Central government guarantees and lending in Sweden – an introduction

The Swedish framework for managing central government guarantees and lending

Laws and policies around management of central government guarantees were revised in Sweden after the fiscal crisis in the 1990s. Accordingly, principles and practices were established concerning transparency, covering of costs and risk management to avoid excessive and unmanageable risks.

In 2011 the framework for central government guarantees was supplemented with corresponding rules regarding lending in cases where the expected loss is not too high (in other cases the lending is funded with means allocated from the central government budget and managed outside of this framework).

In many respects, the robustness of the Swedish framework for managing guarantees and lending relies on well managed central government finances, on the basis of the Swedish budget policy framework, and an appropriate division of roles between politicians and civil servants. Regarding the latter, decisions about the purpose of central government guarantees and lending, amounts and general rules regarding risk management and reporting are made by the Riksdag (the Swedish Parliament) and the Government. Specific risk assessments, settlement of contractual terms, calculation of fees, recoveries of defaulted claims etc., on the other hand, are managed by specialized agencies.

The main building blocks of the Swedish framework are:

- The Budget Act
- The Lending and Guarantees Ordinance
- Specific schemes
- International agreements
- Accounting rules

The Budget Act

According to the Budget Act, the Riksdag must decide on the purpose and the amount of central government guarantees and lending. Additionally, the general rule is that a fee should be charged that corresponds to the expected cost of a guarantee or loan. This includes the expected loss and administrative costs (and the central government's funding cost regarding lending).

The Riksdag can make an exception from this rule, allowing the fee to be lower than the expected cost. This results in a fee that is partially or entirely subsidized by the central government. When such exceptions are granted, the Government must make a proposal to the Riksdag on how to fund such a subsidy. This is usually done by allocating funds from the central government budget.

The rules governing central government guarantees and loans build on the cost-recovery principle. This means that the central government’s guarantee and lending activities are expected to be self-financed in the long term.

Another feature of the Budget Act is the reporting of the central government’s aggregated guarantee and lending portfolio in the central government annual report to the Riksdag. This requirement covers both financial reporting and informing about essential risks in the portfolio.

There is no explicitly stated criterion regarding the choice between central government guarantees or lending. In this regard, it is important that the choice of instrument is guided primarily by what constitutes the best way of supporting a particular activity, not the way it is reported or paid for.

The Lending and Guarantees Ordinance

This ordinance contains more detailed rules regarding management of central government guarantees and lending. It covers principles around contractual terms, fees, monitoring, reporting etc.

One aspect of the Ordinance is the requirements on risk mitigation. One important condition is that any guarantee holder or borrower must be financially viable at the time of the issuance. Furthermore, any guarantee or loan must include contractual terms that limits the central government’s risk and ensures that the central government has appropriate rights to monitor and control the risk.

Monitoring of issued guarantees and loans is also stipulated. This includes monitoring of the central government’s interests and entitlements, and assessment of any changes to the guarantee holder’s or borrower’s ability to perform their financial obligations.

Another element of the Ordinance is the rules about the set up and management of the notional reserve accounts for the agencies that manages guarantees and lending.

Specific schemes

Some central government guarantees and lending are, partly or fully, exempted from the general framework. Examples are callable capital to multilateral development banks and lending funded with budgetary means.

Other guarantees and lending are treated differently because they are governed by specific laws. Examples are the deposit insurance scheme (the Deposit Insurance Act) and student loans (the Student Aid Act).

International agreements

Prominent international agreements regarding central government guarantees and lending are EU state aid rules and the OECD arrangement on Officially Supported Export Credits. Among other things, these agreements address pricing issues and risk sharing arrangements to mitigate distortion on competition.

Accounting rules

Both the Budget Act and the Lending and Guarantees Ordinance require that central government guarantees and loans are transparently reported. More detailed guidelines on how to perform the financial reporting of central government guarantees and lending are published by the Swedish National Financial Management Authority.

Management process of central government guarantees and lending

Approval by the Riksdag

The Riksdag decides on central government guarantees and lending with respect to the purpose, amount and type of the instrument.

Decisions on central government guarantees and lending do not compete with those on the expenditures in the budget process with respect to the Central Government Expenditure Ceiling. The exception is if the Riksdag decides that the fee for any central government guarantees or loans should be, partly or fully, subsidized. This results in expenditure with respect to the central government budget.

Approval by the Government

The Government usually delegates the Riksdag's approval to issue the central government guarantees or loans to the specialized agencies. In most cases, these approvals are made annually by granting a maximum amount in the government directives for the related agency. In other cases, the Governmental approval is granted in separate decisions regarding a specific guarantee or loan, or a program of guarantees or loans.

Management of central government guarantees and lending by specialized agencies

There are five major agencies that are responsible for issuing, monitoring, reporting and closing central government guarantees or loans:

- The Swedish Export Credits Guarantee Board
- The Swedish National Board of Housing, Building and Planning

- The Swedish International Development Cooperation Agency
- The Swedish Board for Study Support
- The Swedish National Debt Office (SNDO)

Issuance

In general, the issuance of central government guarantees or loans includes due diligence regarding the guarantee holder or borrower, assessment of creditworthiness, decisions on contractual terms and calculation of the fee.

Although there is no standardized method for the credit risk assessment, a commonly used analytical approach is credit rating methodology (or equivalent).

Depending on the type of counterparty, the contractual terms, availability of reliable data etc. there are different ways of estimating the expected loss for a guarantee or loan.

A common approach is to use the historical default rates (based on credit ratings) and the recovery rates published by the major credit rating agencies. Credit ratings, or equivalent, are also often the basis when a market based fee, for example due to state aid rules, is calculated. Such a fee can be estimated by studying market prices of fixed income securities (e.g. corporate bonds) or derivatives (e.g. credit default swaps) with the same credit risk, and other characteristics, as the guarantee or loan at hand.

Another possible approach is to estimate the market price for a guarantee or loan by using an option model, based on stock market data. But, due to the many shortcomings of this type of model, it is seldom used.

A common practice is to calculate the fee ex ante for the whole duration of the central government guarantee or loan. However, fees are often charged periodically.

There are exceptions to the general rule regarding the issuing process. For example, both student loans and the deposit insurance scheme are managed differently than other guarantees and lending.

Monitoring

Each agency monitors the outstanding guarantees and loans in its own sub-portfolio. Changes in the credit risk are monitored and analyzed. An important prerequisite for this risk monitoring is having access to adequate information. Covenant compliance, with respect to the guarantee or lending contract, is also monitored.

Similar monitoring also applies to claims on defaulted guarantees and loans with respect to the ongoing recovery processes.

Reporting

Each agency is responsible for the financial reporting of guarantees and lending in its annual and semi-annual reports to the Government.

Closing

The agencies are also responsible for closing the central government guarantees and loans as they mature or default. In case of default, the responsible agency will represent the central government in the legal process to pursue possible recoveries.

Central government debt management

Even though the management of central government guarantees and lending is the responsibility of the specialized agencies, a few specific tasks are performed by the SNDO as the central government debt manager.

Management of payments and notional reserve accounts

The SNDO manages the funding of lending and payments due to the calls on guarantees.

The SNDO also manages the notional reserve account that each agency that manages central government guarantees or loans holds. A call on a central government guarantee is booked against the applicable notional reserve account and the resulting payment is then charged against the Treasury Single Account. The same mechanism applies to collected fees and recoveries. All else being equal, calls on guarantees increase central government borrowing requirement while collected fees and recoveries decrease central government borrowing requirement.

Additionally, there is an unlimited credit linked to each notional reserve account. In this way the reserves can be allowed to be negative from time to time.

This set up ensures that the guarantees issued by the Kingdom of Sweden will be honored in a timely manner if called upon. This is true irrespective of the current balance on the responsible agency’s reserve account and without any need for the Riksdag’s approval of budgetary means. Another benefit of this centralized structure is that the payments are managed efficiently.

However, there are exceptions. One prominent example is the deposit insurance fund that, contrary to the notional reserve accounts, is an actual reserve. The fund can be invested in debt instruments issued by the Kingdom of Sweden or in an account held at the SNDO. But like the notional reserve accounts the SNDO has an unlimited mandate to raise new debt for the purpose of honoring calls on the guarantee, in case of deficit in the fund. Accordingly, there is no uncertainty about the reliability of the deposit insurance scheme.

Defaults on outstanding loans do not call for any payments. Recorded losses are booked accordingly against the applicable notional reserve account and central government debt will, all things being equal, be at a higher level compared to if full repayment of what was lent was made.

Consolidated reporting

The SNDO also coordinates the reporting on the aggregated portfolio of central government guarantees and lending in the central government's annual report to the Riksdag. This includes both financial reporting and a portfolio-based risk analysis. The former includes:

- Issued amounts
- Limits
- Expected losses on guarantees (that are not exempted from the general framework)
- Write-downs on loans
- Balance in reserves
- Cash flows (e.g. calls on guarantees, collected fees, and recoveries)

The latter includes:

- Identification and assessment of essential risk factors with respect to unexpected losses
- Assessment of liquidity risks with respect to central government guarantees (i.e. the risk of marginally higher borrowing costs if the payment of a guarantee is very large and/or needs to be executed in an extraordinary short period of time)
- In-depth information about the portfolio that goes beyond financial reporting

This high level of transparency promotes sound risk management. It also facilitates the communication within the central government and to external parties (e.g. central government bond investors) that the central government's guarantees and lending activities are under control.

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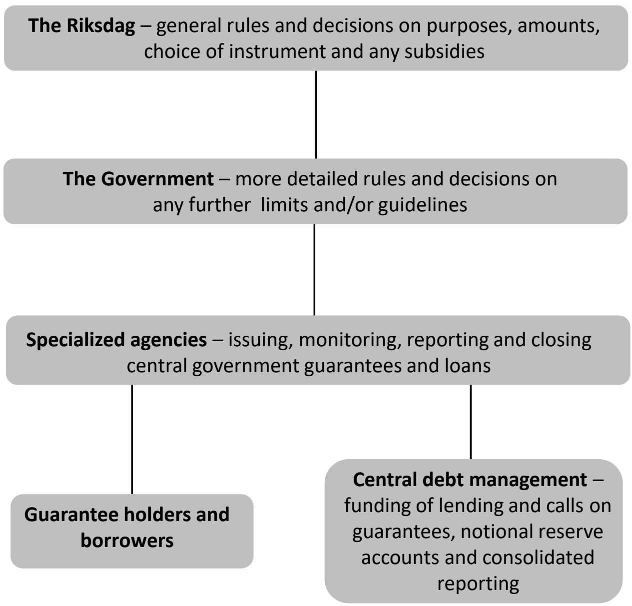
Figure: Summary of the management of central government guarantees and lending in Sweden



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