Annex - 1

Contingent Liabilities

Contingent liabilities are costs which the government will have to pay if a particular event occurs. These are obligations triggered by a discrete but uncertain event. Relative to government policies, the probability of a contingency occurring and the magnitude of the required public outlays are exogenous (such as natural disasters) or endogenous (such as implications of market institutions and government programs for moral hazard in the markets). Contingent liabilities are therefore not recognized as direct liabilities. However, contingent government liabilities are associated with major hidden fiscal risks. A common example of a contingent liability is a government-guaranteed loan. At the time a guarantee is entered into there is no liability for the government, since this is contingent upon the borrower failing to repay the loan as contracted. However, in the event of default, the lender can invoke the guarantee and the government will be obliged to repay the amount of the loan still outstanding. At that point, the contingent liability will become an actual liability of the government, and a payment must be made. These liabilities support specific policy objectives by creating financial incentives, without an immediate financial outlay. However, when these contractual guarantees or non-contractual commitments are realized, the government faces significant fiscal costs at the expense of other outlays.

Unreported contingent liabilities and the fiscal risks they pose played a major role in the economic crises that disrupted growth in a number of developing countries in the second half of the 1990s. These crises demonstrated that government analysis needs to cover a complete portfolio of assets and revenue base as well as direct and indirect contingent liabilities. This in turn requires the identification, classification and assessment of fiscal risks faced by the government so that it can provide an accurate estimate of future payments that may ensue from past and pending liabilities. Only by identifying and measuring its exposure can a government bring its fiscal risk under effective control.

The following framework highlights the two types of contingent liabilities. Contingent liabilities grow with weaknesses in the financial sector, macroeconomic policies, regulatory and supervisory system, and information disclosure.

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.

Explicit Contingent Liabilities:

Explicit contingent liabilities legally oblige the government to make a payment if a specific event occurs. Because their fiscal cost is invisible until they are triggered, contingent explicit liabilities represent a hidden subsidy, blur fiscal analysis, and can drain future government finances. Nevertheless, government guarantees and financing through government guaranteed institutions are more politically attractive than budget support even if they are more expensive later. The budgetary cost of these legal obligations during FY 2006-07 amounted to Rs.35.36 billion and Rs.63.05 billion in FY 2007-08. Explicit liabilities for FY 2008-09 reached a total of Rs. 72.481 billion. These comprise payments made on account of contractual guarantees issued on Ghee Corporation of Pakistan (GCP), Rice Export Corporation of Pakistan (RECP), Trading Corporation of Pakistan (TCP), Cotton Export Corporation (CEC) and Saindak bonds; Pakistan Steel Mills Corporation's liability payments contractually assumed by the Government; and payments to Fouji Fertilizer Company Bin Qasim on account of 1989 Investment Policy pertaining to the fertilizer industry. Key organizations with explicit and implicit guarantee structures have been discussed below. The following table analyses the trend.

PIA: During FY 2008-09, an amount of Rs.0.93 billion was paid out as an interest (equity) to the restructured loans and Term Finance Certificates to PIA. GOP has guaranteed interest payments (restructured loans and TFCs) for five years starting in FY 2001-02.

Railways: During FY 2008-09, an amount of Rs.2.376 billion has been paid on account of debt servicing liability (Government guaranteed loans).

Table-1 : Explicit Liabilities (Cash outflow streams from federal budget) **Rs. In billion**

	Enterprise	2006-07	2007-08	2008-09
1.	GCP, RECP, TCP & CEC (GOP's guaranteed)	2.64	4.12	-
2.	Saindak Metal Limited (GOP's guaranteed)	1.24	0.90	-
3.	GOP Bonds for Saindak Metal Limited (SML) liability	1.74	-	-
4.	GOP's Bond for the HEC, PODB; and the USC's liability	0.30	0.14	0.053
5.	Pakistan Steel Mills (GOP's guaranteed)	0.42	0.48	0.736
6.	PIA (Interest on GOP's guaranteed TFCs and loans)	0.73	0.89	0.93
7.	FFC Jordan(GOP guaranteed)	0.98	0.86	0.231
8.	SOPREST/GIK guaranteed)	0.08	0.80	0.078
9.	Peoples Steel Mills (GOP's guaranteed)	0.85	0.16	0.155
10.	Karachi Shipyard & Engineering Works (KS&EW) (GOP guaranteed loans)	-	0.17	0.432
11.	Pakistan Railways (GOP's guaranteed debt Servicing)	2.58	2.53	2.376
12.	WAPDA Sukuk Bonds	7.00	-	-
13.	System of Improvement of KESC (GOP's guaranteed loan)	3.00	-	3.0
15.	NBP Loan to WAPDA	7.00	8.00	15.59
16.	Loan from HBL, ABL, Bank Al-Falah, Askari Bank and Brunal Investment Company	-	44.00	48.90
17.	WAPDA Bond (10^{th} Issue)	7.00	-	-
	Total:	**35.56**	**63.05**	**72.481**

Source: Ministry of Finance.

In consonance with the Macroeconomic and the Medium Term Budgetary Framework adopted by the Government and containing risk exposure, a policy of limiting guarantees and the risk analysis of contingent liabilities has been institutionalized. The Fiscal Responsibility and Debt Limitation Act 2005 places specific limits on contractually binding guarantees (i.e. explicit contingent liabilities) including those in rupee lending, bonds, rates of return, output purchase agreements and other claims that may threaten the future fiscal stance of the Government.

Implicit Contingent Liabilities:

Implicit contingent liabilities are not officially recognized until a failure occurs. The triggering event, the amount at risk, and the required government outlay are uncertain. In most countries the financial system is the most serious contingent implicit government liability.

Markets expect government support far beyond its legal obligation if financial stability is at risk. These include the government's quasi-fiscal activities including mainly the bail-outs of strategically important State Owned Enterprises and the non-performing loans of the banking sector. Through robust financial sector reforms, prudent monetary management and the strengthening of the State Bank of Pakistan's regulatory role, non-performing loans started declining.

It can be inferred from the Table 2 that the Water and Power Development Authority (WAPDA), the Karachi Electric Supply Corporation (KESC), and implicit liabilities in the shape of subsidies to various sectors have been the largest drain on the budget. Financial Improvement Plans of the two power utilities are currently under implementation to curtail these outflows. The privatization of KESC and the successful corporatization of WAPDA will eventually plug these financial leakages.

Table-2 : Impact of implicit contingent liabilities on the federal budget (Rs. In billion)

Enterprise	06-07	07-08	08-09
WAPDA's Subsidy	18.46	52.89	92.84
WAPDA's non-recovery of loans	6.15	-	16.44
WAPDA's new loans	38.02	5.825	3.88
KESC's Equity (An injection of fresh equity	0.77	-	-
KESC's subsidy against an adjustment of additional surcharge against GST	2.72	3.35	1.28
KESC's subsidy (Cash shortfall)	-	-	-
Subsidy to Utility stores Corporation (price differential for sale of goods)	0.47	1.73	2.70
Subsidy to TCP for import of wheat	-	30.00	35.00
Pakistan Railways (Other operational shortfalls)	4.25	4.77	8.158
Subsidy to TCP on import of Sugar	0.35	6.24	6.30
Subsidy to manufacturers of Phosphatic and Potassic fertilizer	4.67	5.26	21.03
Subsidy to importers of Phosphatic and Potassic fertilizers	-	20.00	7.62
Subsidy to TCP on import of Urea	2.95	4.00	3.00
Subsidy to PASSCO for commodity operations	0.13	0.41	0.30
Subsidy to exporters of textile sector	9.59	19.00	4.81
GOP grant to Dairy Development Company, Lahore	0.10	0.20	0.081
GOP's Equity in Pakistan Textile City Ltd.	-	0.5	-
Total:	**88.625**	**154.17**	**203.44**

Source: Ministry of Finance.

Table-3: Contingent Liabilities (Explicit and Implicit Liabilities)

Fiscal Year	Rs in billion	As % of GDP
2006-07	124.18	1.42%
2007-08	217.21	2.11%
2008-09	275.89	2.12%

Source: Ministry of Finance.