

SECTION 5:

FISCAL RISK AND LIABILITY

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SECTION 5: FISCAL RISK AND LIABILITY

Overview

Fiscal policy instruments encompass more than just revenue and expenditure management. Most developed economies have utilised other fiscal tools such as in the form of public private partnership (PPP) arrangement and government guarantees (GGs) to invest in public infrastructure projects. The public investment undertaken via off-budget initiatives have been implemented to accelerate economic development and achieve desired socioeconomic outcome. Given

the rise in off-budget initiatives, there is a need to assess fiscal risks, particularly arising from contingent liabilities. In the context of Malaysia, among the sources of fiscal risk for the Government are GGs, PPP and other contingent liabilities. These sources of fiscal risk need to be identified, assessed and reported in order to provide a comprehensive picture of the Government's financial position. Comprehensive assessment and reporting of fiscal risks and liabilities are essential for economic and fiscal sustainability.

Feature Article

Fiscal Risk Management

Introduction

Since independence, the Government has embarked on 12 five-year development plans with the aim of achieving economic development and improving the wellbeing of the rakyat. Malaysia has gradually developed from an agriculture-based economy to an industrialised nation, with a well-diversified economic structure and per capita income of USD9,828 as at end-2017. One core element of the nation's economic transition is the Government development initiative through fiscal policy instruments. However, excessive use of fiscal tools will increase fiscal risk exposures, particularly debt and liabilities.

The fiscal risk is generally defined as the possibility of deviations of fiscal outcomes from what was expected at the time of the budget or another forecast. With the global economy and trade becoming more interconnected among countries, the economy is more exposed to external and domestic risks which in turn influence the targeted fiscal outturn and debt position. The growing need for comprehensive identification and management of fiscal risk is imperative, particularly for Malaysia to ensure the nation's fiscal balance and indebtedness is contained at a sustainable level. With effective fiscal and monetary policy, the nation will be able to maintain its macro-stability and remain competitive in the global economy.

As the nation remains bold to achieve its development goals, the Government has to ensure sufficient fiscal policy space and investors' confidence. Despite strong economic fundamentals, as an open economy, our currency and financial markets are vulnerable to investors' perception, particularly with regard to governance and conduct of the Government. Volatility in capital flows will lead to increased risk premium and impact the cost of doing business, which will cause economic and financial vulnerabilities. This will, in turn, affect the nation's fiscal balance and debt position, subsequently distorting the national development agenda and reduce the wellbeing of the rakyat.

Sources of Fiscal Risk

The fundamental aspect of effectively managing the fiscal risk exposure is to identify the sources of fiscal risk. According to the International Monetary Fund's (IMF) conceptual framework, there are three main categories of fiscal risks, namely general economic risk, specific risk and structural or institutional risk. Each of these components will then have to be assessed, particularly on its exposure to the fiscal and debt position.

a. General economic risk

This category refers to the impact of deviation of economic and fiscal outturns from what was estimated during the budget forecast, which in turn affects the fiscal and debt targets for the year. For example, in the event of economic crisis or commodity price volatility, oil-related revenue collection and fuel subsidy will vary according to changes in global oil prices. In addition, the fiscal risk may arise from other macroeconomic components such as inflation, foreign exchange and interest rates, which will affect countries with high level of external debt.

b. Specific risk

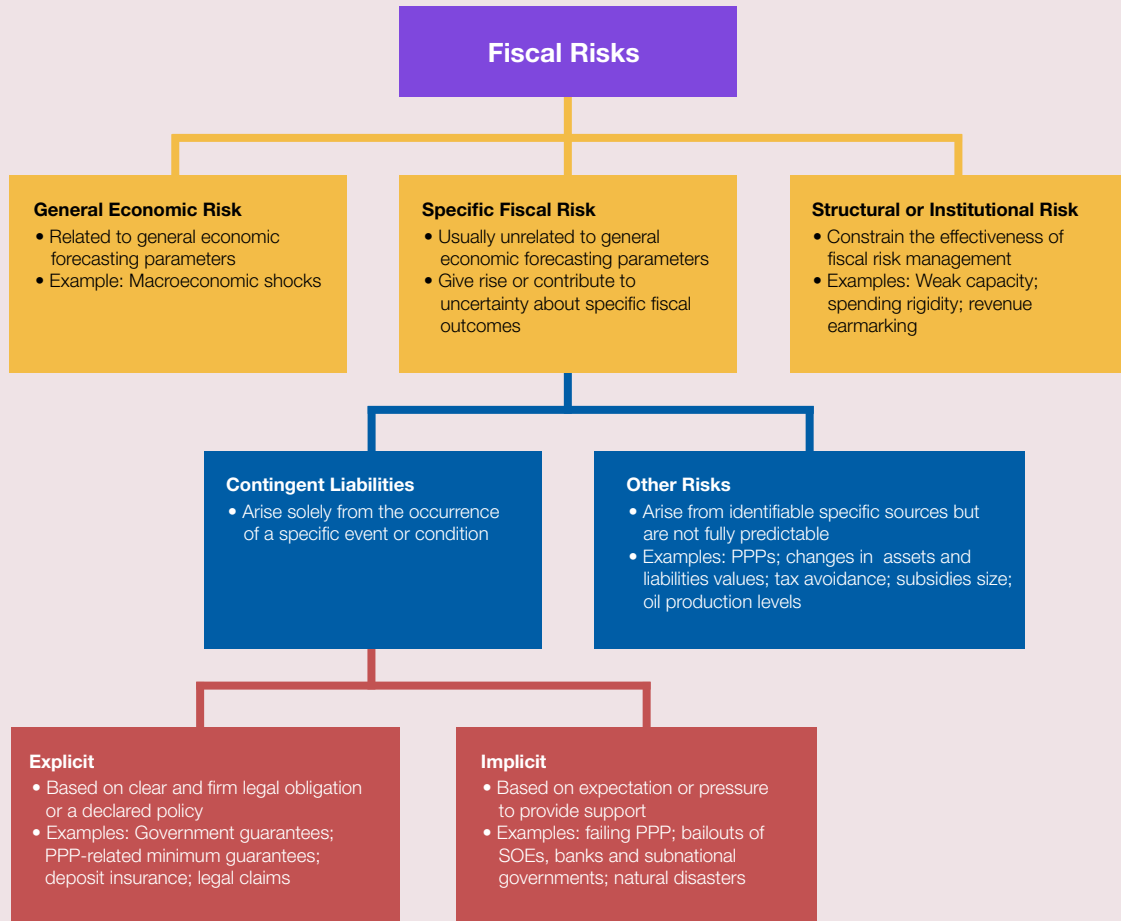
The fiscal risk arising from this category is not directly related to economic forecasting, but distinctive across countries. However, it does contribute to uncertainty in fiscal outcomes. The most common component of this category is contingent liability, which refers to obligations to make a payment due to the occurrence of a specific event or condition. These events may be explicitly stated via government policies or legal obligations, or committed implicitly, due to expectations or pressure to provide support.

In Malaysia, explicit contingent liabilities arise from government guarantees (GG), public private partnership (PPP) commitments and also legal claims to Federal Government via its government-linked companies (GLCs) or special purpose vehicles (SPVs). GGs are published annually in the Federal Government Financial Statements. As for implicit contingent liabilities, this type of risk is often less visible as well as complex to measure and identify. This refers to fiscal commitment which may arise due to public expectation, national interest or to address market failures. For example, supports or assistance need to be provided to the financial institutions in the event of a financial crisis or extended to the affected victims of natural disasters, such as flood and landslide.

c. Structural or institutional risk

This category refers to the structural aspect in the public financial management, which may constrain the effectiveness of the country's fiscal risk management. The source of risk from this category may be in the form of revenue or expenditure structure, budgeting systems and information asymmetry. For example, revenue risk may arise from overdependence on commodity-related revenue or lack of revenue diversification. Another example is a budgetary process which is either too flexible or too rigid, which in turn amplifies fiscal risk in the event of external shocks or uncertainty. In addition, fiscal risk managers are unable to recommend effective risk mitigation measures due to inadequate tools, and lack of timely and quality information.

Types of Fiscal Risks



Source: International Monetary Fund.

Current Framework

The Government has instituted control mechanisms in the form of fiscal and debt rules, with the objective of safeguarding the fiscal position and limit debt exposure. Regulations under various Acts impose limits on borrowings by Federal Government, through Loan (Local) Act 1959 and Government Funding Act 1983, where the combined outstanding borrowing for development expenditure is capped at 55% of GDP. Additionally, the External Loans Act 1963 caps the foreign-denominated debt at RM35 billion, while the maximum amount of conventional Treasury bills outstanding is limited to RM10 billion.

The Government is also guided by several administrative guidelines to strengthen fiscal discipline further. There must be an operating surplus, where operating expenditure must be well within revenue. The operating surplus is utilised to fund the development expenditure partially. This guideline ensures that the operating is financed through revenue while borrowings are only for development expenditure. In terms of debt servicing, to ensure debt affordability and productive spending, debt service charges (DSC) should not exceed 15% of revenue or operating expenditure. Furthermore, DSC is treated as charged expenditure which takes priority over other expenditures.

More importantly, the Ministry of Finance has recently established two main committees, namely the Public Finance Committee and Tax Reform Committee. The Public Finance Committee is chaired by the Finance Minister, with members comprising Minister of Economic Affairs, Governor of Bank Negara and senior Government officials. The main aim of the Committee is to strengthen the institutional structure of the country's fiscal management. The high-level committee will deliberate on important fiscal issues, including mitigation plan in fiscal risk management. As for the Tax Reform Committee, the objective is to enhance the tax structure and revenue base.

Best Practices and the Way Forward

In an increasingly interconnected and complex global economic and trade relations, countries have to be equipped with ample tools and resources in managing their fiscal risk. While the features of fiscal risk may vary and unique across countries, the fiscal components and factors are identical, particularly in the form of resources such as revenue and expenditure, the role of fiscal rules, information availability and analysis as well as the capability of human capital. In addition, the key processes in comprehensive risk management practices are uniform, which involves risk identification, evaluation, mitigation, implementation and policy review.

International institutions, such as the IMF, World Bank and Organisation for Economic Co-operation and Development (OECD) have studied and published several recommendations that can be applied, which are based on various countries' best practices and evidenced via past events. Recognising that fiscal shocks are more correlated among countries, the IMF, for example, is actively supporting and encouraging its member countries in enhancing fiscal risk analysis and management. The technical assistance includes areas in constructing public sector balance sheets, developing institutions and capacity to identify specific fiscal risks and to quantify their potential impact, undertaking fiscal stress tests and integrating risks into the design of medium-term fiscal targets.

The formulation of a robust and comprehensive fiscal framework is a fundamental element in ensuring effective fiscal policy. While existing fiscal rules have facilitated the economic advancement of the nation, there is an urgent need to improve further and enhance fiscal framework, particularly in the era of digitalisation and volatile global economic environment. Among the best practice recommendations that can be adopted in the fiscal framework are as follows:

a. IMF Fiscal Transparency Code

The code establishes transparency principles based on four main pillars, namely fiscal reporting; forecasting and budgeting; risk analysis and management; and revenue resource management. In relation to fiscal risk management, a government is recommended to disclose, analyse and manage risk to ensure effective coordination of fiscal decision making and execution throughout the public sector.

b. Clear legal and administrative framework

The regulatory framework is important in ensuring effective risk management, particularly with regard to clear allocation of roles and responsibilities. A clear fiscal framework and parameters will govern and guide the level of collections, investments, commitments and the use of public funds. Several countries have established fiscal responsibility legislation to govern the conduct of fiscal policy as well as defining numerical fiscal rules in relation to deficit, debt, guarantees and other contingent liability commitment. In addition, there

is a need to integrate and consolidate budgetary practices, specifically the exposure of contingent liability and state-owned enterprises in the government budget, resulting in a more comprehensive budgetary framework.

c. Institutional arrangements

The key components of this category are risk management policies, the establishment of a central oversight body and accountability structure which identify the responsible entity in monitoring fiscal risk. In this regard, the Government has established the Fiscal Risks and Contingent Liabilities Technical Committee to better monitor and coordinate fiscal risk management.

d. Information availability and analysis

Comprehensive lists of material fiscal risk components should be compiled and analysed in terms of its exposure to fiscal position. The IMF has also recommended for countries to conduct a fiscal stress test which will illustrate the robustness of the fiscal framework. In addition, more vigorous monitoring and evaluation tools should be adopted in analysing each fiscal investments and programmes to mitigate and ring-fence the fiscal risk. Thus, the Government has committed to accrual accounting practice, which will reflect a consolidated view of both Government assets and liabilities. Additionally, publication of Fiscal Risk Statement will also be explored to enhance fiscal risk analysis further.

Conclusion

The Government recognises the need to enhance fiscal risk management and establish a more robust fiscal framework. Moreover, with a commitment to further reduce the Government debt and liability exposure, it is important to remain prudent and fiscally responsible. The existing tools to enhance revenue and expenditure efficiency are fragmented and need to be complemented with a fiscal risk management framework, which is more strategic and forward-looking. Guided under the competency, accountability and transparency principles, the Government will further embark on fiscal governance enhancement initiatives to ensure fiscal discipline and generate sustainable economic growth.

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Government Guarantee

Government guarantees are governed under the Loans Guarantee (Bodies Corporate) Act 1965 [Act 96]. The Act authorises the Government to issue guarantees for loans or financing raised by certain bodies corporate or entities, namely statutory bodies, government-linked companies, and state government companies or its subsidiaries. Under the GGs arrangement, the entity is liable for its financing obligation, while the Government acts as the secondary obligor or guarantor. In addition, under Section 8 of the Act, the entity is obliged to repay to the Government the sum paid (including interests or profits) in respect of any liability incurred by the Government under the GGs. GG facilities enable entities to secure favourable financing conditions such as lower coupon rate and provide comfort for the entity to manage its risk exposure.

As at end-June 2018, outstanding GG debt registered RM258.4 billion or 18.1% of GDP (end-2017: RM238.2 billion; 17.6%). Loan guarantees granted during the period include to finance infrastructure projects such as the mass rapid transit (MRT), light rail transit (LRT), Pan Borneo Highway, East Coast Rail Link (ECRL) as well as to National Higher Education Fund Corporation (PTPTN) which manages tertiary education loans and Public Sector Home Financing Board (LPPSA) for civil servant housing loans. About 90% of the outstanding loan guarantees are

ringgit-denominated while the balance is in renminbi, yen and US dollar, thereby minimising the foreign exchange risk exposure.

As at end-June 2018, almost half of the outstanding loan guarantees were extended to infrastructure (47.8%) followed by services (22.7%), investment holding (13%), utilities (11.1%), financial (3.8%) and plantation (1.6%). The average-to-maturity of the guarantees stood at 8 years with 58% of the guarantees expected to mature within 10 years while the balance above 10 years.

GG facilities are provided for socio economic programme such as education and housing. For example, PTPTN is also a beneficiary of GG for social-oriented programme. GG was given to PTPTN to enable the entity raise sufficient fund for the tertiary education financing scheme. The GG granted which reduces the funding cost for PTPTN has enabled the entity to charge only a minimum *ujrah* rate of 1% to the borrower, which helps to lower the repayment burden. In the case of LPPSA, the GG facility is granted to ensure low cost of funding for their financing requirements which will be used to finance the civil servants' housing loans. The civil servants' loan installment is deducted from salary while the property is charged to LPPSA, which provide secured cash flows and reduce the credit risks, thus minimising the likelihood of these guaranteed facilities to be called upon.

Table 5.1. Top 10 Loan Guarantees as at end-June 2018

	RM million	Share (%)	Share of GDP (%)
Total loan guarantees	258,392	100.0	18.1
<i>of which:</i>			
DanaInfra Nasional Bhd	48,380	18.7	3.4
National Higher Education Fund Corporation	38,450	14.9	2.7
Prasarana Malaysia Bhd	28,414	11.0	2.0
Malaysia Rail-Link Sdn Bhd	19,020	7.4	1.3
Khazanah Nasional Bhd	17,000	6.6	1.2
Public Sector Home Financing Board	13,750	5.3	1.0
Pengurusan Air SPV Bhd	13,310	5.1	0.9
Projek Lebuhraya Usahasama Bhd	11,000	4.3	0.8
Suria Strategic Energy Resources Sdn Bhd	8,049	3.1	0.5
GovCo Holdings Bhd	7,300	2.8	0.5
Total	204,673	79.2	14.3

Source: Ministry of Finance, Malaysia.

In addition, several GG facilities are also provided for public infrastructure projects such as rail, tolled bridge and airports. However, the Government needs to provide financial support in the form of coupon or profit payment during the construction period and at the early stage of operation due to insufficient income stream particularly for rail operations. These are recognised as committed GGs. For example, DanaInfra Nasional Bhd (DanaInfra) provided funds for the development of MRT infrastructure. As the MRT service only commenced operations recently, the fare collected is insufficient to service the debt of DanaInfra, thus requiring annual allocation from the Government. The funding arrangement is to ensure smooth implementation and operation with assurance and support from the Government. The Government support is not only to secure low cost of funding but also to ensure the rakyat will enjoy reasonable fare rate to lower transportation cost, promote better usage of public transportation as well as reduce carbon emission.

The same applies for other public transportation infrastructure projects namely Prasarana Malaysia Bhd and Jambatan Kedua Sdn Bhd. These entities receive assistance or grants from the Government via operating expenditure (transfer items), and included in the budget. The amount will depend on their cash flow requirement and not necessarily on a regular or annual basis. For prudent debt management, while the debt has not defaulted, the committed GGs are treated as an obligation of the Government whereby the Government partly subsidises the cash flow of the entities. Similarly in the case of ECRL as well as Trans-Sabah Gas Pipeline and Multi-Product Pipeline, both projects are under review and as such are also treated as direct obligation of the Government. As at end-June 2018, the committed GGs are estimated at RM117.5 billion or 8.2% of GDP.

Public Private Partnership

The history of PPP in Malaysia can be traced back to the 1980s when the Malaysia Incorporated and Privatisation policies were formally promulgated respectively in 1981 and 1983. These two

policies were introduced in an effort to reduce the financial and administrative burden of the Government while working in close cooperation and encouraging the involvement of the private sector in the development of the country with the strategic intention to improve Malaysia's competitive advantage.

PPP is a smart partnership between the Government and the private sector for the purpose of providing public infrastructure, community facilities and related services. Generally, PPP is characterised by the sharing of investment, risks, responsibilities and rewards between partners. The main reasons for establishing such partnerships are to ensure efficient design, construction, operation and maintenance of infrastructure to enhance services to the public. Since its introduction, PPP has played an important role as part of the Government's overall economic planning to invest in infrastructure and services. The efficiency of PPP projects provides better value for money for the rakyat.

In the context of Malaysia, PPP generally comprises privatisation and private finance initiatives (PFI). Privatisation methods include sales of assets or equity, corporatisation, land swap, Build-Operate-Transfer (BOT), Build-Operate-Own (BOO), outsourcing/management contract and leasing. As for PFI, its methods include Build-Lease-Transfer (BLT), Build-Lease-Maintain-Transfer (BLMT) and Build-Lease-Maintain-Operate-Transfer (BLMOT). Malaysia has successfully implemented more than 400 PPP projects in various sectors.

As at end-June 2018, there are 100 PPP projects which involves outstanding Government commitment amounting to RM135.1 billion, with the concession tenure ranging from 10 to 30 years and the final payment commitment ending in 2047. Most of the Government commitment for PPP arises from BLMT contracts, involving 48 projects. The obligations include availability charges, maintenance charges, asset replacement charges and other related charges.

PPP has been used widely across a broad range of sectors, namely social, general administration, economic and security. The

social sector with a total of 49 projects involves a commitment of RM55 billion or a share of 40.7%. Among the projects in this sector include UiTM and polytechnic campuses, Pagoh Higher Education Hub and hospital support services. The **general administration sector** which is the second largest sector, recorded a commitment of RM38.6 billion or 28.6% with 29 projects. These projects include construction of government buildings, Government Integrated Telecommunication Network (MyGov*Net) and Vehicle Fleet Management System. This is followed by the **economic sector** with an amount of RM37.9 billion or 28% involving 15 projects such as the Gombak Integrated Transport Terminal; fisheries complex in Kuching, Sarawak; and the maintenance of federal roads. Meanwhile, the **security sector** constituted 2.7% or RM3.6 billion comprising seven projects, which include the development of the Immigration, Customs and Quarantine complex in Bukit Kayu Hitam, Kedah; the National Enforcement and Registration (Biometric) System; and the development of naval base.

In 2005, the Government has also established Pembinaan BLT Sdn Bhd (PBLT) which is responsible for developing quarters and facilities for the Royal Malaysian Police. The hybrid PPP concept is applied where housing allowance was deducted for the usage of the quarters. PBLT has successfully developed 74 projects with an outstanding obligation of RM6.3 billion as at end-June 2018. In addition, the PFI Trust Account was established in the Ninth Malaysian Plan to finance several public infrastructure projects which include schools,

hospitals, water reservoir, as well as renovations and refurbishment works. As at end-June 2018, the outstanding obligation stood at RM43.5 billion.

Debt and Liabilities Exposure

In consonance with a more comprehensive monitoring of Government debt and liabilities exposure, the debt reporting has taken into account the direct debt of Federal Government, committed contingent liability and other obligations. This enables effective evaluation of the level of indebtedness of the Government and its risk exposure, which in turn provides a more prudent debt and liability management. The reporting is also in line with the International Public Sector Accounting Standards (IPSAS) and IMF's Public Sector Debt Statistics. These reporting standards will be applied once the Government adopts accrual accounting practices by 2021.

The Government takes a more prudent and realistic approach especially in the aspect of fiscal management with more comprehensive reporting that reflects the overall obligation of the Government. The addition of committed contingent liabilities will provide a full picture of the longer-term implications of the Government's debt obligations as close scrutiny of both direct and indirect liabilities provides more transparency, accountability and sound financial management. Due to these principles, the Government believes investors' confidence towards Malaysia is strengthened.

Table 5.2. Federal Government Debt and Liabilities

	RM billion		Share of GDP (%)	
	end-2017	end-June 2018	end-2017	end-June 2018
Federal Government debt	686.8	725.2	50.7	50.7
Committed Government Guarantees	102.1	117.5	7.5	8.2
1Malaysia Development Berhad (Net debt)	38.3	38.3	2.8	2.7
Other liabilities (PPP, PFI and PBLT)	260.1	184.9	19.2	12.9
Total	1,087.3	1,065.9	80.3	74.5

Source: Ministry of Finance, Malaysia.

As at end-June 2018, the Federal Government debt and liabilities stood at RM1,065.9 billion or 74.5% of GDP compared to 80.3% as at end-2017. This is after taking into account Federal Government debt of RM725.2 billion (50.7% of GDP), committed GGs of RM117.5 billion (8.2%), net debt of 1MDB of RM38.3 billion (2.7%) and other liabilities of RM184.9 billion (12.9%). The slight reduction was due to measures undertaken which include reviewing all large infrastructure projects and its cost structure based on their needs, scope and priorities; raising funds mainly through domestic market to minimise foreign exchange risk exposure; borrowing only to finance development projects; as well as restructuring debts with high financing cost.

Under the current economic backdrop, new PPP projects that require annual commitments from the Government would not be carried out. In addition, new proposals would be undertaken via a new PPP model through open tender. Measures to enhance fiscal governance, particularly establishment of fiscal risk management framework will be considered in the medium-term to ensure fiscal discipline adherence. Moving forward, the Federal Government debt and liabilities are expected to lessen as the Government will consider and take appropriate measures to reduce debt and liabilities exposure, thus reducing the financial burden of the Government.

Figure 5.1. Outstanding Loan Guarantees

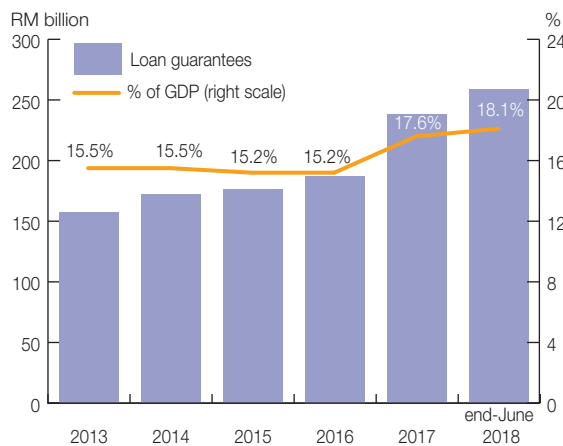


Figure 5.2. Loan Guarantees by Sector (End-June 2018)

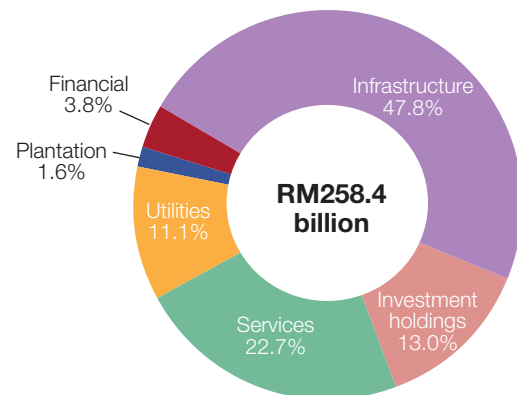


Figure 5.3. Maturity Profile of Loan Guarantees (End-June 2018)

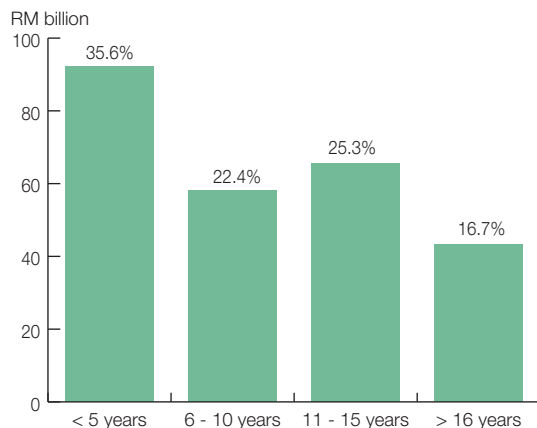
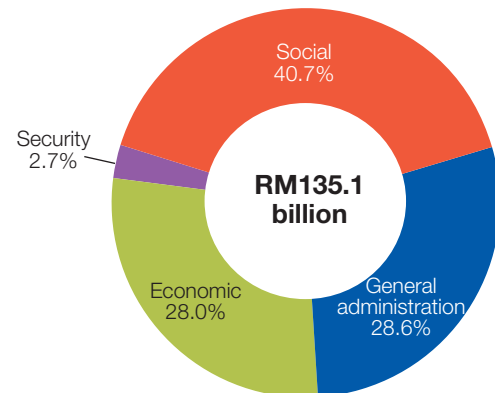


Figure 5.4. Outstanding PPP Obligations by Sector (End-June 2018)



Source: Public Private Partnership Unit (UKAS) and Ministry of Finance, Malaysia.

