5. PIELIKUMS. ERNST&YOUNG KONSULTĀCIJAS

PROTOCOL[1]

Consultation on fiscal risk assessment

<u>Participants of consultation:</u> Jānis Platais (Fiscal discipline council (FDC), Latvia), Dace Kalsone (FDC, Latvia), Andžs Ūbelis (FDC, Latvia), Daniel R. Mullins (EY, USA), Renāte Strazdiņa (EY, Latvia), Zane Zilberga (EY, Latvia)

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1. **Overall Risk Management assessment of fiscal risks declaration attached to the medium-term budget framework law year 2015-2017 and 2016-2018** (Novērtēt vispārējo risku vadību Fiskālo risku deklarācijās, kuras pievienotas vidēja termiņa budžeta ietvara likumiem 2015.-2017.gadiem un 2016.-2018.gadiem)
3. **Capital sector related selection of the quantifiable fiscal risk indicators of state and municipalities** (Ar valsts un pašvaldību kapitālsabiedrību sektoru saistīto kvantificējamo fiskālo risku rādītāju atlase)

One of the most important elements in fiscal risks mitigation is intervention policy or practice. For example if county is moving in the budget year/circle to what risks are identified and then come to the actual numbers need for additional spending and reduction in revenues.

Regarding risks IMF and World Bank often measure the promoted fiscal transparency that is vehicle for mitigating risks. Not necessarily to quantify and precisely identify what the scale of the risk is, but to identify the fact that this may be the risk factor to open the policy debate. To measure the transparency information on the flows have to be available and often it is the best that can be achieved. Quantification of all risks may not be feasible and open acknowledgement (with some understanding of possible magnitude and probability of occurrence, high, medium, low) and discussion may be a very useful approach. Particularly if there is a requirement that a risk statement have to be approved.

For a general perspective one of the most important vehicles for the risk mitigation is agri risk forecast. Revenue and expenditure forecast need agri in order to be able to deal with risk. The next most important vehicle would be transparency with respect to how the budget execution stays within the scope of the year and after year closing. General tendency is to provide transparency in agreements between government and public/private partnership, as well as clear understanding on implicit and explicit guarantees which are provided by government on political perspective. It's easier to provide the guarantee in future perspective than in actual spending. These guarantees which produce liabilities are growing, because of the political ease in doing so they create no direct real "pain" in involvement, but they produce future "pain". Suggested is that the risk assessment and the processes for risk mitigation is shared between the agencies, spending units of the government and financial government institutions.

Probabilities have to be calculated to predict and act in case if risk materializes as well as resources necessary to recover from the effect. One way is keep contingency reserves. Normally those funds lapse in the end of the year because of the impropriations in the process.

In order to assure that the highest priority services can be met, common practice for state institutions is to spend conservatively in first to third quarter (mostly in later quarters and depends on the time period covered in the commitment) of the year and to push anything that is capital spending and funding to the operating budget in third to fourth quarter. Additional funds are used to meet the ongoing,

[1] The protocol contains summary of the consultations that occurred during the project. Summary is based on the original consultations video (files attached in CD attached) and do not contain all the details discussed and recorded in video.

institutional, operating maintenance services and other services that could be concerned as more discretionary spending. One of the interesting implications is that people have looked at the spending patterns of the agencies and discovered they spend more in the fourth quarter than any other quarter of the year. The agencies have to make this kind of risk mitigation claiming acceptable, because often people see it as irresponsible way of spending budget.

Allocation of responsibilities in case of materialized risk instead of formal risk assessment is opposite for risk management, that is responding to the risk that is already developed and emerged as oppose to savaging the strategy which is forward looking in anticipation to those risks.

In any situation when there is price regulation potential of corporations for additional risks appearing to enter the system, there have to be interference in ability to set prices which is at least at costs recovery and then normal economic returns.

Normal utility which is in a space of monopoly doesn't generally purpose much in the way of risks if the regulators are responsible for setting the tariff at the normal economic return to the entity that could be significantly discounted of the list. Regarding other risks associated in the local level infrastructure risks are not significant in the form of debt, but significant in the form of maintenance capital deterioration, capital stock deterioration.

Experience in other countries

USA experience:

For long period of time in USA local governments and states are essentially autonomous and independent of national government, they have their own budget systems and budget structure and national government has limited abilities to tell them what actions they should take and how to split the budget. State governments have their own constitutions which often also grant home rule to local jurisdictions allowing state's and local jurisdictions finance beyond expenditures and issue debt to finance capital projects.

One of the distinctions regarding local government is between operating expenditures and capital:

- operating expenditures has to be near balance;
- capital is entering debt market or finance capital projects - stays in local level to balance operating budgets.

Tendency is:

1) to assume a potential imbalance in any given year;
2) to budget what's after to refer to as a continuous;
3) to reserve which is essentially a fund balance that is carried over from year to year in a state and local government.

The states and local governments tend to carry positive balance any given year, which are used as a physical cushion in order to create stabilising resources.

The rule of thumb is that USA national and local governments previously have never really considered the specific implications of one form of potential liability versus another form. They are looking at the degree in which they have essentially set a target of 5%, 5% is included in the operating budget continues reserve and holds there. But with the physical downturn form the financial crisis it became obvious that 5% isn't sufficient. Therefore the government finance association in USA have recommended two month (~16%) as reserve, although for one jurisdiction 16% is much different than to another.

National perspective in USA is to ignore it entirely, because of the ability to enter the debt market and to issue additional debt. Recently government accountability office of national government undertake the risk assessments in order to determine what the most likely risk policy and program activity is. And these risk assessments are most likely used to inform future budget standings, but the critical process stands to significant impact in the actual risk mitigation assessments, they provide the information on transparency, but not clear how it actually impact expenditure on revenue client.

Recently USA states and local governments has been analysing the fluctual relations of the revenue and expenditure profile over time and executed equivalent to gap analysis. And have been individually now setting continues reserves which are consistent with the expected future fluctuation in 10 or 15 year shock.

One way how to look at the fiscal risks, risk assessment and risk mitigation is on the standing side. For example there are few jurisdictions in USA who are using a formal risk assessment of the implications of responding to fiscal risks. Presumption is that there are numerous ways to respond to generate more revenue and what are the economic consequences. You can issue the debt or cut spending. USA identifies a matrix setting which include:

- feasibility of the easiness at which the policy can be introduced;
- consequences of the introduction to the achievement of the government objectives.

Their risk mitigation strategy is an attempt to reduce spending in context in the areas which make the least negative consequences for the population.

Even though USA doesn't have a formal risk assessment in contentious place in budget, if you have contractual relationships which are likely to produce contingent liabilities, it must be appropriated in the budget to the degree to which there is expectation that particular liability is going to become due, while it doesn't have a process for mitigating risks as whole. As more of a micro process for mitigating risks by forcing agencies to actually budget out of their recourses an amount which is equivalent to the expected value to that risk.

In USA and Canada, jurisdictions can often choose to go to capital markets themselves or enter into bond market relationship with the state, and the state will issue which then can be pulled across all subnational jurisdictions and they will each pay their share of debt obligations.

During global recession, there were many states in USA that were under fairly significant distress. National government was bailing out banks, suffering the consequences of the economic conditions which created the need to bail out the banks and bank bailout was by the national government to the degree that it existed. But other jurisdictions were feeling distress very strongly, because of economic consequences.

Other country experience:
Australia and New Zealand are taking the formal process for the mitigation of risk. And New Zealand identifies as scheduled the status of the risk across the number of problematic areas on annual basis and then tries to determine if these risks are changed or unchanged over time for the preceding year. If they are changed and expectations are they will change, then they are doing analysis of what the potential impact is.
New Zealand, Australia, UK, Brazil and Sweden have risk assessment process, but there are significantly different elements than in USA.

Sweden and Australians has system which is similar to USA micro system described previously. It requires that when a liability is incurred that beneficiary of that liability pay some fee to the government which is consistent with the presumed risk at the time of entering into the agreement. Under those conditions it forces the actual beneficiary and agency to consider the potential cause. Have to be careful with this system because it also generates the revenue stream and it can be thought to go to a contingency reserve fund that cannot be touched by any kind of other actions.

New Zealand and Australia has the risks on their Ministry of Finance (MF) website. Some of them are much less engaged in contingent, they are more focused on direct liabilities. New Zealand is defining:

- labour market risks;
- specific elements of their revenue system;
- identify expectation of risks;
- expenditure risks;
- operating budget initiatives;
- housing and social involvement;

- science and innovations;
- etc.

They go through all the different departmental areas and identify the risks. And it is all supported by very detailed information from the individual programs. They are able to produce the contentious asset estimate for all of their contentious liabilities. It comes as part of the budgeting process. Swedish budget system goes through to identify the actual cause and assign them to the ministries and agencies.

New Zealand started preparing fiscal risk assessment 8 years ago, Australia - 9, UK – 7. Fiscally independent councils have been looking at forecast of revenues for longer period of time, earliest in Netherlands right after the war in 1945 But transition to formulate and trying to integrate the fiscal risks assessment in the budget is something that is not as nearly as wide spread. But it has been done and it's been in a way which is aligned with medium term economic and expenditure framework in a way which is very supportive to the ability to plan.

Experience of Latvia:

FDC: Describes the situation of Latvia in EU, practice and challenges in Latvian retirement's system and public health care system, as well as state guarantee issuing situation in the field of transportation, metallurgy etc.

FDC: A loan guaranteed for the major iron company here turned out sour at the early stage, while the risks assumed at the moment when the guarantee was issued were viewed as not very high. So certainly treasury protected themselves at the moment when issued guarantee, they assume that there are certain probabilities at this to go bad. Minister verified and signed the guarantee knowing that this was politically imposed. But later when everybody look back at this case it was not appropriate.

FDC: There is no specific contingent liability fund associated if those loan guarantees are present. It is more responsibilities allocation and this is responsibility for MF to budget for these things whenever they are not appropriate.

EY: There have to be clear demarcation who is responsible on what kind of risks of entities, so that the private sector partners experience the consequences of the failure to perform in the manner in which directly affects their economic well been. And at the same time the state has to have the protection for the social implications for the need of air travel and aircraft. This is really difficult aspect of risk mitigation to put finger on as when you have public-private partnership in which private entity is in such a critical role that they can't be subject to normal market conditions of failure.

FDC: At the moment Latvian government owns telecom companies and almost 80% of airline and not in a hurry to divest these assets. Most of the population supports the idea that government is controlling these companies including utilities, which are not operating poorly and are reasonably good market producers. In case of iron company in the beginning of the problems only relationship with government was the guarantee, but the airline was owned by Latvia (51%) at the beginning.

EY: The rational way of approaching this is:

1) to identify the inventory of risks (risks faced by government, contingent, direct, indirect risks etc.);
2) then rationally identify the economic value of these risks. That can include pension system risks, social safety risks which are associated with economic downturns and although those are often much broader, but certainly including risks associated with loan guarantees to private industry;
3) when there is the list, attempt to value the risks have to be separated from actual act of making the choice on whether or not to offer the support.

If it's major steal company or airline it's probably very difficult to separate evaluation process from the offer support. For example, if there is a program to support small business development and want to provide loan guarantee to small business enterprises that are making investments in equipment and you have potentially hundreds or more of enterprises, under that circumstances there is a risk that can be reasonably evaluated. There will be separated entities such as sub-parts of MF that would evaluate the actual economic consequences of the guarantee and expected revenue outflow. And then there should be a separate entity (for example, department of commerce) which would make a decision whether to offer this for. Also the private banking sector can be brought into the partnership. It can serve as a market test of the level of risk, assuming that the private bank assumes a share of risk proportionate to their investment and potential gain.

EY: That separation of evaluation from the decision to offer support means that there is at least some level of check on the process, therefore the entity that offers support should also have some budget for that expected outlay, so that guarantee demander do not recognise these as free resources that they can pursue the problematic objectives without consequences. That is mill type of experience, which is often difficult to handle for government, but it is far simpler than the concept of major airline or iron company, which makes a significant component to GDP of the nation. These issues impose both political and economic dimension in the same decision making structure.

FDC: In practice government didn't really look in matter of airline and iron company in detail. They just let it flow as part of price for passing the budget in that specific year (in case of iron company).

EY: As the expectation is that government will step in and support what otherwise would fail, if this is the concern and essentially a certainty, then risk mitigation becomes fairly large from macro perspective in any particular year. One suggestion would be to take the biggest employers and, assuming they are going down soon, prepare the risk assessment for all of them.

EY: Have to look at it in a sense of overall cycle or period in which the events have occurred and decide what to do at the similar events on similar cycle and similar magnitude of the proportion of GDP, what would that do to physical balance? If they were result of the past recession in global characteristics of that recession they most likely are periodic, the occurrence of that will be significant in the future, but that mean that should suggest evaluation process.

FDC: At the moment day to day risks are reasonably well covered and government is learning from the past mistakes. Compared with other countries here are relatively good fiscal rules related to operation to local government. Currently MF is not including explicit risks on the fiscal risk declaration.

EY: To the degree to which the actual benefits of industry are public, they serve the public purpose, then there should be an appropriate public sector risk sharing and that can be covered by the assets of the entity itself. Private risk has to be shouldered by effective management of the entity. However once there is management split (entity managed by private sector and supported by government) it is difficult to enforce that because of the incentives that exists and are somewhat problematic.

FDC: There are strong frameworks to manage risk assessments in the local government. They are independent with the budgetary decisions. Restrictions are related with solvency.

FDC: Local infrastructure is responsibility of local governments, but national government has to allocate EU convergence funds for local infrastructure/environment projects. Problem in this area is defined maintenance. Local government may easily exclude this from the budget telling we have other priorities, national government would say this is not their responsibility.

FDC: To guarantee state issued loan repayments from local governments, Treasury of Latvia has strict tools in their hand as it is responsible institution for sharing the tax revenues and risks have been reduced quite radically.

FDC: There is a general need for the improvement in procedures and the content to perform valuable risk assessment. The cabinet has passed the degree witch says that ministries has responsibility to come up with risk assessment, they have responsibility to communicate this to the MF, so that this would be included in the government statement and in the risk declaration. The problem is that government building safeguards in defining inconvenient risks therefore few banks goes down from time to time.

EY: To calculate the probabilities and assign resources is the way to recover faster in case of materialized risk. Just the way the recourses are spent it's very difficult for the operating agencies to keep contingency reserves. Normally those funds lapse in the end of the year because of the impropriations in the process. Exception is EU budget that can be executed in seven years.

FDC: Local government have significant responsibility in setting prices of utility services and the price levels can be significantly different between municipalities. At the moment no information if regulator would impose much lower tariff because of social or other reasons at which the costs can't be at the costs recovery level.

EY: In any situation when there is a price regulation potential, additional risks appear to enter the system, if there is interference in ability to set prices which is at least at costs recovery and then normal economic returns.

FDC: Currently nobody is specifically responsible for determining the probability of the risk occurring and fiscal consequences as well as there is a lack of competence and growing bureaucracy in field of risk in responsible institutions. MF concern is if they take the responsibility to prepare fiscal risk assessment in full scale, they won't have time to do the everyday job and they are afraid to suggest minister extra calculation possibility as this other jobs won't be done.

EY: This is an opportunity to MF to change the view. Have to explain the benefits of fiscal risk assessment in a manner how FM will understand it's for their own good. Fiscal risk assessment has a potential to reduce their workload in another way, for example, if the ministries are taking the action to create future liabilities they are going to value those liabilities against other pursuits they are engaged in. Then will have to establish a method for prioritising and therefore split resources accordingly, some ministries will have to receive fewer resources and flexibility to work with, but form the government and MF perspective this being engaged by all ministries simultaneously would increase the flexibility of resource flow in their discretionary that will be possible to reallocated across the ministries by the MF.

FDC: There are many risks that are in field of MF itself, for example it is hard for them to fight risks in financial sector, because no one else will stand with them.

EY: There is a changing approach that can be used by MF which is to focus on issues that are less threatening to them or potentially corresponding to the MF mission. And then gradually move in to the financial sector of risks and quantifications when they feel the benefit. It has to be done in a way that segregates strategic objectives which allows making progress on those who are supportive from the perspective of MF; these are the ones that are more difficult. It takes multiyear timeframe, as this is a relatively new methodology in Latvia and it can't be accomplished instantly.

FDC: At the moment there is at least risk assessment that include costs and it's possible to agree on decent level of provisioning the risks and appropriate responsibilities. Problem for MF is that EU is overtaking the arrangements to assure the financial sector sustainability and as in this case the national level responsibility is minimised, therefore they do not want to take responsibility.

EY: In practice if there is a slightest probability then it should be calculated. To suggest that EU will be stabilization vehicle that's useful position, but it doesn't change the fact that risks are local and they have direct implications on revenue. And even if it is localised access to funds of different source it

doesn't change the fact that risk is there, the risk still exists. Still have to borrow and access funds externally. European stabilization mechanism has to intervene, but economy is still affected, meaning there is a reduction in local risk, but it still presents fiscal risks in the government itself.
FDC: MF has narrowed down actions related with fiscal risk assessment and generally is on quite narrow path. The discussion they are having is much broader than what is now defined in our current law. The challenge now is to improve the way how fiscal risk assessment is managed and how to make it more comprehensive and how to improve managing system.

EY: It is fairly complicated to manage full scale fiscal risk assessment at the moment, but most of these processes have started in relatively simple terms. They start by incremental process in sense of comprehensiveness and quality of the estimates. One step is that MF already has a risk matrix, that's incremental with respect to scope. Have to reach to use fiscal risk assessment continuously adding to that scope to enhance the quality of the estimates. Also someone has to take the ownership in making the estimates. The start of the fiscal risk assessment is good, have to continue improvement.

FDC: Department which is council closest counterpart in MF is fiscal policy department. They are supposed to be fully staffed for these tasks and are relatively small comparing to what you see in other countries and lacking experience in field of risks.

EY: If the physical department in the MF doesn't have a risk analysis unit itself dedicated to this they should face the difficulties in preparing the type of estimating needed to do. Other governments are dealing with this involving external audit entity that could be a vehicle to stimulate the development of the necessary capacity. FDC also suggests state auditors would agree to do it, but the problem is that for causing risks they can't take anybody into prosecution what is set as their KPI.

2. **Conformity assessment of the fiscal risk symmetric principle in the annual state budget and the medium-term budgetary framework preparation** (Fiskālo risku simetrijas principa lietojuma atbilstības izvērtēšana gadskārtējā valsts budžeta un vidēja termiņa budžeta ietvara sagatavošanā)

At the moment Latvian government face the challenges related with standing appropriation by other laws, but the major challenge is related with different implicit government liabilities which are coming from finance sector as well as there are other sectors where fiscal outflows are recognised. Government has an opinion that some of these risks could be symmetrical, which could be neglected in the fiscal framework (excluded out of impact assessment) because of good estimates, compensating these risks in time.

Symmetrical risks are assumed to be symmetrical over time and can be:

- Implicit liabilities that will have positives and negatives, which offset themselves over time;
- Offsets that occur simultaneously between different liabilities, where some liabilities will create positive budgetary impacts in this cycle as well as other liabilities creating negative liabilities.

In Latvia there are both cases.
Symmetrical risks are certainly not symmetrical in the economic downturn. They normally are symmetrical in terms till three years, but in order to understand the budget implications at any given time of the year have to be aware of them during the economic downturn as well.
Symmetrical risks are known and are associated with existing government relationship with entities not natural or other disasters. They are identifiable and should definitely be included in risk assessment.

If the government as well as state owned enterprises are publishing their budget on accrual basis, then normal liquidity issues, working capital issues, levels of equity would be normal measures to use for the public sector assessment to understand the risks and moreover to understand the pattern over time. Trends for the public entities are probably more important than actual number.

Symmetry should be annual symmetry. It can be symmetrical highest in scope of three year budget framework but not more. But then it depends on the nature of the risks and the conditions of the economy. It is possible to take offsetting hedge positions in the financial markets (with surplus funds), but that is not a usual governmental role. Government is to provide public services, not an investment bank.

<u>Other country experience:</u>

Australia and New Zealand have made huge effort trying to incorporate fiscal risks on budgeting process in consideration. The effort can't be valuated jet, but they have made an attempt.

USA has incorporated fiscal risks by executing special assessments of risks in the health care industry or transportation, but they are not incorporated in the budget in any direct fashion. USA local governments have probably done better job in trying to incorporate some of the risk assessments and following the accounting standards framework to identify long term liabilities. Some local governments have made an attempt to put fiscal risks into their accounting system for the annual financial reports. But that doesn't meet that they are well incorporated in the budget. Symmetrical risks in USA have been ignored. Not a practice that you would advise. In USA local governments are more conservative in budgeting practice than in national level. However that's not necessary the case depending on economic circumstances, meaning when have to go through the process of budget reductions minimising the risks of population and services. Claim of symmetry might be the vehicle of reducing the information content requirement.

<u>Experience of Latvia:</u>

Basis for fiscal policy are:

- balanced budget;
- precise estimates;
- good coverage of the budget.

This is a matter of discussion with Latvian Ministry of Finance (MF), because currently there are items that are not covered up, therefore outflows happening in financial sectors. MF recognise these as a symmetrical risks based on historical financial trends. Information on public sector entities finance situation can be allocated in two groups:

- entities that are monitored closely - corporations that are classified as part of the general covenant (100% included in statistical information);
- more commercial entities - no good summaries for this category available. Unfortunately sector ministries manage their own ministries and nobody is producing There is no centre to supervise these entities. As parliament coalition is fighting for the advantageous ministries, full information is not shared between them.

One of the generally symmetrical working arrangements is depositary scheme. The fund collects the money outside the budget, but the only thing is that MF and treasury is generally guaranteeing the sustainability of operations of that fund. And whenever they proceed the incoming money they come up with the bridge load which is stretching the payment. Initial contributions by banks haven't been sufficient causing the increase of the fee for all banks. Then banks start to contribute at increased rate against specific deposit amount levels to compensate for the past loses. If the economic situation is good they enjoy relatively low contribution rate and the fund is growing, so as soon as economic downfall appears fund is facing hard time. FM needs to come up with the loan to the fund so the banks will need to recover this through the contributions. It is Very important to convey the appropriate incentives to the private actors. Financial institutions will pursue their own self-interest. Experience in the US shows that unanticipated vehicles for private gain at the expense of public losses have been common and created serious risks for government (savings and loan scandal of the late 1980's, housing market sub-prime loans associated with the housing bubble and great recession etc.).

At the moment MF actually is not challenged to put numbers on all the risks because their perspective is that they are symmetrical. It is a very convenient assumption, unless they have taken specific steps to incorporate specific offsetting hedges, the assumption of symmetry is quite suspect. These are risks that may fluctuate around some level that include budget projections. MF is costing these risks as low probability (happening once in 10 years).

But if we look at the most recent 10 years Latvia have faced major problem with four to five financial institutions. Three of these cases caused damage to the fiscal balance. These are not the cases which MF says they are symmetrical. They admit that those risks actually materialized, but the argument is: since the EU system holds bank supervision and has changed, the risk is not our, it is related with EU. Other case is that our exposure is limited. An example discuses recently regarding payments: payments recently were taken to EU budget, each year they are planed and each year they are wrong (ten years in the row). Because EU and Latvian MF use different formula to calculate the size of economy and respect to payments, economic projections change. For five years MF underestimated the payment and then for other five years – overestimated. In ten year period it is symmetrical, but in five years it's not.

This example is only symmetrical in the sense of long term debt position or long term budgetary outlay. But symmetry should be annual or in scope till three years. There is no good reason to consider this example as symmetrical as in such a long period the risk symmetric characteristics is changing significantly. As MF considering risks is analysing trends in different historical time periods (three till ten years) for all of the identified risks we can conclude it have been done in order to adjust the situation. In this case the example is symmetrical in ten year period and therefore could be neglected in the fiscal framework.

Last ten years have also include really problematic physical conditions during the world wide recession therefore including significant economic peaks, valleys and recovery relevant from the fiscal position and fiscal perspective affecting symmetrical characteristics as well.