Risk Management of Contingent Obligations

Contingent obligation risk results in the sovereign taking over the debt servicing obligations of a guaranteed party. The common cause for a contingent obligation to be called is the guaranteed entity becoming unable to service the debt.

Q. 8-04. How do contingent obligations affect sovereign risk?

Events involving other entities or third parties may impinge on the state's credit. The state's resources for borrowing and servicing that borrowing may be affected by events involving other entities. The sovereign assesses its contingent obligations in the context of its responsibility to manage the economy efficiently, to avoid severe cycles and crises, and to have in place effective tools to manage such events if they do occur.

The state should assess its contingent obligations in light of its responsibility to manage such events if they occur. Probable calls on contingent obligations should be included in projecting a sovereign's borrowing program. Variations among each macroeconomic scenario used to project future borrowing needs would likely entail a different volume of calls on contingent obligations.

Q 8-04.01. What are sovereign guarantees?

A guarantee is a contract involving three parties: the lender, the direct borrower (the guaranteed party), and the guarantor. In this discussion, the guarantor is the sovereign.

The direct borrower, often some other state entity or house buyer or agricultural entity, is obliged to repay the lender. The guarantee, however, obliges the guarantor to repay the lender in place of the direct borrower under certain conditions. The specified condition represents the contingency of the obligation from the guarantor's viewpoint. Once the contingency has occurred, the state's obligation to repay is the same as for any other form of sovereign debt it issued.

Q 8-04.02. What is a credit substitution guarantee?

Under a credit substitution guarantee, a sovereign agrees to pay one or more of the debt service payments owed by a third party to a lender if that third party does not make the payment on time and in full. This is a simple substitution of the sovereign's credit standing for that of the direct borrower, the guaranteed party.

The lender finds this guarantee valuable because the sovereign is less likely to miss a debt payment than that the third party. The size of the payment covered by the

guarantee at the time the contingency materializes is the sovereign's risk exposure and that amount is specified in the guarantee contract.

Q 8-04.03. How can contingent obligations be acknowledged?

Contingent obligations should be recognized by the likelihood of their occurrence. To calculate the likelihood, however, the probability associated with event risk should be forecast and the probability distribution estimated. As discussed above, this can be highly problematic. Further, the events triggering calls on contingent obligations are often linked to macroeconomic conditions and neither they, nor their linkages with calls on the guarantees, can be forecast with complete accuracy.

Q 8-04.04. What amounts should be reported for contingent obligations?

Transparency in reporting contingent liabilities should highlight the probable amount and its probable loss and any guarantee fees. For a more complete picture, the sovereign's exposure should be reported.

- The probable amount is the expected cash obligation of the sovereign if the guarantee were called. The amount that would be owed usually is specified contractually under the guarantee, and is date-specific. The amount is probable because it is calculated as the product of the probability of the event occurring and the contractual cash obligation of the sovereign.

- Probable loss is the probable amount, net of the likely amount of funds, if any, subsequently recovered by the sovereign from the guaranteed party.

- A guarantee fee is compensation paid to the guarantor for accepting the risks and costs of a contingent obligation. When there is sufficient historical data on independent guaranteed parties, the fee can be computed using an actuarial method. This information will help determine the adequacy of the guarantee fee and the associated reserves.

- Exposure is the total amount the sovereign has promised to guarantee, and therefore conceivably could be obligated to fund independent of any probability: the maximum amount can be called at any point. Exposure is the measure by which the guarantor tracks its aggregate outstanding promises.

Q 8-04.05. What is gained by guarantees?

Any contingent obligation should benefit the guaranteed party through a reduced cost of financing, better financing terms, or improved access to funds. Such a benefit is necessary, but not sufficient to justify the guarantee.

Benefits from some contingent obligations are difficult to quantify. For example, how does one measure the expected civil stability that is expected to follow from widespread home ownership made possible through sovereign home mortgage guarantees? Other benefits may be more easily measured. Extending sovereign guarantees to the debt of small businesses might improve their viability by lowering their debt servicing obligations and so generate increases in employment and income tax revenue that more than compensate for the state's cost and risk exposure from extending the guarantees.

Q 8-04.06. How can contingent obligations be assessed?

The costs and benefits of exposure to contingent obligations can be analyzed by "stress testing" a portfolio of contingent obligations. The stress test takes an extreme case, even if it seems unlikely, and works through its dynamics and feedback effects. A stress test examines two important attributes of potential calls from contingent obligations: their covariance with other cyclical impacts in the economy and the degree of concentration of these potential claims that is optimal for macroeconomic management.

For example, if the contingent obligation requires a payment in a foreign currency, the risk analysis of the crisis condition is a crucial part of the evaluation because the foreign currency to honor the guarantee must be acquired at market prices. In a crisis, the exchange rate may move adversely against the domestic currency even if the domestic currency had been pegged under pre-crisis conditions to a strong foreign currency.

Evaluating and managing sovereign contingent obligations requires dynamic risk analysis. Not every contingent obligation structure necessarily produces benefits that outweigh risks.