Credit Risk and Public Sector Financial Risk Management

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The Meaning of Credit Risk

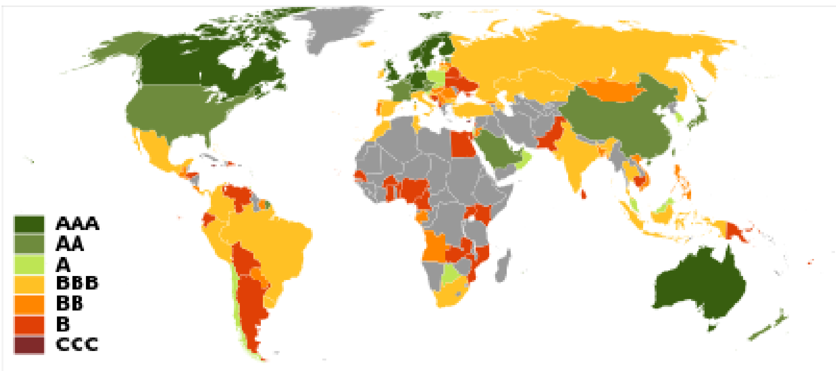
"A debtor is someone who owes money

A creditor is someone who thinks they will get it back"

Sources of Credit Risk

- Governments/agencies as borrowers (debtors)
  - Perceived credit rating affects cost of borrowing
- Governments/agencies as investors
  - Promised returns on investments in debt securities don’t always eventuate
- Governments/agencies as guarantors
  - Contingent liability if guaranteed entity defaults
  - Equivalent to government borrowing and lending those funds to the (guaranteed) entity
- Governments/agencies as economic transactors
  - Extending trade credit (and rate payments etc) creates credit risk

Sovereign Ratings: March 2013



S&P ratings: Grey = not rated: 14 AAA rated

Determinants of Ratings

- Sovereign ratings reflect factors such as:
  - Income per head (+); GDP growth (+); Inflation (-); Budget surplus (+); Current account surplus (+); External debt (-); Economic development (+); Default history (-); and judgement
- But do ratings provide additional information?
  - Or just reflect available public information?
- If new information, announcements of ratings changes would cause bond price changes
  - Recent ECB working paper finds evidence for Euro area govt (particularly for downgrades)
    - But studies of corporate rating changes give mixed results

ECBWP1347

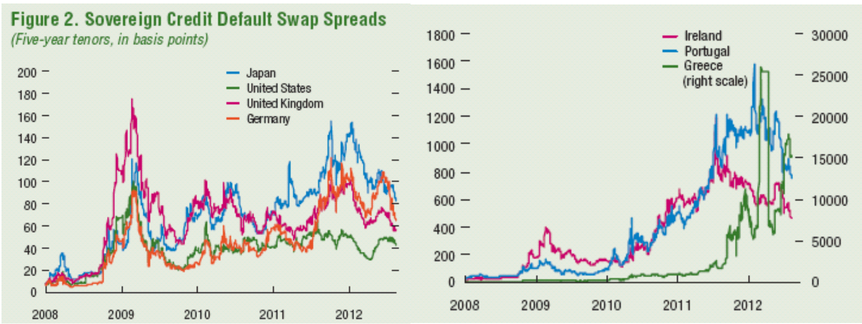
Do Ratings Matter?

- Effect on government's borrowing costs in international markets
- Domestic company and financial institution credit ratings constrained by sovereign rating
- Institutional investors often limited to investments with high ratings
- But is the game always worth the candle?
  - What is the cost of achieving a higher rating (eg austerity programs) relative to lower borrowing costs?

Credit Ratings and Borrowing Costs

- How much do sovereign ratings matter?
  - Most easily seen in case of Europe, governments issuing in same currency (Euro)
  - March 2013 (10 year govt. bond yields)
    - Germany 1.35%
    - France 2.07%
    - Spain 4.92%
    - Greece 11.38% (down from high 20's)
- Alternatively use Credit Default Swap spreads
  - CDS spreads are like an insurance premium

Sovereign Credit Risk Indicators

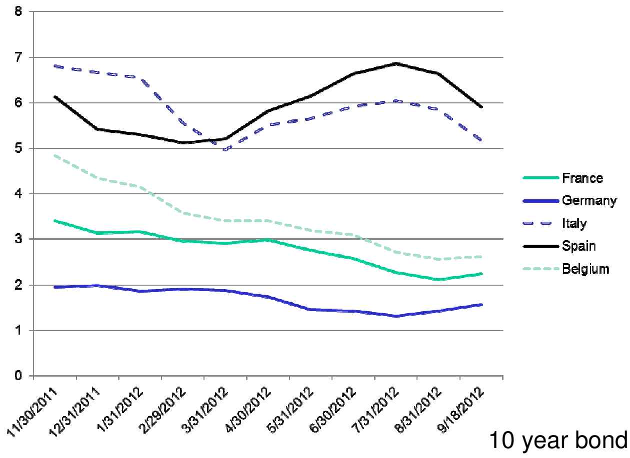


The A's
(sub 100 bps)

The B's *et al*
(500 - ? bps)

Source: IMF

Sovereign Bond Yields – Euro Area



10 year bond yields
Source: IMF.

Investment Risks

- If its too good to be true then…..
  – 78 Australian Councils, Charities, Churches found out the hard way via investments in SCDOs (with names like *Federation*) from Lehmans (Grange Securities)
    - CDO's offered a higher promised return but risk of loss of principal if certain "credit events" occurred.
    - But high ratings from ratings agencies
      – Met the "prudent investor" test?
- Why do it: 1% extra on $5 mill is $50K

Investment Risks

- Federal Court (Justice Rares) Sept 2012 decision that councils etc were owed $242 million from Lehman's corpse
  - Calculated on losses on "dead" and "live" SCDOs and on *Dante* notes which are tied up in US/UK legislation
- Rationale: breach of fiduciary duty and misleading and deceptive conduct
  - Will this change the behaviour of sellers of investment products?

Investment Risks

- November 2012 Federal Court (Justice Jagot) $30m ruling against S&P (and others) that rating of *Rembrandt Notes* was misleading and deceptive (under appeal)
- Next instalment – class action against S&P
- And US Department of Justice civil action!

Government Guarantees

- GFC - guarantees of new issues of debt by Australian banks: Fees charged
  - 70bp for AA, 100bp for A, 150bp for others
  - Generally less than by overseas govts.
  - Well below differential cost of borrowing independently
- Different perspectives:
  - Treasurer - source of budget revenue
  - Banks – additional cost of fund raising
  - Taxpayer – possibly inadequate compensation for risk taken on (certainly less than was possible)

Government Guarantees

- Guarantees of Borrowings by Government Trading Enterprises
  - Fees required for competitive neutrality
  - And to induce good financial management
    - Choice between equity and debt
  - And to ensure prices charged compensate taxpayers for risks of business
- Appropriate fees can be derived by reference to borrowing costs of similar private sector entities
- Generally State Government guarantee fee information not publicly available!

Assessing and Managing Credit Risk

- Credit risk from providing services, rates etc is largely unavoidable
  - Manage by pricing (to reflect default risk), payment terms, recovery arrangements etc.
- Assessing credit risk is hard – it's about the future!
  - Accounting/Financial indicators can help
    - As can financial market information (and credit bureaus)
  - Sophisticated financial models can also help
- But don't downplay judgement based on the 3+ C's
  - Collateral, character, capacity (cashflow)
- Ensure possible credit risk losses are priced in!

Thank You

Questions?