FELLOWS PROGRAM | KORET MILKEN INSTITUTE

November 2012
No. 58

Executive Summary

Risk Management of Israel's Contingent Liabilities

By Ravit Nuriel
Koret-Milken Institute Fellow

KORET FOUNDATION
MILKEN INSTITUTE

About the Koret-Milken Institute Fellows Program

The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

More about the program: www.kmifellows.org

Contact us: info@kmifellows.org

Introduction

Contingent liabilities are a significant share of a government's obligations, but in most cases they are not included as part of the government debt or as a budget expenditure (OECD, 2005). These liabilities form a "hidden debt" that is not expressed in the debt-to-GDP ratio but is likely to increase the ratio significantly in the future. For this reason, politicians can exploit contingent liabilities to enlarge the budget in the short term—in return for significantly higher future risk. This document will survey the preparedness of the Israeli government to deal with contingent liabilities and suggest tools to manage the risks.

A contingent liability is a debt that may or may not be incurred, depending on the outcome of a future event such as a court case or credit default. Two types are generally recognized: explicit liabilities based on contractual agreements between the government and another party, and implicit liabilities based on a moral obligation to give governmental financial support when needed. Examples of implicit liabilities include insurance for public savings in banks, aid for government companies, and assistance during natural disasters.

This paper examines the following explicit contingent liabilities: Government guarantees (maximum exposure as of May 2012 was about 12.3 billion NIS), "safety nets" for PPP projects (exposure of around 1 billion NIS), and insurance and indemnities granted by the government (insurance of government property and military damages, compensation for government employees, etc.).

To achieve more transparency in managing and reporting contingent liabilities, decisionmakers must consider the budgetary consequences of contingent liabilities just as they consider direct aid. This policy can also have a positive influence on Israel's credit rating and the cost of government support (Glennerster and Shin, 2008).

Currently the Israeli government lacks a coordinated, centralized system for managing contingent liabilities. By their nature, implicit liabilities are not documented as liabilities and often don't even exist until an emergency occurs. Even explicit contingent liabilities are not managed as a part of the state debt and are not housed in a single database. In the case of liabilities such as secondary insurance for the government company Kanat or compensation for damages from war or hostile activity, there is no model to check the premiums charged for the liabilities and no model for calculating the capital required to offset these liabilities. Similarly, there is no model to examine the balance sheet of government safety nets for public-private partnership projects (government exposure to the cash flow expected for the project), and there is also no regular evaluation of the risk that derives from the probability that indemnities granted by the government will be realized.

This document recommends methods for the government to grant aid and cover contingent liabilities while managing the associated risks. **Based on the research, it is apparent that a key part of managing contingent liabilities is having a consistent method for allocating funds and for verifying the need for government involvement.**

With regard to implicit contingent liabilities, this document will show that it is important for the government to be aware of them, given that they expose the government to future expenditures.

For this reason, government officials should consider defining the liabilities in an explicit contract and assess the benefits and costs of such a move.

As for explicit contingent liabilities, it is important to verify the need for government intervention, using a cost-benefit analysis, before granting a liability. If government aid is required, the next step is determining whether a contingent liability is the most efficient way to solve the problem. The duration of government intervention should be based on whether the market failure is temporary or permanent.

This paper also establishes principles for managing contingent liabilities based on two main parameters: the expected loss (the premium for government aid should be fixed in accordance with the expected loss) and the unexpected loss (a future payment that takes place if a certain extreme event occurs, also known as value at risk).

Under the proposed model, after the expected loss is calculated, a premium is charged to either the aid recipient or a government budgetary source. The evaluation and pricing of the contingent liability allows a comparison to be made with direct aid and contributes to the efficient allocation of contingent liabilities, in accordance with the priorities of government decisionmakers. As a complementary step, capital should be allocated to cover unexpected losses using a model specific to the type of liability. In addition, decisionmakers should examine tools such as secondary insurance to reduce or eliminate the government's risk.

Principal Recommendations

1. **Build a central database for government contingent liabilities.** The database will hold information on the level of exposure in practice for each liability, the level of expected risk (the probability of payment), and the timetable for payment. The database should be updated at a predetermined frequency and reflect all data on all liabilities. Toward this end, the aid recipient should be required as part of the contract to report on the status of the liability, including the extent of exposure and current risk level.

2. **Examine the need for granting contingent liabilities and find the optimal tool for granting government aid.** The government should grant contingent liabilities according to a set methodology that includes examining the need for government intervention and choosing the best tool to provide the aid (direct aid or contingent liability) in a way that is similar to the methodology for government guarantees.

3. **Consider converting implicit liabilities to explicit liabilities.** As part of the government's risk management, it needs to examine the pros and cons of converting existing implicit liabilities to explicit liabilities by fixing them in a contractual agreement.

4. **Evaluate the expected loss of a contingent liability and collect payment.** The government should use cost models to evaluate the risk expectancy of future payments. It is extremely important to demand a reasonable premium from an aid recipient—or alternatively from a government source—so the liability is allocated efficiently and in accordance with government priorities. In addition, it is possible to include the liability as part of the government's debt.

5. **Examine mechanisms for reducing the government's risk in contingent liabilities by demanding various securities.**
    a. **Covenant requirements—**The government needs to examine agreements for contingent liabilities the same way that bank loans are examined, including imposing limitations on the recipient, such as a prohibition on drawing dividends, negative pledges, etc.
    b. **Variable premium pricing**—For long-term commitments, it is important to consider updating the premium annually, adjusting for market conditions and the risk associated with the liabilities (as opposed to a fixed premium for the whole period of assistance).
    c. **Risk-sharing mechanisms**—These mechanisms will both reduce the government's exposure and increase the incentive of the aid recipient to reduce the risk. Possible mechanisms include deductibles, setting a threshold value (of loss) above which assistance will be given, and allocating responsibility for the payment between the Ministry of Finance and the ministry that undertakes the activity, etc.

6. **Allocation of capital for unexpected loss.** The government should build models to calculate the capital required for the various contingent liabilities and examine existing avenues for hedging the risk and ensuring that required payments can be met.

7. **Build models for risk management of contingent liabilities.** These models should:

    a. **Estimate the premium and the equity required from Kanat**—Develop a model to estimate the premium collected from Kanat for the secondary insurance provided by the government. A model is also needed to estimate the equity required by the government for this liability.
    b. **Estimate the premium and equity required for the compensation fund for war and acts of hostility**—It is recommended that the government examine a model to estimate the premium that should be collected for compensation arising from war or acts of hostility. The government should also build a model to examine the equity required for these liabilities.
    c. **Examine the level of equity required for government guarantees**—The model for estimating premiums collected for the government guarantees fund needs to be updated.
    d. **Examine the allocation of capital for indemnities**—The government should examine the methodology for determining whether to grant indemnity. It should also consider risk management (fixing a ceiling, self-participation, etc.) and the allocation of capital for future claims.
    e. **Manage "safety nets" that have been granted to public-private partnership projects**—The government should examine the expected cash flow from projects that have been granted "safety nets" to evaluate the extent of government exposure.

FELLOWS PROGRAM | KORET MILKEN INSTITUTE

Koret-Milken Institute Fellows Program
Beit Milken, 13 Tel Chai Street,
Jerusalem, 97102, Israel

info@kmifellows.org
www.kmifellows.org