Special Section 2: Managing Contingent Liabilities in Pakistan

Contingent liabilities (CLs) are off-budget activities that appear on government balance sheet only when the event actually happens. These generally relate to government guarantees, which may be explicit or implicit. The explicit liabilities are the guarantees issued to sub national governments, public or private sector entities against their borrowing. While these explicit government guarantees are issued by law or by a contract, implicit guarantees could be in the form of moral obligations like rehabilitation expenses in post-natural disasters or support to troubled banks and/or public sector enterprises (PSEs) during crises.

The main risk associated with the CLs is the fiscal cost after their occurrence. Once realized, these could result in additional burden on the government resources and can lead to a higher debt/GDP ratio. Bova et al (2016) shows that CLs – mainly government support to financial institutions – emerged as a drain on fiscal resources in advanced and emerging economies during 1990-2014. Their estimates show average cost of 6.1 percent of GDP, the median stood at 2.3 percent of GDP (**Table S2.1**). Another important finding was that CLs usually realize during the crises period; for instance, emerging market economies during Asian Crises 1997-98 and advanced economies during Global Financial Crises 2008.

Table S2.1: Cost of Contingent Liabilities Realization (1990-2014)

Type	Number of episodes	Episodes with cost	Average cost*	Maximum cost*
Financial sector	91.0	82.0	9.7	56.8
Legal	9.0	9.0	7.9	15.3
Sub-national governments	13.0	9.0	3.7	12.0
SOEs	32.0	31.0	3.0	15.1
Natural disasters	65.0	29.0	1.6	6.0
Private non-financial sector	7.0	6.0	1.7	4.5
PPPs	8.0	5.0	1.2	2.0
Others	5.0	3.0	1.4	2.5
Total	**230**	**174**	**6.1**	**56.8**

*As percent of GDP

Source: Bova et al (2016)

In case of Pakistan, the latest available data shows that issuance of new guarantees amounted to Rs 586.3 billion during FY17 compared to an average of Rs 143 billion during last five fiscal years.[1] As a result, the outstanding stock of CLs rose to Rs 936.9 billion or 2.9 percent of GDP as of June 2017. Importantly, around 90 percent of the guarantees were on domestic loans.

Table S2.2: Government Guarantees to PSEs

Billion rupees

	FY11	FY12	FY13	FY14	FY15	FY16	FY17
SECMC						52.0	
NPGCL				37.7		35.6	
PHPL		136.5	103.0		96.0	32.5	
PIA	4.5	9.5		38.5	58.8	18.7	
WAPDA	6.5			19.3			
PSM		8.9	20.0	4.2			
Central Power Generation Company Limited		43.9					
Others	51.5	4.5	13.0	6.2	1.2	52.2	
Total(Flow)	62.4	203.2	136.0	105.7	155.9	190.9	586.3*
Outstanding stock	559.0	516.0	626.0	555	644	721.2	936.9
Percent of GDP							
Flow	0.3	1.0	0.6	0.4	0.6	0.6	1.8
Outstanding stock	3.1	2.6	2.8	2.2	2.3	2.4	2.9

*Absolute number derived from data on new guarantees as percent of GDP for FY17 period

Source: Debt Policy Coordination Office, Finance Division (http://finance.gov.pk/dpco/guarantees.pdf)

Guarantees are generally issued to PSEs to cover for their losses and to ensure smooth running of their

[1] This largely stemmed from ongoing investment in power sector.

day-to-day operations.[2] This, nevertheless, creates a moral hazard and increases the default risk, as guarantees usually cover losses on default. The entity-wise detail suggests that loss-making entities regularly rely on government guarantees for their day to day operations (**Table S2.2**). [3]

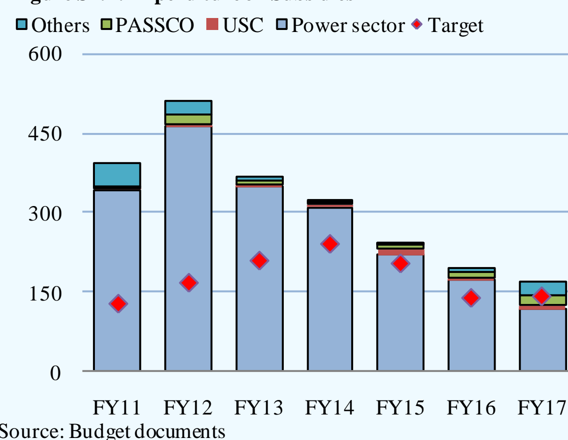
Table S2.3:PSE Debt
billion rupees

	Stock						Flow	
	Jun-12	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17	FY16	FY17
Domestic	281.1	312.2	366.2	458.7	568.1	822.8	109.3	254.7
WAPDA	9.6	9	20.6	18.9	55.8	81.4	36.9	25.7
OGDC	1.1	0.9	2.5	2.3	2.0	3.1	-0.3	1.2
PIA	48.3	61.1	67.6	78.7	99.8	122.4	21.1	22.6
PSM corporation	25	36	39.7	42.3	43.2	43.2	0.9	0
Other	197.1	205.2	235.9	316.6	367.3	572.6	50.7	205.3
External	144.2	183.2	203.8	252.6	294.0	283.8	41.3	-10.2
Guaranteed	21.4	59.3	53.1	98.7	132.5	127.3	33.8	-5.2
Non-guaranteed	122.8	123.9	150.7	153.9	161.4	156.5	7.5	-4.9
Total debt	**425.2**	**495.2**	**569.8**	**711.3**	**862.1**	**1106.6**	**150.8**	**244.5**
Total debt (% of GDP)	**2.1**	**2.2**	**2.3**	**2.6**	**3.0**	**3.5**	**-**	**-**

Source: State Bank of Pakistan

Despite significant increase in the new guarantees issued, it remained within the limit of 2 percent of GDP set under the Fiscal Responsibility and Debt limitation Act 2005. At the same time, the stock of the PSEs debt has increased sharply by Rs 232.3 billion during FY17 with the stock of PSE debt reaching Rs 1.0 trillion as of June 2017 or 3.5 percent of the GDP (**Table S2.3**). This coincides with the reduction in expenditures on subsidies, which are alternate to guarantees (**Figure S2.1**).[4]

Figure S2.1: Expenditure on Subsidies



Source: Budget documents

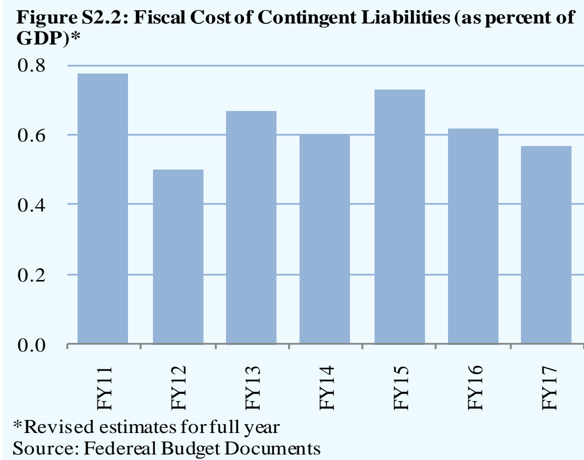
The data on fiscal operation shows that government expenditures on contingent liabilities have in general declined in terms of GDP in past few years (**Figure S2.2**). Despite some improvements, annual financial losses of PSEs remain at 0.3 percent of GDP, reaching around 3.8 percent of GDP in cumulative terms (source: IMF estimates). Given government guarantees behind most of borrowings by PSEs and the need for government grants to cover these losses, the fiscal cost could increase in future.

[2] This is worth noting that despite privatization, PSEs carry a lot of significance for the economy. First, Aftab et al (2013) show that more than hundred of the PSEs are involved in wide range of economic activities, that accounts for 10 percent of GDP and one-third of the market capitalization. These PSEs provide public services like power, transport, logistics, banking insurance etc. Second, disruption in operations of the PSEs can hurt private sector growth due to poor service delivery of the public goods.
[3] The estimated losses of some key PSEs enjoying government guarantees stood at Rs 29.9 billion for PIAC (2015), Rs 28.2 billion for PR (2015-16), and Rs 18.5 billion for the power sector (FY15).
[4] Generally, it is believed that the government guarantees are alternate to subsidies or direct transfers. The key difference between the two is their impact on the fiscal account. Subsidies hit the budget directly and increase the public debt, while guarantees only affect, if realized. In terms of cost, issuing guarantees could nevertheless be cheaper than the direct subsidies, if the default risk is low. However, it can result in an additional cost due moral hazard behavior, both from beneficiary and issuer perspective. As the lending is guaranteed, this can lead to insufficient losses prevention efforts by the beneficiary. From the issuer perspective, such support doesn't involve any approval or scrutiny involved in the budget making process.

How to minimize the impact of CLs on fiscal accounts and public debt?

Avoiding contingent liabilities is neither feasible nor a realistic option for the governments. The CLs have to be managed to minimize their fiscal costs and impact on debt sustainability. It has become more important, particularly in view of projects under CPEC, some of which are in public-private partnership mode. The absence of any oversight on CLs could either result in fiscal cost or disruption in the projects or production process in public entities. In this regard, some of the best practices adopted by many countries to manage the risks associated with CLs are summarized as follows:

Figure S2.2: Fiscal Cost of Contingent Liabilities (as percent of GDP)*



*Revised estimates for full year
Source: Federeal Budget Documents

Ceiling on stock/flow of contingent liabilities

Pakistan has already adopted this best practice and placed a ceiling on issuance of new guarantees to 2 percent of GDP under FRDLA 2005. A few countries have also introduced limit on stock of guarantees. For instance, South Africa limits the sum of net debt and contingent liabilities to 50 percent of GDP. Similarly, India has the rules for some states; which require outstanding state guarantees should not exceed some percentage of their revenue (around 70-80 percent). Limiting the stock of government guarantees is important for Pakistan, as the outstanding stock of CLs hovers around 2.5 percent of GDP over the last five years.

Parliamentary approval of the contingent liabilities

A number of the OECD countries require parliamentary approval of the loan guarantees. In some countries, this requirement is a part of budget laws and is written in the constitution in other countries. For example, Sweden's Budget law only allows guarantees for the purposes approved by parliament, while Finland and Germany has such requirement in the constitution. In some cases, the ministry of finance is authorized to approve the guarantees; however, they have to report to parliament at the time of its realization (e.g. South Africa).

The rationale behind need for approval of contingent liabilities from parliament is due to their likely impact on the fiscal accounts. In particular, the explicit guarantees are considered like government debt instruments that require contingent expenditures, which require approval as in case of any conventional expenditure.

Impose limit on financial claims

When the lending is fully backed by government guarantees, the banks have little incentives to carry out due diligence with respect to borrower's credit worthiness. One arrangement to minimize such moral hazard could be to share some risk with private sectors. Usually, the governments set the limit on the financial claims that can arise in case of contingent liability realization. For instance, in Canada, the government sets limits on guarantees to a maximum of 85 percent, while EU state rules prohibit the government from guaranteeing more than 80 percent of any loan.

Contingency reserve fund

Many countries secure financing in the form of contingency reserve fund in the budget that could be used to meet calls on contingent liabilities. The size of this fund is small (usually less than 3 percent of total spending) and its usage is restricted to items to calls on contingent liabilities. While most of the countries have the contingency funds for natural calamities, Colombia has contingency fund for state entities. This fund is managed by the ministry of finance and financed through the fee charged

to public entities according to their exposure to guarantees. The Public Debt Office is responsible for assessing the individual entities' contribution, ensuring that present values of contingent liabilities are aligned with present value of the contributions.

Scrutiny through Auditor General of Pakistan

Many countries have supreme audit institutions (SAIs) having responsibilities of oversight and audit of contingent debts. Along with future implications of other economic decision made by the government, the audit office also examine the fiscal impact of contingent debts (e.g., Lithuania, Mexico, Portugal, and Sweden). The SAI findings are generally reported to parliament, either as stand-alone reports or through annual reports on the work of the SAI.

Early caution system

Many countries developed early caution system for the issuance of government guarantees. For example, in Australia, the guidelines require the government not to issue guarantees in case there is any explicitly identified risk of default and that the expected benefits outweigh the risks associated with the guarantee, even if the associated risks are managed through commercial insurance.

Canada has a similar principle under which they evaluate: the possibility of project financing without a government guarantee and whether future cash flow would be enough to cover principal and the interest payment. In the European Union, the framework restricts the provision of guarantees to a limited set of activities.

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