



BETTER POLICIES FOR BETTER LIVES

Policy Dialogue on Managing Contingent Liabilities

Session 1: Understanding the risks

Pretoria, South Africa

December 7-8 2016

Outline

- The concept of risk management
- Understanding the risks arising from CLs
 - Types and main characteristics of CLs
 - Fiscal risks associated with CLs
- Final remarks

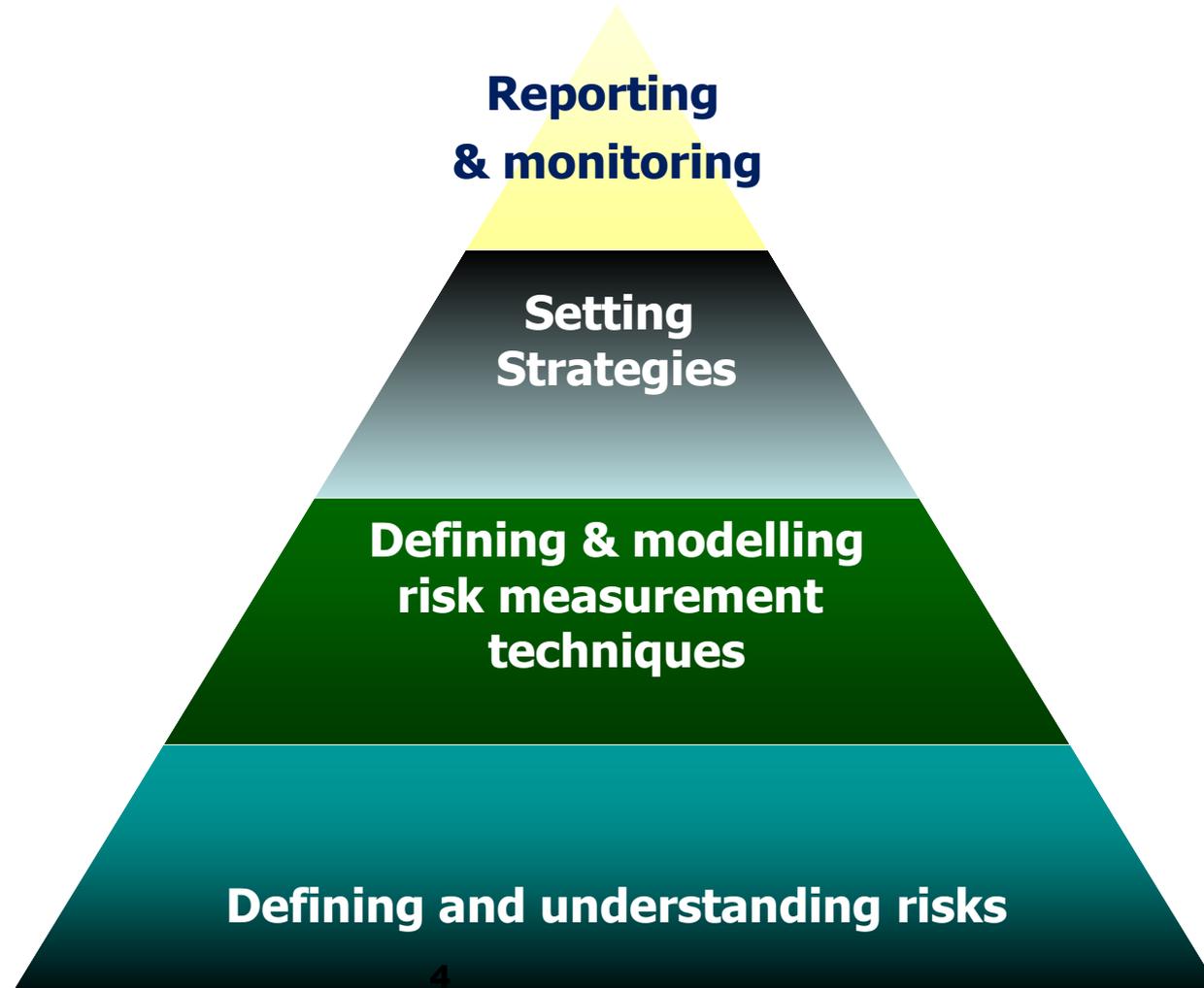
The concept of risk management

- Risks can come from uncertainty in financial markets, legal liabilities, counterparties, accidents, operational procedures, natural disasters, or events of uncertain or unpredictable root-cause.
- Risk management is the process of identification, assessment, prioritization, control, avoidance, minimization, or elimination of unacceptable risks.
- Its purpose is to support better decision-making through understanding the risks inherent in a proposal and their likely impact.

Source: www.wikipedia, [ISO 31000](#)

The concept of risk management

Process Phases



Understanding the CLs

- **Explicit CLs**
 - Legal obligations for governments to make payments only if particular events occur
 - Examples: State guarantees, state insurance schemes, trade and exchange rate guarantees
- **Implicit CLs**
 - Moral obligations of governments to undertake
 - Examples: bail-outs of banks, defaults of nonguaranteed obligations of local governments/SOEs, environmental recovery, disaster relief

Source: Advances in Risk Management of Government Debt, OECD 2005

Understanding the CLs

Main characteristics

- **Degree of uncertainty**
 - CLs materialize only if certain events occur, and the size of the fiscal pay-out depends on the structure of the undertaking
- **Wide range of sources**
 - CLs can arise from a wide range of sources (including Treasury guarantees, insurance schemes such as deposit insurance, derivative contracts and PPPs) with involvements of a number of public and private institutions
- **Optimism bias**
 - Several country cases show that governments are usually biased towards favourable outcomes in contingent liabilities

Understanding the risks arising from CLs

- **Credit risk** is particularly relevant for CLs
 - It refers to the risk of non-performance by borrowers on loans or other financial assets, or by a counterparty on financial contracts
- **Operational risk**
 - The risk of direct or indirect loss resulting from inadequate or failed internal processes, people, system or from external events
- **Moral hazard**
 - If contingent liabilities are poorly managed, they tend to be associated with significant moral hazard problem among beneficiaries

Source: Advances in Risk Management of Government Debt, OECD 2005 and Revised Guidelines for Public Debt Management, IMF/World Bank 2014

Understanding the risks arising from CLs

- **An effective governance of contingent liabilities requires**
 - A robust legal framework
 - Policy and project level risk management (see slide 4)
 - Institutional arrangements of roles and responsibilities
- **A centralized approach in risk management**
 - Country examples suggest a “pareto efficiency” when risks associated with CLs are managed as an integral part of the debt management. If not, the debt managers should be aware of the explicit contingent liabilities that the government has entered into.

Source: *Advances in Risk Management of Government Debt*, OECD 2005 and *IMF/World Bank Revised Guidelines for Public Debt Management 2014*

Final remarks

- CLs are important sources of fiscal risks
- Mismanagement of these risks can result serious fiscal instability
- Sound risk management practices of CLs suggest followings:
 - ✓ Identification and classification
 - ✓ Measurement and pricing
 - ✓ Design and application of risk mitigation techniques
 - ✓ Monitoring and reporting of the CLs.

Final remarks

- By adopting risk based CL management approach, we can better understand, measure and effectively manage the exposure
- A Risk-based approach is necessary but not sufficient for a prudent CL management. Other elements include
 - Efficient co-operation and coordination with all stakeholders
 - Ensuring transparency and accountability principles