Fiscal Risk

The World Bank has developed a fiscal risk toolkit to provide capacity-building to emerging and developing economies on assessing and managing their fiscal risks. An extensive program of on- and off-site technical assistance, in-person and virtual workshops, knowledge products, and analytical tools help deliver these advisory services. The toolkit consists of the following pillar:

- **Fiscal Risk Assessment (FRA):** FRA is a framework to identify and assess the fiscal risks to which a country is exposed. This is a diagnostic tool to identify direct and contingent liabilities and map them into a fiscal risk matrix. Such mapping helps countries to capture the big picture and develop a broad understanding of their exposure to fiscal risks. The FRA framework also assists the prioritization of risks by quantitative and qualitative assessment where possible, considering "likelihood" and "impact." Ultimately, the FRA findings allow for customized reform actions around the building blocks (e.g., governance arrangements, coordination among government policies) and developing strategies to monitor and mitigate specific fiscal risks. Based on these strategies, countries can develop various policy measures taking into account the direct, contingent, explicit, and implicit nature of the exposure (e.g., whether to issue guarantees to SOEs instead of being exposed to the implicit contingent liabilities from them).

- **Technical assistance tailored to individual fiscal risks:** For each fiscal risk arising from debt-related liability, risk-management strategies are developed to implement tools to mitigate and monitor risks. Such tools help to raise awareness about risks (e.g., risk disclosure and accounting); mitigate risks (e.g., through financial hedges, and insurance); and increase preparedness in case risks materialize (e.g., through fee revenues; contingency funds; and budgeting). The set of analytical tools for these risks consists of:

  i) **Guarantee-management framework for guarantee** to help governments develop sound governance arrangements, establish the institutional and technical setup to evaluate the contingent liabilities from guarantees, and build tools to manage and monitor credit risk arising from guarantees. This framework and the analytical tools also help address the implicit risks from state-owned enterprises (SOEs), public corporations, and subnational entities.

  ii) **Public-Private Partnerships Fiscal Risk Assessment Model** (**PFRAM Model**), developed by the IMF and the World Bank Group, is an analytical tool to assess fiscal costs and risks arising from public-private partnership (PPP) projects. It is designed to assist governments in assessing fiscal implications of PPPs, as well as in managing these projects in a proactive manner. PFRAM has been used by World Bank infrastructure and macroeconomics teams to advise governments on the medium- to long-term fiscal implications of PPPs and can be used for an individual project or a set of projects.

  iii) **Stochastic fiscal sustainability assessment,** which incorporates the effects of uncertainty into the standard debt sustainability analysis and aggregates the fiscal risks in a probabilistic and endogenous analytical framework.

Related

- [Fiscal risk matrix]
- [Contingent Liabilities Management Strategy]
- [Building blocks of fiscal risk management advisory services]
- [Learning & Training Notes for Assessing and Managing Credit Risk from Contingent Liabilities]

Subsequent pages of the website

Fiscal Risk Matrix

Fiscal risks are deviations from fiscal outcomes expected at the time of budget formulation. This deviation might create significant impact on government finances, impair the capacity of the government to use fiscal policy to stabilize economic activity and support long-term growth.

Experience has shown that governments often lack the capacity to understand their exposure to overall or individual fiscal risks well and that the capacity to mitigate risks can be limited. Following the global financial crisis, governments have increased efforts in holistically identifying and managing fiscal risks. International financial institutions, rating agencies, and investors have also put more emphasis on improved fiscal risk management by governments. Traditionally, some governments have had strong risk management practices in particular areas. Previous crises have often triggered the development of sound risk management practices. However, few governments have implemented a comprehensive framework to understand their overall exposure to fiscal risks and the interaction among them.

To identify fiscal risks affecting a government's liabilities, the fiscal risk matrix (see below) that categorizes the sources of risks has proven a useful conceptual framework. Sources of fiscal risk may be explicit or implicit and direct or contingent. Explicit liabilities pose a legal obligation to the government. Implicit liabilities derive from expectations about government behavior (e.g., electoral promises related to benefit extension). While the government has no legal obligation to incur implicit liabilities, there may be a strong moral or political impetus to do so. Direct liabilities are predictable obligations that arise in any event. Contingent liabilities are obligations trigged by a discrete but uncertain event.

Fiscal Risk Matrix for Liabilities - Central Government

	Direct liabilities	**Indirect liabilities**
Explicit liabilities (Legal obligation, no choice**)**	• Foreign and domestic sovereign debt • Budget expenditures—both in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions)	• Guarantees for borrowing and obligations of sub-national governments and SOEs. • Guarantees for trade and exchange rate risks • Guarantees for private investments (PPPs) • State insurance schemes (deposit insurance, • private pension funds, crop insurance, flood • insurance, war-risk insurance) • Unexpected compensation in legal cases related to disparate claims. • Reconstruction of public assets

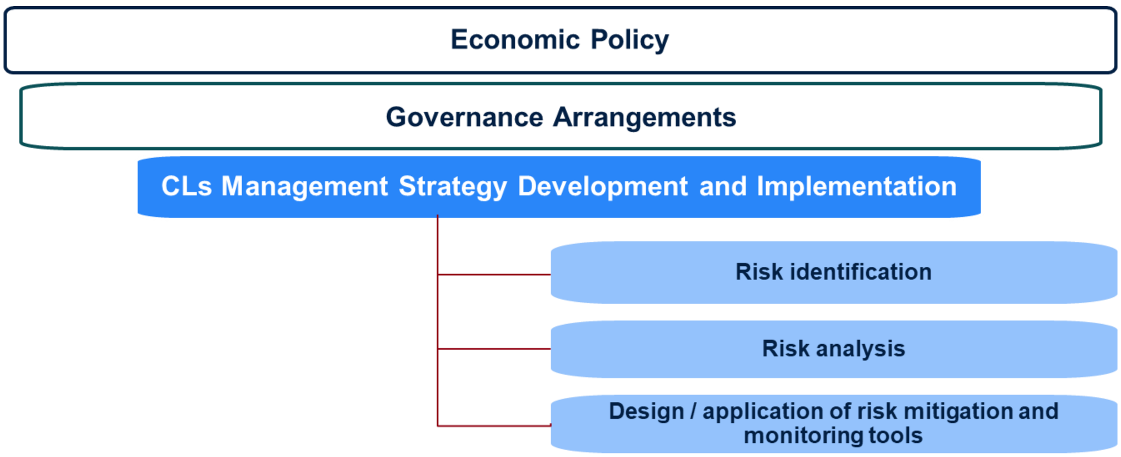
Implicit liabilities (Expectations – political decision)	• Future public pensions if not required by law • Social security schemes if not required by law • Future health care financing if not required by law • Future recurrent cost of public investments	• Defaults of sub-national governments and SOEs on nonguaranteed debt and other obligations • Liability clean-up in entities being privatized • Bank failures (support beyond state insurance) • Failures of nonguaranteed pension funds, • or other social security funds • Environmental recovery, natural disaster relief

Source: Polackova-Brixi, Hana and Alan Schick (1998), Government at Risk, World Bank. p. 26.

Contingent Liabilities Management Strategy

A stylized risk management framework for fiscal risks from contingent liabilities starts with setting economic policy (Figure 1). The government formulates policy, such as electrifying rural areas, and may decide to assume contingent liabilities, such as government guarantees to electricity utilities, to achieve its objective. The management of contingent liability risks should be embedded in sound governance arrangements, including the legal framework and institutional setup.

Figure 1: A stylized risk-management framework for any type of fiscal risk from contingent liabilities



The objective of a risk management strategy is to implement tools to mitigate and monitor risks in line with the policy framework. Such tools help to raise awareness about risks (e.g., risk disclosure and accounting); mitigate risks (e.g., through financial hedges[1], and (re-)insurance); and raise preparedness in case risks materialize (e.g., through fee revenues; contingency funds; and budgeting). Implementing risk mitigation and monitoring tools depends on an understanding of the fundamental risks to which the government is exposed. The types of risks and risk exposure need to be identified, analyzed, and ideally quantified to allow for better comparison among alternative policy measures and the potential impact on government finances. To undertake such analysis as a basis for evidence-based policymaking requires smooth information flows within the government. Particularly formal information sharing channels between ministries of finance and line ministries is essential.

This stylized framework is agnostic to the type of contingent liability a government is exposed to. However, different types of contingent liabilities call for different risk assessment, quantification, and management approaches.

[1] Including catastrophe bonds and oil hedges, both of which are instruments governments have used to hedge risks, with facilitation by the World Bank

Fiscal-risk-management advisory services

World Bank teams provide customized support for addressing fiscal risks arising from debt-related contingent liabilities. This support is delivered in several categories: Strengthening institutions, capacity-building, and management of internal operations. In each category, there are areas along which the technical assistance can be customized to fit the circumstances of the country.

Each country's engagement starts with a diagnostic mission to undertake a fiscal risk assessment mission. Depending on the main risks identified and mapped in the fiscal risk matrix, action plans for the development of the risk specific strategies can be developed and implemented through downstream support, following the areas described below.

Institutional Strengthening

- **Governance:** Focuses on the legal framework, institutional arrangements, risk management tools, and accountability and transparency mechanisms that shape and direct the operations of government fiscal risk managers concerning the overall fiscal risks and the ones that are significant for the country

- **Policy coordination:** Focuses on the establishment of efficient coordination mechanisms between fiscal risk management and other relevant policies. These are monetary policy, budget planning processes, debt and cash management, public investment policies, territorial plans, etc.

- **Capacity and management of internal operations:** Includes analysis of organizational structures, development of strategies for recruiting and training staff, and evaluation of information technology systems for portfolio level and individual fiscal risk management activities

Technical Capacity Development

- **Fiscal risk management strategy development**: Covers formulation of fiscal risk management strategies to develop mitigation and monitoring tools, subject to the country's macroeconomic framework and various development policies

- **Fiscal risk evaluation methodologies**: Focuses on developing models to identify, measure, and manage specific fiscal risks to support the development of strategies. Credit risk assessment models (toolkits mentioned in the previous section) will help to evaluate the exposure from guaranteed and non-guaranteed debt of SOEs, subnational governments, and non-financial private sector entities as well as guarantees issued to public-private partnerships.