

Government Support during Financial Crisis: Impacts on Public Debt and Potential Roles for SAIs

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A. Context

The financial and economic crisis is affecting the fiscal accounts of virtually every country. Many countries have supported the financial sector directly, primarily through “below-the-line” operations affecting governments’ assets and liabilities, as well as operations giving rise to contingent liabilities. Second, the growth deceleration, coupled with asset and commodity price declines, is affecting revenues (and, in some cases, spending). Third, discretionary stimulus has been used to support aggregate demand. Moreover, the losses suffered by funded pension schemes may involve contingent liabilities for the state. All these issues represent important challenges for SAIs. They all impact on the level and management of public debt.

B Proposed outline

Introduction

The fiscal deterioration is particularly strong for developed countries, where the increase in both government debt and contingent liabilities is unprecedented in scale and pervasiveness since the end of the Second World War.

Around the world, public debt has increased significantly following the government actions that followed the financial crisis that started in 2007. The fiscal position in OECD countries worsened over the last two years. Average actual balance as a percentage of GDP of OECD countries are expected to increase from -1.4 % (2007) to -4.1% in 2010. For example, the US deficit is expected to reach \$US 1.7T in 2009 according to the Congressional Budget Office. The deficit of the government of Canada is expected to reach almost \$CAN60B in 2009-10 – this after 12 years of consecutive annual surpluses.

The proposed theme to be lead by SAI-Canada will first explore the impact on public debt of the governments’ interventions to stabilize financial market and failing institutions and of economic stimulus packages. Both type of interventions have significant budgetary consequences on governments, their fiscal exposure/vulnerability and on the management of public debt. The second part of the paper will provide some guidance on the possible roles of SAIs in auditing issues to these two areas.

Note that in order to encompass the issue of government bailout and stimulus package the working title will be reviewed to *Government Support during Financial Crisis: Impact on Public Debt and possible Roles for SAIs* (the paper was originally entitled: Adequacy of regulatory framework in the financial services sector: impact on contingent liabilities and public debt).

1.0 Government Support to Stabilize the Financial Sector

Public bailouts of individual institutions are often inevitable – especially if failure of institutions lead to increased systemic risks (e.g. collapse of AIG). This is why many governments announced measures to support the financial sector, the extent and nature of the interventions varying across countries.

Hana Polackova-Brixi (1999, World Bank) published a tool that provides a snapshot of a country's fiscal exposures. Bank failure is considered an implicit contingency (ie. that there is a moral obligation to intervene in the case of a bank failure or default of a private entity on nonguaranteed debt)

Categorisation of fiscal risk

	Direct An obligation in any event	Contingent An obligation if a particular event occurs
Explicit Government liability as recognised by a law or contract	Sovereign debt Budgetary expenditures (including legally binding long-term expenditures such as public/civil servant salaries and pensions)	State guarantees State insurance schemes Guarantees agreed in public-private partnerships Financial system failure
Implicit An obligation of government that reflects public expectations	Future public pensions, if not required by law Social security schemes, if not required by law	Financial system failure Default of non-guaranteed state-owned enterprise or sub-national level of government Disaster relief

Collapses in the financial services sector can seriously damage the fiscal position of governments and can be a major source of fiscal vulnerability – see Polackova matrix above. Failures in the financial system of a country can lead to both explicit and implicit contingent liabilities. The same is true for collapses of major non-bank corporations (e.g. automobile manufacturing sector in the United States and Canada).

1.1 List forms of government interventions:

Direct fiscal support is being provided to the financial sector.

- Guarantees
- Acquisition of equities, bonds and loans
- Unrequited payments from the government
- Debt assumption and debt cancellation
- Liquidity injection

1.1.1 Examples of interventions in selected governments

US, UK, Euro zone, Iceland, others

Example of the US purchasing toxic assets.

The Troubled Asset Relief Program (TARP) is a program of the United States government to purchase assets and equity from financial institutions in order to strengthen its financial sector. It is the largest component of the government's measures in 2008 to address the subprime mortgage crisis. TARP allows the Department of Treasury to purchase or insure up to \$700 billion of "troubled" assets. "Troubled assets" are defined as "(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress."

In short, this allows the Treasury to purchase illiquid, difficult-to-value assets from banks and other financial institutions. The targeted assets can be collateralized debt obligations, which were sold in a booming market until 2007 when they were hit by widespread foreclosures on the underlying loans. TARP is intended to improve the liquidity of these assets by purchasing them using secondary market mechanisms, thus allowing participating institutions to stabilize their balance sheets and avoid further losses.

Example of GSE

The Federal Reserve Board announced an increase in purchases of Government Sponsored Enterprises (GSE) debt and mortgage-backed securities by US\$100 billion and US\$750 billion, respectively. These operations will increase the Fed's liquidity support by 6 percent of GDP but would not entail any upfront government financing.

1.2 Impact of financial rescue plans on fiscal position/public debt of governments

One important effect of banking crises is on governments' fiscal positions. Past episodes indicate that direct fiscal cost can be substantial. Paper will provide some estimates to illustrate the fiscal impact of financial stress. For example, according to the OECD, the direct fiscal cost of the Japanese banking crisis (1992-) is estimated at more than 9% of GDP. The banking crisis in Finland (1991-1994 ; following a collapse of exports to Russia) was priced at 11 percent of GDP.

2.0 Economic Stimulus Plans

In order to stimulate aggregate demand, government around the world has introduced a number of discretionary fiscal stimulus measures. The stimulus plans exceeds 4% of GDP in some countries. These measures needs to be financed through increased borrowing impacting directly on the public debt level..

2.1 Description of government stimulus packages

2.1.1 Stimulus Plans in Selected Countries

2.2 impacts of Plans on Fiscal position and on public debt level

3.0 Potential Roles of SAIs

The impact of government intervention on the fiscal position of government and on the public debt is significant. SAI might have some key roles to play in auditing government support. This could also include audit the adequacy of the regulatory/supervisory regime of the banking sector

3.1 Auditing Government intervention to support to financial system/institutions

Fiscal Accounting Treatment of Support to the Financial Sector

(source: Government Finance Statistics Manual (GFSM 2001))

The following is the recommended treatment of the impact on the government balance of the main financial support operations:

- *Capital grants*: Increase the deficit by the amount of the grant.
- *Equity purchases*: Have no impact on the fiscal balance, if purchase is at market value, but increase government gross debt. Raise the deficit by any marked/undisputable excess of what the government pays over the value of the equity.
- *Asset purchases/swaps*: Same as equity purchases.
- *Loans*: Have no immediate impact on the fiscal balance if there is no inherent subsidy, but increase government debt. Reduce the balance by any amount that the government cannot expect to be repaid.
- *Guarantees*: Have no immediate impact on the fiscal balance or debt unless there is a significant probability the guarantee will be called (in practice when a reserve has been created). In other cases, the fiscal balance would weaken and debt increase if and when the guarantee is called.
- *Associated fees, interest, and dividends*: Affect the deficit in the same way as other government income or expense.
- *Central bank operations*: Are reflected in its own balance sheet and income statement, rather than those of the government. However, losses on these operations will affect the budget over time, as they affect profit transfers or necessitate recapitalization. For transparency and to facilitate policy decision making, these operations should be disclosed, possibly as complementary information in the budget

See also section 3.3 below

3.2 Auditing the adequacy of the regulatory regime (section is optional – could be dropped)

It can be argued that there is a reversed correlation between the level of stress faced by the banking sector and the adequacy of the regulatory/supervisory regime. An effective regulatory regime would likely protect better the fiscal position of the government in time of financial stress.

Hence SAIs might want to examine the robustness/completeness of the regulatory/supervisory framework in place, if regulators obey international standards and guidelines and if the regulators/supervisors share information. A number of principles/standards (e.g Core principles for effective banking supervision, Basel II Capital Accord, Financial Stability Board...) could be used to guide SAIs.

Other questions that SAI community might want to take action on:

- What should the role of SAIs be? How can SAI improve banking supervision and regulation?
- What role performance audits could play in encouraging governments to strengthen as much as possible the regulatory and supervisory regime for the financial services sector?
- How can SAIs help regulators and supervisors adhere to “best practices” and guidelines issued by Bank of International Settlements (e.g Basel II Capital Accord), the G-20, the IMF...?
- How can SAIs ensure economic stability in financial markets?

3.3 Auditing Economic Stimulus Plans

The government must ensure that effective management and controls over the spending of public money be in place. SAIs could look at the program design and accountability regime (e.g. definition of success, tracking of cost, reporting on results...), processes to ensure compliance with legislation/rules (e.g. authority to spend), management frameworks (decision-making process, eligibility criteria, timely delivery...), and finally outcome/results of spending plans (including exit strategy).

3.4 Impact on Debt management

Debt strategies of governments might need to be adjusted to take into account the new financial requirements under fiscal stress. SAIs might want to audit the adequacy of risk management policies and debt strategies when facing extraordinary fiscal pressure. What were the lessons learned by debt managers?

C Timeframe

The paper should be completed in 2011. Note that after SAI-Canada proposed to take the lead on this project at the last meeting in Fiji, an INTOSAI Global Financial Task Force was established. There might be some overlap between the proposed work and the GFTF projects that are underway. We might need to reassess the need and our contribution once the GFTF has determined its work plan. Also there might be some overlap between the paper prepared by the US entitled “Impact of financial crises on public debt” for the Public Debt Working Group. Scoping decisions will be required.

SAI Canada would appreciate support from another SAI, particularly on section 3.