A CREDIT RISK MANAGEMENT FRAMEWORK FOR SOVEREIGN GUARANTEES AND ON-LENDING

Webinar on contingent liabilities risk management

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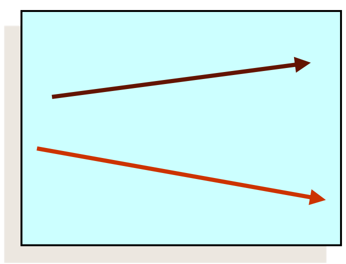
Agenda

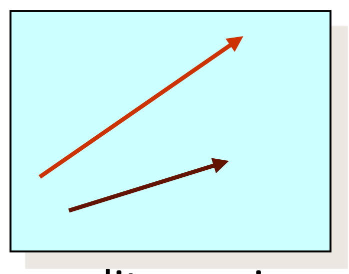
- **Defining and categorizing contingent liabilities**
- Framework for measuring and managing credit risk from sovereign guarantees and on-lending

Fiscal risks are deviations from expected outcomes

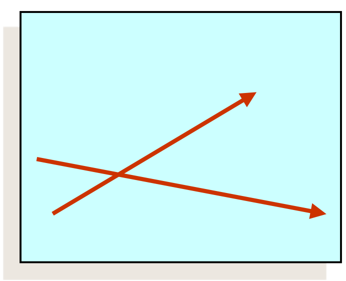
- Fiscal risk can be broadly defined as deviations of fiscal outcomes from what was expected at the time of the budget or other forecasts
- Fiscal risk can arise from both government revenues (assets) and expenditures (liabilities)



revenues fall



expenditures rise



worst case: both occur at same time

Source: World Bank Treasury

Definition of contingent liabilities

- Contingent liabilities are obligations triggered by a discrete but uncertain event
  - (Polackova Brixi and Allen Schick)

- Refers to obligations whose timing and magnitude depend on the occurrence of some uncertain future event outside the control of the government
  - (Aliona Cebotari)

- Like other obligations, they can have an impact on government finances – budget and debt size (fiscal risk)

Source: World Bank Treasury

Sources of fiscal risks can be direct or indirect and explicit or implicit

Possible sources of fiscal risk for central governments

	Direct liabilities	Indirect (contingent) liabilities
Explicit liabilities (Legal obligation, no choice**)**	❑ Foreign and domestic sovereign debt ❑ Budget expenditures—both in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions)	❑ Guarantees for borrowing and obligations of sub-national governments and SOEs ❑ Guarantees for trade and exchange rate risks ❑ Guarantees for private investments ❑ State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit liabilities (Expectations – political decision)	❑ Future public pensions if not required by law ❑ Social security schemes if not required by law ❑ Future health care financing if not required by law ❑ Future recurrent cost of public investments	❑ Defaults of sub-national governments and SOEs on nonguaranteed debt and other obligations ❑ Liability clean-up in entities being privatized ❑ Bank failures (support beyond state insurance) ❑ Failures of nonguaranteed pension funds, or other social security funds ❑ Environmental recovery, disaster relief

Source: Polackova, Schick (editors), Government at Risk, 2002, p. 23

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Guarantees and on-lending have similar economic implications

On-lending

- Government issues debt – and acquires an asset
  - Increases gross debt of govt.
  - Net debt unchanged
- **Contingent asset**
- **Credit risk**
  - If default, govt. writes down asset
- Transparent
  - Both assets and liabilities accounted and reported

Guarantees

- Government guarantees repayment
  - No effect on gross debt of govt.
  - Net debt unchanged
- **Contingent liability**
- **Credit risk**
  - If guarantee is called, govt. takes over liability
- Often not transparent
  - Guarantee not recorded

- While often treated differently in budgets and debt reports, objectives and economic implications of on-lending and guarantees are similar
- Willingness to repay may differ depending on institutional setup!

Source: World Bank Treasury

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Agenda

- ❑ Defining and categorizing different types of contingent liabilities
- ❑ **Framework for contingent liabilities risk management**

A sound risk management framework is based on risk analysis and quantification

1. **Defining characteristics**
   - ❑ Understanding context and key characteristics influencing approach to risk analysis
2. **Risk analysis**
   - ❑ Analyzing specific risk drivers
3. **Risk quantification**
   - ❑ Translating risk analysis into quantifiable measures
4. **Application in risk management**
   - ❑ Using risk measures to inform risk mitigation and management tools

Source: World Bank Treasury

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Defining characteristics of guarantee portfolio and risk exposure

1. **Defining characteristics**
2. **Risk analysis**
3. **Risk quantification**
4. **Application in risk management**

- **A** Characteristics of guarantee portfolio
- **B** Clear definition of risk exposure
- **C** Data availability
- **D** Resources and capacity

Source: World Bank Treasury

Key risk factors can be analyzed using different approaches

1. **Defining characteristics**
2. **Risk analysis**
3. **Risk quantification**
4. **Application in risk management**

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

Source: World Bank Treasury

Risk quantification can target various measures

1. **Defining characteristics**
2. **Risk analysis**
3. **Risk quantification**
4. **Application in risk management**

- Various **target measures**, such as
  - Expected loss
  - Market value
  - Unexpected loss
  - Maximum probable exposure

- 2 **primary approaches**
  - Price differentials
  - Bottom up: estimation of default probabilities

Source: World Bank Treasury

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Risk analysis and measurement can inform implementation of risk management tools

1. **Defining characteristics**
2. **Risk analysis**
3. **Risk quantification**
4. **Application in risk management**

Risk management tools

A Structuring of guarantee agreements
- ❑ Guarantee fees
- ❑ Partial guarantee coverage
- ❑ Collateral

B Setting limits

C Provisioning for financial losses
- ❑ Budgeting
- ❑ Contingency reserve accounts

D Reporting on and monitoring of risks

Source: World Bank Treasury

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