Annex 1 Contingent Liabilities

Contingent liabilities are possible future liabilities that will only become certain on the occurrence of some future event. Contingent liabilities are not shown in the balance sheet, but must be given adequate disclosure. Contingent liabilities can be both explicit and implicit as discussed in the framework below.

Explicit Contingent Liabilities: These are specific government obligations defined by a contract or a law. The government is legally mandated to settle such an obligation when it becomes due.	• Guarantees for borrowing and obligations of provincial governments and public or private entities. • Umbrella guarantees for various loans (SME loans, agriculture loans) • Guarantees for trade & exchange rate risks • Guarantees for private investments • State insurance schemes
Implicit Contingent Liabilities: These represent a moral obligation or expected burden for the government not in the legal sense, but based on public expectations and political pressures.	• Defaults of provincial governments and public or private entities on non-guaranteed debt and other obligations. • Liability clean-up in entities being privatized • Bank failures • Disaster and relief financing • Failure on other non-guaranteed funds

The Government issues guarantees for public sector borrowers with relatively weak credit worthiness. In some cases, such as in the case of Trading Corporation of Pakistan (TCP), the government has 100% ownership, hence any creditor to the entity has full recourse to the government.

Table 1: Contingent Liabilities

Fiscal Year	Issuance (Rs. Billions)	As % of GDP
FY07	140.7	1.6
FY08	138.8	1.4
FY09	276.3	2.2
FY10	224.0	1.5
FY11*	20.9	0.1

* : July 2010-April 2011

Source: Budget Wing & EF Wing, MoF

The government may also issue guarantees as part of a cost reduction strategy, by taking on risks it is best able to mitigate or absorb. However, there are also costs associated with the provision of government guarantees. Hence, such off-balance sheet transactions can not be overlooked in order to gain a holistic view of a country's fiscal position and unveil the hidden risks associated with the obligations made by the government outside the budget. Similarly, reported debt levels of a sovereign may be understated owing to the non-inclusion of guarantees, explicit or implicit, which may materialize in future. In the case of Pakistan, these include, for instance, explicit and implicit guarantees issued to Public Sector Enterprises (PSEs) and unfunded losses of state owned entities such as Pakistan Steel Mill, PIA, WAPDA, PEPCO, Railways, etc.

The Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 stipulates that the issuance of guarantees, including those for Rupee lending, bonds, rates of return, output purchase agreements and all other claims and commitments that may be prescribed from time to time as well as renewal of existing guarantees, should not exceed 2.0 percent of the estimated gross domestic product in any financial year. Since 2005-06, there has been a steady increase in the issuance of contingent liabilities but the threshold of 2.0 percent has only been breached in 2008-09 by 0.2 percentage points. As of April 2011, guarantees amounting to Rs. 20.9 billion have been granted to PSEs, which accounted for 0.12 percent of the projected GDP for 2010-11.

A further breakdown of institution-wise government guarantees in domestic and foreign currencies indicates that WAPDA/PEPCO has been the biggest beneficiary of this provision.

Table 2: Institution-wise Issuance of Government Guarantees in Domestic Currency (Rs. billion)

S. No.	Organization	FY08	FY09	FY10	FY11*
1	PIA	4.0	25.0	7.7	
4	WAPDA	54.9	228.3	112.3	10.8
5	Pakistan Railways			17.1	1.2
6	SABIC				8.5
7	Pakistan Stone Dev. Company				0.4
8	PSM			10.0	
9	KESC			3.0	
10	KSEW	3.4			
11	PSO	42.0			
12	Shell	11.0			
13	National Industrial Parks Dev. & Mgmt. Co.	2.0			
14	Pak Textile City Limited	0.3		1.0	
15	PAF Shahbaz Air HQ		1.0	6.0	
16	NIT		20.0		
17	TIP			1.1	
	Total	**117.6**	**274.5**	**224.0**	**20.9**
	As percent of GDP	**1.1**	**2.2**	**1.5**	**0.1**
	Memo:				
	GDP (mp)	10,243	12,724	14,837	18,063

** July2010-April 2011* *Source: Budget Wing, MoF*

WAPDA was issued guarantees amounting to Rs. 228.3 billion and a rollover of US$ 125 million in the 2008-09. In the fiscal year 2009-10, Rs. 112.3 billion has been awarded in respect of public guarantees to PEPCO/WAPDA in addition to US$ 248 million of foreign currency guarantees. During 2010-11, only Rs.10.8 billion worth of guarantees issued to PEPCO/WAPDA.

The outstanding contingent liabilities as of April 30, 2011 stood at Rs. 541.4 billion. This includes the stock of explicit debt guarantees in both domestic and foreign currencies that appear in the accounting books of PSEs. The Rupee guarantees accounted for 55 percent of the total stock. Such a high magnitude of public guarantees may lead to distortions in the domestic yield curve, and have fiscal consequences. The issuance of guarantees have witnessed secular decline in the current fiscal year.

Table 3: Guarantees Outstanding as of April 30, 2011

Outstanding Guarantees extended to PSEs (total)	**541.4**
- Domestic Currency (Rs. Billion)	297.6
- Foreign Currency (Rs. Billion)	243.8
Memo Item:	
(Foreign Currency US$ Million)	2,878.7

Source: DPCO

In addition to these explicit contingent liabilities, the records of which are being maintained at the Ministry of Finance, there is a need to quantify various implicit guarantees embedded in many government contracts that represent a potentially significant charge on future budgets. Ideally, the government should restrain from issuing new guarantees in bulk and instead, advise the PSEs to explore alternative sources of funding, i.e., issuing Real Estate Investment Trust (REIT) units, securitization, etc, in an attempt to improve their solvency positions.

Other than the publically guaranteed debt of PSEs, Finance Division has issued, each year, continuing guarantees against the commodity financing operations undertaken by TCP, PASSCO, and provincial governments. Commodity financing is secured against hypothecation of commodities and letter of comfort from the Finance Division. The quantum of these guarantees depends on the supply-demand gap of various commodities, their price stabilization objectives, volume procured, and domestic and international prices. As per previous practice, these guarantees are not included in the limit of 2 percent imposed by the FRDL Act 2005.

As of April 2011, the outstanding stock of Rs. 297.6 billion against the end-June 2010 position of Rs. 328.8 billion indicates a retirement of Rs. 31.2 billion on behalf of commodity financing operations. The government intends to introduce world class warehousing facilities in the near future that will allow the entities involved in the commodity operations to secure financing against the warehouse receipt without explicit guarantee or letter of comfort from the government.