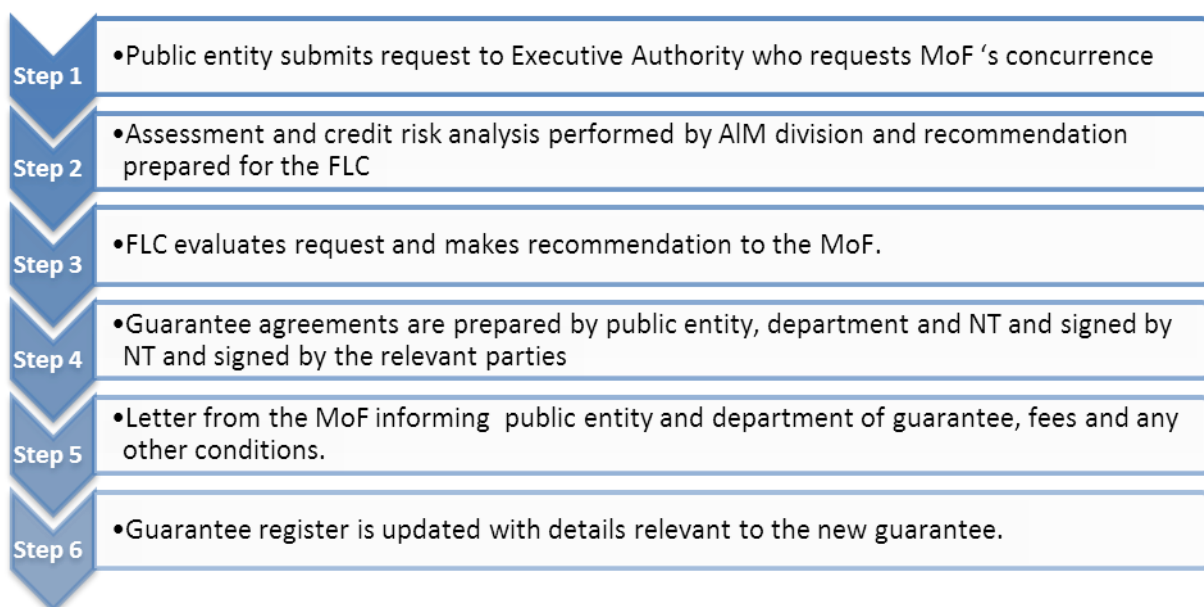
**Step 4:** If the FLC supports the issuance of the guarantee, the public entity and the relevant department in consultation with the National Treasury would prepare legal documentation (guarantee agreement). Once these documents are finalised, they will be forwarded to the Executive Authority for approval and signature. After the executive Authority’s approval, the documentation would be forwarded to the Minister of Finance for his concurrence to the issuance of the guarantee, indemnity or security.

**Step 5:** After concurrence by the Minister of Finance, a letter is sent to the public entity, indicating the conditions attached to the guarantee, indemnity or security, the applicable once-off administrative fee as well as the annual guarantee fees.

**Step 6:** In the case of a guarantee, the guarantee is recorded in the guarantee register detailing the following information:

- The guarantee amount;
- The issue and maturity;
- Currency denomination;
- Guarantee conditions;
- Guarantee fee payable; and
- Administrative fee

**Figure 5.3. Guarantee issuance process**



Source: National Treasury

There is currently no limits specific to guarantees in terms of total guarantees that can be issued, however a prudential sustainable debt level benchmark of net debt, provision plus contingent liabilities is used. The current limit for this benchmark is 60% of GDP. Most SOCs operate as near monopolies and as such, the issuance of guarantees does not have material impact on competition. There is currently no on-lending and as such no specific strategy with regard to using this instrument.

The levying of fees is also meant to equalise the benefits on borrowing costs margins of SOCs borrowing without guarantees. Currently, an administration fee of R75,000.00 for each year (5 years or less) of the term of the exposure is payable in full upon the issuance of the guarantee, while R50,000.00 is payable on long-term exposures. In addition, a guarantee fee of 30 basis points on the nominal amount of the guarantee is levied per annum. The guarantee fee policy is currently under review.

### ***Risk management and risk sharing***

The expected cost of guarantees is based on the amount of guarantees that have been used by the public entity. On occasion, this amount tends to be less than the amount of guarantee that is issued. What is included in the expected cost is the amount utilised and this amount is reported to the responsible department quarterly by the specific public entity. The department collates the amounts from the public entities and these numbers are audited before being submitted to the National Treasury.

The information with regard to contingent liabilities is published annually in the budget review. Once the data on utilised guarantees (exposure amounts) is collated, they are submitted to the Credit Risk Directorate within the Asset and Liability Management Division of the National Treasury. A risk-based methodology is applied to assess the guarantee portfolio on an annual basis and highlight any possible and future challenges that pose risks to the quality of the overall guarantee portfolio. The analysis aims to yield recommendations to the FLC on a quarterly basis on the state of the contingent liabilities and alert the forum on any improvement or deterioration on the overall guarantee portfolio.

The portfolio is monitored for concentration and this is taken into account when requests for guarantees are evaluated. In addition, sustainability measure of net debt, provisions and contingent liabilities as a percentage of GDP against a self-imposed limit of 50% (benchmark is 60%) is also monitored. The Southern African Development Community (SADC) agreed prudential limit is currently 60% of GDP.

The National Treasury monitors the credit spreads of the guaranteed public entities and report on a weekly basis outlining the rate at which it will cost the public entities to raise debt on their respective bonds in the capital markets. The credit ratings assigned to the respective public entities are also monitored on a frequent basis and an analysis is conducted on the risks that are likely to impact on their future borrowings and advice on corrective actions that these public entities need to implement in their operations. Finally, the public entity's debt composition is monitored and analysed and reports prepared on whether it has deteriorated or improved.

On an annual basis, the individual public entities with guarantees are analysed to determine their ability to service guaranteed debt using an internally developed methodology. The methodology follows a sequence determined in terms of the Credit Risk policy and stipulates the business risk and financial risk indicators of public entities to be used when performing an analysis. The business risk indicators focus on the qualitative information of public entities. The financial risk indicators focus on information from the Annual Financial Statements of public entities and stipulate the financial ratios to be used to measure the entities' ability to service guaranteed debt.

Guidelines for assigning risk ratings to each of the individual risk indicators are provided and seek to ensure that the risk ratings are assigned in relation to government’s exposure to each public entity. The guidelines, depending on specific indicators have been developed having taken into account a combination of the industry norms, rating agencies benchmarks and peer analysis. However, these guidelines are not considered in isolation from a public entity’s own target for a specific period as stipulated in their corporate plan. Risk ratings are applied to the different indicators for each public entity. The ratings are aggregated to determine a risk rating for each of the public entities and thereafter the ratings of the different public entities are consolidated to determine a consolidated rating for the portfolio.

Currently the ALM Division is in the process of reviewing its methodologies and to standardise them per sector in order to cater for the sector specific indicators and industry specific benchmarks. This is done with the view of ensuring that the methodology does not disadvantage some of the public entities whose nature of business is different from the rest of the public entities within the portfolio. The ALM Division also hopes to develop the methodology further in order to use it to determine default probabilities and expected loss while also using the final rating to determine guarantee fees and on-lending rates.

Table 5.1 highlights the business (qualitative) and financial (quantitative) risk indicators used to analyse and rate the public entities and the portfolio.

**Table 5.1. Financial and business risk indicators**

<b>Business Risks</b>	<b>Financial Risks</b>
<b>Industry Prospects</b>	<b>Profitability</b>
<ul style="list-style-type: none"> <li>▪ Operating Environment</li> <li>▪ Regulatory Framework</li> </ul>	<ul style="list-style-type: none"> <li>▪ Cost to income ratio (DFIs)</li> <li>▪ Net profit margin</li> <li>▪ EBITDA margin</li> </ul>
<b>Corporate Governance</b>	<b>Capital structure</b>
<ul style="list-style-type: none"> <li>▪ Adherence to PFMA</li> <li>▪ Management Quality</li> </ul>	<ul style="list-style-type: none"> <li>▪ Debt to assets</li> <li>▪ Debt to equity</li> </ul>
<b>Market Position</b>	<b>Cash flow adequacy</b>
<ul style="list-style-type: none"> <li>▪ Diversification</li> <li>▪ Size</li> </ul>	<ul style="list-style-type: none"> <li>▪ Funds from operations/Debt</li> <li>▪ Interest cover</li> </ul>
	<b>Liquidity ratios</b>
	<ul style="list-style-type: none"> <li>▪ Cash ratio</li> <li>▪ Quick ratio</li> <li>▪ Current ratio</li> </ul>

Source: National Treasury

Table 5.2 shows the guidelines for the scoring of the financial risk indicators, which seek to reduce subjectivity when rating the different SOCs.



**Table 5.2. Guidelines for scoring financial risk indicators**

Risk Ratings		1	2	3	4	5	6	7	8	9	10
Scale	Financial Risk Classifications	Extremely Low	Very Low	Low	Moderate Low	Moderate	Moderate	Moderate High	High	Very High	Extremely High
	Risk Descriptions	Excellent	Strong	Good	Fair	Acceptable	Marginal	Special Attention	Substandard	Doubtful	Known Loss
1-10	Net Profit Margin	>30	28-30	25-27	22-24	19-21	16-18	13-15	10-12	6-9	<6
1-10	Operating profit margin	>50	46-50	41-45	36-40	31-35	26-30	21-25	16-20	11-15	<10
1-10	Cost-to-income	<10	10-19	20-29	30-39	40-49	50-59	60-69	70-79	80-89	>90
1-10	EBITDA Margin	>50	45-50	40-44	35-39	30-34	25-29	20-24	15-19	10-14	<10
<b>Capital Structure</b>											
1-10	Debt ratio (Debt/Assets)	<10	10-19	20-29	30-39	40-49	50-59	60-69	70-79	80-89	>90
1-10	Gearing ratio (Debt/Equity)	<0.50	0.51-0.6	0.61-0.7	0.71-0.8	0.81-0.9	0.91-1	1.1-1.2	1.21-1.3	1.31-1.4	>1.4
<b>Cash Flow Adequacy</b>											
1-10	Funds from operations/Total debt	>50	45-50	40-44	35-39	30-34	25-29	20-24	15-19	10-14	<10
1-10	Interest Cover	>2	1.8-1.9	1.7-1.79	1.6-1.69	1.5-1.59	1.4-1.49	1.3-1.39	1.2-1.29	1.1-1.19	<1
<b>Liquidity</b>											
1-10	Cash ratio	>0.65	0.61-0.65	0.56-0.60	0.51-0.55	0.41-0.5	0.36-0.40	0.31-0.35	0.26-0.3	0.21-0.25	<0.21
1-10	Quick ratio	>1.8	1.61-1.8	1.41-1.6	1.21-1.4	1.01-1.2	0.81-1	0.61-0.8	0.41-0.6	0.21-0.4	<0.20
1-10	Current Ratio	>3	2.8-3	2.4-2.7	2.1-2.3	1.8-2	1.5-1.7	1.2-1.4	0.9-1.1	0.5-0.8	<0.5
1-10	Credit Rating	AAA	AA	A	BBB	BB	B	CCC	CC	C	D

Source: National Treasury

Table 5.3 below illustrates how the risk rating methodology is applied to determine a rating for a specific SOC. Table 5.4, on the other hand, illustrates the consolidated rating for the portfolio and also indicates the portfolio concentration for reporting purposes.

**Table 5.3. Application of the risk rating methodology**

Criteria	Weight	Weight with credit	Weight without credit	Entity (2009/10) rating	R X W	Entity (2008/9) rating	R X W	Priority Methodology		
								Strategic Importance	Risk Priority	Ease of Measurement
<b>Business Risk Profile</b>										
<b>Industry prospects</b>										
i) Operating Environment	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
ii) Regulatory Framework	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Corporate governance</b>										
i) Adherence to the PFMA	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
ii) Management quality	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Market Position indicators</b>										
i) Diversification (in core business)	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
ii) Size (relative to the market)	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Financial Risk Profile</b>										
<b>Efficiency ratio</b>										
Cost to income	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Profitability indicators</b>										
Net profit margin	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
Operating income as % of business (s:	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
EBITDA/Sales	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Capital structure indicators</b>										
Debt ratio (Debt/Assets)	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
Debt to equity (gearing)	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Cash flow adequacy indicators</b>										
Funds from operations/total debt	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
debt service coverage ratio (interest cc	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Liquidity Indicators</b>										
Cash/Current liabilities	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
Quick ratio	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
Current ratio	0.001	0.055556	0.05882353	0	0	0	0	0	0	0
<b>Credit rating</b>										
	0.001	0.055556		0	0	0	0	0	0	0
total with credit rating	0.018									
total without credit rating	0.017									
<b>weighted risk rating</b>					<b>0</b>					<b>0</b>
<b>Exposure (2009/10 figures) in millions</b>					<b>0</b>					<b>0</b>
<b>proportional exposure</b>					0					0
Weighted risk rating in proportion to exposure					0					0

Source: National Treasury

Weights are assigned on a scale of 1 to 5 depending significance of the specific indicator and its relevance and ability to measure the SOC's ability to service guaranteed debt. The weights are based on the strategic importance, the risk priority and the ease of measurement. The strategic importance is crucial in making prompt decision for the operations of the company. This is mainly because most of the decisions taken within a company require management interventions and therefore it is also crucial in weighting the decisions taken by management. The risk priority gives weights to the indicators mentioned in terms of how well a certain indicator is considered relevant from a number of available indicators in terms of providing information about a company's ability to service guaranteed debt.

Table 5.4. Consolidated portfolio rating

Application of Risk Rating Methodology for SOE		2011/12		2012/13	
Criteria	TOTAL	Ranking Drivers	TOTAL	Ranking Drivers	
<b>Qualitative Analysis</b>					
Industry prospects	1,927	3	1,942	3	
Regulatory framework	2,801	5	2,725	5	
<b>Corporate governance</b>					
i) Adherence to the PFMA	3,774	7	3,693	8	
ii) Management quality	2,685	4	2,678	4	
<b>Market Position</b>					
i) Diversification (in core business)	1,641	2	1,414	2	
ii) Size (relative to the market)	1,450	1	1,290	1	
<b>Financial Risk Profile</b>					
Profitability ratio (profit margin)	4,352	11	4,811	11	
Operating income as % of business (sales)	4,706	10	4,875	12	
Cost to income	4,547	12	4,180	10	
EBITDA	3,406	6	3,379	6	
<b>Capital structure</b>					
Debt ratio	5,093	14	5,429	14	
Debt to equity (gearing)	5,696	16	6,707	16	
<b>Cash flow adequacy ratios</b>					
Funds from operations/total debt	6,737	17	7,159	17	
Debt service coverage ratio (interest cover)	4,913	13	5,400	13	
<b>Liquidity Indicators</b>					
Cash ratio	5,368	9	4,173	9	
Quick ratio	3,833	8	3,574	7	
Current ratio	5,362	15	5,524	15	
<b>Credit rating</b>					
Total with credit rating					
Total without credit rating					
Weighted risk rating	<b>69,327</b>		<b>70,326</b>		
% in proportion to whole portfolio (ideal)					
<b>Exposure (2012/13 figures) in millions (Actual)</b>	<b>153706</b>		<b>180239</b>		
<b>Ideal exposure in proportion to risk</b>					
<b>Weighted exposure</b>					
<b>Weighted risk rating in proportion to exposure</b>	<b>6,1</b>		<b>7,1</b>		

Source: National Treasury-ALM

The ALM Division monitors SOCs on a continuous basis to ensure that SOCs are able to continuously service, not only their guaranteed debt, but also their entire debt portfolios. The monitoring aims to determine mitigation strategies well in advance to ensure that all guaranteed debt is repaid as scheduled. As such, there is no specific procedure for the non-payment of guaranteed debt. There has to date, not been any direct effect on the central government debt as well as any direct government payments related to credit guarantees.

South Africa does not currently have a contingency reserve account, although one of the mandates of the FLC is to consider the introduction of a funded contingency reserve account. Reports are prepared quarterly for the FLC while an annual report is also prepared for the Minister of Finance and Cabinet. Additionally, the level of outstanding contingent liabilities is published in the budget review as well as in the consolidated annual financial statements of government.

As at 31 March 2014, the total issued guarantees to SOCs amounted to R470.7 billion while the exposure amount was R209.1 billion. This comprises 13 and 6.1 as a percentage of GDP respectively.

### **PPP commitments**

Treasury Regulation 16, which is issued in terms of the PFMA, stipulates the rights, roles and responsibilities with regard to PPPs. The Preferential Procurement Policy Framework Act stipulates roles and responsibilities with regard to procurement within government and includes the issuance of PPP commitments.

#### ***Types of PPP agreements/ Commitments***

- In the health sector, PPP commitments are only in unitary fees and compensation due to termination;
- Road infrastructure compensation due to termination;
- Rapid rail transport PPP commitment is in the form of Patronage Guarantee Costs and compensation due to termination;
- Fleet management commitment is in the form of service fee payment and they only have a first right of refusal to purchase vehicles in case of termination;
- Office accommodation commitments are in the form of unitary fees and payment due to termination;
- Correctional services commitments are in the form unitary fees and compensation due to termination; and
- Nature conservation commitments are only for compensation due to termination.

#### ***PPP Agreement Termination***

Within the PPP environment, projects can be terminated due to private party default, force majeure and termination due to government default. All termination requires the state to compensate the Private Party.

#### *Termination for institution default*

The PPP agreement should clearly stipulate the events that would constitute an Institution Default and which entitle the Private Party to compensation. The Institution Default should be limited to those breaches by the Institution which will render the contractual relationship between the Parties untenable or completely frustrate the Private Party.

The events that may lead to termination due to Institution Default may include but are not limited to:

- Non or late payment;
- Incorrect penalty application; and
- Utilising different service provider to provide services contracted to the Private Party without proper agreement

#### *Termination for Private Party default*

The PPP agreement must deal comprehensively with the possibility of early termination owing to Private Party Default. The agreement should specify the events of Private Party Default that may lead to termination. As far as practical, the objectives must be clear and provide for reasonable tolerance.

The events that may lead to the Private Party Default include but are not limited to:

- Poor performance; and
- Bankruptcy

#### *Termination for force majeure*

To the extent that an event of Force Majeure has occurred and the Parties have been unable to agree upon a mutually acceptable solution for dealing with the consequences of the event of Force Majeure, either Party should be entitled to terminate the PPP Agreement. The event of Force Majeure will by this time have subsisted for a substantial period during which all or at least a material portion of the Project Deliverables would not have been performed. The Private Party should be compensated on termination for Force Majeure.

#### *Termination for corrupt act*

The PPP Agreement must deal comprehensively with the consequences of Corrupt Acts. It must make provision for the Institution to terminate the PPP Agreement for Corrupt Acts in certain circumstances.

The magnitude of compensation is guided by the party that has defaulted and the formula related to that. The calculation of the expected costs (contingent liability) is based on the government guaranteed debt and the maximum estimate government costs on termination as stipulated in the PPP agreement.

Typical calculation includes:

- Outstanding senior debts or percentage of debt to be paid;
- Shareholder loans;
- Equity loans;
- Breakage costs (miscellaneous costs); and
- Percentage of profit if applicable

### ***Responsibility for implementation of PPP projects***

Only the relevant accounting officer or accounting authority may enter into a PPP transaction on behalf of that specific institution. The institution is responsible for performing the initial feasibility study and for submitting all the relevant requests for approval to the National Treasury. The accounting officer or accounting authority of the institution that is party to a PPP agreement is responsible for ensuring that the PPP agreement is properly implemented, managed, enforced, monitored and reported on.

### ***Benefits of a PPP***

- The Private Party performs an institutional function and/or uses state property in terms of output specifications;
- Substantial project risk (financial, technical, operational) is transferred to the Private Party; and
- Private Party benefits through unitary payments from government budget and/or user fees.

### ***Institutional Framework***

As already mentioned, only the accounting officer or accounting authority may enter into a PPP agreement on behalf of the specific institution. However, the National Treasury, which reports to the Ministry of Finance must approve the initial feasibility study. The National Treasury must approve the procurement documentation and draft PPP agreement prior to the documentation being issued to prospective bidders.

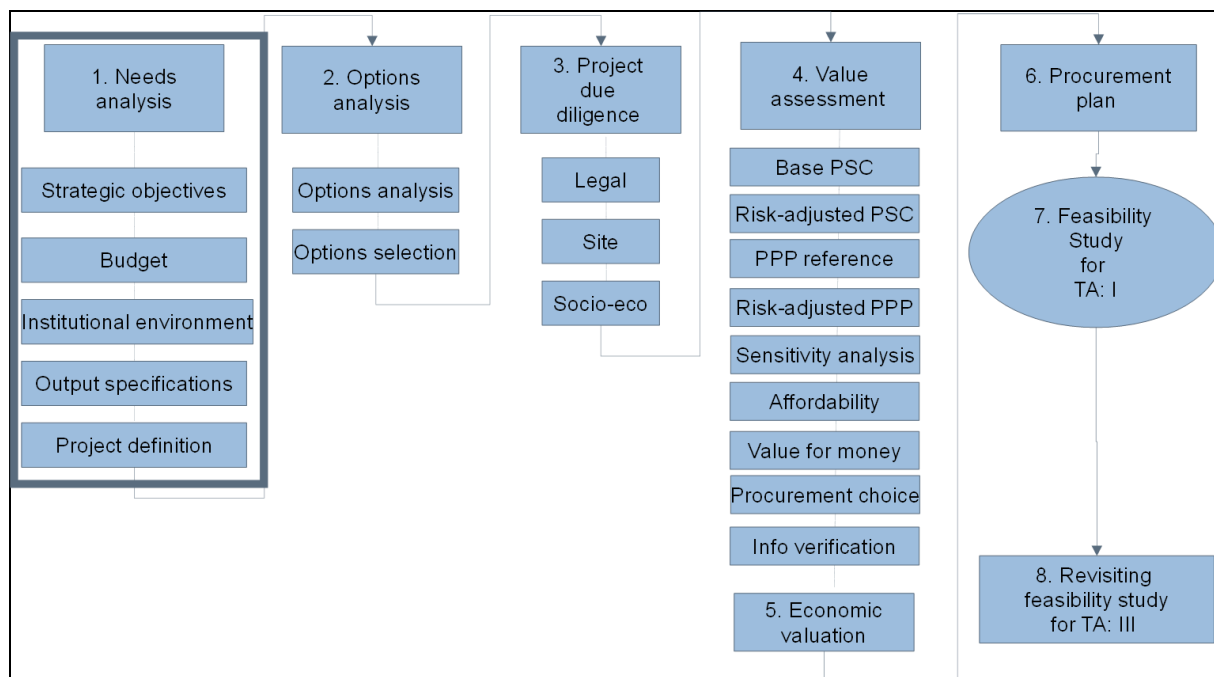
After the evaluation of the bids, but prior to appointing the preferred bidder, the institution must submit a report for approval by the National Treasury, demonstrating how the criteria of affordability, value for money and substantial technical, operational and financial risk transfer were applied in the evaluation of the bids. This report must also demonstrate how these criteria were satisfied in the preferred bid and must include any other information as required by the National Treasury.

After the procurement procedure has been concluded, but before the accounting officer or accounting authority of an institution concludes a PPP agreement, that accounting officer or accounting authority must obtain approval from the National Treasury. Prior to granting final approval by National Treasury, projects of higher cap are presented to the FLC for consideration and approval.

**Risk management and risk sharing**

Figure 5.4 below, illustrates the feasibility study framework, which guides the scope of the feasibility study to be conducted for every PPP agreement that an institution may wish to initiate.

**Figure 5.4. Feasibility study framework**



Source: National Treasury

As part of their responsibilities, the PPP Unit within the Budget Office of the National Treasury oversees debt management across the implemented projects. This is to ensure that Private Parties do not raise debts for activities not related to the PPP projects. All financing including capital debt and equity are accounted for with unitary fees payable to the Private Party as per the PPP agreement. Unitary fees, which represent the annual service fees payable to the private party, include the following: i) the debt portion and ii) the operations portion. Unitary fees do not constitute contingent liabilities and they are included in agreements where the project does generate sufficient revenues. Private Parties are monitored closely to determine whether they are complying with debt payment schedules, as failure to do so might lead to a default that has a potential to cause termination due to Private Party default.

Debt repayment commitments are monitored through Private Party monthly and quarterly reports as well as their financial statements. Guarantee commitments or patronage costs are monitored through departmental reports, their financial statements as well as private party reports and their financial statements. Compensation for termination commitments falls within the government guarantee facility and risk monitoring and mitigation ensures that no termination is triggered.

There is no specific limit in terms of projects that may be undertaken in a year and most of the PPP projects, with the exception of Gautrain Rapid Rail link, are insignificant compared to other projects guaranteed by the Government. These exposures have had a minimum or no impact on the government debt stock or borrowing requirements while the role of the ALM Division has not materially changed after the crisis, other than the enhanced monitoring and reporting. The National

Treasury continues to develop its methodology in terms of managing contingent liabilities stemming from these transactions in order to ensure that it stays robust and relevant to the ever changing environment.

As at 31 March 2014, the Maximum Likelihood Exposure (MLE) from PPPs amounted to R16.8 billion (0.5 per cent of GDP). Of this amount, R6.2 billion (0.2 per cent of GDP) was outstanding debt on the projects, while R10.6 billion (0.3 per cent of GDP) represents the largest amount to be paid by government in the case of termination.

## **Implicit contingent liabilities**

### *State insurance schemes*

As already indicated, contingent liabilities on state insurance schemes are based on actuarial differences of the different companies, which include;

- Road Accident Fund (RAF);
- South Africa's Special Risk Insurance Association (SASRIA);
- Unemployment Insurance Fund (UIF);
- Compensation Fund (CF); and
- Export Credit Insurance Corporation of South Africa SOC Limited (ECIC).

### *Risk management*

The ALM division is responsible for the management of contingent liabilities stemming from state insurance schemes and the methodology employed for determining the quality of this exposure is similar to that used for state guarantees with the difference being the indicators that are used.

On an annual basis, the individual institutions are analysed to determine their ability to make payments on claims submitted and this analysis is based on an internally developed methodology. The methodology follows a sequence determined in terms of the Credit Risk Policy and stipulates the business risk and financial risk indicators to be used when performing an analysis. The business risk indicators focus on the qualitative information of the institutions. The financial risk indicators focus on information from the Annual Financial Statements of SOCs and stipulate the financial ratios to be used to measure the institution's ability to continue operations and to make good on claims.

Guidelines for assigning risk ratings to each of the individual risk indicators are provided and seek to ensure that the risk ratings are assigned in such a way that they are a true reflection of the quality of government's exposure as well as the operations and financial position of the institution. The guidelines, depending on specific indicators have been developed having taken into account a combination of the industry norms, rating agencies' benchmarks and peer analysis. However, these guidelines are not considered in isolation from an institution's own target for a specific period as stipulated in their corporate plan. Risk ratings are applied to the different indicators for each institution. The ratings are aggregated to determine a risk rating for each institution and thereafter the ratings of the different institutions are consolidated to determine a consolidated rating for the portfolio.



Table 5.5. below provides a list of the financial indicators that are used when analysing state insurance schemes.

**Table 5.5. Financial indicators for analysing state insurance schemes**

Ranking	1	2	3	4	5	6	7	8	9	10
Investment Return ratio	≥12	11	9	7	5	4	3	2	1	<1
Acid Test ratio	>8	2.8-3	2.4-2.7	2.1-2.3	1.8-2	1.5-1.7	1.2-1.4	0.9-1.1	0.58-0.8	<0.5
Loss ratio	10	20	30	40	50	60	70	80	90	100
Expense ratio	0,2	0,4	0,6	0,8	1	1,2	1,4	1,6	1,8	>2
Combined ratio	20	40	60	80	100	120	140	160	180	>200
Cash flow/Debt	>50	45-50	40-44	35-39	30-34	25-29	20-24	15-19	10-14	<10
Audit Opinion	Unqualified		Unqualified with emphasis			Qualified		Disclaimer		Adverse
Solvency ratio	>100	80	60	40	20	15	12	9	6	<3
<b>Risk Classification</b>	<b>Extremely Low</b>	<b>Very Low</b>	<b>Low Risk</b>	<b>Moderate Low</b>	<b>Moderate</b>	<b>Moderate</b>	<b>Moderate High</b>	<b>High Risk</b>	<b>Very High Risk</b>	<b>Extremely High</b>
<b>Risk Description</b>	<b>Excellent</b>	<b>Strong</b>	<b>Good</b>	<b>Fair</b>	<b>Acceptable</b>	<b>Marginal</b>	<b>Special Attention</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Known Loss</b>

Source: National Treasury

### ***Bank failures***

#### *Monitoring*

National Treasury needs to monitor the health of banks for two principles. The first requirement is to mitigate counterparty risk as the single largest depositor in the financial system. Monitoring in this regard is actively performed by the ALM Division. This monitoring is achieved through the analysis of the credit quality of banks as counterparties similar to a process utilised for SOCs. The methodology for this analysis also takes into account business and financial risk indicators relevant to banks in order to determine their ability to meet their obligations toward government as counterparties.

The second function is a requirement to monitor the banking sector as part of the broader financial sector as a key economic industry. The central operational responsibility for this function has been delegated to the Prudential Authority within the Central Bank. In addition to the intensive micro prudential monitoring and supervision of banks, the Central Bank also monitors the macro financial sector. This macro prudential monitoring is performed in coordination with all financial sector regulators.

#### *Responsibility for forecasting possible effects of bank failures on the budget*

The National Treasury is responsible for monitoring the effect of contingent liabilities and the Fiscal Policy unit within the Budget Office is responsible for forecasting broad contingent liabilities as

part of the state's fiscal planning framework. The ALM Division however is the relevant department responsible for the issuance and monitoring of guarantees provided by the sovereign.

#### *Developments in managing contingent liabilities from bank failures after the 2008 crisis*

There has been much greater emphasis on mitigating contingent liabilities arising from the financial sector in the wake of the crisis. This has resulted in a response in 2 regards.

- Increased coordination to monitor and prevent system failure along with the economic and social cost of generalised financial sector stress. This is done through a fundamental overhaul of financial sector regulatory framework and a movement towards greater coordination of financial regulatory authorities and more intensive and intrusive supervision of regulated firms.
- Adherence to international best practice to reduce the fiscal cost of financial firm failure, as coordinated by the G20 and Financial Stability Board (FSB). These reforms are focused on ending too-big-to-fail (TBTF) and making the financial sector more resilient. On making the financial sector more resilient, SA has been found compliant by G20 and IMF assessments of BCBS, IOSCO and IAIS standards. On ending TBTF, SA has formulated a regulation and implemented a framework with regard to the OTC derivatives and an effective resolution framework. Together, these steps strengthen banks and other financial firms by reducing the likelihood and impact of failure.

#### *Reporting and monitoring of the estimated amount of contingent liabilities from bank failures*

International best practice and agreed standards have endorsed a Risk Weighted Approach (RWA) to capital, particularly in banking. This means that supervisors are constantly monitoring the size, exposures and probability of failure.

The government has in the past provided partial compensation to retail depositors up to a level of R 50,000. However SA is currently developing a Deposit Guarantee Scheme, which will formalise this previous implicit support.

#### **Conclusion**

The management of contingent liabilities is primarily the function of the ALM division and the Credit Risk Policy stipulates processes that continuously seek to shield the government budget from any adverse event. This is done through robust and continuous evaluation and monitoring process that seek to ensure that mitigation strategies are implemented well in advance.

## 6. SWEDEN

### Introduction

The Swedish National Debt Office (SNDO) is a central government authority that reports to the Ministry of Finance. As the central government financial manager its assignment includes:

- Providing banking services for the central government
- Raising loans and managing central government debt
- Providing state guarantees and loans
- Managing distressed financial institutions by means of
  - Deposit Insurance and Investor Compensation schemes
  - Resolution
  - Precautionary financial support

The SNDO is one of the five major authorities within the central government that, independently from each other, manage government contingent liabilities including loans. The other four authorities are:

- The Swedish Export Credits Guarantee Board (guarantees),
- The Swedish National Board of Housing, Building and Planning (guarantees),
- The Swedish International Development Cooperation Agency (guarantees and loans)
- The Swedish Board for Study Support (loans).

Main sources of government contingent liabilities (including loans) are:

- Deposit Insurance (managed by the SNDO)
- Export credit guarantees (managed by The Swedish Export Credits Guarantee Board)
- Development aid guarantees and loans (managed by The Swedish International Development Cooperation Agency)
- Housing credit guarantees (managed by The Swedish National Board of Housing, Building and Planning)
- Capital guarantees to multilateral development banks (managed by the SNDO)
- Miscellaneous guarantees and loans (managed by the SNDO)

- Student loans (managed by The Swedish Board for Study Support)

There are a few individual central government projects that have some similarities to the PPP model. However, these are negligible in size and numbers. Disregarding these exceptions, PPPs are not on the agenda in Sweden.

State guarantees and loans are always subject to the approval by the Parliament and the Government. Once approved and commissioned to a particular authority, each authority is responsible for issuing, monitoring, reporting and closing the guarantees and/or loans in its own sub-portfolio.

However, the SNDO's role regarding state guarantees and on-lending is twofold. The SNDO holds responsibilities both as a state guarantee and on-lending authority in the same way as other authorities and as the central government financial manager and coordinator in reporting guarantees and loans. This coordination role includes developing the management of government guarantees and loans in collaboration with other relevant authorities.

### **The Swedish fiscal policy framework**

Laws and policies around management of explicit state guarantees were revised in Sweden after the fiscal crisis in the 1990s. Accordingly, important principles and practices were established concerning:

- Transparency
- Covering of costs
- Risk management to avoid excessive and unmanageable risks

In 2011 the framework for state guarantees was supplemented with corresponding rules regarding on-lending in cases where the expected loss is not too high (in other cases the lending is funded entirely with means allocated from expenditure titles in the state budget and managed outside of this particular framework).

In many respects, the robustness of the Swedish framework for managing state guarantees and loans relies on well managed state finances, on the basis of the Swedish budget policy framework, and an appropriate division of roles between politicians and civil servants. Regarding the latter, decisions about the purpose of state guarantees and loans, amounts and general rules regarding risk management and reporting are made by the Parliament and the Government. Specific risk assessments, settlement of contractual terms, calculation of fees, recoveries of defaulted claims etc., on the other hand, are managed by the credit risk specialists at the responsible authorities.

- The main building blocks of the Swedish framework are:
- The Budget Act
- The Guarantee and On-lending Ordinance
- Specific schemes
- International agreements

- Accounting rules

### ***The Budget Act***

According to the Budget Act, the Parliament must decide on the purpose and the amount of state guarantees and on-lending. The general rule is that a fee should be charged that corresponds to the Government's expected loss and other costs relating to the undertaking (e.g. administrative costs and the funding cost regarding on-lending). The Parliament can make an exception from this rule, allowing the fee to be lower than the level reflecting the expected costs. This results in a fee that is partially or entirely subsidized by the state. When such exceptions are granted, the Government must make a proposal to Parliament on how to fund such a subsidy. This is usually done by allocating funds from the central government budget.

The rules governing the issuance of state guarantees and loans build on the cost-recovery principle, i.e. the state's guarantee and on-lending operations should, in expectation, be self-financed in the long term.

Another feature of the Budget Act is the reporting of the state's accumulated guarantee and on-lending portfolio in the Government's Annual report to Parliament. This requirement covers both accounting and informing about essential risk factors in the portfolio (e.g. single institution or sector concentrations).

There is no explicit criterion regarding the choice between state guarantees or on-lending. However, the framework is set up in such a way that the choice is guided primarily by what constitutes the best way of supporting a particular activity, not the way it is reported or paid for.

### ***The Guarantee and the On-lending Ordinance***

This ordinance contains more detailed rules governing the work of all authorities managing state guarantees and loans. It covers the main principles around fees, contractual terms, monitoring, reporting etc.

One aspect of the Ordinance is the requirements on risk mitigation. One important condition is that any beneficiary of a guarantee or loan must be financially viable at the time of the issuance. Furthermore, any undertaking must include contractual terms that limit the state's risk and ensures that the state has appropriate rights to monitor and control the risk. The Ordinance also empowers the responsible authorities to process recovery actions in case of a default on any state guarantee or loan.

Each authority's responsibility for monitoring outstanding guarantees and loans is also stipulated. That responsibility includes monitoring of the state's interests and entitlements, and assessment of any changes to the creditworthiness of the beneficiaries'.

Another element of the Ordinance is the rules about the set up and management of the nominal reserve accounts for each guarantee and on-lending authority.

### ***Specific schemes***

Some state guarantees and loans are, partly or fully, exempted from the general framework. Examples are callable capital to multilateral development banks (MDB's) and lending funded with budgetary means. Other schemes are treated differently because they are governed by specific laws.

Examples are the Deposit Insurance Scheme (the Deposit Insurance Act) and student loans (the Student Aid Act).

### ***International agreements***

Prominent international agreements regarding state guarantees and loans are EU state aid rules and the OECD arrangement on Officially Supported Export Credits. Among other things, these agreements address pricing issues and risk sharing arrangements to mitigate distortion on competition.

### ***Accounting rules***

Both the Budget Act and the Guarantee and On-lending Ordinance require that state guarantees and loans are transparently reported. More detailed guidelines on how to report state guarantees and loans are published by the Swedish National Financial Management Authority.

## **Management process of government guarantees and on-lending**

### ***The Approval by the Parliament***

The Parliament decides on state guarantees and loans with respect to the purpose, amount and type of the instrument. Budget Act contains general rules on how such guarantees and loans are to be handled.

Decisions on state guarantees and on-lending do not compete with those on the expenditures in the budget process with respect to the Central Government Expenditure Ceiling. The exception is, if the Parliament decides that the fee for any state guarantees or loans should be, partly or fully, subsidized. This results in expenditure with respect to the state budget.

### ***Approval by the Government***

The Government delegates the Parliament's approvals to issue the state guarantees or loans to the specialized authorities. In most cases, these approvals are made annually by granting a maximum amount in the government directives for the related authority (so-called Appropriation directions). In other cases, the Governmental approval is granted in separate decisions regarding a specific undertaking or a program of undertakings.

### ***Management of state guarantees and loans by specialized authorities***

The respective guarantee and on-lending authorities, including the SNDO, who are responsible for issuing, monitoring, reporting and closing any state guarantees or loans, employ credit risk specialists.

**Issuance:** In general, the issuance of state guarantees or loans includes due diligence regarding the guarantee or loan beneficiary, assessment of creditworthiness of the beneficiary, decisions on contractual terms and calculation of the fee.

Although there is no standardized method for the credit risk assessment, a commonly used analytical approach is the credit rating methodology.

When setting fees corresponding to the expected loss, the calculation is often based on the historical default rates and the recovery rates published by the international rating agencies. Credit

ratings are often the basis also when a market based fee, for example due to state aid rules, is calculated. Such a fee is usually estimated by studying the market prices of fixed income securities (e.g. corporate bonds) or derivatives (e.g. credit default swaps) with the same credit rating, and other characteristics, as the state guarantee or loan at hand.

Another possible approach is to mathematically derive the market price for a state guarantee or loan by using an option model, using stock market data. But, as the markets for corporate bonds and credit default swaps are the primary source of data when estimating the market price of credit risk, the no-arbitrage condition of such theoretical model is not convincing and the applicability being limited to publicly traded companies, an option model is seldom used.

A common practice is to set fees ex ante for the whole duration of the state guarantee or loan. However, fees are usually charged periodically.

One exception to the general rule regarding the issuing process is student loans. These loans are issued exclusively on the premise of educational criteria. However, for any new lending, funds are allocated from the central government budget corresponding to the expected loss.

**Monitoring:** Each responsible authority monitors the outstanding guarantees and loans in its own sub-portfolio. Changes in the creditworthiness of the guarantee or loan beneficiaries are carefully monitored and analysed. An important prerequisite for this risk monitoring is having access to adequate information (e.g. information about the business model of a company and relevant and detailed financial information). Covenant compliance, with respect to the guarantee or loan contract, is also monitored. Similar monitoring also applies to claims on defaulted guarantees and loans with respect to the ongoing recovery processes.

**Reporting:** The responsible authority reports the outstanding guarantees and loans in its annual and semi-annual reports. This includes current exposures, expected losses on guarantees, assessed write-downs on loans, recorded payments (collected fees, calls on guarantees and recoveries), balance of reserves, valuations of defaulted claims etc.

**Closing:** Each appointed authority is responsible for closing the state guarantees and loans as they mature or default. In case of default, the responsible authority will represent the state in the legal process to pursue possible recoveries.

### ***Management of payments and nominal reserves by the SNDO***

Even though the management of state guarantees and on-lending is the responsibility of the specialized authorities, a few specific tasks are performed by the SNDO as the central government debt manager.

Such tasks include funding of on-lending and payments due to the calls on guarantees. The SNDO also provides each state guarantee and loan authority's notional reserve account. There is an unlimited credit linked to each notional account. A call on a state guarantee is booked against the applicable nominal account and the resulting payment is then charged against the Treasury Single Account. The same mechanism applies to the collected fees and recoveries. All else being equal, calls on guarantees increase government debt while collected fees and recoveries decrease government debt. The mechanism ensures that the guarantees issued by the Kingdom of Sweden will be honoured in a timely manner if called upon. This is true irrespective of the current balance on the responsible authority's reserve account and without any need for the Parliamentary approval of budgetary means.

Another benefit of such a centralized structure is that the payments are managed efficiently, jointly with regular state payments.

Defaults on the outstanding loans (on-lending) do not call for any payments. However, recorded losses are booked accordingly against the applicable notional reserve account and central government debt will, all things being equal, be stay at a higher level compared to full repayment of what was lent. Hence, even though the mechanics differ, the long-term net effect is similar to guarantees.

To sum up, the debt manager's role in managing state guarantees and on-lending is rather limited in Sweden. Guarantees and on-lending are managed by other authorities or by the Guarantee and on-lending Department in the SNDO. That the latter is within the same authority that is responsible for debt management is thus more of an institutional than functional feature of the set up.

### ***Consolidated reporting***

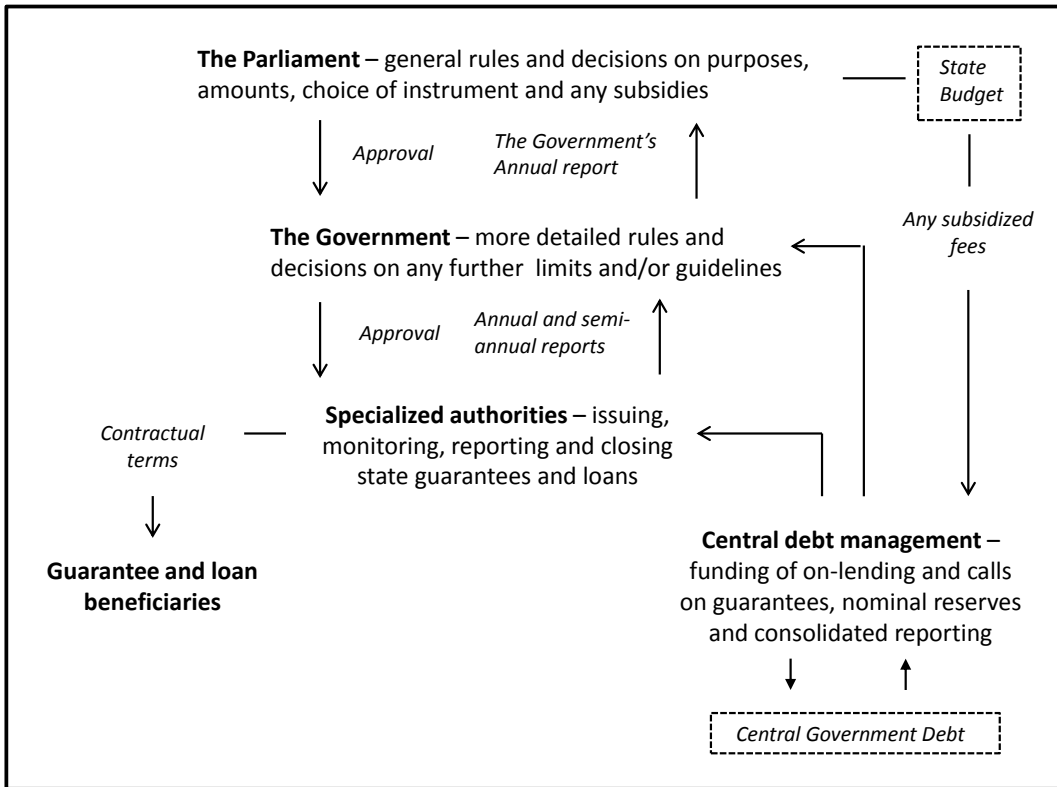
The SNDO coordinates reporting on the aggregated portfolio of outstanding state guarantees and loans in the Government's Annual Report to the Parliament. This includes both accumulated accounting and a portfolio-based risk analysis. The latter includes:

- Identification and assessment of essential risk factors with respect to the unexpected losses (e.g. any name or sector concentrations)
- Comments on the ability of the SNDO as debt manager to handle the potentially large cash payments within a short time frame due to the calls on state guarantees
- In-depth information about the portfolio that goes beyond regular accounting (e.g. the portfolio's maturity structure)

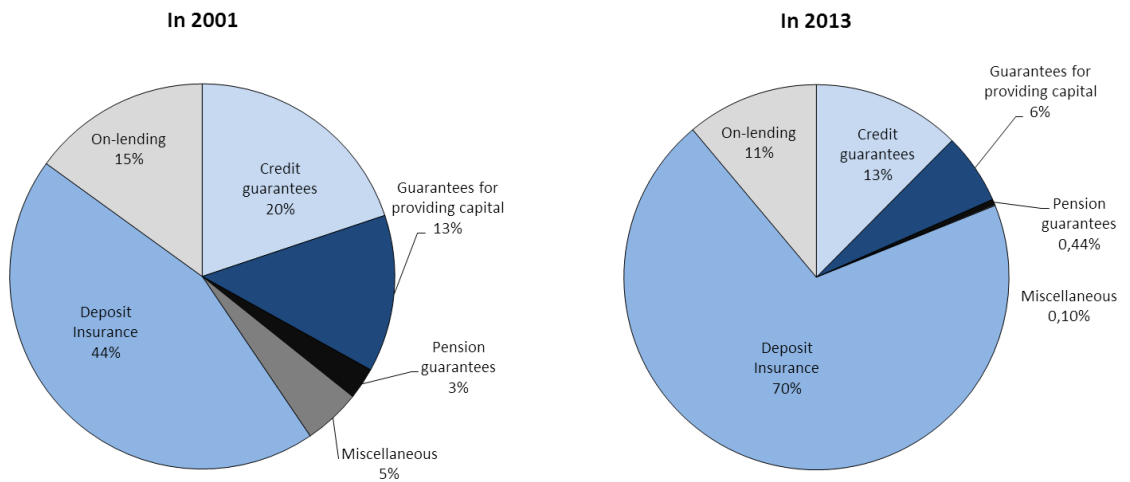
This high level of transparency promotes a sound risk management and to communicate within the state and to external parties (e.g. government bond investors) that the control over contingent liabilities is good.



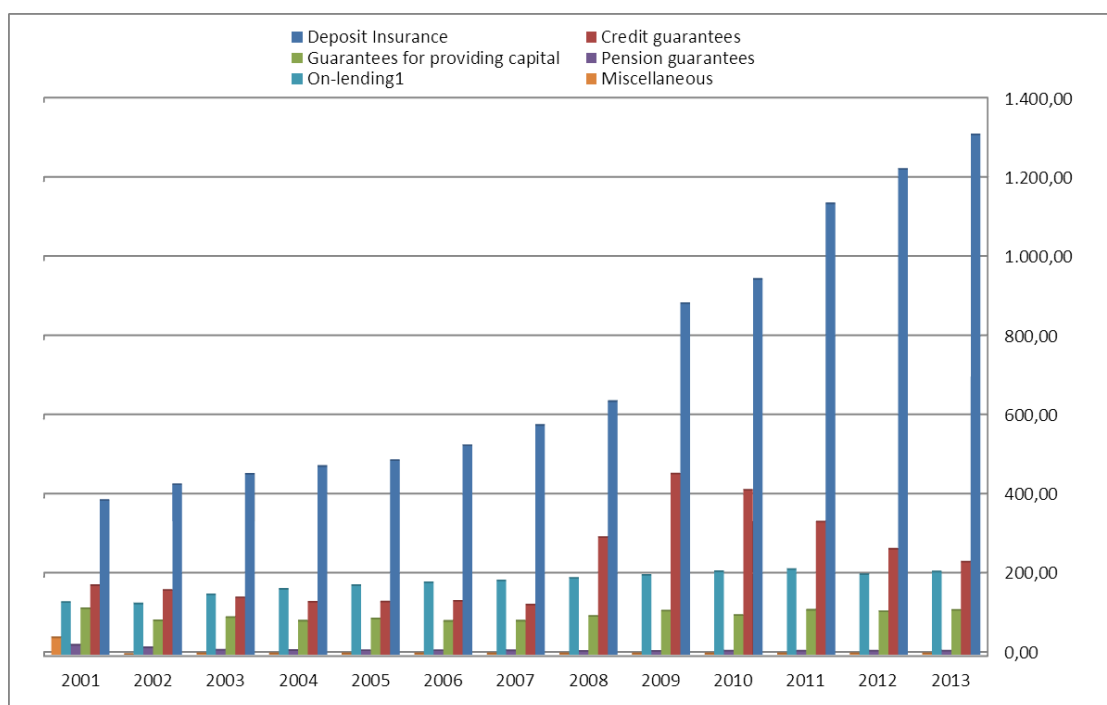
**Figure 6.1. The process for managing the state guarantees and on-lending**



**Figure 6.2. Share of state guarantees and on-lending**



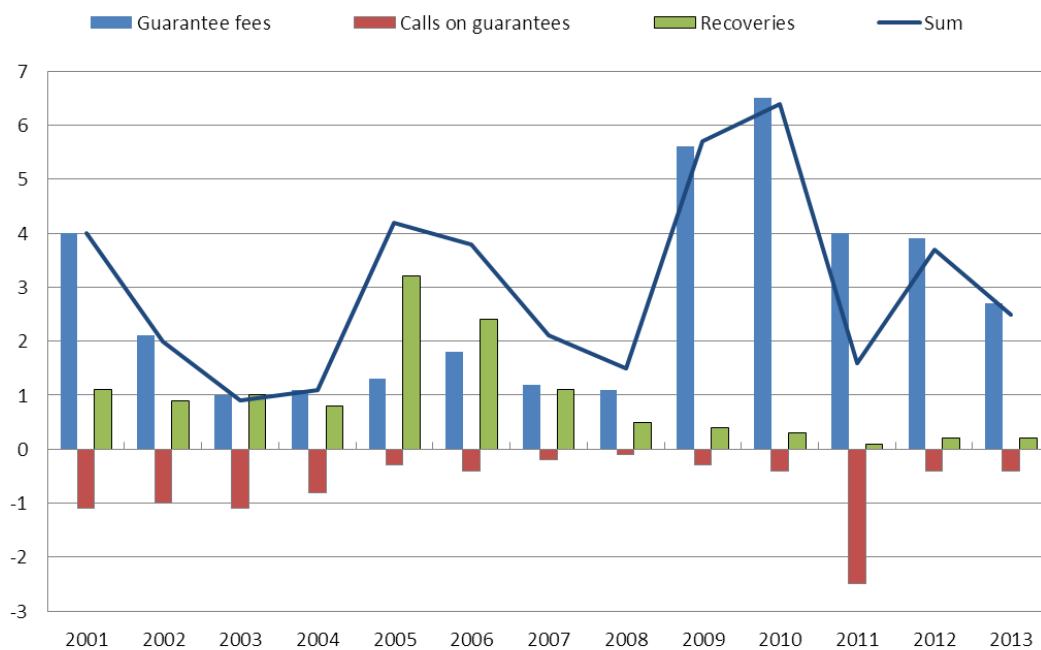
**Figure 6.3. Amounts of state guarantees and on-lending (SEK billion)**



<sup>1</sup>Excluding lending funded with budgetary means

Source: Government Annual reports

**Figure 6.4. Cash flows regarding state guarantees 2001–2013 (SEK billion)**



Source: Government Annual reports

## **Contingent liabilities related to the financial sector**

Contingent claims regarding the financial sector are managed by the SNDO. This responsibility includes both the deposit insurance and investor compensation schemes.

### ***The Swedish deposit insurance scheme***

The deposit insurance scheme covers virtually all types of accounts at deposit taking institutions (including banks, credit-market companies and certain investment firms). The guarantee covers deposits up to EUR 100,000 per customer and institution.

The deposit insurance scheme is regulated in the Swedish Deposit Insurance Act, which in turn is based on an EU Directive.

The deposit insurance scheme is funded via annual ex ante contributions. The funding model is fully regulated by law. The annual aggregated fee is fixed at a rate of 0.1 per cent of covered deposits. The aggregated fee is allocated among the individual institutions according to a risk differentiation metric based on capital adequacy (within a fixed range of 0.06 and 0.14 per cent). There is no relationship between the total annual fee and the expected loss of the guarantee.<sup>38</sup> As the new EU directive is implemented a more risk sensitive model for calculating fees for the deposit insurance will be developed.

Contrary to the notional reserve accounts that are set up for other state guarantees and loans, the Swedish deposit insurance is backed by an actual fund. The fund can be invested in bonds and treasury bills issued by the Kingdom of Sweden or in an account held at the SNDO. Additionally, in case of deficit in the fund the SNDO has an unlimited mandate to raise new debt for the purpose of honouring calls on the guarantee. Hence, there is no uncertainty about the reliability of the deposit insurance scheme.

The SNDO is responsible for the administration of the scheme, including calculating and charging fees, managing the fund and in case of a default executing payments to customers and to pursuing recoveries.

Since the recent financial crisis begun in 2008 the coverage level of the deposit insurance scheme has been raised twice, in October 2008 and in December 2010.<sup>39</sup> Furthermore, in 2008 the guarantee was extended to also include time deposits.

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<sup>38</sup> However, the fund today amounts to approximately 2% of covered deposits, which exceeds the target funding level of 0.8 percentage points of covered deposits that has been adopted for all EU countries in the new EU directive on deposit insurance that was finalized in April 2014.

<sup>39</sup> In the first instance, the coverage level was raised from SEK 250,000 to SEK 500,000. In the second instance, the coverage level was raised to EUR 100,000. This was done because of changes to the EU directive.

**Table 6.1. The deposit insurance scheme 2001–2013**

In SEK billion

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Exposure	389	429	455,3	475	490	527,4	578,6	638,9	886,4	947,6	1138,5	1225,5	1312,8
Fees	0,4	0,4	0,5	0,4	0,5	0,5	0,6	0,6	0,9	1,0	1,1	1,2	1,3
Calls	0,0	0,0	0,0	0,0	0,0	-0,2	-0,1	0,0	0,0	0,0	0,0	0,0	0,0
Recoveries	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	5,0

Source: Government Annual reports

### ***The Investor Compensation Scheme***

The SNDO is also responsible for administering the Investor Compensation Scheme. This scheme is regulated in the Investor Compensation Act and an EU directive.

The scheme covers investors in securities held in custody by an institution (securities companies, brokers etc.). If the institution that provides the investment services goes bankrupt and the client is unable to recover the securities, the client is entitled to compensation for the market value of the securities up to a maximum of SEK 250,000 (approximately EUR 27,000). For example, the client is compensated for losses resulting from the fraudulent behaviour by the defaulted institution.

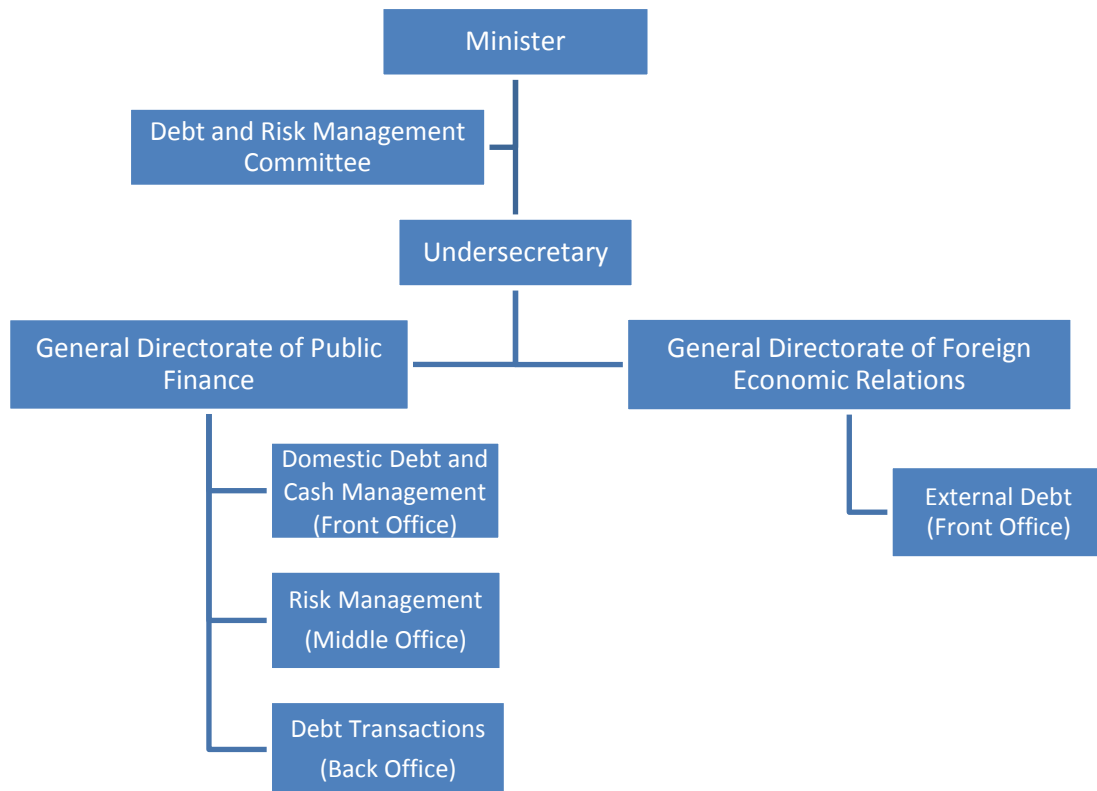
The SNDO is responsible for the administration of the scheme, the related reporting and, in case of default, executing the payments to clients. After such a payment, the SNDO is obligated to calculate and recover the paid out amount by charging fees from remaining institutions covered by the scheme. The scheme is thus based on ex post fees, in contrast to deposit insurance, where only ex ante fees are used

## 7. TURKEY

### Introduction

In Turkey, a law was enacted in 2002 (Law no. 4749) aiming to increase the effectiveness of debt management operations conducted by the Turkish Treasury<sup>40</sup> by adopting a holistic approach to every phase of debt management including risk, cash and receivables management. The Law established that the Treasury is the sole authority responsible for performing the borrowing function for the central government; further strengthening the legal and organizational infrastructure of debt management.

**Figure 7.1. Organizational structure of debt management in Turkish Treasury**



Parallel to the international best practices, in the Turkish case, the fund-raising function of Treasury debt management is carried out by the front office, which has operational responsibility. The middle office (the risk management unit), on the other hand, is in charge of determining the benchmarks in line with the economic and monetary policies and monitoring the implementation. It develops alternative borrowing strategies, measures and manages the fundamental risks such as market risk, liquidity risk and credit risk.

<sup>40</sup> Turkish Treasury is an Undersecretariat, an affiliated institution of the Prime Ministry. It is separate from the Ministry of Finance, contrary to some other country examples.

Within this institutional framework, the management of contingent liabilities where the Treasury is directly involved lies with the Credit Risk Management Department of the middle office. However, there are some contingent liabilities resulting from the commitments given by institutions other than the Treasury. The risk management of this second category is not centralized, i.e., each contingent liability is monitored and managed by the party equipped with the special expertise in the area. On the other hand, being aware of the fiscal risks that these liabilities entail, the Treasury has been monitoring these commitments as closely as possible, in order not to get caught unprepared when they had material impacts on the budget and debt sustainability.

Main sources of contingent liabilities in Turkey can be listed as follows:

- Explicit contingent liabilities
  - Treasury credit guarantees
  - Contingent liabilities arising from the PPPs (Treasury investment guarantees, debt assumption commitments of Treasury and other central government institutions, guarantees issued by the central government institutions under the PPPs.
  - Treasury Support to the Credit Guarantee Fund
  - Government Insurance Schemes
- Implicit contingent liabilities
  - Banking sector bail-outs
  - Direct and contingent liabilities of non-central government public institutions including public corporations, local governments and public funds
  - Natural and environmental disaster relief

The classification above reflects a central government debt management perspective, according to which the contingent liabilities of central government institutions that are based on laws and contracts are categorized as “explicit”, while such commitments of non-central government parties, especially the public corporations and local governments are put under the category of “implicit” contingent liabilities.

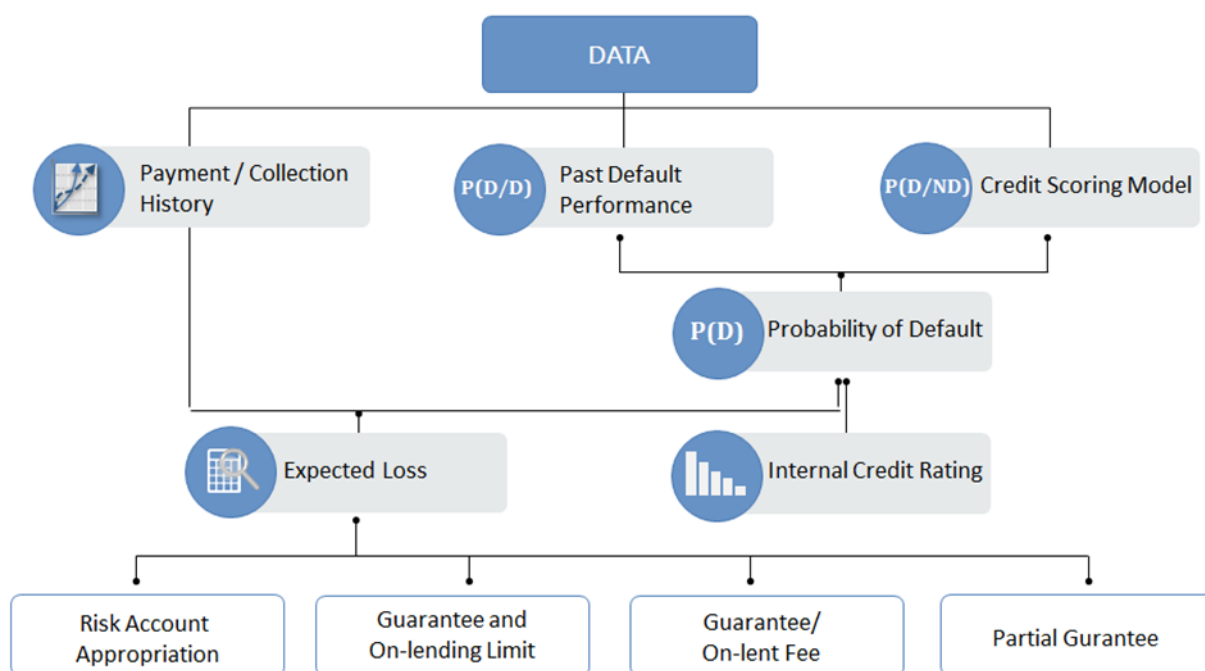
### **Treasury credit guarantees**

Treasury credit guarantees (“Treasury repayment guarantees” in the Turkish context) are provided for the repayments of external financing utilized by eligible institutions. The institutions which are eligible for applying for a guarantee are clearly stipulated by the Law. In practice, credit guarantees are provided mainly to the public banks, investment and development banks, municipalities and the SOEs.

The middle office developed a “Credit Rating Model” in cooperation with an external consultant, in order to measure the credit risks arising from these guarantees, as well as the Treasury investment guarantees and receivables portfolio. This model uses the financial ratios, past payment performances and future payment obligations of the institutions as inputs. Default probabilities of the institutions are calculated based on what is called “Altman Z-score” in the literature. This method estimates the

default probabilities of institutions by using their financial ratios, calculates the expected losses of the institutions. In addition, the Treasury assigns internal credit ratings to the institutions in the portfolio by using the Model outputs.

**Figure 7.2. Credit rating model of Turkish Treasury**



Source: Turkish Treasury

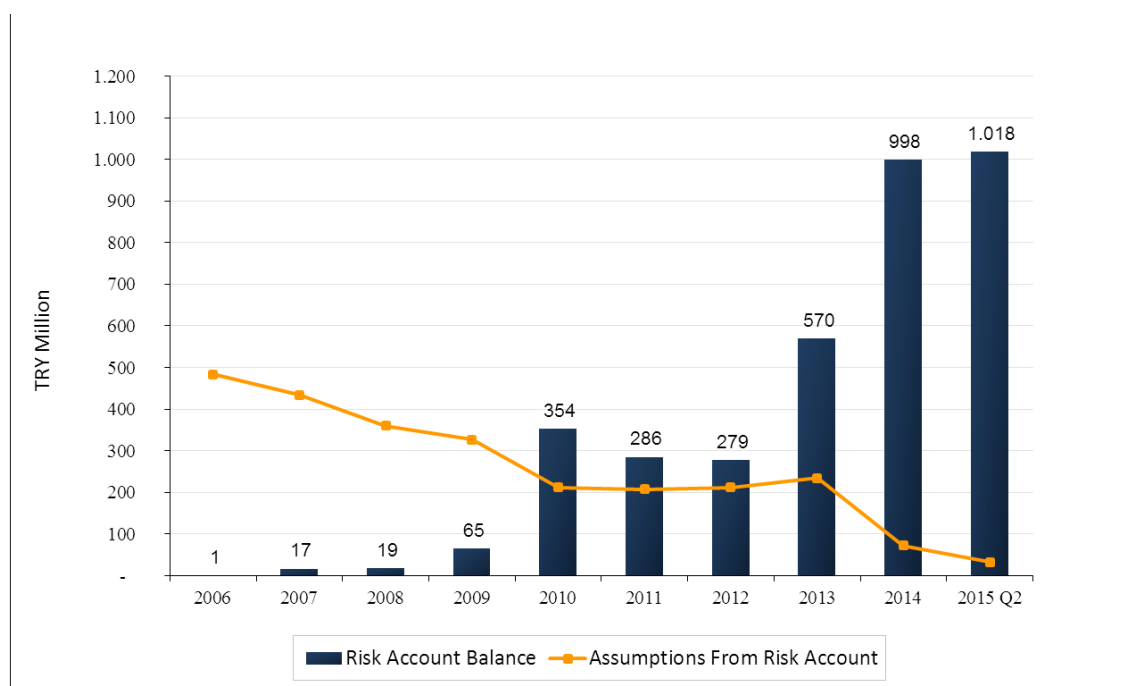
Treasury uses several tools to mitigate and manage the risks arising from these guarantees. The major ones are as follows;

- Risk Account:** It is a contingency reserve account established in 2003 at the Central Bank with the purpose of funding any realized payments (which are called “undertakings” in Turkey) due to the Treasury guaranteed credits. The revenues of the account consist of the collections from undertakings, guarantee/on-lent fees and interest income. If these revenues do not meet the need for undertakings, budgetary allocation for the risk account is utilized. In this context, predicting the annual budgetary allocations of this account is an important function performed by the credit risk management team of the Treasury. Using the existing and prospective Treasury guarantees as input, the risk management team predicts the expected expenditures of the risk account using default rates assigned to each entity via the Model. The calculation of guarantee/on lent fees follows a similar course to expenditures where default and collection rates are applied to the payment schedule of each prospective guarantee. The difference between expected revenues and expenditures, in other words the financing need, is then reflected in the annual budgetary allocation.

At the time the risk account was first created, there was a need for budgetary transfers, as the amounts of payments under guaranteed debt were relatively high while the revenues of the risk account had not reached sufficient levels to cover these payments. With the introduction of the risk management measures to reduce the portfolio risk of guaranteed debt, the

undertakings of guaranteed debt fell gradually as the revenues of the account accumulated. Currently, the balance of the risk account is more than enough to cover the expected losses from the guaranteed debt portfolio (Figure 7.3).

**Figure 7.3. Guarantee payments and the balance of risk account**



Source: Turkish Treasury

- Guarantee and on-lending limit:** In order to control the size of the risk originated from the Treasury guarantees and on-lent credits, a ceiling is imposed through the annual budget laws. This limit is calculated each year under various scenario analyses by using the Model outputs.
- Guarantee and on-lent fee:** In order to compensate for the losses that stem from the guaranteed/on-lent credits and to share the risk with beneficiaries, a one-time guarantee fee is applied up to 1% of the total credit amount which is collected upfront. The fee is determined on the basis of the credit risk levels of the beneficiaries derived from the Model, calculated from their financials and historical payment performances.
- Partial guarantee:** The Treasury guarantees are provided up to 95 per cent of repayments of the agreed credit amount. Loans provided from international and regional organizations, foreign government funds, and export credits provided by the official export insurance agencies of foreign countries are excluded from this practice due to their favourable credit terms. Partial guarantee ratio is determined by taking into consideration the financial ratios of the beneficiary institution, financing terms of the credit and past repayment performance if the institution used a Treasury guaranteed/on-lent loan before.
- Foreign debt payment account (FDPA):** Created as escrow accounts, the FDPA aims to ensure that local governments can meet their external obligations guaranteed or on-lent by the Treasury. A local government must establish an FDPA in a commercial bank, dedicating



certain sources of its income that will be enough to meet the loan payments, before the provision of guarantees or on lent loans.

### **Contingent liabilities arising from the PPPs**

Turkey has a very ambitious PPP agenda with some large scale projects in the construction phase and with many others in the pipeline. Depending on the risk sharing arrangements in each specific project, central government institutions including the Treasury might make certain, usually long term, commitments contingent upon some conditions. Below, some different types of such PPP commitments will be summarized.

#### ***Treasury investment guarantees***

Treasury investment guarantees generally take the form of counter guarantees given to guarantees such as demand, revenue, exchange rate etc. extended by the public entities in a PPP project. The aim of the Treasury investment guarantees is to increase the bankability of PPP projects by eliminating the downward risks being borne by the private parties.

In order to mitigate the risk created by Treasury investment guarantees, several mechanisms have been introduced in Turkish legislation. One such mechanism obligates each entity that has been provided a Treasury investment guarantee to pay a fee that will be recorded as an income to the risk account. Another risk mitigation mechanism employed by the government is the guarantee and on-lending limit explained above, which includes also the Treasury investment guarantees. Finally, the risk account is used to finance the losses under the Treasury investment guarantees; which is a mechanism diminishing or completely eliminating the budgetary risks.

Currently, there are 14 energy production firms operating in the PPP model that have Treasury investment guarantees. The guarantee periods of three firms have ended and the remaining are expected to end around 2020. Of the 17 firms that have been extended a guarantee, in only one case the Turkish Treasury had to step in since the public entity which had undertaken the contract could not fulfil its obligations. As a result, the Treasury had to assume around USD 2 Billion to pay for its contractual obligations rooting from the Treasury investment guarantees.

#### ***Debt Assumption Commitments by the Treasury***

Debt assumption commitment is a new tool used by the Treasury to ease the financing of the PPP projects by changing the risk allocation between the administration and the project company. International practices vary on the methodology of the termination compensation, in some cases partial or full debt assumption commitments are observed, in some others, a lump sum termination payment amount is predetermined. In Turkey, partial or full debt assumption commitment could be extended to the lenders for the external financing including some of the financing costs.

Treasury's assumption of debt is triggered by the termination of the PPP contract. Since it is a contractual liability and the triggering event, in nature, has an uncertain timing and creates an uncertain liability, debt assumption commitments are classified as explicit contingent liabilities for the Treasury. In order to manage this contingent liability effectively, several important roles have been assigned to the Treasury by the recently enacted regulatory framework. Accordingly, the process of the issuance of a debt assumption commitment for a PPP is as follows;

- Public Administrations are liable to send their draft implementation contracts to the Treasury with written request for debt assumption before publishing the procurement notice.

- Treasury assesses the draft contract clauses which are directly related with debt assumption and gives its affirmative opinion if it deems appropriate.
- A Council of Minister’s decision is issued designating the Treasury as the authorized institution to negotiate the scope, elements and payment conditions of debt assumption.
- Public Administration calls for tender after the Council of Ministers’ decision and then sends the draft contract to the Treasury again following the tender.
- Treasury assesses the draft contract clauses which are directly related with debt assumption and gives its affirmative opinion if it deems appropriate.
- Treasury carries out and concludes the debt assumption negotiations and submits the scope, elements and payment conditions of debt assumption to the Council of Ministers.
- After the issuance of the Council of Ministers’ final decision, debt assumption agreement is signed.

Like other contingent liabilities, debt assumption commitments do not affect the debt stock directly unless they are realized. However, these commitments need to be measured, managed and monitored in order to achieve fiscal discipline and debt sustainability, by the Treasury. In this framework, several ex-ante risk management tools have been developed by the Treasury;

**Debt assumption commitment limit:** In order to limit the debt assumption commitments to be given in a fiscal year, a debt assumption commitment limit is determined with annual budget laws. Each year, this limit is calculated by analysing the potential impacts of debt assumptions commitments - both existing and to be provided, on debt sustainability, under different termination scenarios.

**Minimum threshold for the investment amount:** The scope of debt assumption is limited to the projects with a minimum investment amount of 1 billion TL to be carried out by public administrations under the general budget and public administrations with a special budget with build-operate-transfer model, and to the projects with a minimum investment amount of 500 million TL to be carried out by the Ministry of Health and the Ministry of Education with build-lease-transfer model.

**Partial debt assumption:** In case of an early termination of the PPP contract by the project company default, the Treasury’s assumption commitment is limited to 85% of the outstanding senior debt of the project company. With this rule the creditor is obliged to undertake a certain percentage of the loss, serving as an incentive on the side of the creditor to take necessary measures for the continuation of the project.

**Treasury’s consent:** The draft implementation contract must be sent to the Treasury for assessment of the clauses directly related with the debt assumption commitment both before and after the tender.

**Capped hedging cost:** A cap of maximum 10% of the senior loan has been introduced in order to limit the costs associated with closing of the hedging instruments which can be bought by the Project Company in order to contain exchange rate and/or interest rate risk.

### ***PPP Commitments of other central government institutions***

In accordance with the current PPP legislation in Turkey, some central government institutions other than the Treasury, including the line ministries and some general directorates, can also provide guarantees to enhance the bankability of the PPP projects.

Currently, this category of commitments includes mainly the demand guarantees on some toll road projects. Also, debt assumption commitments constitute another source of contingent liability under this category, although the number of projects involving such commitments is quite few.

Treasury is aware that these guarantees harbour important fiscal risks for the central government and in order to mitigate these fiscal risks, close monitoring of them is crucial. To this end, a fiscal risk bulletin is prepared quarterly by the middle office, which includes parts analysing fiscal risks arising from these commitments and their possible impacts on debt sustainability. The guarantees analysed in this bulletin include the commitments of non-central government agencies in PPP projects as well.

### **Government support to the credit guarantee fund**

In order to bring the expectations of financial institutions and risk levels of SMEs in line, the Turkish government has set up a mechanism to provide additional funds to the already existing Credit Guarantee Fund. This government support was one of the several measures taken to mitigate the negative impacts of the global financial crisis on the Turkish real sector. Initially, government support to the Credit Guarantee Fund was designed to ease financing conditions of SMEs. Today, in addition to SMEs, women entrepreneurs, tour operators and ship building firms can benefit from the system.

According to this mechanism, the Credit Guarantee Fund guarantees to pay out around 75%-85% of the credit used by the beneficiaries from financial institutions in case of a default. The total amount of funds committed by the government to this mechanism is TL 2 Billion (around USD 700 Million). To further enhance the sustainability of the system, certain fees are collected from the beneficiaries making use of the Credit Guarantee Fund, where the proceeds are spent to finance the losses stemming from the defaults. Whenever these proceeds are not sufficient to pay out losses from defaults, the government transfers the necessary amount to the credit Guarantee Fund. In this context, the credit guarantee mechanism is regarded as a source of contingent liability for the government.

### **Government insurance schemes**

In Turkey, government intervenes in several insurance schemes to provide reinsurance to markets where the risks are prevalent. The most prominent insurance scheme in this regard is the deposit insurance system, as is the case in many other countries. There are several other insurance mechanisms as well.

#### ***Government Deposit Insurance System***

Saving Deposit Insurance Fund (SDIF) was established in 1983 within the Central Bank in order to insure savings deposits in Turkey. As a result of the economic crisis that broke out in 1994, the SDIF's powers were expanded; in addition to insuring savings deposits, it was entrusted with strengthening the financial status of banks and restructuring them when the need arises.

The financial sector crossed state borders in the late 1990s, and began to function in a more complex and rapid fashion, thus calling for more specialized, better functioning, independent regulatory and supervisory organizations. As a response to that, the Banking Regulation and

Supervision Agency (BRSA) was founded in 1999 to which the SDIF's authority and administration were transferred.

The establishment of the BRSA coincided with the second financial crisis that broke out in Turkey in late 2000. The number of insolvent banks, which was 4 in 1994, increased to 25 in early 2000's following this second wave. On December 26, 2003, the Fund Board was appointed as the decision making body of the SDIF, and received an autonomous status.

The Banking Law No. 5411 entered into force in November 2005 brought about major changes for the Turkish deposit insurance system and the SDIF. This law expanded the SDIF's authorities, and entrusted the Fund with the authority to designate the coverage and limit of insured deposits, which according to previous regulations were specified by the BRSA. In addition, the SDIF was authorized to design the risk-based insurance premium system, collection schedule and collection method. Another change introduced by the Banking Law No. 5411 was to broaden the SDIF reinsurance to cover the participation funds of real persons in participation banks<sup>41</sup>.

In order to contribute to the stability of the financial system, the SDIF;

- Insures deposits and participation funds,
- Resolves, in the most efficient way, the banks and assets transferred to it.

Saving deposits and participation fund premiums are payable to the Fund by the end of the last working day of the second month following the period the financial statements are prepared. The premiums are paid in the form of the same currency type for the Turkish Lira, US Dollar and Euro accounts and in US Dollars for the precious metals accounts and in other currency types.

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<sup>41</sup> The participation banks are those operating in the financial sector, through utilizing the funds they collect from the savers, in trade and industry, and then sharing the resultant profit or loss with the savers. The word "participation" appearing in the names of such banks means that the kind of banking activity we carry out is the one that is based on the principle of participating in profit and loss.

### **Box 7.1. General profile of the Turkish deposit insurance system**

Management: Autonomous legal entity (SDIF)

Membership: Compulsory (for all banks & participation banks that accept deposit & participation funds in Turkey)

Premium System: Risk-based

Premium Collection: Ex-ante

Scope of the deposit insurance:

- Real person
- TL, FX deposits, participation funds, precious metals
- With banks & participation banks/branches operating in Turkey

Insurance limit: TL 100,000 (approx. USD 47,000)

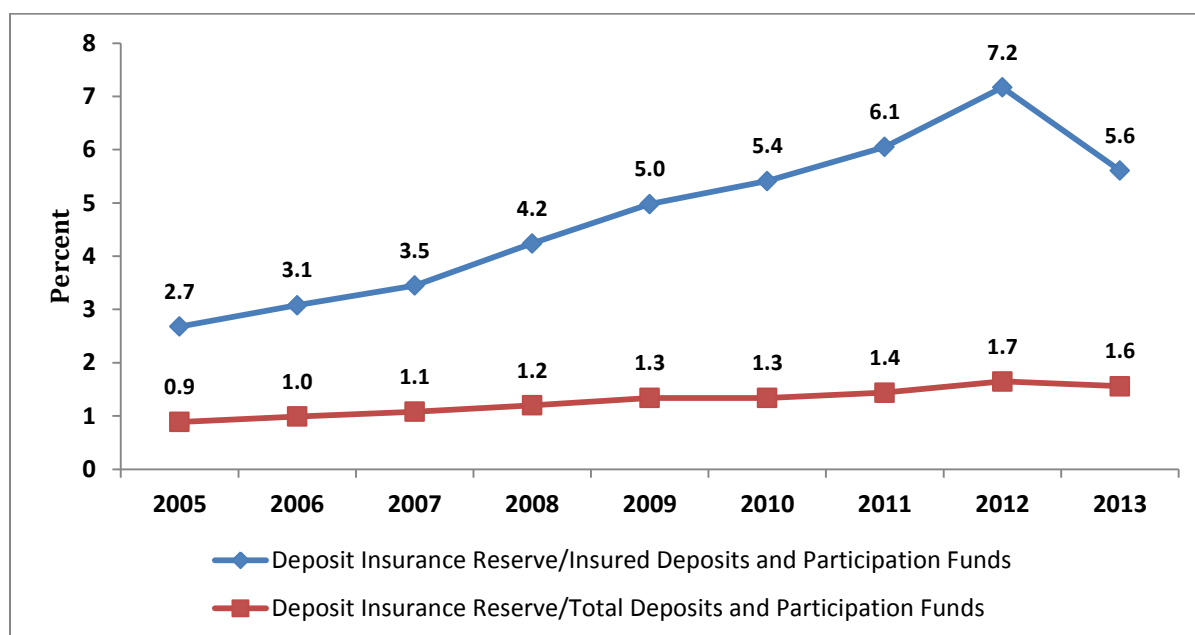
#### *Management of the Deposit Insurance Reserve*

The Fund's reserve is made use of in line with the "Principles on SDIF's Financial Asset Management" entered into force by the Resolution of the Fund Board. The reserve owned by the Fund as part of its functions for insuring deposit and participation funds makes up the “**Deposit Insurance Reserve**” while the collections made as a result of resolution operations constitute the “**Resolution Reserve**”.

After deducting the current and potential resolution expenditures and compulsory payments to other institutions from cash income items, which are generated as a result of resolution operations, the Fund submits the remaining balance to the Treasury, as required by Law.

The "Deposit Insurance Reserve" of the Fund is used in deposits, Government Debt Securities (GDS) and sukuks issued by the Treasury. The current level of the deposit insurance reserve is remarkably high compared to its earlier levels (Figure 7.4). This high reserve level makes a major contribution to the achievement of strategic objectives, "Raising Trust and Awareness of Depositors" and "Contributing to the Stability of the Financial System".

**Figure 7.4. Deposit insurance reserve ratios<sup>(\*)</sup>**



Source: SDIF

<sup>(\*)</sup>The decreases in 2013 stem from the legislative change increasing the limit of the insured deposit from TL 50,000 to TL 100,000 in February 2013.

#### *Risk Management Policies of Deposit Insurance*

The SDIF develops risk management policies in consideration of deposit insurance strategies of investment as a part of the corporate risk management. The Fund's reserve can be in any financial institution whereas it can be exposed to credit risks, interest risks, liquidity risks and operational risks.

The Fund takes investment decisions within the limits specified by the Fund Board and the Financial Risk Committee with regard to asset allocation and term structure in order to avoid such risks.

- **Credit Risk:** In fact, the credit risk exposed by the Fund's reserve, results from the deposits held in banks.
- **Currency Risk:** Potential changes in the Fund's assets and liabilities as a result of a change in currency are tracked within the framework of the financial risk management.
- **Interest Rate Risk:** The interest rate risk results from the estimation that changes in interest rates would affect future cash flows or fair value of financial tools. As a part of the financial risk management, the SDIF tracks the term structure and interest rate of deposits and securities in its portfolio.
- **Liquidity Risk:** The liquidity risk results from the inability to fulfil financial liabilities that require cash. The management of liquidity risks is defined by investment decisions in consideration of type of investment tools, their liquidity in the market and due date.

- **Operational Risk:** The internal control system and data processing infrastructure are consolidated in an attempt to eliminate operational risks that may emerge in managing Fund's reserve. The Fund carries out transactions via the Portfolio Management System, Payment Management System and Auction Management System in an effort to minimize operational risks. In addition, processes for reserve management are supervised by internal audit.

#### *Government Deposit Insurance as a Source of Contingent Liability*

The deposit insurance system is a source of explicit contingent liability for the central government since in the event of a major banking failure where the reserves of the SDIF proves to be insufficient to cover for the insured deposits, the Treasury would have to provide the funds, as is the case in many other countries. Indeed, the obligation of the Treasury to issue special-category government securities<sup>42</sup> to the SDIF for this purpose is set in the Banking Law. On the other hand, it is stipulated in the Banking Law that these government securities will be issued to the SDIF to be “on-lent”, i.e., the Treasury will record receivables from the SDIF for the corresponding amounts. Therefore, the contingent liability of Treasury results in contingent assets, should the liability is realized.

#### *Other Government Insurance Schemes*

There are several other insurance mechanisms in Turkey, other than the deposit insurance where the government commitment to support such schemes is regulated by laws. In this sense, they are sources of explicit contingent liabilities for the central government.

The first such mechanism aims at containing the earthquake risk in Turkey. A mandatory government led insurance scheme has been put in place in 2000. However, given the risk levels and potential number of participants, the government has stepped in to lower the perceived risks of the insurance scheme and provided additional coverage. According to the legislation a reinsurance support amounting up to EUR 241 Million will be transferred to DASK, in case the insurance payments to cover the damages of citizens resulting from an earthquake exceed EUR 840 Million.

Another insurance scheme is in agricultural sector, which has been designed to protect farmers from the effects of the natural disasters. According to this scheme, the government provides reinsurance in case the TARSİM fails to purchase enough protection from the markets. However, unlike DASK, the amount of reinsurance support is not pre-specified. The reinsurance payments to TARSİM are a function of damage to premium ratio with payments increasing as the damage increases.

Apart from the above mentioned insurance schemes where the government commitment is explicit; there are two additional insurance schemes. The first one is the **Assurance Account**, set up to meet the medical treatment expenses of those who suffer from bodily injuries if the insured person can't be determined in such cases as hit and runs or accidents involving stolen vehicles. Payments for disability indemnities and death benefits to the deceased's dependents are also made from this account. Even though there is no explicit commitment of the government to contribute to the Assurance Account, in case of a financing need, the Assurance Account can be seen as an implicit contingent liability.

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<sup>42</sup> State Domestic Borrowing Notes, which are issued under the relevant legislation and the Budget Laws of the relevant year and against which no cash inflow is obtained,

The last insurance scheme, **Investor Compensation Program**, is in place to cover the financial intermediary risks of capital market investors. According to this scheme, a maximum amount of TL 100,000 (around USD 45,000) will be paid to the investors if the financial intermediary fails to fulfil its fiduciary duty. The amount of investor compensation can be increased fivefold with a council of ministers' decision. Again, even if the revenues of the program are composed of fees collected from financial intermediaries and there is no explicit guarantee of government to step in, like Assurance Account, Investor Compensation Program can also be regarded as an implicit contingent liability.

### **Statistics and transparency**

Guarantee statistics are published periodically in the Public Debt Management Reports (PDMR), which is a comprehensive monthly publication, aiming to inform the parliament and the general public about the developments in public finance. The information and statistics on guarantees cover:

- nominal stock of Treasury guaranteed debt
- information on guarantee agreements signed
- balance of risk account
- borrower payment projections under guarantees
- collections from Treasury receivables

In the PDMR, debt assumption commitments of Treasury provided to PPP projects are also reported. The tables included in the report are based on nominal values and do not contain any information about expected losses from these contingent liabilities. In addition, all these statistics together with the information on Treasury investment guarantees are included among the public finance statistics provided on the Treasury web-site<sup>43</sup>.

### **Implicit contingent liabilities**

#### ***Bailouts in the Turkish banking sector: A crisis experience***<sup>44</sup>

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<sup>43</sup> <http://www.treasury.gov.tr/en-US/Stat-List?mid=702&cid=12&nm=768>

<sup>44</sup> This part was prepared as a brief summary of the Chapter “Systemic Risk: What it Means for Public Debt Management” of BALIBEK E. and TAŞKIN V. (2012); and “From Crisis to Financial Stability” BRSA Working Paper 2010. For a detailed analysis regarding the Turkish financial crisis of 2000-2001 please refer to these sources.



At the beginning of 2000, the government launched an IMF-supported economic program aiming at lowering inflation, providing sustainability in public finance and restructuring the financial sector. The exchange rate regime was crawling peg with a TL depreciation path, which was serving for the predictability of the exchange rate. The banks were borrowing in foreign currency and investing in local currency bonds. Interest rates had declined sharply as a result of increasing demand for local currency instruments.

Starting from the middle of the year 2000, however, current account balance started to deteriorate, as a result of the persistent inflation, not following the foreseen path and appreciation of the real exchange rate. Also, the deviations from the privatisation targets and the structural reform agenda occurred, impairing the credibility of the program and leading to a rise in interest rates.

Towards the end of the same year, liquidity squeezes started and turned into a system wide liquidity crisis in November. The IMF funds totalling to USD 7.4 billion was used to mitigate the impacts of this initial wave while concerns over the sustainability of the economic program continued. High short term funding requirements of the public banks increased the pressure on interest rates. Finally, demand for liquidity and foreign exchange was fuelled by rising political tension leading to the crisis of February 2001. As a first response to the crisis, the crawling peg regime was abandoned and a floating rate regime was adopted.

A number of banks suffered enormous losses due to the crisis, which resulted in their taken over by the SDIF. During 2000 and 2001 14 private banks were transferred to the SDIF, while at the end of 2003 the number of banks in the SDIF portfolio was 24.

In order to ensure that the banks, whose financial structures and profitability had been largely impaired during the crisis, regain their health; the Banking Sector Restructuring Program was launched in May 2001. The main pillars of this reform program was; restructuring the public banks, resolution of the banks taken over by the SDIF, rehabilitation of the private banking system, strengthening the supervision and auditing framework and increasing the efficiency in the sector.

The total cost of the restructuring of the banking sector reached over one third of the national income. During the crisis, the financing requirement of the SDIF and the public banks were mainly met by the Treasury. In other words, the cost of the crisis was transferred to the central government. The Treasury debt stock rose significantly because of the direct debt issuance to the banks and the need for financing these securities, from TL 36.4 billion at the beginning of 2001 to TL 122.2 billion at the end of the year. The effect of the crisis on the central government debt stock continued until the year 2010.

From a contingent liability perspective, it is hard to make a clear-cut distinction within the realized cost of the crisis, between the explicit contingent liabilities and implicit contingent liabilities items. It is important to note that bailouts of public banks were in the form of “duty-losses” payments to these banks, a legal obligation on the side of the central government existing before the crisis. Likewise, some of the transfers from the Treasury to the SDIF could be considered as explicit deposit insurance obligations of the government, which was declared as an unlimited guarantee during the crisis. However, some of the resolution and recapitalization costs were unforeseen payments not stipulated by law before the crisis.

After that, the Treasury carried out a domestic swap operation in June 2001 aimed at relieving the burden of immediate debt service. By means of debt swap auctions, the Treasury managed to extend the average maturity of its debt stock while the banks could close their open foreign currency positions thanks to the foreign currency linked bonds issued by the Treasury during the operation.

After the crisis, there has been a major debt management reform in Turkey, while the government strengthened the mandate of the BRSA to ensure a sound financial system. The crisis showed that the interaction between the risk perceptions regarding debt sustainability and concerns over financial stability is crucially important.

In order to strengthen further the coordination between the debt management and financial system management, Turkey established a Financial Stability Committee in 2011 to which the Treasury is a member alongside the BRSA, Central Bank, SDIF and Capital Markets Board.