

Contingent Liability Risks from State-Owned Enterprises

What are the key principles to emphasize in addressing contingent liabilities of poorly performing state-owned enterprises (SOEs) and parastatals?

INTRODUCTION

Countries across all continents face the challenge of managing contingent liabilities arising from multiple sources, including state-owned enterprises, parastatals, off-budget financing arrangements, civil servant entitlement schemes etc. The current financial crisis has made countries even more vulnerable to the severe impact of contingent liabilities on government finances, creating an urgent need to institutionalize systems to control and mitigate fiscal risks arising from these contingent liabilities.

This note captures the technical advice provided by the PSP GET in response to a just-in-time request by Bank staff working with government officials in a Middle-Eastern country to manage contingent liability risks arising from state-owned enterprises (SOEs).

The financial crisis in this case posed two distinct challenges. One, a large number of off-budget and contingent liabilities have emerged—mainly from SOEs—creating considerable unforeseen costs for the government. Second, there is a need to reassure financial markets that the country takes public fiscal and corporate governance seriously. The financial crisis is creating considerable impetus for reform in the area of public financial management and opening doors for more far reaching governance reforms.

What are the key principles that should be emphasized in response to government concerns about contingent liabilities emerging from poorly performing state-owned enterprises (SOEs)?

SUMMARY OF ADVICE:

In essence, reform strategies should bring SOEs into more transparent arrangements and to control, or otherwise limit, the financial exposure that such entities can undertake. For some entities, this may involve fully integrating them into the budget, while for others placing them within a broader holding company or otherwise ensuring that their holdings are audited regularly would be the solution.

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First, get a clear picture of the *magnitude of the problem* the government is confronting. This would involve conducting an inventory of state enterprises and parastatals, their assets and liabilities, and flagging assets and liabilities whose value is unknown and or highly speculative. Particular attention should be put on the banking and real estate sectors, which for many countries enjoys markedly less oversight and weaker regulatory environment than other sectors.

Next, a *classification of the risks* faced should be undertaken, including establishing the boundaries or parameters of fiscal risk in the form of low and high-end estimates.

Based on the risk identification and classification, a range of *strategies that acknowledge the political economy issues* should be devised—and employed on a case-by-case basis—to mitigate against these risks.

GUIDING PRINCIPLES:

PRINCIPLE 1: Know the nature and scope of the problem

- 🌐 Conduct an inventory of all SOEs. Unfortunately, some countries do not have a clear picture of how many SOEs exist, as each ministry is able create them at will (sometimes they are used as an extra-budgetary fund to ‘park’ budget resources) or they can be created by sub-national governments (where they might take on domestic and external debt without oversight).

- 🌐 Quickly review a given country’s capacity for debt management, identifying how the office is structured and managed, staff training and capacity needs, performance targets and other elements.

GUIDING PRINCIPLES:

- **Know the magnitude of the problem;**
- **Put in place viable length governance principles for State-owned Enterprises;**
- **Create transparent arrangements for loan guarantees;**
- **Incorporate fiscal risk assessment in policy discussions and budgeting processes.**

PRINCIPLE 2: Put in place viable arms’ length governance principles for State-owned Enterprises

Getting the governance arrangements right for public commercial and non-commercial business operations is essential. The state should place at arms' length its enterprise interests and attempt to limit public exposure (for the value of its equity in the business).

- 🌐 Put in place clear and consistent accounting standards for the SOEs, consistent with IPSAS/IFAC international standards, and requirements for regular financial reporting, auditing of year-end financial statements, and transparency through public annual reports. To improve transparency, the balance sheets of SOEs could be added as an informational annex to the budget.
- 🌐 Ensure clear arrangements for oversight of SOE finances. One example is to have a unit in the treasury responsible for SOE oversight, which includes monthly monitoring of all SOE balance sheets, and with a mandate to intervene before financial trouble arises to avoid hitting the central government balance sheet.
- 🌐 Clear identification of quasi-fiscal activity (non-commercial activity) required by government. That is, incorporate in the annual budget quasi-fiscal activity transfers for SOEs, including general subsidies and new requested guarantees by SOEs. Hence, making these decisions subject to transparency and explicit risk assessment.

PRINCIPLE 3: Create transparent arrangements for loan guarantees

- 🌐 Show all loan guarantees in an annex to the budget documentation. Information should at a minimum specify: i) name of beneficiary; ii) lending institution; iii) amounts to be paid per year, including the final principal payment; and iv) the purpose of the guarantee.
- 🌐 Collect information on loan guarantees for X number of previous years to estimate risks, construct a frequency distribution of default rates and analyze the assembled information for default rates in different sectors, liquidity exposure by year, repeater borrowers and other relevant categories.
- 🌐 Value the loan guarantees (where it is possible) using a variety of methodologies available, for example, by creating an upper and lower band via a simulation.
- 🌐 Include – eventually – a contingency in the budget for payment of guarantees. Initially, the contingency may be based on rough estimates but over time, as data on default risks becomes more comprehensive, a more precise estimate can be developed.

PRINCIPLE 4: Incorporate fiscal risk assessment into policy discussions and budgeting processes

- 🌐 Other contingent liabilities may not appear to be quite as risky as loan guarantees, however, the financial crisis may be an opportune moment for governments to perform an overall assessment of fiscal risk, including the structure of entitlements.
- 🌐 Establish tracking mechanisms to provide comprehensive and timely data to inform budgeting and policy formulation. An entity, such as a public debt management office, should be given the responsibility for tracking key indicators related to the guarantees. Once established, in the context of annual budgeting, the legislature/executive could set *ex ante* limits on the amount of guarantees that can be issued, depending on the fiscal situation and resource estimates. In one country, each new guarantee had to be approved by parliament, and the total transparency substantially reduced requests for new guarantees.
- 🌐 Be transparent about recording contingent liabilities. Some contingent liabilities are easy to value, while others are not. At the very least liabilities should be recorded and made transparent. Where they are of a contractually known nature, such as a guaranteed loan, they should be recorded in all their glory.
- 🌐 In early pre-budget statements or policy documents, some government discussion of the problem, and the policies being put in place to manage it, will do much to give confidence to markets.

FURTHER READING MATERIALS AND REFERENCES:

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Polackova, Hana and Allen Schick. *Government at Risk: Contingent Liabilities and Fiscal Risk* (2002). World Bank, Oxford University Press.

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