MANAGING THE FINANCIAL COST OF DISASTERS

DISCUSSION PAPER

LESSONS FOR IDA FROM THE UK GOVERNMENT'S APPROACH TO RISK MANAGEMENT OF EXPLICIT CONTINGENT LIABILITIES

CENTRE FOR DISASTER PROTECTION

UKaid from the British people

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Oxford Policy Management

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The Centre for Disaster Protection works with developing countries to find better ways to manage the risks of disasters and to deliver earlier, more cost-effective support for people when disasters occur. One element of the Centre's work is influencing global policy on financing responses to disasters. This series of papers was commissioned to provide analysis, ideas and recommendations for the upcoming nineteenth replenishment of the International Development Association. The series comprises Discussion Papers and Policy Briefs, all available at www.disasterprotection.org.

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TABLE OF CONTENTS

● ACRONYMS

DRF	Disaster Risk Financing
DRM	Disaster Risk Management
HMT	Her Majesty's Treasury
IDA	International Development Association
MFR	Managing Fiscal Risk
MoF	Ministry of Finance
NAO	National Audit Office
PFM	Public financial management
WGA	Whole of Government Accounts

EXECUTIVE SUMMARY

Low-income countries are highly vulnerable to the financial impacts of disasters. These financial impacts can be conceptualised as **contingent liabilities**: i.e. government obligations that are triggered when a potential, but uncertain future event occurs. Disaster contingent liabilities vary by context and peril, ranging from economic losses due to damage to physical infrastructure, to the cost of a food security response. Considerable progress has been made by countries and their development partners in the domain of disaster risk management in recent years—however, the management of contingent disaster liabilities remains a deep-rooted challenge, related to insufficient incentives, as well as deficits in the public financial management capacity (PFM) required for the systematic consideration of potential future costs. Consequently, many low-income countries remain highly vulnerable to budgetary disruption following disasters, which has a detrimental impact on development objectives and fiscal stability.

The UK government provides an example of a structured and participatory governance process for the systematic identification, approval and management of contingent liabilities, including a contingent liability approval framework and checklist. This process creates a space for a dialogue between the finance department, HM Treasury (HMT) and departments, leading to a better understanding of the risks faced, and building capacity in the department for managing contingent liabilities.

This discussion paper draws on the relevant learnings from the UK's Contingent Liability Approval Framework to consider how IDA could build on its current efforts in disaster screening and disaster risk financing, to better support the systematic identification and management of contingent disaster liabilities for its client countries. The paper presents the case for where change is required, and a number of options for further discussion and analysis; it does not provide a detailed proposal on how IDA processes should be reformed.

KEY FINDINGS

There are some challenges for IDA countries using a system similar to the UK's Framework:

- There is a lack of incentive for governments to invest in disaster preparedness, including financial planning; crisis response is routinely financed by donors, rather than planned for by the government. Additionally, PFM capacity in many low-income countries is not at the level of sophistication required for explicit and systematic consideration of contingent liabilities.
- In the UK, approved contingent liabilities are guaranteed by government; such a commitment would be difficult for countries with severe fiscal constraints and weak PFM systems. There is likely to be a constraining limit to the value of contingent liabilities a government is willing to make explicit, and an added importance to the role of mitigation tools for the residual fiscal risk, including international aid.
- The UK Framework has not yet been applied to a disaster-related liability, and would require some adjustment to be appropriate for the assessment of pre-existing liabilities. In particular, the emphasis when assessing risk would move to the extreme end of possible outcomes.

There are also some significant benefits for IDA countries in employing a simplified and amended version of the UK's Framework:

- The UK contingent liability checklist could be useful as a tool for IDA to engage countries in an active, structured dialogue on contingent disaster liabilities and their management. This dialogue could centre around simple set of questions that lead to the acknowledgement that a risk exists, an understanding of the scale of that risk, who owns it, and who is going to pay for it if it materialises.
- The brevity and simplicity of the checklist makes for a collaborative and workable approach for IDA countries beginning to develop PFM capacity; additional technical assistance may be required as this is built, and its impact must outweigh the additional administrative burden it brings.
- The process of completing the Framework obliges departments to be precise about the nature of liabilities on the government balance sheet, providing a basis for stronger accountability.
- Whilst the Framework is not an overarching model to cover all risks for IDA countries (and some risks will not be identified or cannot be managed under this Framework), using a standardised approach applied to 'known unknown' disaster risks would ensure they are being identified in a consistent way by partner governments, laying the foundations for more comprehensive risk management, and delivering the key aspects of international best practice.

KEY RECOMMENDATIONS

While using access to IDA funding as an entry point for this discussion to take place, it should be framed in a way which can inform the Government's wider management of contingent liabilities as they affect the entirety of public finances. This requires framing the identification of contingent disaster liabilities through a public financial management lens, and placing the onus on Government entities to identify and plan for them.

There are a number of possibilities for where this dialogue could be initiated: it could happen as part of the development processes for IDA country partnership frameworks, or for projects and programmes. It could also be an additional consideration when assessing country eligibility for accessing any of the global financing instruments for crisis response that are managed by IDA. The most appropriate entry point(s) should be determined through further discussion consultation, informed by additional analyses as required.

Further considerations include the appropriate questions to ask as part of the checklist; how it can maintain the flexibility to apply in different contexts and different levels of capacity and economic objectives; what are the tools and technical assistance required by governments to support the completion of the checklist; what other examples of best practice exist and can be drawn from, including in other countries vulnerable to disasters; and, how to link this process to other aspects of risk management, including the use of different contingent financing instruments.

INTRODUCTION

Low-income developing countries are increasingly engaging in disaster risk management (DRM) alongside their development partners, such as the World Bank's International Development Association (IDA). This includes the creation of financial strategies to manage the cost of disasters. However, despite considerable progress in this area, the absence of ex-ante financial planning for disaster losses inevitably leads to the reallocation of programmed funds, many of these same countries remain vulnerable to budgetary disruption. As well as undermining governments' fiscal positions, this has a detrimental impact on development objectives. Where the required funds are sourced ad-hoc and ex-post, this produces delays in response and inefficiencies in fund deployment.

Box 1: Contingent liabilities refer to government obligations triggered when a potential but uncertain future event occurs.

Contingent liabilities may be explicit or implicit:

Explicit contingent liabilities are expenditures that might arise due to pre-arranged explicit agreement made, for example in contracts or through laws. An agreed future payment or set of payments are made if a particular event or disaster occurs, and the agreement sets out how the funds will be used and includes mechanisms to ensure this will happen ('hard triggers').

Implicit contingent liabilities are expenditures that might arise due to moral obligations, without any prior commitments or due to public expectations or political pressure on the government.

Paterson, C (2019) Financing explicit contingent liabilities through IDA, Centre for Global Disaster Protection

Gamper, C. et al. (2017), Managing disaster-related contingent liabilities in public finance frameworks, OECD

Working Papers on Public Governance, No. 27, OECD: Paris

Losses from natural disasters can usefully be conceptualised as **contingent liabilities**, as defined in Box 1. While contingent liabilities of this type maybe uncertain in timing and scale, they are often not entirely beyond the scope of credible expectations; these are referred to as 'known unknowns'. Indeed, managing contingent liabilities effectively requires that these risks have been identified ex-ante, and, preferably, that and there is clarity on who owns the risk and who is responsible for a response. A robust public financial management (PFM) system, which explicitly incorporates financial planning for the potential costs of disasters, can therefore be considered a cornerstone of financial resilience to disasters.

The PFM systems and processes of low-income countries rarely involve the explicit and systematic consideration of contingent liabilities. Whilst it is common for a budget to include line items for contingencies in order to meet unforeseen and urgent spending needs, this seldom amounts to a comprehensive and systematic identification of the potential costs arising from disasters, much less involves the assignment of responsibility of those costs across line ministries. There are a number of reasons for this deficiency, including insufficient incentives to recognise liabilities that may impact on a government's borrowing potential, or limit the flexibility with which they can respond to disasters once they occur, or discourage other actors (like donors) from doing so. However, even where political-economy factors are conducive, few PFM systems in low-income countries have the requisite technical capacity that this sort of systematic risk analysis demands, with some governments struggling to form credible budgets for current liabilities, let alone contingent ones. The UK's Contingent Liability Approval Framework, presented as a model in this paper, is a recent development; therefore, expectations of IDA client countries should be realistic.

This is not to imply that management of contingent liabilities can only be introduced when PFM systems have reached a certain level of maturity; given the growing frequency and severity of disasters impacting on many low-income countries, there is a need to introduce at least some basic elements of liability identification to form the basis of a DRM system. This should be a simplified approach, introduced as means of gradually building financial resilience alongside the development of general PFM capacity.

Specifically, this paper argues that there is an opportunity to promote a simple, structured, and participatory process with countries, around the identification and management of contingent disaster liabilities. IDA is well placed to take on this role with its client countries, given the extensive work that the World Bank is undertaking to emphasise DRM in development investment, and in the preparation of comprehensive disaster risk-financing (DRF) strategies. The provision of IDA financing could be used as an entry point for discussions around the management of contingent liabilities. This would be appropriate framing, as IDA development financing,

grants and guarantees frequently result in new or modified contingent disaster liabilities for governments (for example by investing in new road infrastructure that may be exposed to storm damage).

The critical factor is promoting a process which could ultimately transfer into countries' own budgetary planning processes, through building countries' PFM capabilities to manage these risks. This would involve shining a light on pre-existing contingent disaster liabilities of the government (beyond those financed through IDA), forming a more complete picture to provide a basis for better management of them. For example, investment in a social safety net (to form part of a food security response) could then initiate a conversation on the cost of drought response.

Dialogues of this type are already happening with IDA-eligible countries, as part of World Bank projects that specifically include DRF components. However, they differ from what is envisioned here, in terms of their focus and levels of participation. For example, IDA's commitment to screen all projects for climate and disaster risk has been in place since 2014, and has resulted in the production of the World Bank's Climate and Disaster Screening Tools , which are used in the preparation of projects. The screening is undertaken by the IDA team leading the project preparation, rather than the country government, and the questions are framed principally to improve project design, as opposed to ensure potential costs are provisioned for through the government budget.

This paper argues that IDA should extend the current screening processes to capacitate client governments in systematically identifying contingent disaster liabilities related to all publicly financed operations, working in a participatory way with the World Bank. This would add value in enhancing the fiscal resilience and sustainability of the country. Moreover, it would provide insight for IDA into the potential budgetary impacts of disasters for its client countries, and give an indication of the likelihood and magnitude of potential demands on IDA-recovery-financing instruments such as the Crisis Response Window and the Immediate Response Window. It would also help IDA to identify where additional ex-ante financial instruments might be needed. Not doing so is a missed opportunity, both for IDA and its client governments.

The design of a contingent liability identification process should necessarily reflect the country context, not least because it must be anchored in the domestic PFM system. However, learning can be drawn from other institutions, and this paper considers the applicability of the UK government's approach. Although the UK has a fairly low exposure to natural disaster risks, it is not immune to other forms of high-severity, low-frequency risks, such as terrorist risk or the risk of serious livestock diseases (such as the 2001 foot-and-mouth disease outbreak). Since 2017, the UK government has adopted a structured, cross-government governance process for the systematic identification, approval and management of contingent liabilities, as summarised in Box 2.

Box 2: The UK's Contingent Liability Approval Framework

The UK Government's Contingent Liability Approval Framework is an accountability and decision-making tool, which provides Her Majesty's Treasury (HMT) with oversight of the contingent liabilities taken on to the government's balance sheet. Contingent liabilities in the UK mostly take the form of government guarantees, letters or statements of comfort (including verbal agreements) and indemnities (in particular, those embedded in contracts for procurement with the private sector which may include contracts of difference).

The Framework incorporates a simple checklist which, when completed, provides the detail required to perform a risk assessment. It includes questions on identification of the risk and the scale of exposure it entails; the likelihood of the liability maturing, and how that can be managed; and the affordability of the liability and source of funds should the obligation arise.

Checklists are completed by the responsible line department, and are then reviewed by HMT, who can decide whether to accept the contingent liabilities, or request that they are modified in some way. Only once the department has gone through the checklist and received all the necessary approvals from HMT and Parliament do they have the all-clear to add the contingent liability to their balance sheet.

In line with good practice in risk management in general, the endorsement of this Framework creates a space for risk management through early and ongoing conversations between HMT and the responsible department, providing a mechanism to approve or improve the risk management of policy decisions.

Given existing processes and engagements on DRF between IDA and developing countries, the questions in relation to the UK approach are:

- What lessons can be drawn from it to inform a more systematic identification of contingent disaster liabilities in other countries?
- Can access to IDA financing provide an entry point to initiate a structured dialogue with IDA-eligible countries on how such a system could be established?
- If so, where within the IDA process would this best be applied?

This paper sets out the UK approach to risk management and the UK's Contingent Liability Approval Framework in Section 2. This includes an illustrative example of how the Framework is used in practice. Section 3 draws on the relevant learnings from the UK's approach and suggests how IDA could extend their current screening efforts to contribute to building greater financial resilience to disasters, providing further illustrative examples. Section 4 summarises the salient points from the analysis and offers some next steps for consideration; presented as options rather than a concrete proposal, these are intended to provide the basis for further discussion and analysis.

1 SECTION 1: THE UK'S APPROACH TO RISK MANAGEMENT AND ITS CONTINGENT LIABILITY FRAMEWORK

1.1 APPROACH TO RISK MANAGEMENT

In the UK it falls to HMT to oversee departments' use of their budget allocations. In the main, departments have considerable discretion about how they distribute these budget allocations, with responsibility for clarifying and managing fiscal risks, including explicit contingent liabilities.

The UK government aims to follow an open and transparent approach to risk management. The financial performance and position of the whole of the UK public sector is openly reported in the Whole of Government Accounts (WGA) . The WGA provide a largely complete picture of the government's financial position including assets (for example, any land and buildings owned by the government) and liabilities (for example, the level of government debt). The WGA are independently audited by the National Audit Office (NAO) and examined by the Public Accounts Committee each year.

The report, 'Managing Fiscal Risk: government response to the 2017 Fiscal risks' (MFR), published in July 2018 by HMT provides an assessment of risks to the UK public finances. It reiterates that the UK government's objective is not to eliminate all fiscal risks—some of which are unavoidable—but to be aware of the risks it is facing, reducing risks where possible in a cost-effective way and without detracting from its wider policy objectives, and ensuring the overall position of the public finances is resilient to the risks that remain. MFR also recognises that actively taking on risk at certain times can minimise overall costs in the future. The UK government follows a five-stage approach to managing fiscal risks, modelled on international best practice as described in Box 3.

Box 3: A five-stage approach to managing fiscal risks

1. Identify the source of risk, the scale of fiscal exposure, and the likelihood of crystallisation. For example, all departments are obliged to identify any contingent liabilities, their size, and probability of realisation in their annual accounts.
2. Disclose the fiscal risk to Parliament and the public to raise awareness and ensure accountability for management of potential threats to public funds.
3. Mitigate fiscal risks where this can be done cost-effectively and without detracting from wider policy objectives. Risk-mitigation tools can include discouraging risky behaviour (e.g. through financial regulation), encouraging actors to pool risk, or placing limits on the extent of government exposure (e.g. through limits on the issuance of export guarantees).
4. Provision for risks that cannot be mitigated but whose size and timing is relatively certain.
5. Accommodate those risks whose size or timing is too uncertain to explicitly provision for in advance.

The WGA and MFR support the effective management of public finances, and provide opportunities for parliamentary and public scrutiny of the government's financial position. Public sector decision makers need to consider not only the most likely future outlook for the public finances, but also the likelihood and scale of impact of alternatives around the central forecast. Therefore, both contingent and definite liabilities (including those with a remote chance of crystallising) are considered, providing a broad picture of public finance risk management and long-term risk profile.

To this end, HMT has recently enhanced its approach to the clarification and management of the UK's balance sheet, with the launch of the Balance Sheet Review in the Autumn Budget 2017. This provides a comprehensive review of the government's wider assets and liabilities management. The 'Contingent Liability Approval Framework' was introduced in July 2017 , in parallel to this review. The Framework was deemed necessary due to increasing financial exposures (in the form of provisions and contingent liabilities) derived from government guarantees such as the 'Help to Buy' mortgage schemes, and promises of support to pension schemes of former nationalised industries.

1.2 CONTINGENT LIABILITY APPROVAL FRAMEWORK

The UK design is for Parliament to be notified of uncertain liabilities in a meaningful way; the Contingent Liability Approval Framework sets out a standardised governance process for ministerial departments when proposing a new policy which results in new or modified contingent liabilities. The Framework is an accountability and decision-making tool, and provides HMT with oversight of the contingent liabilities taken on to the government's balance sheet (via each ministerial department's balance sheet).

The Framework is required to be applied on any contingent liability considered to be novel , contentious or repercussive , and where the maximum exposure is greater than £3m.
For qualifying contingencies, a checklist of questions is completed by the departments responsible for the policy decisions that have originated a risk. The checklist is short, with further background detail provided in the main body of the Framework. The checklist provides a formal way for departments to acknowledge, understand and document the proposed management of contingent liabilities, and share this information with wider stakeholders. Departments work closely with HMT and other expert advisors throughout this process. This collaborative working has helped build capacity in departments who are getting better equipped at quantifying risk, structuring guarantees and proactively taking steps to reduce risk.

Completed checklists are reviewed by HMT, who can decide whether to accept the contingent liabilities, or request that they are modified in some way. Only once the department has gone through the checklist and received all the necessary approvals from HMT and Parliament do they have the all-clear to add the contingent liability to their balance sheet, from where it will appear on the WGA. In this way, the Framework allows for the consistent evaluation of contingent liabilities, building confidence that government is behaving consistently in risk-management decisions. Having an overall view of the risks to the balance sheet enables identification of correlation risks and diversification benefits, as well as strategies which make sense across groups of contingent liabilities.

Since the Framework was published in July 2017, it has been applied to over 60 new contingent liabilities, with a total value of £158 billion . Of these, a small proportion (less than 1%) of the new liabilities were rejected outright, whereas the vast majority were approved, but only after significant modification to the new policy in order to reduce risk exposure. This demonstrates how the Framework has been useful in both identifying risk and providing a mechanism for improving risk management in policy decisions.

The sections of the UK's Contingent Liability Approval Framework checklist are as follows:

- **Rationale**—this involves identification of the risk, a discussion of why it is necessary and consideration of any alternatives, primarily to ensure the government doesn't take on a risk that it doesn't need to. The UK government is most likely to take on risk in the case of market failure; however, identification of a market failure is not a requirement.
- **Exposure**—this involves quantification of the severity of the risk based on the elements-at-risk that are subject to potential losses, including details of the term and maximum size of the contingent liability.
- **Risk and return**—considering the likelihood of the liability maturing, and corresponding discrete distribution of losses used to calculate the expectation of loss.
- **Risk management and mitigation**—the approach to managing the risk is presented, including assigning risk ownership and identifying risk mitigation tools to be deployed, as well as fees to be charged, and potential moral hazard implications.
- **Affordability**—considering the funds currently available to finance the obligation and how this compares to the distribution of losses.

Table 1, below, provides a hypothetical example of how the checklist might be completed by a UK government department. In this case, we have considered an overly simplified and fictitious example, whereby the UK's 'Department for Railways' has received approval for a project to provide financial backing to a commercial railway owner to support improvements in the infrastructure. The Department believes the guarantee of bank loans to be the best way to incentivise investment, without the need for additional government spending. HMT would review the checklist and consider whether they would accept the contingent liability, or whether there are elements requiring modification before the policy can be approved. As an example, HMT may require the Department to review the fees charged to the rail owner (section 4c in Table 1) if they don't think these provide a good enough return given the risk. (For example, HMT may have seen other departments charge more for a similar risk.)

On review of the completed checklist, all stakeholders, including parliament, are informed of:

- the context,
- the likelihood of the government needing to pay out,
- how much may need to be paid out, and
- whether this is available from the department's existing budget / budget reallocation from within or outside the department will be required.

It also sets out what alternatives have been considered, and importantly, the evidence base for the numbers, including any independent advice taken.

Table 1: Illustrative example of checklist completed by a hypothetical UK government department

		ANSWERS TO CHECKLIST AS PROVIDED BY HYPOTHETICAL 'DEPARTMENT FOR RAILWAYS'
1. RATIONALE		
A	What is the problem that needs to be solved (the market failure) and why is government intervention necessary?	The commercial railway owner cannot access the credit required (at an affordable rate) to invest in the railway infrastructure, due to a lack of available capacity in the market for these types of loans. The Department plans to offer a guarantee on bank loans to enable the railway builder access to affordable credit and encourage investment in infrastructure. A project of financial assistance to encourage this investment has been approved by Parliament—based on an assessment of the additional investment expected with the guarantee, compared to without the guarantee as previously discussed with HMT colleagues.
B	Why is incurring / modifying a contingent liability necessary to address the market failure?	Without access to affordable credit, sections of the railway are falling into disrepair, as owners are not investing in upkeep.
C	What other alternatives have been explored? For example, direct spending such as subsidies. Why were these rejected?	Direct government spending would not incentivise appropriately.

		ANSWERS TO CHECKLIST AS PROVIDED BY HYPOTHETICAL 'DEPARTMENT FOR RAILWAYS'
2. EXPOSURE		
A	What is the maximum size of the contingent liability, if any?	The maximum is estimated to be £400m.
B	Why is this size necessary? If there is no explicit maximum, please explain why.	The work required is estimated to cost around £200m (confirmed by an independent review of the commercial owner's assessment). The loan guarantee covers this amount plus interest less the first-loss slice which falls to the bank. In the event that the railway owner becomes insolvent and defaults on debt, there will also be the cost of making good any outstanding repairs which could fall to the government.
C	What is the maturity of the contingent liability, if any? I.e., when does it cease to exist?	The term of the loan, which is expected to be 10 years.
D	Why is this maturity necessary? If there is no explicit maturity, please explain why.	This is the standard loan term offered by the banks.
E	If, prior to maturity, the contingent liability no longer proves to be value for money, is there an exit strategy? If yes, how would it work? If no, why not?	No, because it is a contractual arrangement.
3. RISK AND RETURN		
A	What are the triggers for potential crystallisation of the contingent liability?	The railway owner defaulting on this debt.
B	What is the likelihood of complete crystallisation over what timeframe? I.e., time t = X%, time t+1 = Y%, time t+2 = Z%, etc.	The chance of default is small. The operator has double-B credit rating and probability of default is assumed to be 0.5% per year, and 5% over the term of the loan (based on analysis by a chosen rating agency).
C	What is the distribution of possible losses over the life of the contingent liability? I.e., loss of A with likelihood of B, loss of C with likelihood of D, etc.	Loss of £400m with likelihood of 0.5% Loss of £370m with likelihood of 1.0% Loss of £330m with likelihood of 1.5% ... Loss of £0 with likelihood of 95% (We have assumed a discrete probability distribution applies)
D	What is the expected loss associated with the contingent liability?	£11m

		ANSWERS TO CHECKLIST AS PROVIDED BY HYPOTHETICAL 'DEPARTMENT FOR RAILWAYS'
E	How do the risks compare to the returns on the contingent liability?	Wider policy benefits of infrastructure going ahead, as per project appraisal. Severe reputational risk to government if long term delays or a disaster on the rail line.
4. RISK MANAGEMENT AND MITIGATION		
A	Who will manage the risks associated with the contingent liability and what is the governance process around the management of these risks?	The private sector team within the Department for Railways are responsible for this project and monitoring progress and spend. A report will go to the risk committee bi-annually and to the Board annually.
B	What risk mitigation tools have been explored? For example, partial guarantees, collateral, controls on risk-taking behaviour, reinsurance, etc.	Guarantee only given to owner if they meet certain requirements—for example, the construction must be done to a certain standard. We have explored whether a partial guarantee was also possible, but based on the advice we have received from our advisors this appears the best approach to encourage take-up.
C	Is the Exchequer being adequately compensated for bearing the risk associated with the contingent liability? For example, guarantee fees, contingent claims, profit-sharing, etc.	The Department is charging a fee to the rail owner, but this is not equal to the value of the guarantee to incentivise uptake. Fee covers 25% of the average expected loss of the loan guarantee.
D	How should the Exchequer guard against the residual risk? For example, contingency fund, setting aside financial assets, hedging, etc.	The Department do not think such an approach is required or proportionate to the risk. One alternative would be for an Excess of Loss insurance policy to be put in place.
5. AFFORDABILITY		
A	If the contingent liability crystallised, to what extent would it be possible to meet the required payment out of the department's existing budget?	100% through budget reallocation.
B	What is the ratio of the contingent liabilities expected loss to the department's available resources?	2%
C	If the contingent liability crystallised, how would it affect public sector net borrowing (PSNB) and public sector net debt (PSND)?	No impact

2 SECTION: 2 APPLICATION OF THE UK'S CONTINGENT LIABILITY APPROVAL FRAMEWORK TO IDA COUNTRIES

Having reviewed the salient features of the UK's Framework, we now consider what lessons can be drawn from it, to inform a more systematic identification and management of contingent disaster liabilities in other (low-income) countries, and the role IDA can play within that.

2.1 OBSTACLES AND CHALLENGES

Firstly, it is worth considering the reasons why many IDA countries are not already undertaking similar systems. In part this is because of incentives: understating liabilities allows governments to take on more risk, and the lack of political incentive to invest in disaster preparedness—including financial planning—are well documented.[1]

The situation is further exacerbated in countries where crisis response is routinely financed by donors, rather than planned for by the government. However, even where there is a political support to improve financial resilience, PFM capacity in many low-income countries is simply not at the level of sophistication required for explicit and systematic consideration of contingent liabilities; many of these governments struggle to form credible budgets even before taking into account contingent liabilities.[2]

Given this operating reality, how suitable would a UK-like framework be for a low-income country facing these constraints? It should be acknowledged that the sort of liabilities the UK government faces are predominantly guarantees, letters or statements of comfort, and indemnities—the Framework has not yet been applied to a disaster-related liability, a reflection of the domestic context within which it has been used thus far.

Once contingent liabilities are approved in the UK, the UK Government stands behind them, including the HMT consolidated fund. Such a commitment would be very difficult for countries with severe fiscal constraints and weak PFM systems. This doesn't negate the inherent value in identifying and quantifying those risks in the first place, but it does mean there is likely to be a constraining limit to the value of contingent liabilities a government is willing to make explicit, and an added importance to the role of mitigation tools for the residual fiscal risk, including international aid.

[1] See for example, Cole, S., Healy, A., and Werker, E. 2012. 'Do Voters Demand Responsive Governments? Evidence from Indian Disaster Relief'. *Journal of Development Economics* 97: 167.

[2] https://www.internationalbudget.org/wp-content/uploads/budget-credibility-what-can-we-learn-from-pefa-reports-ibp-2018.pdf

2.2 BENEFITS AND AREAS FOR DEVELOPMENT

The Framework is defined in an intentionally broad way so as to be applicable to a wide range of contingent liabilities, which could potentially include disasters. By the same notion (whilst its application in the UK has been in relation to clearly defined government obligations), in principle it could also be used for more discretionary policy-type commitments which could be expected in IDA countries, in relation to government obligations for disaster response. One of the Framework's benefits is that the process of completing it obliges the user to be more precise about the nature of liabilities on the government balance sheet, providing a basis for stronger accountability.

A clear advantage of the UK's approach is the brevity and simplicity of the checklist, which can be completed by Departments working closely with HMT. In IDA countries, the Framework might need to be simplified further, and additional technical assistance called for as capacity is being built. Finance Ministries may need to have a more central role in the screening process (as compared to the UK model, where they are limited to a quality assurance/approval role), as this is where existing economic forecasting capacity is usually found. Collaborative working with line departments is also necessary, helping to build their capacity in quantifying risk, structuring guarantees and proactively taking steps to reduce risk. In time, the Ministry of Finance (MoF) could assume a quality assurance role, closer to the UK model (assuming that the MoF has the political weight to enforce compliance amongst line ministries).

The UK's Contingent Liability Approval Framework's remit is for new and modified obligations only. For low-income countries looking to introduce a systematic contingent liability identification and monitoring process from a very low baseline or from nothing, this would need to be expanded to include pre-existing contingent liabilities, in order to capture the full cost of disaster response.

Screening all public investments for all potential risks is not a practical proposition for most IDA countries, even if the analysis is just is to be focused (at least initially) on disasters, which would limit the appraisal to medium/high-severity, low-frequency risks. Focusing only on those sectors of public expenditure where the potential losses from the risk are considerable (such as infrastructure), or where the budgets pertain to particularly disaster-vulnerable regions or localities might be more pragmatic. Once established, the UK model of applying the checklist just to new or modified obligations could be adopted, and the scope of relevant risks broadened.

The UK's checklist questions would require some adjustment to be appropriate for the assessment of pre-existing liabilities. **Some suggestions on what these changes might look like for the IDA context are as follows**:

- **Rationale—identification of the risk.** The emphasis is on building a picture of the risks the government faces, to decide where to focus attention given limited resources. For a disasters-only focus (as this paper pre-supposes it would be, at least initially) the types of risks considered must be clarified, e.g.: medium/high severity low-frequency risks only. This section of the checklist would be adapted to focus on identification of risk, and not decision-making about whether to proceed with actions that create the risk. The decision on whether or not to proceed with an investment would be entirely independent of any outcomes from the checklist (and may relate to investments already made).
- **Exposure—estimation of the severity of a risk**, based on the elements-at-risk that are subject to potential losses, including details of the term and maximum size of the contingent liability. It is unrealistic to expect quantification of all potential contingent disaster liabilities to be incorporated into this process; considerable flexibility on what constitutes an acceptable estimate would be necessary. An estimate of the likely maximum loss or a broad range around this could be provided, as a minimum, e.g. for the exposure of a physical asset, the respondent could provide the estimated reconstruction cost, based on original construction cost. The availability of tools to perform quantification will vary substantially, country by country.
- **Risk and return—quantification of the likelihood of the liability maturing,** and corresponding discrete distribution of losses used to calculate the expectation of loss. Questions 3B to 3D in the checklist (Table 1) provide simple approaches for how to describe the loss distribution without requiring a full distribution. In the case of disasters, it would be preferable to understand the full probability distribution. Full probabilistic loss distributions will be available in cases for IDA countries where risk modelling work has been undertaken as part of disaster risk management engagements. However, availability of this type of information will be the exception rather than the rule.

- When considering disaster (high-severity low-frequency) events, in general, the tail of the distribution is more helpful than the average. Unlike the UK model, in the IDA context focus should be on the most extreme possible outcomes.
- Question 3E asks about the risks versus returns. This will not generally be applicable for our IDA example, as the checklist is intended as a communication, rather than a decision-making tool for an investment.

- **Risk management and mitigation—understanding the current approach to managing the risk** (including risk ownership) and whether this is optimal. This section's function would be to identify responsibility for managing and owning the risk, and to draw out actions that have been taken by the government and IDA to mitigate the risk.
- **Affordability—what funds are currently available to finance the obligation** and how does this compare to the distribution of losses, identifying where contingent provisions and contingent financing instruments are available to meet costs that could arise, either from within the fiscal budget or from other sources, including IDA's portfolio of crisis response financing mechanisms.

As illustrated with the hypothetical UK example, the extent to which these questions can be answered is limited in some cases, but there is still value in asking the questions and understanding the limitations of the available answers, both for the partner government and the World Bank. There are risks which will not be identified or cannot be managed under this Framework; for example, the risk management framework can only be applied in the case of identifiable risks, often referred to as 'known unknowns', but not unidentifiable risks—those 'unknown unknowns', nor risks such as conflict. These points considered, a standardised approach like this applied to 'known unknown' disaster risks would ensure they are being identified in a consistent way by partner governments, laying the foundations for more comprehensive risk management. This would deliver the key aspects of international best practice on risk management (as highlighted in Box 3, above). Furthermore, whilst this paper is focused on how the Framework could be applied to manage disaster-related contingent liabilities, it would be very possible for the partner governments to also use it to identify and manage other types of contingent liabilities.

2.3 WHAT IS THE ROLE FOR IDA IN IMPLEMENTING A FRAMEWORK?

IDA interactions with developing countries already carry elements of contingent liability identification; this is happening through efforts to bring disaster risk management into development investment across World Bank operations. Countries are encouraged to plan financially for disasters through comprehensive disaster risk financing strategies, and they are receiving technical assistance in the development of risk profiles that quantify potential disaster losses at the national and sub-national level. Additionally, climate and disaster screening is undertaken as standard, as part of the project preparation process for World Bank operations with countries[3].

The Climate and Disaster Screening Tools take a sectoral approach to the identification of risk and adaptive capacity, with questions tailored to specific sectors (i.e. agriculture, health, energy). However, this differs from the systematic, government-led process envisioned above in a number of respects. Firstly, the IDA team leading the project preparation undertake the screening, and although the process informs the dialogue with the client country, the responsibility to respond to screening questions sits with the IDA Task Team—not the country. Furthermore, the questions are framed principally to improve project design—therefore, they don't present risk identification through a public financial management lens, i.e. what potential costs may need to be provisioned for, and what provisions are in place to meet these costs.

The key aspects of the UK approach that differ from the existing IDA processes and could be incorporated to add value are as follows:

- Framing the identification of contingent disaster liabilities through a PFM lens, to facilitate the identification of public expenditures (from the government and donors) which would be needed in the event of the shock occurring.
- Placing the onus on the line ministry responsible for the asset/programme to identify and plan for the management of identified contingent liabilities.

  Applying a simple set of questions that lead to the acknowledgement that a risk exists, an understanding of the scale of that risk, who owns it, and who is going to pay for it if it materialises.

One vision for such an approach within IDA-eligible countries would be for a simplified version of the UK checklist to be completed in collaboration between the MoF and the relevant departments in the recipient government, supported by IDA staff—for example, the Task Team leading IDA grant and lending operations. There are a number of possibilities for positioning this tool as part of IDA processes: it could be incorporated into the development of country partnership frameworks, or included within project preparation processes; alternatively, or additionally, it could be a factor explicitly considered by the World Bank when determining country eligibility to access global funds for crisis and disaster financing managed by IDA or the World Bank (such as the Crisis Response Window, or the forthcoming Global Risk Financing Facility). If accompanied with technical support to governments, this could be similar to the current requirement for a Disaster Risk Management programme under Catastrophe Deferred Drawdown Options (Cat DDOs). However, there would need to be careful consideration as to how mandatory such a criteria would be, in order to strike a balance between the need to create positive incentives while not unnecessarily impeding countries in need from accessing crisis support.

Using the tool as means of enhancing access to these funds would signal to client countries that in return for engaging in a more robust process for contingent liability screening and management, IDA would help finance some of those liabilities, which creates a strong incentive for countries to engage fully in the process, and may help address some of the existing counter incentives mentioned previously. It would also give IDA better oversight of the financial gaps in managing disaster liabilities, so that new ex-ante financing instruments might be introduced where needed.

In any of these options, the inclusion of the checklist as a business-as-usual process would be vital, to ensure that it was being used systematically across IDA operations, while at the same time emphasising the value of the *process* as a means improve the underling investment and management of risk, rather than just another obstacle to overcome. That said, it is important to recognise that the addition of such a checklist into any aspect of IDA operations would constitute an additional compliance burden, and as such, there must be strong demonstrable value from the process that outweighs the additional resources and time required to undertake it.

[3] https://climatescreeningtools.worldbank.org/

2.4 FUTURE BUDGETARY CAPACITY BUILDING AND PFM REFORM

While access to IDA support could be an entry point for introducing the discipline of contingent liability identification, this process should be undertaken in a format that would ultimately transfer into countries' own budgetary planning processes, building the countries' PFM capabilities to manage these risks. This is hard to achieve in practice, as reforming the management of public finances tends to be a highly politicised, non-linear and long-term undertaking. Certain strategies may help increase the chances of success, such as ensuring that any version of the checklist is implemented through a fully participatory process, and the recipient country government takes the lead in its completion, probably led by the MoF, but with active engagement of ministerial departments. IDA's role could be to provide technical support to the quality assurance of the identification process, mirroring the role of HMT in the UK case. Where an existing World Bank-support PFM capacity building project is operating, it would make sense to add this to its remit; otherwise additional targeted technical assistance should be considered. Aligning the timing of the contingent liability review with the domestic budget process would be advantageous from the outset. It may then feed into upstream macro-fiscal forecasting and sustainability analysis, and inform the preparation and approval of ministry budgets.

Below (Table 2) are two examples of dialogues between the government and IDA on managing contingent liabilities as part of IDA operations, in which they improve capacity for the financial management of disaster risks in-country. The purpose of the examples is not to present a tool for implementation, but rather to stimulate discussion: if the proposed approach shows the required potential to add value, further work should be undertaken to develop a tool that would complement IDA's existing processes, and offer a systematic participatory process to improve capacity for financial management of disaster risks.

These examples highlight how this dialogue could identify risks, align responsibilities, and over time lead to better preparedness:

- For the hypothetical IDA programme for investment in a social protection programme, the desired outcome would be an acknowledgement that the risk from severe drought exists, the scale of this relative to the funds available, and the named department responsible for managing this risk. This can develop over time into a dialogue within government on preparedness plans and social protection programmes.
- For the hypothetical IDA programme for investment in physical infrastructure, the desired outcome would be an acknowledgement of the risk to infrastructure, the scale of this relative to other risks and the wider economy, and the named department responsible for managing this risk. This can develop over time into a broader dialogue on investing in risk reduction and prevention to manage future risk.

Table 2: Illustrative example of two completed checklists in the IDA context

		EXAMPLE 1: SOCIAL PROTECTION EXAMPLE IN IDA ELIGIBLE COUNTRY	EXAMPLE 2: RESILIENT INFRASTRUCTURE IN IDA ELIGIBLE COUNTRY
1. RATIONALE			
A	What is the nature of the contingent disaster liability, and from what policy or asset does it originate?	The social protection system that will be developed under this IDA operation may need to rapidly and substantially expand in the event of a severe drought, as part of the food security response of the government and its humanitarian partners.	The infrastructure being developed under this IDA operation is exposed to tropical cyclone risk. In the event of a disaster, direct and indirect losses could arise from damage. Costs could include the cost of reconstruction.
2. EXPOSURE			
A	What is the maximum size of the contingent liability, if any? Further guidance will need to be given to countries, and assistance from the Task Team in answering this question.	Up to 20 million people are exposed to severe drought in the country. The highest historical annual cost of response has been estimated at US$1bn. This is based on experience from recent disasters and evidence compiled by technical experts in the region. It assumes that the cost per person affected is US$50.	The cost of rebuilding the main access roads throughout the country following a storm is approximately US$300m. This is based on scaling up the cost of recent road reconstruction following last year's hurricane season.
C	Is this liability expected to change over time? I.e. are any prevailing or future trends expected to impact the size?	Climate change is likely to have an impact and will likely increase the regularity of droughts. For example a 1 in 25 year drought may become a 1 in 15 year drought.	Unknown, but likely to increase over the lifetime of the infrastructure due to climate change impacts on the frequency and severity of storms.
3. RISK AND RETURN			
A	What are the triggers for potential crystallisation of the contingent liability?	A severe drought, resulting in poor crop yield.	A severe storm, likely occurring during the tropical cyclone season between November and March.
B	What is the likelihood of crystallisation over what timeframe? I.e., time t = X%, time t+1 = Y%, time t+2 = Z%, etc.	Mean = US$300m 1 in 5 year = US$600m 1 in 10 year = US$700m 1 in 25 year = US$1bn	We don't have much data, but the number of storms is increasing.

		EXAMPLE 1: SOCIAL PROTECTION EXAMPLE IN IDA ELIGIBLE COUNTRY	EXAMPLE 2: RESILIENT INFRASTRUCTURE IN IDA ELIGIBLE COUNTRY
		1 in 50 year = US$1.2bn 1 in 100 year = US$1.5bn	In 2007 the cost of re-building the roads was US$100m. In 2015 the cost was US$300m.
4. RISK MANAGEMENT AND MITIGATION			
A	Who will manage the underlying risks associated with the contingent liability, and what is the governance process around the management of these risks?	The National Drought Department are responsible for monitoring the development of any droughts over time and for implementing any response. They will feedback to the Ministry of Finance. Relevant management and governance responsibilities are articulated in legislative documents: [to be inserted]	The Infrastructure Department, feeding back to the Ministry of Finance. There is no formal governance process for the management of the risks at present, but this will change with forthcoming development of policy: [specifics to be inserted]
B	What risk mitigation tools have been explored?	The government is mitigating and managing food security and drought risk and through several approaches; [this section would detail investment projects and policies to manage drought risk, and to prepare for a food security response e.g. through pre-positioning of goods.]	The disaster vulnerability of this infrastructure has been mitigated through actions including: [this section could detail efforts to undertake resilient construction, any requirements for insurance purchase mandated by government during or after the construction process]
5. AFFORDABILITY			
A	If the contingent liability crystallised, what financial provisions are available to deal with the costs, and from where?	Contingency budget of X million within the departmental budget; potential to access up to X million through the recovery financing instruments; otherwise reallocation of programmed funds within the fiscal budget or IDA envelope.	Contingency budget of X million within the departmental budget; potential to access up to X million through recovery financing instruments; otherwise reallocation of programmed funds within the fiscal budget or IDA envelope.
B	What is the ratio of the contingent liability expected loss to the departmental and whole-of-government annual fiscal budget?	For the departmental budget: X%. For the whole-of-government budget: X%	For the departmental budget: X%. For the whole-of-government budget: X%

		EXAMPLE 1: SOCIAL PROTECTION EXAMPLE IN IDA ELIGIBLE COUNTRY	EXAMPLE 2: RESILIENT INFRASTRUCTURE IN IDA ELIGIBLE COUNTRY
C	If the contingent liability crystallised what impact would it have on public finances? This question would need to be flexible to deal with the capability of modelling these types of impact. There should not be a requirement to commission new analysis beyond current capabilities. A qualitative answer might be acceptable.	Potential increase on [public sector net debt/other available indicator] of X%.	Potential increase on [public sector net debt/other available indicator] of X%.

CONCLUSION AND CONSIDERATIONS FOR IDA

Many low-income countries are highly vulnerable to budgetary disruption following disasters, which has a detrimental impact on development objectives and fiscal stability. Therefore, there is a clear need to improve the identification, acknowledgment, and management of disaster-related contingent liabilities, enabling countries to become risk managers rather than crisis responders in the context of disasters. A systematic approach for identifying risks, estimating their potential impact, and assigning responsibility for managing and monitoring them are first steps in the development of a comprehensive risk management system.

IDA is well placed to meet this need in client countries, and failing to do so is a missed opportunity for both the Association and its client governments. While interactions between IDA and countries already include risk identification, with institution-wide climate and disaster screening incorporated into the project preparation process, the value of this process could be greatly enhanced by reorienting it towards supporting a more government-led, systemic approach to contingent liability identification and management, fully integrated into the domestic public financial management processes.

Based on the UK model, this means placing the onus on the MoF and the line ministry responsible for the asset/programme to identify and plan for managing identified contingent liabilities, potentially applying a simple set of questions that lead to:

- the acknowledgement that a risk exists,
- an understanding of the scale of that risk
- who owns it, and
- who is going to pay for it, if it materialises.

The UK model would need to be adapted to capture existing and new liabilities, to focus on a subset of risks related to disasters, and could benefit from further simplification. However, if accompanied by the necessary technical support, the adaptation and application of the UK checklist could build the capacity of governments to understand and own risk. This has been the experience of the UK, where the vast majority of contingent liabilities have been approved, but only after significant modification to reduce risk exposure, demonstrating that the Framework is being effective at promoting and improving risk management in government.

IDA could initiate the introduction of such a process, through a structured dialogue on contingent liabilities between developing countries (MoFs, line ministries) and IDA, as part of its existing operations. Using access to IDA financing as an entry point, elements of the checklist could be incorporated as part of IDA's general project preparation or country partnership framework processes, or could be considered as part of a pre-qualifying process for global funds for crisis financing. The checklist should be used as a communication tool between a developing country and IDA, rather than a decision-making tool, and give IDA better oversight of the financial gaps in managing contingent disaster liabilities so that new ex-ante financing instruments might be introduced where needed. If accompanied by the necessary technical support, the adaptation and application of the UK checklist could build the capacity of governments to understand and own risk, becoming part of routine budget processes.

The purpose of this paper is not to present a tool for implementation, but rather to stimulate discussion of the benefits or otherwise of such a dialogue. Consideration should be given to the additional compliance burden that adding such a checklist into any aspect of IDA operations constitutes; it will be important to harness the views of governments and World Bank staff to understand if this can offer strong demonstrable value, that outweighs the additional resources and time required to undertake the extra process.

Full reliance cannot be placed on this approach, as there are risks which cannot be managed under this Framework, such as the risk of conflict. Additionally, the risk management framework can only be applied in the case of identifiable risks—the 'known unknowns'—and not the 'unknown unknowns'. It will also be challenging to 'size' certain contingent disaster liabilities, as the past may not be predictive of the future, and modelling will not be available for all situations (however, in this case, even asking the questions may lead to additional insights into the risk management process).

If the proposed approach showed the required potential to add value, further work would need to be undertaken to develop a tool that would complement IDA's existing processes, and offer a systematic, participatory process that improves capacity for disaster risk financial management. Initial next steps might be to consider:

- Where it fits within IDA's current processes—projects or country partnership framework processes, or for access to global funds for crisis financing.

- What are the appropriate questions to ask as part of the checklist, potentially incorporating those currently asked as part of the World Bank-wide climate and disaster screening.
- How the checklist can maintain the flexibility to apply in different contexts and meet the needs of governments with different levels of capacity and economic objectives.
- What are the tools and technical assistance required by governments to support the completion of the checklist, particularly for completing the baseline of existing liabilities but also in the identification of new or modified liabilities.
- What other examples of best practice exist and can be drawn from; this paper only considers the UK approach, and a wider review would be beneficial (including in other countries vulnerable to disasters).
- How to link the process here—which focuses primarily on screening—to other aspects of risk management, including the use of different contingent financing instruments.

Cover image: Cover image: Clean up continues in Jeremie, Haiti following the heavy rains and winds of Hurricane Matthew. October, 2016
Image: Logan Abassi / UN / MINUSTAH

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