INTOSAI PUBLIC DEBT COMMITTEE

MEMBER STATES QUESTIONNAIRE ON CONTINGENT DEBT

OUTCOMES & RECOMMENDATIONS

1. Introduction

1.1 The INTOSAI Public Debt Committee has a long standing interest in the subject of contingent debt. In May 2000, the Committee published "Guidance on the Reporting of Public Debt" – this included the results of a survey of Supreme Audit Institutions (SAIs) on the levels and type of contingent debt and their audit role. This was followed in February 2003, with the publication of "Fiscal Exposures: Implications for Debt Management and the Role for SAIs" and "Public Debt Management and Fiscal Vulnerability: Potential Roles for SAIs". In their consideration of fiscal exposure, both documents recognised the risk of contingent debt as a potential source of significant public debt.

1.2 At its 2003 meeting in Mexico City the Committee noted the desirability of further focussed work on contingent debt informed by a questionnaire circulated to member SAIs. A draft questionnaire was prepared for approval at the 2004 meeting in Moscow and the results presented at the Committee's 2005 meeting in Sofia.

1.3 This paper draws on the results of the questionnaire to identify outcomes and make recommendations for INTOSAI members to consider when addressing the issue of contingent debt. The paper is organised around key areas that SAI's might take into account when planning their work. These are summarised briefly below.

- definition of contingent debt – is there a shared understanding between relevant entities of what is meant by 'contingent debt'?

- identification and classification of contingent debt – does a framework exist to facilitate complete and accurate identification and classification of contingent debt?

- assessing the expected costs of contingent debt – is an appropriate methodology used to calculate the expected cost of contingent debt?

- reporting of contingent debt – are adequate reporting processes in place?

- budgeting for contingent debt – to what extent is budgetary provision for contingent debt aligned to estimates of expected costs?
- control mechanisms and risk management – are adequate controls in place around the take on of contingent debt and are the risks associated with contingent debt managed effectively?

- role of the SAI – does the SAI's remit allow for effective independent scrutiny of contingent debt?

2. Definition of contingent debt

2.1 There is widespread recognition and usage of the term 'contingent debt' amongst different countries. Generally, the term is used to encompass potential liabilities that might arise as a result of defined events whose future incidence is uncertain. However, precise interpretations between countries vary depending on local circumstances and the framework used to consider the concept of contingent debt. For example, legal, GAAP, or national accounts based approaches may lead to different conclusions about precisely what should or should not be included.

2.2 Some countries use terms other than contingent debt to express similar concepts. For example, Sweden uses the term 'economic commitments' to cover a wide range of explicit liabilities including government guarantees. Argentina uses 'indirect debt' to represent the debt of any natural or legal person, public or private, other than central government itself, which is backed, secured or guaranteed by central government.

2.3 The potential for confusion about exactly what is meant by contingent debt or similar terms could be carried over to the domestic arena, with scope for different entities within a country to have varying views. Consequently, when working in this area the SAI should, at an early stage, agree with relevant entities a common terminology and understanding of what it means. This issue might be eased in the context of financial audit, where prevailing accounting standards are likely to include relevant definitions. However, it would still be prudent to ensure that the interpretation of accounting standards is consistent between different entities. The need to agree terminology and its scope is potentially greater when conducting performance audit where such work is not bound by the accounting standards framework with a consequent increase in the risk of misunderstanding occurring.

> **Recommendation 1 –** *when conducting work on contingent debt, and if not already in place, the SAI should at an early stage, seek agreement with relevant entities on the terminology to be used and its precise meaning.*

3. Identification and classification of contingent debt

3.1 To manage actual and potential liabilities effectively, countries need to have reliable methodologies in place to facilitate the identification and classification of contingent debt. The results of the Committee's questionnaire on contingent debt indicated that not all countries had effective systems in place, while those that did often adopted different approaches to suit their particular circumstances. Some examples of approaches used to classify actual and contingent debt are given below.

Approaches to the classification of actual and contingent debt
1. Fiscal risk matrix – this approach separates debt into direct (predictable obligations that will arise in any event) and contingent (obligations triggered by a discrete but uncertain event). Direct and contingent debt can be either explicit (specific obligations defined by law or contract) or implicit (a moral obligation or expected burden). This results in four classes of possible debt: (i) explicit direct debt (ii) implicit direct debt (iii) explicit contingent debt (iv) implicit contingent debt).
2. Debt spectrum – a variation on the fiscal risk matrix, this approach, notes the usefulness of regarding fiscal exposures as a spectrum extending from explicit liabilities to implicit promises embedded in current policy or public expectations. The spectrum identifies four types of possible debt: (i) explicit liabilities (ii) explicit financial commitments (iii) financial contingencies (iv) exposures implied by current policies or the public's expectations about the role of government.
3. GAAP approach – this approach follows Generally Accepted Accounting Practice and uses the following classifications depending on the level of certainty of a liability occurring: (i) creditor – a financial transfer will definitely take place in the future (ii) provision – a financial transfer is certain or probable, but there is uncertainty over the timing or precise amount (iii) contingent liability – possible financial transfer but uncertainty around whether the event that would trigger the transfer will occur (iv) remote contingent liability – possible financial transfer but unlikely to occur.

Recommendation 2 – *when conducting an audit of contingent debt figures, the SAI should consider the integrity of the systems that produced them - for example to ensure the completeness and correct disclosure of the figures presented for audit. More generally, scope may exist for the SAI to add value through an examination of how the government identifies and classifies its liabilities, including contingent debt.*

4. Assessing the expected costs of contingent debt

4.1 Nearly all the respondents to the Committee's questionnaire indicated that their country made efforts to calculate the expected costs of at least some elements of the government's contingent debt. Most common were estimates in respect of 'explicit contingent debt' (specific obligations defined by law or contract) and in particular, of amounts relating to government guarantees.

4.2 Respondents noted a range of factors about practices in their countries that SAIs might find useful when working in this area. These are summarised below.

Assessing the expected costs of contingent debt – key points arising from the questionnaire on contingent debt
1. The diverse nature of contingent debt types - government contingent debts can arise in a wide-variety of areas both within and outside the public sector – countries may not have effective systems in place to (a) calculate the expected costs of all contingent debts (b) draw together expected cost information to facilitate the overall management of contingent debt.
2. Relative indicators of contingent debt - in addition to calculating the absolute values for contingent debt and its expected costs, many countries produce relative assessments – for example, expressing contingent debt costs as a percentage of annual government expenditure or gross domestic product. Such indicators can be useful when considering the 'affordability' of expected liabilities.
3. Contingent revenues - estimates of expected contingent debt costs are supplemented in some countries by additional estimates in respect of 'contingent revenues' – revenues that are due to the government but will probably not be paid. This wider approach can help to provide a more complete picture of the overall fiscal position.
4. Probability of contingent debt materialising – some countries calculate the total value of contingent debts – for example, state guarantees – but not the amounts that are expected to actually be paid. Others do estimate expected payments – for example, by assessing the

likelihood of government guarantees being called upon during the year. This approach seems likely to provide a better platform for the effective management of contingent debt.
5. Exchange rates – some countries perform an assessment of future exchange rates to help determine the expected value/cost of foreign denominated contingent debt.
6. Ratings agencies – one respondent to the questionnaire noted that ratings agencies were used to help assess the likelihood of the government's need to make payments against explicit contingent debts.
7. Self financing contingent debt – certain types of contingent debt might be operated as 'self financing'. For example, a state guarantee scheme could have the objective of being self financing through the payment of guarantee commission or fees.
8. Quantifiable & non quantifiable contingent debt – many countries recognise the distinction between quantifiable and non-quantifiable debt i.e. that in some cases it may not be possible to attach numerical figures to the contingency with any degree of reliability. Rather than ignoring such non-quantifiable contingencies, some countries ensure that appropriate descriptions are provided in reports/statements containing information on contingent debt – this helps to reduce the chance of the risks associated with non-quantifiable contingent debt being overlooked.
9. Implicit contingent debt – the questionnaire responses indicated that most countries focus their efforts on calculating the expected costs of explicit rather than implicit contingent debt. This reflects the more 'immediate' nature of explicit contingent debt relative to implicit contingent debt. Also, recognition of implicit liabilities creates the risk of 'moral hazard' – i.e. the knowledge that the government has accepted a responsibility to meet implicit liabilities may encourage those who benefit from this assurance to behave in 'morally hazardous' ways and increase the government's exposure. However, it would be imprudent for governments not to consider exposures to implicit risks and it was notable that where implicit debt was analysed the amounts involved were very large.

4.3 When undertaking work on the expected costs of contingent debt, the SAI might usefully consider the relevance of the specific points identified above for its work. More generally, the SAI should reflect on the questions in 'Recommendation 3' below.

Recommendation 3 – *when examining the expected cost of contingent debt the SAI should include consideration of the following issues:*

- *has the government attempted to assess (a) the total potential liability and (b) the expected cost, for each type of contingent debt identified. Does the assessment encompass a range of scenarios?*

- *for those areas where no attempt has been made to assess the potential liability and expected cost – could such an assessment be made using practical and reliable techniques or is the contingent debt unquantifiable?*

- *does the government produce appropriate descriptive information about non-quantifiable contingent debt?*

- *for those areas where the total potential liability and expected cost have been estimated – have suitable techniques been used to produce reliable figures?*

- *is implicit contingent debt a neglected subject? – given the potentially large scale of the contingencies that fall into this debt classification is there a need for work on the absolute value and expected cost of implicit contingent debt, taking into account the risk of 'moral hazard'?*

5. Reporting of contingent debt

5.1 The ability of a country's Parliament to oversee effectively the contingent debt taken on by the government is determined largely by the adequacy of reporting arrangements – i.e. by the information on contingent debts that is reported to it each year. This is an area where SAIs may have a keen interest as they seek to ensure the accountability of the executive to the legislature.

5.2 Responses to the Committee's questionnaire on contingent debt indicated that most countries had some form of reporting arrangements, although the details varied. Some examples of reporting requirements that SAIs might expect to find are given below:

- an annual report from the government to Parliament which includes a section on contingent debt – for example, including numerical and narrative information on state guarantees;

- the presentation to Parliament of an annual statement of state guarantees;

- an annual statement from the government on national debt;

- the presentation to Parliament of audited accounts for individual government bodies, central government or the whole of government, containing information on contingent debt as required by prevailing GAAP;

- the government's annual budget statement containing information on contingent debt;

- the completion of ad-hoc reports on specific aspects of contingent debt – for example, on significant implicit contingent debts not reported on elsewhere.

Recommendation 4 – *when considering the adequacy of arrangements for the reporting of contingent debt information to Parliament, the SAI should assess whether the information provided is:*

- *complete – does it cover all material elements of contingent debt?*

- *understandable – can it be understood by those receiving it?*

- *accurate – where appropriate, does it reflect audited amounts?*

- *regular and consistent – does the frequency and form of the information provided facilitate effective ongoing oversight?*

6. Budgeting for contingent debt

6.1 When contingent debts become actual debts, it is important for the maintenance of fiscal stability that the government has the means to service these liabilities. To this end, the Committee's questionnaire on contingent debt revealed that many countries recognised the expected costs of certain contingent debts in the government's budget – for example, through the creation of general or specific contingency reserves.

6.2 Budgetary recognition of contingent debt is generally restricted to areas where the government expects costs to be incurred within the period covered by the budget – for example, explicit contingent debts where past experience indicates that a certain percentage will become actual debts during the year. All respondents to the questionnaire indicated that implicit contingent debt was not recognised in the government's budget.

Recommendation 5 – *when considering the government's budgetary arrangements for contingent debt, the SAI should consider whether budgetary outcomes are aligned with the government's work to assess the* *expected costs of contingent debt. In particular, do the budgeted amounts for contingent debt appear adequate to cover the costs likely to be incurred by the government?*

7. Control mechanisms and risk management

7.1 Given the potential significance of contingent debt to a country's fiscal stability it is important that, where they can, governments operate effective control mechanisms around the level and extent of contingent debt. If entities take on contingent debts without effective oversight or control - where any resultant liability ultimately rests with the government - then fiscal stability could become threatened. Similarly, the government's fiscal position could become undermined if it does not mange effectively the risks around new and existing contingents debts.

7.2 The Committee's questionnaire on contingent debt revealed some key issues that are likely to interest SAIs when examining the government's control and risk management systems around contingent liabilities. These are summarised below.

Control mechanisms and risk management of contingent debt – key points arising from the questionnaire on contingent debt
1. Nature of control mechanisms – while some contingent debt will arise as a result of circumstance (for example, legal cases brought against the government) other types of contingent debt are taken on deliberately (such as the provision of state guarantees). Countries use both legal and administrative measures to try and control the take-on of contingent debt by government. Essentially these impose some form of approval process that entities should go through before they can take on new contingent debt.
2. Risk management techniques – risk management techniques for contingent debt vary between countries, but generally they tend to be complex methodologies which sometimes form part of a country's overall processes for asset/liability management. Other countries seek to manage the risks around contingent debt in a less co-ordinated way – for example, the risks are managed by the particular entity that has 'ownership' of the contingent debt. Generally, methodologies are applied to estimate the expected costs of certain contingent debts – often based on an assessment of which contingent debts have the most risk of materialising. In some countries these figures form the basis for calculating fees to charge recipients of government guarantees – in this way governments seek to offset the expected cost of some contingent debts.

3. Variability of application – the extent to which risk management techniques are used across the range of contingent debt types varies. Different risks will be present both within and between contingent debt types with resulting differences in how best to assess the risks involved. Another important factor is the extent to which risk management techniques are co-ordinated and applied on a centralised basis across government (for example, by the Finance Ministry). Some respondents to the Committee's questionnaire reported that risk management took place at the level of individual contingent debts without systems in place to facilitate a consistent approach.

7.3 It is important that countries seek to implement effective control and risk management systems around contingent debt and SAIs can play a positive role in encouraging developments in this area. However, given the frequently complex nature of control and risk management systems, it is important that the SAI's work makes realistic and practical recommendations that are grounded in the circumstances of the particular country. For example, rapid development towards a co-ordinated risk management process encompassing the government's entire balance sheet, while desirable, may not be a realistic initial target for many countries. A more practical approach might be to focus initial efforts on the most significant risks that pose the greatest threat to fiscal stability.

> **Recommendation 6 –** *when examining the control and risk management processes around contingent debt, the SAI should consider whether the arrangements in place are appropriate for the country's circumstances and whether there are practical improvements that should be made.*

7.4 The potentially complex and specialised nature of government risk management systems may mean that the skills required to undertake a detailed examination in this area are not immediately available to the SAI. In such circumstances, the SAI may need to train staff in such work or 'buy in' expert external assistance.

> **Recommendation 7 –** *because of their potentially complex and specialised nature and prior to engaging in detailed work, the SAI should ensure that it has suitably skilled resources available to undertake an expert assessment of government risk management systems.*

8. Role of the SAI

8.1 To be effective in this area the SAI must have a mandate that enables it to undertake financial and performance audit on contingent debt. Respondents to the Committee's questionnaire indicated that this was the case, but this may not be so for all SAIs around the world. Where the SAI does not have such powers, given the potential significance of contingent debt, it may consider lobbying Parliament (or the executive if appropriate) to extend its existing mandate.

> **Recommendation 8 –** *where SAIs do not have a mandate to undertake financial and performance audit on contingent debt, they should consider the merits of seeking to extend their powers to allow such work to take place.*

8.2 If the SAI does have a mandate to examine contingent debt related issues, it will then determine the extent to which it chooses to exercise its rights in this area – unless this is set out in legal or regulatory requirements. Like all entities, the SAI must try and use its limited resources to best effect. Consequently, decisions on the amount of work in this area are likely to be determined by relative priorities and cost/benefit considerations. In particular, the extent to which public debt and more specifically, contingent debt is a source of public/Parliamentary interest and/or concern will play a part in the level of work undertaken.

> **Recommendation 9 –** *the SAI should ensure that its work in respect of contingent debt reflects its own and Parliament's assessment of the relative importance of this subject area in their country while making an appropriate contribution to Parliamentary accountability.*