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MANAGEMENT CONSULTANTS

# The Fiscal Risks of Contingent Liabilities

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# Government Contingent Liabilities

- Main types of government contingent liabilities:
  - **guarantees** – a legal obligation to take on a liability should a specified uncertain event occur e.g. a loan guarantee
  - **warranties and indemnities** – assurances of protection from specified losses
  - **uncalled capital** – an unpaid portion of a shareholder's equity
  - **under-financed insurance schemes** where the premiums do not cover expected claims, or payments are financed entirely from general taxation
  - **legal action** against the state

**A contingent liability is not yet a liability – and may never become a liability!**

# Why Contingent Liabilities Create Problems

It may not be known today whether the government will have to pay something tomorrow, or next year, in five years time, or never

The amount of any payment is typically not known until and if the event or loss occurs – making it difficult to provide a budget provision

There is often a lack of information within government on individual contingent liabilities, and especially on the government's total possible exposure from all contingent liabilities

A single event may result in government having to pay out on a number of contingent liabilities at the same time, often at the same time that government revenues are falling – this can result in a shock to the government's budget

# Implicit Contingent Liabilities

- In contrast to explicit contingent liabilities – where there is a legal obligation - *implicit contingent liabilities* arise when there is an expectation that the government will take on an obligation *despite the absence of a contractual or policy commitment to do so*
- Experience suggests that markets expect governments to provide financial assistance far beyond any legal obligation if financial system stability is at risk
- Other common examples of implicit contingent liabilities arise from potential obligations to provide assistance to a sub-national or state entity that gets into financial difficulties

# Contingent Liabilities in Colombia

Figure 3.1: Stock of four types of explicit contingent liabilities in Colombia (in USD bn.)<sup>34</sup>



Source: Sub-directorate of Risk at the Directorate General Public Credit and National Treasury of Colombia

Contingent Liabilities Risk Management: A Credit Risk Analysis Framework for Sovereign Guarantees and On-Lending - Country Experience from Colombia, Indonesia, Sweden, and Turkey

# Legal Claims in Ireland

## **State Claims Agency**

Acting as the State Claims Agency, the National Treasury Management Agency (NTMA) manages certain claims against the State and assists State authorities in minimising their claim exposures

# Disaster Risk Financing Initiative (DRFI)

- In 2013, the OECD in cooperation with the ADB, UNISDR and the World Bank, conducted a survey of disaster risk financing practices within APEC, including implementation challenges
- In 2013, the ASEAN Secretariat established the ASEAN Cross-Sectoral Coordination Committee on DRFI which in phase 1 (2015-16) focused on capacity building on risk information, assessment and modelling, policy development, and knowledge management on DRFI
- APEC Disaster Risk Financing Solutions Working Group established in February 2016 (currently chaired by Peru)
- World Bank is managing the *Sovereign Disaster Risk Financing and Insurance-SECO Program* (DRFI) covering 7 countries including Azerbaijan, Indonesia and Vietnam

# Management of Contingent Liabilities

A comprehensive approach to managing contingent liabilities requires:

1. Centralised register of all contingent liabilities
2. Controls over issuing new guarantees and other types of explicit contingent liabilities
3. On-going monitoring of existing guarantees and contingent liabilities
4. Connecting contingent liabilities to budgeting, fiscal reporting, debt management, and auditing
5. Incorporating contingent liabilities into fiscal risk and fiscal sustainability analysis



# Reporting: New Zealand

Notes to the Financial Statements

## Note 28: Contingent Liabilities and Contingent Assets

Contingent liabilities are:

- ☐ costs that the Crown will have to face if a particular event occurs, or
- ☐ present liabilities that are unable to be measured with sufficient reliability to be recorded in the financial statements (unquantifiable liabilities).

Typically, contingent liabilities consist of guarantees and indemnities, legal disputes and claims, and uncalled capital. The contingent liabilities facing the Crown are a mixture of operating and capital risks, and they can vary greatly in magnitude and likelihood of realisation.

In general, if a contingent liability was realised, or the amount becomes sufficiently reliable to record as a liability, it would reduce the operating balance and net worth and increase net core Crown debt. However, in the case of some contingencies (eg, uncalled capital), the negative impact would be restricted to net core Crown debt.

Contingent assets are possible assets that have arisen from past events but the amount of the asset, or whether it will eventuate, will not be confirmed until a particular event occurs.

Contingent liabilities and contingent assets involving amounts of over \$20 million are separately disclosed. Any quantifiable contingencies less than \$20 million are included in the "other quantifiable" total. Some contingencies of the Crown are not able to be quantified; these unquantifiable contingent liabilities and contingent assets are disclosed as at 30 June 2016 where they are expected to be material but not remote. Where there is an obligation under New Zealand GAAP, amounts have been recognised in the financial statements.

## Contingent liabilities

### Quantifiable Contingent Liabilities

Uncalled capital  
Guarantees and indemnities  
Legal proceedings and disputes  
Other contingent liabilities


### Total quantifiable contingent liabilities

### By source

Core Crown  
Crown entities  
State-owned enterprises

### Total quantifiable contingent liabilities

Note	Actual	
	30 June 2016 \$m	30 June 2015 \$m
a	7,910	7,337
b	288	310
c	221	247
d	314	379
	<b>8,733</b>	<b>8,273</b>
	8,593	8,025
	40	30
	100	218
	<b>8,733</b>	<b>8,273</b>



# Annexes: Examples of Contingent Liabilities

# Examples of Implicit/Explicit Liabilities

	<u>Direct</u>	<u>Indirect</u>
<u>Explicit</u>	<b>CREDITOR: bondholders, banks, governments</b>	<b>CREDITOR: central government, foreign governments, banks, bondholders</b>
	Central government tradable debt <ul style="list-style-type: none"> <li>• Domestic and external</li> </ul> Central govt non-tradable debt <ul style="list-style-type: none"> <li>• Domestic and external</li> </ul>	Liabilities of SOEs Liabilities of sub-national governments State guarantees: <ul style="list-style-type: none"> <li>• Loans &amp; deposit guarantees</li> <li>• Financial guarantees (i.e. currency board)</li> </ul>
<u>Implicit</u>	<b>CREDITOR: central government unless passed on to above creditors</b>	<b>CREDITOR: central government unless passed on to above creditors</b>
	Public works projects Future public pensions not under law Social security schemes not under law Health care financing	Default of sub-national government or SOE Cleanup of privatized entities Bank or capital markets failures Non-guaranteed pension fund failure Central bank defaults Disaster or emergency relief

# Examples of Contingent Liabilities

## (1)

Government guarantees repayment of a loan borrowed by a non-government entity such as an SOE, a sub-national entity, or even a private company

Government has an established practice of providing assistance to those who suffer losses from natural disasters, and finances this from general taxation rather than from insurance premiums

Government provides a guarantee to a private provider of a public utility service that there will be a minimum level of demand for the service (e.g. volume of electricity consumed/sold)

Government gives an undertaking that it will protect consumers of a good or service from any losses they may suffer (e.g. protect depositors from losses in the event of a bank failure)

# Examples of Contingent Liabilities

## (2)

Government is obliged, as a shareholder, to provide further capital to an international financial institution should the institution require it (e.g. ADB, IMF or World Bank)

Government faces possible losses arising from legal action taken against it under a commercial contract with a private company or as a result of an environmental incident

As part of the privatization of an SOE, government indemnifies the buyer against possible future environmental clean-up costs resulting from past levels of contamination

Government enters into a PPP with a private electricity company for BOT hydro power plant – the agreement provides a guaranteed minimum price & supply for electricity sold on the grid