

CONTINGENT LIABILITIES

THE COLOMBIAN EXPERIENCE



Ministry of Finance and Public Credit
Republic of Colombia

Bogotá D.C., 2011

CONTINGENT LIABILITIES

THE COLOMBIAN EXPERIENCE



Ministry of Finance and Public Credit
Republic of Colombia

Bogotá D.C., 2011

Ministry of Finance and Public Credit
Republic of Colombia

Colombia. Ministry of Finance and Public Credit - General Directorate of Public Credit and National Treasury.

Contingent Liabilities: the Colombian Experience — Bogotá: Ministry, 2011
64 p. - ISBN:

1 Contingent liabilities	2 Valuation of contingent liabilities	3 Administrative contracts
4 Sentences and conciliations	5 Public Credit Operations	6 Natural disasters
I Arango Varón, Luis Eduardo, Cord	II Camacho Arenas, Maria Andrea	
III Manrique Diaz Luis Felipe	IV Rodriguez Samaca, Sandra Lucero	

CDD 20ed. 336.3046

CEP. Library: "José María Del Castillo y Rada"

Edition: August, 2011

Ministry of Finance and Public Credit

Exclusive publishing and distribution rights

Carrera 8ª No.6-64 Bogotá – Colombia, Fax. (57 - 1) 381 1700

atención_usuario@minhacienda.gov.co; www.minhacienda.gov.co

Legal deposit made according to Law 44 of 1993

Partial reproduction of the content of this work is allowed only
with the proper citation of the source.

For all purposes, the official language of this document is
Spanish. In case of differences between the original language
and the translation, the Spanish version will prevail.

Contingent Liabilities: the Colombian Experience

ISBN: 978-958-9266-73-1

Bogotá D.C., September 2011.

Design and Publishing:

Dígitos & Diseños Industria Gráfica Ltda.

www.digitosydisenos.com.co

Minister of Finance and Public Credit

Juan Carlos Echeverry Garzón

General Vice-minister

Bruce Mac Master Rojas

Technical Vice-minister

Rodrigo Suescún Melo

Secretary General

Diana Vivas Munar

Director General of Public Credit and National Treasury

Germán Arce Zapata

Deputy Director of Risk

Luis Eduardo Arango Varón

Technical Team

María Andrea Camacho Arenas - External Consultant

Luis Felipe Manrique Díaz - External Consultant

Sandra Lucero Rodriguez Samacá - Consultant

CONTENT

PRESENTATION	9
INTRODUCTION	10
CONCEPTUAL FRAMEWORK	11
CONTINGENT LIABILITIES IN COLOMBIA	16
CONTINGENT LIABILITIES OF INFRASTRUCTURE PROJECTS DEVELOPED UNDER PUBLIC-PRIVATE PARTNERSHIP SCHEMES	23
First Generation Grants	24
Second Generation Grants	24
Third Generation Grants	25
Methodology and assessment of contingent liabilities in infrastructure sharing schemes developed under Public- Private Partnerships	28
Challenges	32
CONTINGENT LIABILITIES DUE TO JUDICIAL PROCEDURES AGAINST THE NATION	34
History	34
Methodology and assessment of contingent liability for litigation activity	35
Significant Processes	40
Cases of Illegal Collection	41
Challenges	45
CONTINGENT LIABILITIES BY PUBLIC CREDIT OPERATIONS	46
Counter-guarantees	47
Payments to the Contingency Fund of State Agencies	48
Methodology and assessment of contingent liability for public credit operations	49
Challenges	51
CONTINGENT LIABILITIES ARISING FROM NATURAL DISASTERS	52
Challenges	59
CONTINGENCY FUND FOR STATE AGENCIES	61
BIBLIOGRAPHY	65

TABLE OF ILLUSTRATIONS

FIGURE 1	Annual contributions to the Contingency Fund.....	31
FIGURE 2	Annual Payment for Statements and Reconciliations	34
FIGURE 3	Participation of collectors within the claims of illegal money catchment	42
FIGURE 4	Concentration of payments effected due to court proceedings in 2010.....	43
FIGURE 5	Historical Participation by Sectors	44
FIGURE 6	Amount in exposure according to the credit rating	51

TABLE INDEX

TABLE 1	Regulations and publication in different countries.....	14
TABLE 2	Comparative of Contingent Liabilities.....	15
TABLE 3	Legal base for Contingent liabilities	22
TABLE 4	Evolution of the criteria for allocation of risks in highway concession contracts.	26
TABLE 5	Current Classification of road concessions.....	27
TABLE 6	Contingent Liabilities in Infrastructure Investment	29
TABLE 7	Road Concessions Contingent Liabilities Second and Third Generation.....	30
TABLE 8	Statistics from the Database.....	37
TABLE 9	Contingent Value per Sentences and Conciliations.....	37
TABLE 10	Entities with a greater concentration of contingencies.....	38
TABLE 11	Ten most significant processes.....	40
TABLE 12	Processes of Illegal Collection by Jurisdiction	42
TABLE 13	Judiciary processes in Latin American countries	44
TABLE 14	Contingent Liabilities by Public Credit Operations	50
TABLE 15	Amount in exposure due to Public Credit Operations	50
TABLE 16	Effects corresponding to low and medium intensity events.....	54
TABLE 17	Structuring of the Project for the Reduction of fiscal Vulnerability.....	55
TABLE 18	Exposure and Potential Loss for Colombia	56
TABLE 19	Indexes of deficit by disaster, Colombia 2003	57
TABLE 20	Recommendations by ERN Consulting	59
TABLE 21	Accumulated Balance for the Contingency Fund.....	62

PRESENTATION

In Colombia, the management process of contingent liabilities is a fundamental part of the principles of fiscal discipline, facing sustainability of the debt, reduction of fiscal risk and transparency in the administration of public resources. Currently, the country has reached the highest standards of disclosure of information regarding fiscal accountability and transparency and is emerging as a pioneer in the management of contingent liabilities in Latin America.

This report is the first publication on the management of contingent liabilities of the Nation, published by the Ministry of Finance and Public Credit, which seeks to disseminate technical and regulatory efforts made by the General Directorate of Public Credit and National Treasury on the subject and present the main figures and their tax implications, constituting a highly relevant tool to monitor the country's fiscal performance.

This report is the result of the valuable work of the team from the Deputy Directorate of Risk, to whom we thank their commitment and consistent effort in the design and implementation of policies intended to improve the management of contingent liabilities in Colombia.

Germán Arce Zapata
Director General of Public Credit and National Treasury

INTRODUCTION

The management process of contingent liabilities starts with Act 448 of 1998, which regulated the budget management of contingent liabilities and established the General Directorate of Public Credit of the Ministry of Finance as responsible for the approval of valuations. A year later, the National Planning Department (DNP), estimated contingent liabilities of the Nation at 154.11% of GDP, confirming the importance of the issue and leading to partial regulation of the Law to Decree 1849 of 1999 repealed by Decree 423 of 2001, effective today.

In 2003, with the entry into force of Law 819¹, the coverage of the process of quota management in the national and territorial scopes was extended by establishing that the relationship of contingent liabilities that could affect the financial situation of the nation or the local authority should be included in the Medium Term Fiscal Framework - MFMP.

Based on the provisions of this Act and the methodological developments that the Risk Branch of the Ministry of Finance has been improving in the process of identification, assessment, mitigation and monitoring of these obligations, from the year 2004 contingent liabilities arising from guarantees granted by the Nation in celebrating public credit transactions, public-private partnership contracts in infrastructure and the legal proceedings against the Nation are reported in the MFMP.

In 2005, Decree 3800 entered into force, which regulated the management process of contingencies generated by public credit transactions, and by Resolutions 2818 and 3299 of 2005, 3045 of 2006 and 4291 of 2007, the valuation methodology of these liabilities was spread. Similarly, valuation methodologies for contingencies generated by contracts of public-private partnerships and judicial processes have been updated and are published on the website of the Ministry of Finance to assist in the management of fiscal risk.

Thus, this report describes, from the conceptual framework for contingent liabilities, the valuation for the fiscal commitments arising from infrastructure projects developed under public-private partnership schemes, public credit transactions secured by the nation and claims against the Nation - to fiscal mitigation mechanism adopted by the Contingencies Fund State Entities.

¹"Which establishes "organic rules regarding budget, fiscal transparency and accountability, and other provisions."

CONCEPTUAL FRAMEWORK

Traditional liabilities have the characteristic that conditions which determine the value of the contracting liabilities are known, as opposed to contingent liabilities whose value depends on the occurrence of future events and uncertainties². The contingency factors may be endogenous or exogenous with respect to who is responsible for them. For example, a natural disaster is an exogenous factor for the State, while a change in the tax rate is an endogenous factor.

In this manner, contingent liabilities can be classified as implicit or explicit. The former can be defined as political or moral obligations of the State, arising from the public's expectations about the latter's intervention facing the occurrence of a disaster or crisis. On the other hand, explicit contingent liabilities are obligation binding documents such as laws or contracts.

Fiscal analyses usually include traditional liabilities such as debt, accounts payable and pension liabilities, leaving aside the impact which the realization of any contingent liability could bring, either because of their difficult valuation or because their fiscal effect only reflected in the time the contingent event materializes.

An accounting mechanism that promotes fiscal transparency is the accrual accounting. Under this scheme a transaction is recorded at the time in which an economic event occurs when no cash flows take place, as recorded in the system cash accounting. Thus, a contingent liability such as a warranty must be registered at the time it is granted and not when it becomes effective. In contrast, in traditional or cash accounting, to be registered, a liability must be measurable with sufficient accuracy, the transaction or event that generates it must have occurred and the entity must have little discretion to avoid the transfer³. This, coupled with the difficulty of assigning a monetary value to contingent liabilities has led most countries not to include them in fiscal balances.

In recent years, multilateral agencies have accompanied the countries in the development of methodologies for the identification, measurement and valuation of contingent liabilities, as well as in the development of technical tools, the definition of minimum standards for disclosure of this information and in building institutional policy, leading to the inclusion in the analysis of national accounts of the fiscal impact that contingent liabilities may have.

² Cebotari Aliona, *Contingent Liabilities: Issues and Practice*, International Monetary Fund.

³ Ministerio de Hacienda de Chile-Dirección de Presupuestos Informe de Pasivos Contingentes 2007.

In this sense, we have taken great challenges that have led to theoretical and methodological development of the management of risks arising from contingent liabilities, a topic which in general is complex if one takes into account the need to build a legal framework, development of valuation models to estimate the probability of occurrence of the trigger event of the obligation, the exposure to the contingent event, the time in which the event takes place, quantification of the fiscal impact, the design of retention and risk transfer mechanisms, and the appropriate allocation of resources, among others.

There are a few countries which have implemented specific mechanisms to assess and manage fiscal risks arising from contingent liabilities, developing legal agreements and different methodologies to address the issue from a more rational point of view and to adopt appropriate mechanisms to handle them. For example, the government of the Czech Republic has begun with the identification of tax risks and their consequences on the stability of its budget; the United States and Italy assigned yearly budget by the present value of future tax costs on account guarantees, and Australia and New Zealand include contingent liabilities and provisions within the Financial Statements of the State.

Other countries like Malaysia and the Philippines have taken a route similar to Colombia, starting with the development of tools to estimate the losses associated with guarantees for infrastructure projects and state agencies and modifying their contract frameworks to incline by tighter contractual arrangements to transfer risks to those with greater ability to manage them efficiently.

In the European Union, for example, only governments are allowed guarantees to finance certain strategic sectors and projects, and determine the investment of resources and the amount allocated to an individual project in order to impose clear rules and avoid competition between different institutions and sectors by obtaining guarantees.

On its part, Australia has developed a methodological guide that allows the government to incur into a contingent liability after having fully identified the risk, quantified it, compared its costs versus the potential benefits, learned about the different options for management and mechanisms for fiscal protection that must be started⁴. Regarding the legal framework, many OECD countries require parliamentary approval before entering into a contingent liability with the purpose of equalizing the treatment with traditional liabilities and contingent liabilities as well as including within the projections their possible fiscal impact. Countries such as Belgium, Canada, Denmark, Finland, Greece, France, Germany, Italy, Poland, Spain, United Kingdom and United States require parliamentary approval for granting credit guarantees, while others such as Denmark, Iceland, Italy, Mexico, Turkey, United Kingdom and Norway require parliamentary approval for the granting of guarantees in PPP contracts⁵.

⁴ Ibid, pag 10

⁵ Lienert, Ian, and Jung, Moo-Kyung, 2004, "The Legal Framework for Budget Systems, An International Comparison," OECD Journal on Budgeting, Special Issue, Vol. 4, No. 3

In the case of Chile, minimum income guarantees are capped at 70% of private investment, plus the cost of maintenance and operation. At the same time, they share the profits if the traffic is higher than expected⁶. Thus, the traffic risk is shared, the government guarantee is not unlimited and excessive losses to the private are avoided, while encouraging private participation in infrastructure.

Facing the quota generated by lawsuits against the state, at present there are no standard valuation models recognized internationally. In the case of Chile and Colombia, the valuation methodologies were developed internally by the Ministries of Finance and the application thereof is held by the Budget and the General Directorate of Public Credit, respectively. In Argentina, the Treasury Solicitor's Office is responsible for providing legal advice to executive branch agencies and employees, to assume the representation and defense of the national state at trial, direct and train the Body of the State Bar, recording, auditing trials and eventually pay the sentences resulting against it. As in Brazil, a cap on annual payments is established for this item.

Meanwhile, countries such as Ecuador and Peru focus their legal defense system in the Attorney General and the Judicial Council of Defense of the State, but make no reports estimating this contingent liability or its management within the country's fiscal accounts.

The following table provides a summary of the regulations concerning the processing and publication of information on contingent liabilities in different countries⁷.

⁶ Ibid , pag 17

⁷ Cebotari Aliona ,Contingent Liabilities: Issues and Practice, International Monetary Fund

**TABLE 1. REGULATIONS AND PUBLICATION
IN DIFFERENT COUNTRIES**

Country	Description
Australia	Within the performance report and fiscal budget, it includes a chapter on fiscal risks and contingent liabilities and published government commitments acquired and the current negotiations. Also included is an intergenerational fiscal sustainability report for the next 40 years.
Brazil	Included within the annual budget law an annex to the estimation of contingent liabilities and fiscal risks.
Canada	Financial statements must include the country's contingent liabilities. Similarly, departments must also maintain a clear report on their assets, liabilities and contingent liabilities.
Chile	An annual report on the nature and amount of contingent liabilities arising from government guarantees is presented, including warranty and beneficiaries, and the estimation of the financial obligations arising from contracts or legislation, such as security and infrastructure minimum pension guarantee.
France	The budget framework required to report of government obligations which lie out of balance.
New Zealand	Fiscal reports submitted with the budget must include a list of government commitments which may push spending in the future, a list of contingent liabilities and a report on the sensitivity of fiscal aggregates to changes in conditions of the economy.
Nigeria	The law requires the budget to accompany an appendix on tax risks and the measures taken to manage them.
Pakistan	A report of debt including information on the guarantees granted is presented annually to the National Assembly.
Peru	The Medium Term Fiscal Framework includes the publication of government guarantees and a debt service relation for the medium term.
United Kingdom	It is mandatory to include in the fiscal projections an analysis of fiscal risks and contingent liabilities.

The International Monetary Fund in order to promote openness, clarity in the presentation of results and development of fiscal policy, has published several versions of the Code of Good Practices on Fiscal Transparency. The code states that information related to contingent liabilities should be part of the annual budget documentation and include a brief description of the nature of the contingency, as well as the exposure of the government and their fiscal impact⁸.

Taking into account the recommendations of the Code and the provisions of Act 819 of 2003 and with the purpose of reporting information on contingent liabilities, according to international standards, Colombia has developed different methodologies of valuation which apply various models such as the estimation of frequencies from historical data, simulation and parametric models.

In this vein, the International Monetary Fund presented in 2009 the following comparative table, facing the report of contingent liabilities in countries such as Australia, Brazil, Chile, Colombia, Indonesia, New Zealand, among others:

TABLE 2. COMPARATIVE OF CONTINGENT LIABILITIES

Contingent risk	Australia	Brazil	Chile	Colombia	Indonesia	New Zealand	Pakistan
Pensional liabilities			X	X	X		
Banking System					X		X
Regional Funds		X					
Debt guarantees	X	X	X	X	X	X	X
Other guarantees	X	X	X	X	X	X	X
Legal Disputes	X	X		X	X	X	
Unclaimed debt	X				X	X	
Quasi-fiscal deficit of the Central Bank			X				
Natural Disasters					X	X	

International Monetary Fund (2009), Fiscal Risks Sources, Disclosure, and Management

⁸ International Monetary Fund, Code of good practices on fiscal transparency 2007.

CONTINGENT LIABILITIES IN COLOMBIA

Since the establishment of the Constitution in 1991, the Colombian economy was freed to international trade, which attracted a flood of foreign capital that strengthened the mechanisms for private participation in investments which had traditionally been the exclusive responsibility of governmental bodies. Additionally, local authorities in their efforts to put aside the lags in comparison to the international average and adapt to the new commercial reality, found in the foreign market different sources of funding for their budgetary needs, the majority of which required guarantees from the Nation.

The Government, in its purpose of development and execution of investments, chose to link private equity decided to the implementation of infrastructure. Additionally, in order to facilitate the financing of these works, the State offered some coverage to the private companies involved.

For example, the electricity sector before the 90s, ran a model based on state monopolies which at the time did not have the resources to meet the growing demand; the above coupled with the poor performance of energy companies and the fact that tariffs not reflect the cost of service, caused an unsustainable fiscal burden.

The power rationing, which lasted fourteen months between 1992 and 1993, accelerated the decision to incorporate the private sector in infrastructure provision, especially to run the necessary investments to increase coverage and quality of service. Thus, after the declaration of economic and social emergency, private companies were allowed to build and operate power generation assets and began promoting thermal generation in the country⁹. Moreover, the State capitalized on several electricity companies while exchanging debt for stocks, becoming the major shareholder of these companies.

In order to gain the support of the emerging regional power sector reform, important concessions were granted and the government authorized the construction of three hydroelectric plants, financed by multilateral banks and guaranteed by the Nation: La Miel, Urrá y Porce.

Despite the political difficulties, foreign investors invested US\$ 7.3 billion in the period 1994-2003 in the electricity sector¹⁰. Private investment

⁹ Jaime Millán, Entre el Mercado y el Estado: Tres décadas de reformas en el sector eléctrico. BID 2006.

¹⁰ Ibid, pag 156

covered both existing assets and investment in new generation. Thus, after the initial investments contracted under the PPP's scheme motivated by the emergency, private entrepreneurs invested in thermal plants. Increased competition in the sector brought about a reduction in generation costs, rates to end users fell in real terms, and the country could successfully confront the threat of rationing on the occasion of the phenomenon of El Niño 1997 and 1998.

Through the figure of PPP's large expanding investments were made; as a result, the service coverage was expanded, especially in the poorest sectors. These contracts contained price cap structures in which the state was responsible for subsidizing the price to end users during periods of scarcity. This scheme would collapse and then generate a high fiscal cost during the 1999 crisis.

On the other hand, the telecommunications sector in the early nineties was characterized by a monopolistic structure in which the State provides most of the services, either through Telecom or local operators. The state-owned Telecom was the sole provider of domestic long distance services and international and local rural telephony in some cities, as well as telegraph services, telex and emerging data services. The local telephone service was also provided as a monopoly by state enterprises, usually of municipal order or with direct participation of TELECOM through its associates (Teleasociadas).

Faced with the imminent technical backwardness and coverage, some state operators including Telecom signed venture partnership contracts for the installation of new lines with international partners. In such contracts TELECOM provided the existing infrastructure and the associated investment made in new equipment and networks, receiving as compensation a percentage of the revenue. At the end of the contract, the modernized infrastructure reverted to TELECOM.

With the purpose of encouraging private participation in building networks, projections of demand behavior were included in the contracts. Such projections would be adjusted every year. When the actual behavior of the demand were less than the adjusted forecast, TELECOM would compensate for the difference through extensions of the contract term, increases in the percentage of shares of income or payments due to the settlement agreements.

Because deviations from the projections were significant, especially given the substantial increase in mobile phone demand which significantly displaced fixed lines, the guarantees agreed upon in the joint venture contracts were enforceable, making equity-based compensations insufficient and that compensations through direct payments began to be demanded by lawsuits and the establishment of arbitration tribunals. Finally, in order to make the privatization of Telecom possible in 2004, the Government authorized a public credit

operation guaranteed by the nation of up to COP\$ 0.9 billion¹¹ (USD\$ 0.38 billion¹²) pesos for the payment of the obligations arising from contracts of partnership venture.

In time, these guarantees and incentives for private sector participation to meet the infrastructure needs of the country were not recorded in the fiscal accounting framework, because there was no assessment instrument, creating great fiscal and budgetary inconvenience, a fact that concerned government authorities regarding the fiscal situation.

With the establishment of the Risk Office within the General Directorate of Public Credit, began the development of identification, assessment, mitigation and control of the different sources of contingent liabilities of the Nation. In 1998, following the financial crisis, measures were taken concerning the management of contingent liabilities of state agencies and issuing rules on public borrowing.

Indeed, in 1998 Law 448 was issued by which action was taken regarding the management of contingent liabilities and it was established that the Nation, together with the territorial and decentralized entities, should include in their budgets debt service appropriations necessary to cover potential losses from contingent liabilities in their care.

Also, the "Contingency Fund for State Entities" was created to meet contingent liabilities and risks of state agencies, which will be determined by the government. Similarly, Article 6 of the Act assigned responsibility for approving and monitoring the valuation of contingencies to the General Directorate of Public Credit and National Treasury, Ministry of Finance and Public Credit - MHCP.

Subsequently, in 1999 the Ministry hired the consulting firm "Arthur Andersen", with the basic purpose of receiving advice in the development of methodological guidelines for the valuation of contingent liabilities and legal design Contingency Fund for Entities State and the regulation of Law 448 of 1998.

As a result of this work Decree 1849 of 1999 was issued, reflecting the first definition of contingent liability, restricting it only to guarantee payment, establishing the budget rules and the general procedure for disbursements from the Contingency Fund and the creation of an Assembly in which all the contributing entities would have the power to elect the management committee and approve the annual accounts of the Fund.

Two years later, the decree would be subrogated by Decree 423 of 2001, currently in force, which deepens into compulsory quota system, eliminates the Assembly of Contributors, separating the management of the Fund and provides a clear and detailed process for the resources management of the Contingency Fund for State Entities.

¹¹ COP\$ 1 billion = 1,000,000,000,000

¹² USD\$ 1 billion = 1,000,000,000, using a official exchange rate of 2,389.75(COP/USD)

This decree defines contingent liabilities as those under which any of the state entities¹³ provide contractually for a contractor, the payment of a sum of money, determined or determinable based on factors identified by the occurrence of a future and uncertain event.

Similarly, this Decree provides guidelines for the management of the “Contingency Fund for State Entities,” and authorizes the General Directorate of Public Credit and National Treasury, Ministry of Finance to approve contribution plans¹⁴ that state entities should be made to the Fund, to cover possible expenses generated by contingent liabilities under their charge. Additionally, in the same year the National Economic and Social Policy (CONPES)¹⁵ established by documents 3107 and 3133, the guidelines of Contractual Risk Policy of the State, in order for State agencies to comply with the principles, guidelines and instructions laid down by the Government.

In 2003, the Republic of Colombia became an example at the regional level by the issuance of Law 819, where organic standards are established in budgeting, accountability and fiscal transparency. Additionally, it dictated regulations on the Medium Term Fiscal Framework, which must be submitted by June 15 of every fiscal period to the Economic Commissions of the Senate and the House. The framework should incorporate information regarding the financial plan, a multi-year macroeconomic program, the primary surplus targets, the level of public debt and sustainability, a report of macroeconomic and fiscal results of the previous fiscal year, an assessment of the main quasi-fiscal activities undertaken by the public sector, the estimated fiscal cost of exemptions, deductions or tax credits available, the fiscal cost of the laws passed in the previous fiscal period, and a statement of contingent liabilities that may affect the financial position of the Nation.

This Act also allowed continuation with the strengthening of the management of contingent liabilities for legal proceedings against the nation, one year after Act 790 of 2002 was issued, which strengthened the Department of Judicial Defense of the Nation and appointed to it the task of coordinating the monitoring and control activities of the attorneys who defend the State.

In the same year, the CONPES document 3250 “Lines of action for strengthening the legal defense of the nation and for valuation of contingent liabilities” was also published, as a result of the number of lawsuits against the nation, 51,484 claims, and the amount of sentences

¹³ According to Article 9 of Decree 423 of 2001, these entities are: the Nation, public institutions, industrial enterprises and state trading, mixed economy societies in which participation is greater than 75%, the special administrative units with legal personality, the regional autonomous corporations, departments, municipalities, districts and the Capital District of Bogota entities the departmental, municipal and district utility companies and mixed officers as defined in Article 14 of Act 142 of 1994 in which the component of public capital is equal to or greater than 75% and public companies.

¹⁴ The Contributions Plan is a schedule of the amounts to be transferred to state agencies under the Contingency Fund for State Entities bound to fulfill quota obligations assumed in the contracts.

¹⁵ The National Economic and Social Policy (CONPES) is in charge of orienting this policy under the principle that it is responsibility of the State agencies to assume the risks pertaining to their public character and to the social object for which they were created or authorized. It is the agency authorized to recommend the guidelines that public agencies must follow when structuring projects, with participation of the private capital in infrastructure, and determining the risks they may contractually assume as contingent liabilities.

amounting to COP \$0.207 billion in 2002 (USD\$ 0.07 billions¹⁶), directly affecting the assets of the nation.

The issue focused on three main factors: i) The lack of financial resources to strengthen prevention measures against unlawful state damage, ii) Poor technical defense against state court proceedings, and iii) the absence of information systems for the collection and analysis of data on the state litigation, which in turn prevented the Ministry of Finance and Public Credit from valuing this contingent liability assessment, versus the provisions of Act 448 of 1998. To quantify this problem and thus resize it, the CONPES recommended issuing a presidential directive that would allow the General Directorate of Public Credit and the National Treasury to collect the information required to assess this contingent liability.

This Presidential Directive was issued on March 30, 2004, with the purpose that entities and agencies of the executive branch of the National Order, would submit to the Ministry of Interior and Justice and the Ministry of Finance and Public Credit information on contingent liabilities resulting from operations of public credit, infrastructure and business contracts at issue before June 15. Against this last contingent, entities had to fill out and submit the unique format of the State Litigation Activity, which was annexed to the Directive, which was drafted jointly by the Directorate of Judicial Defense and the General Directorate of Public Credit and National Treasury - Deputy Directorate of Risk.

As a result of this effort, in 2004, the MHCP Deputy Directorate of Risk performs the initial assessment of contingent liability lawsuits against the nation¹⁷, and presents it in the Medium Term Fiscal Framework 2004-2014. However, for the following years, the valuation of contingent liabilities continues to exhibit the problem in the collection of information at issue and the need to create a system that concentrated all this information from the State.

For this reason in 2007 Decree 1795 was issued, which states that the Unique System for Juridical Management Information LITIGOB, will be the only system of collection and management of information related to the legal, domestic and international activity of the State. Based on the information provided by this system, the Deputy Directorate of Risk conducted the assessment of contingent liabilities in 2007; however, there continued to be inconsistent information, poor parameterization of the fields and deficiencies in the functioning of the system, which in 2008 did not report the valuation of contingent liabilities by business disputes under the Medium Term Fiscal Framework.

In the two following years, the valuation of this liability was timely made because the Deputy Directorate of Risk developed a provisional format for collecting information in Excel to apply directly to institutions and complement the information reported by LITIGOB. Therefore in order to find a definitive solution to the full and timely collection of

¹⁶ Using a official exchange rate (TRM) of 2,864.79 (COP/USD)

¹⁷ This first valuation was performed with the methodology of evaluation designed by the District Secretary of Finance.

information, the Ministry of Finance is supporting the efforts of the Ministry of Interior and Justice to consolidate Phase II LITIGOB source of information latest assessment of the contingent liability for the 2011-2021 Fiscal Framework.

Faced with the contingent liabilities generated in public credit operations, Decree 3800 was issued in the year 2005 to partially regulate Law 448 of 1998 and Article 3 of Law 819 of 2003, which states that these liabilities are understood as pecuniary obligations under condition arising by entities¹⁸ where they act as guarantors of payment obligations to third parties.

Along the same lines, Resolution 2818 is issued in 2005, which establishes the methodology for the valuation of contingent liabilities by external public debt operations in which it acts as a guarantor of the State. A year later, through Resolution No. 3045, the methodology for the valuation of these liabilities for the operations of external public debt and concessional rate is established, and in 2007, through Resolution No. 4291, the methodology for internal public debt operations is established. Additionally, it requires state agencies that require guarantees from the developing nations of the public credit operations, to make contributions on behalf of the National Contingency Fund for State Entities, according to the valuation methodology defined by the General Directorate of Public Credit and National Treasury.

In the same year, Law 1150 was issued to partially reform the General Statute of Public Administration Procurement, highlighting the importance of the identification, typification and valuation risk in previous studies of all state contract.

In this vein, the country's experience regarding the process of managing these liabilities, has followed the best standards and practices in regard to fiscal transparency indicators¹⁹, allowing the nation to identify four sources of contingent liabilities: i) the competitive bidding process or public or private, contract and award those contracts to develop schemes for private participation in infrastructure projects and public services, ii) court proceedings against the State, iii) guarantees public credit operations and iv) the occurrence of natural disasters.

In the process of management of contingent liabilities has been assigned to the General Directorate of Public Credit and National Treasury of the Ministry of Finance and Public Credit, the responsibility for approving the valuation of them, thus contributing to the strengthening of the fiscal responsibility, in a preventive approach to fiscal discipline.

¹⁸ The entities which may act as guarantor of payment obligations are: the Nation, departments, districts and municipalities, public institutions, industrial and commercial enterprises and state owned companies, economy companies mixed in the direct or indirect state equals or exceeds 50% of capital, special administrative units with legal personality, the regional autonomous corporations, businesses and public services officers mixed in the latter case when direct or indirect state exceeds 50% of the capital, metropolitan areas and associations of local autonomous bodies at the state university or official, and the National Television Commission.

¹⁹ Codes and Standards of the International Monetary Fund and the Code of Best Practices for Budget Transparency of the Organization for Economic Cooperation and Development (OECD).

Table 3 shows the legal framework and approach that is used to report contingent liabilities described in this chapter.

TABLE 3. LEGAL BASE FOR CONTINGENT LIABILITIES

Contingent liabilities	Legal base for Contingent liabilities					
	Laws	Decrees	Resolutions	CONPES	Other Dispositions	Treatment of Report
Infrastructure projects with APP scheme	185 of 1995, 448 of 1998, 819 of 2003	423 of 2001	2080 of 2008, 6128 of 2008, 446 of 2010	3045 of 1999, 3107 of 2001, 3133 of 2001, 3186 of 2002, 3249 of 2003, 3413 of 2006, 3535 of 2008		Analysis and valuation
Operations of Public Credit			2818 of 2005, 3045 of 2006, 4291 of 2007			Analysis and valuation
Verdicts and conciliations					3250 of 2003	Presidential Order 01 of 2004

Source: Deputy Directorate of Risk - MHCP

CONTINGENT LIABILITIES OF INFRASTRUCTURE PROJECTS DEVELOPED UNDER PUBLIC - PRIVATE PARTNERSHIP SCHEMES

With the issuance of the 1991 Constitution mechanisms for private participation in investments that have traditionally been the exclusive responsibility of government agencies were strengthened. The Government, in its purpose of developing and executing investments, decided to link private equity to the implementation of social development projects, for which it created mechanisms designed to encourage the interest of private agents to their participation in infrastructure projects. The concession processes in Colombia were an important mechanism by which the state was associated with a private company for it to finance, build, operate, maintain and / or exploit a project of public infrastructure.

In order to facilitate the financing of these works, the State offered some guarantees to concessionaires, especially relative to the demand²⁰, with which the government went from being the financier of infrastructure projects to be the guarantor of the concessionaires.

Such traffic guarantees have one counter-cyclical characteristic, i.e. the probability that the asset is reduced as the economy grows and conversely its probability of occurrence increases during a recession. This, together with the fact that the securities were not registered under the tax accounting due to the absence of an instrument to do so, were factors that concerned government authorities regarding the fiscal situation.

Thus, the experience showed that the way in which concession processes were structured in the past, led to great fiscal and budgetary inconveniences for the government, since at the time the guarantees were made effective, there was no sufficient liquidity, no provision for coverage, having to resort to borrowing transactions and / or jeopardize future funds facing the obvious need to pay.

The high incidence of contingent liabilities and the difficulties of a budget, led the government to initiate the study and monitoring of contingent liabilities in Colombia derived from infrastructure contracts, and to regulate actions in relation to their management.

The infrastructure concession projects incorporated contingent liabilities primarily related to guarantees of traffic, geologic media, property, environmental and general contingencies associated with the

²⁰ The main guarantee granted in concession contracts is called "guaranteed minimum income", which ensures a minimum level of income from a dealer, the government must cover the difference if the income of the concession is below the agreed contract.

risks assumed by the nation. In this sense, we can define the three generations in which road concessions have been classified:

First Generation Grants

The First Generation of concessions is made up of eight (8) projects with contracts signed between 1994 and 1997, structured at that time by the National Roads Institute (INVIAS)²¹. In total, this first generation includes 1,595 km of roads.

In these projects, the risks are at the head of the Nation by providing guarantees for higher value of the designs, greater amounts of work, minimum traffic and rate differential. In addition to the guarantees, the nation had a responsibility to deliver the land required for the development of works and obtaining environmental permits for the project.

Under this scheme of contracts, the Nation guarantees rates, traffic, revenue and internal rate of return, with a guaranteed minimum income for the duration of the contract. Risk transfer is limited to the dealer and any cost overruns on site could be reached to present (purchase of land or operational costs) was secured with a guarantee of the nation.

The Guaranteed Income mechanism is activated when the concessionaire's annual revenues are lower than the guaranteed minimum income in the event that the State must pay the income gap to the dealer, and this difference is what constitutes a potential contingent liability for the contracting entity.

Second Generation Grants

The main feature of these contracts is that limits to income guarantees are set and partial risk guarantees are eliminated from the first generation contracts.

The second generation of concessions is composed of two (2) contracts signed between late 1997 and 1999, with a total length of 1,506 km of roads currently only one active contract since pleaded breach of contract award The Wine - Tobiagrande - Puerto Salgar - San Alberto. These contracts are sought to transfer a greater portion of the risks to dealers from design to operation, and introduce the concept of expected income, which implies a more flexible term reversion to the grantor of the project until the dealer gets the expected revenue requested in the bidding proposal.

The logic underlying the grant schemes is that the second generation license expires when the licensee reaches the expected income. This

²¹ Until 2003, the implementation of the concessions was in charge of the National Roads Institute (INVI), an entity in charge of the country's road infrastructure, and Decree 1800 of 2003 was created to INCO to gather into one entity structuring, execution and administration of concession contracts for transport infrastructure (roads, ports and railways) and private sector involvement.

mechanism provides a guarantee of total revenues for the award, but to operate on the time it does not involve spending. However, the government proposed income support, in charge of the State, granted in fixed terms and amounts. These supports were awarded in the categories of income support (for the coverage of debt service) support of media exchange or geological risk support:

- Income support seeks to contribute to debt service coverage in the period of greatest narrowing of the project and ensure sufficient liquidity to assure the operation and maintenance of infrastructure concession. Generally, the State considers as a more narrow period of free cash flow that which occurs between the first 7 to 10 years of the concession. The amounts of coverage of income support are defined based on the amount of debt service (interest and amortization), so that the income guaranteed enable the dealer to cover at least the debt service considering a certain debt / equity ratio.
- Moreover, exchange support seeks to cover the reduction in revenue of the project, caused by real devaluations of the peso against the dollar. It is applied when it may affect the debt in foreign currency taken by the concessionaire, and is granted over the percentage of dollar debt according to the financial closure.
- The geological risk support is a partial guarantee to cover cost overruns resulting only from the geological hazards in the construction of works of great difficulty in unstable areas such as construction of tunnels and viaducts.

Third Generation Grants

The Third Generation of concessions is comprised of four (4) contracts between 2000 and 2006, with a length of 930.11 km of roads, and new concession contracts signed between 2007 and 2008 (some analysts consider them the fourth generation) includes ten (10) projects with a length of 842 km of roads in particular are: Metropolitan Area of Bucaramanga, Ruta Caribe, Ibaguè - Girardot, Cordoba - Sucre, Metropolitan Area of Cucuta, and Rumichaca - Pasto - Chachagüí as shown in Table 4.

These contracts are variable within the scope of the projects and are defined as of basic scope and progressive extent. The progressive range corresponds to the development of additional works to the basic scope of works, which will be developed as long as pre-established conditions prevail regarding, inter-alia, the level of traffic and the availability of additional resources.

In this type of contracts, the transfer of risks is extended to the concessionaire, and studies on social and environmental impact of projects are included within its structure, providing an additional priority to the financial structuring of projects, with the aim of ensuring

adequate funding. The dealer assumes the risk of land management and acquisition of environmental permits. These contracts are also framed within the concept of expected income.

The third generation grants sought to reduce the risks to the nation and structure concessions under the concept of expected income offered. The focus of these contracts is to reduce the risk of demand to adjust the time according to income.

TABLE 4. EVOLUTION OF THE CRITERIA FOR ALLOCATION OF RISKS IN HIGHWAY CONCESSION CONTRACTS

Risk	Primera Generación		Segunda Generación		Tercera Generación	
	Privado	Público	Privado	Público	Privado	Público
Construction	X	Partial	X		X	
Traffic		X	X		X	
Toll fees		X		X		X
Lands		X		X	Management	X
Environmental license		X		X	Management	X
Tax	X		X		X	
Currency exchange	X	X	Partial		X	Partial
Financing	X		X		X	
Force Majeure (insurable)	X		X		X	
Force Majeure (Not insurable)		X		X		X

Source: Ministry of Transportation, National Planning Department.

Additionally, in recent years projects have been awarded under the scheme of real income line, which retains the risk allocation of contracts for third generation as well as the expected income scheme operates on the term of the concession, that is, it expires when the dealer gets the present value of bid revenue. Thus, the present value of revenue is obtained by discounting the income earned by the dealer by state contributions and collection of tolls.

The following table shows the current highway concession contracts with their respective classification.

TABLE 5. CURRENT CLASSIFICATION OF ROAD CONCESSIONS

Generación	Proyecto
First Generation	<ol style="list-style-type: none"> 1. Road system of Meta ("Autopista de los Llanos") 2. Road development to the East of Medellín 3. Armenia-Pereira-Manizales 4. Fontibón-Facatativá-Los Alpes 5. Bogotá (Puente El Cortijo) - Siberia - La Punta - El Vino (TIR guaranteed) 6. Autopistas de la Montaña
Second Generation	<ol style="list-style-type: none"> 1. Road system of Valle del Cauca
Third Generation	<ol style="list-style-type: none"> 1. Zipaquirá - Palenque 2. Briceño - Tunja - Sogamoso 3. Bogotá - Granada - Girardot 4. Pereira - La Victoria 5. Metropolitan zone of Bucaramanga 6. Ruta - Caribe 7. Girardot - Ibagué 8. Córdoba - Sucre 9. Metropolitan Area of Cúcuta 10. Rumichaca - Pasto - Chachagüí. 11. Cartagena - Barranquilla (started as first generation) 12. Road development to the North of Bogotá (Devinorte) 13. Neiva - Espinal - Girardot 14. Santa Marta - Paraguachón (started as first generation)
Real income line	<ol style="list-style-type: none"> 1. Ruta de Sol Sector 1, Sector 2, Sector 3 2. Ruta de las Américas Sector 1 3. Bogotá - Villavicencio (started as first generation)

Source: National Institute for Concessions - INCO

It is worth mentioning that according to Article 28 of Law 1150 of 2007, all extensions or additions to the contract must have prior favorable concept of the National Council of Economic and Social Policy - CONPES, and the modifications of contracts granting greater contributions involving state and / or higher expected income and / or extension of time agreed by contract, require the prior tax assessment by the Higher Council for Fiscal Policy (CONFIS). In addition, these amendments²² must conform to the maximum amounts established by the CONFIS regarding contributions of the nation and follow the guidelines on risk discount rate defined by the Ministry of Finance and Public Credit.

²² According to the CONPES document 3535 of 2008.

In this sense, and in order to reflect market conditions in the addenda to the contracts already awarded, Resolutions 2080 July 31, 2008, 6128 of December 22, 2008 and 446 of February 24, 2010 were issued, with the methodology for calculating the discount rate for road concessions. Thus, within the Ministry of Finance and Public Credit methodologies were developed for calculating the cost of capital, considering the macroeconomic and financial conditions at the time of contract modification.

Methodology and assessment of contingent liabilities in infrastructure sharing schemes developed under Public – Private Partnerships.

To estimate the contingent liabilities of perfected contracts after the effective date of Act 448 of 1998, we used a methodology based on the identification, assessment, management and monitoring of risk factors that may affect the expected financial results of infrastructure projects. The implementation of this methodology allows for the estimation of the level of exposure and potential contingent liabilities by the state that cover must enter through the Contingency Fund for State Entities.

Overall assessment methodology for contingent liabilities in infrastructure projects, schemes developed through public-private participation takes the following steps:

1. Contextualization: It verifies that you have met the basic provisions in the planning stage of projects, including the recognition and allocation of risk in the minutes of the contract.
2. Risk Identification: Identify possible causes and effects of risk factors that cause and determine which party (dealer or nation) is better able to anticipate and handle each type of risk.
3. Evaluation: At this stage we estimate the probability of occurrence of each of the identified risks and their potential impact on project results, based on past records, relevant experience, publications, expert judgments and experts. From this assessment it is possible to determine the best mechanism to mitigate risk to be implemented, and outline the results in a risk matrix.
4. Valuation: From the risks assessed in the previous stage, consider those whose probability of occurrence and impact is higher on economic performance of the project, to perform a quantification of the additional costs to the state by the occurrence of the event generating risk. From this measurement a contributions plan for the Contingency Fund is made.

In general, the emphasis is on factors that may generate economic impact on the balance of the contract with contingent monetary implications for the state.

Modeling techniques and risk assessment can be classified into two types of models: parametric and simulation. The application of one or the other depends largely on the information that is available, i.e., whether the distribution of the risk variable is known or not.

If you can estimate a reliable distribution of the risk variable through simple statistical parameters (e.g., mean and volatility), then you could use a parametric model. On the other hand, when estimating the distributions is not reliable, it is necessary to conduct a simulation model to quantify the contingency.

Contingent liabilities associated with highway concessions of second and third generation, represent 0.10% of GDP cut in April 2011. The evaluation of these contingencies to 2010, corresponded to 0.13% of GDP, as evidenced in Table 6. The variation corresponds to changes in contributions plans made under the regular monitoring process established by Article 47 of Decree 423 of 2001.

TABLE 6. CONTINGENT LIABILITIES IN INFRASTRUCTURE INVESTMENT

	2010 - 2020		2011 - 2021	
Contingent liabilities	COP\$ billion	% of GDP	COP\$ billion	% of GDP
Infrastructure	0.734	0.13%	0.574	0.10%
	USD\$ billion		USD\$ billion	
	0.412		0.322	

* Using a official exchange rate (TRM) of 1,783.25 (COP/USD)

Source: Contribution Plans approved by DGCPNTN

Constant Millions of pesos (COP) in December 2010

It is important to note that since the entry into force of Act 448 of 1998 to April 2010, a total of twenty (20) risk assessments of road concessions with their respective additions²³ were approved by the Deputy Directorate of Risk of the General Directorate of Public Credit and National Treasury, and contribution plans Contingency Fund for twelve (12) of them were determined. Following is the estimated contingent liability for the period 2011-2021, disaggregating the granting and risk generated by the contingent liability.

²³ These concessions are: 1) Cartagena-Barranquilla, 2) Malla Vial del Valle, 3) Santa Martha -Paraguachón,4) Zona Metropolitana de Cúcuta, 5) Bogotá - Villavicencio, 6) Armenia - Pereira - Manizales, 7) Pereira - La Victoria, 8) Ruta del Sol, 9) Ruta de las Américas 10) Zona Metropolitana de Bucaramanga, 11) Córdoba - Sucre, 12) Ruta Caribe, 13) Briceño - Tunja - Sogamoso 14) Bogotá - Girardot, 15) Fontibón - Facatativá - Los Alpes, 16) Zipaquirá - Palenque, 17) Rumichaca - Pasto, 18) Autopistas de la Montaña, 19) Girardot - Ibagué - Cajamarca, 20) Palenque - Y de Ciénaga.

TABLE 7. ROAD CONCESSIONS CONTINGENT LIABILITIES SECOND AND THIRD GENERATION

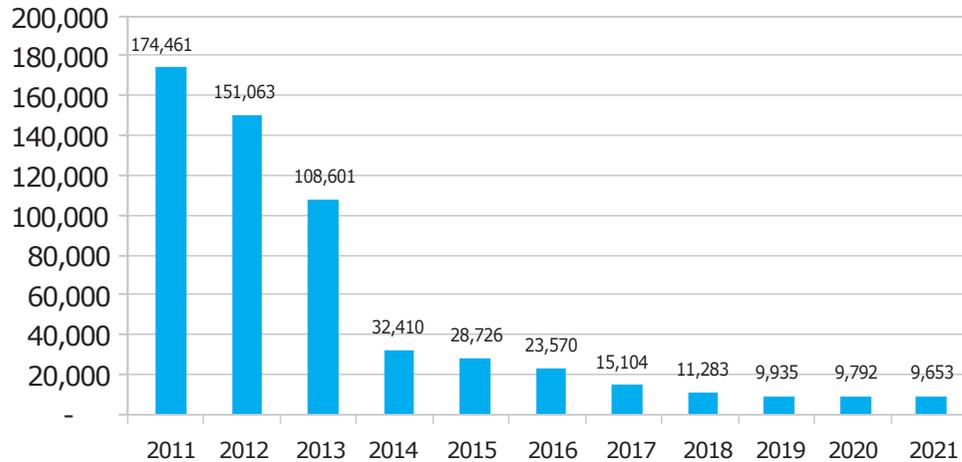
Concession	Risk	Contingent liabilities
Bogotá - Girardot	Land tax	\$ 23.365
Rumichaca -Pasto	Income support	\$ 19.562
Met. Zone. Bucaramanga	Income support	\$ 23.059
Córdoba - Sucre	Land tax	\$ 72.651
Met Area. Cúcuta	Land tax	\$ 24.449
	Tariffs	\$ 36.261
Ruta Caribe	Land tax	\$ 39.506
Bogotá - Villavicencio	Land tax	\$ 9.269
	Environmental	\$ 13.124
	Designs	\$ 66.681
	Geological	\$ 30.239
	Laudo	\$ 25.256
Ruta Sol Sector 1	Geological	\$ 40.011
	Land tax	\$ 1.614
Ruta Sol Sector 2	Land tax	\$ 16.664
Ruta Sol Sector 3	Land tax	\$ 21.707
	Expected income	\$ 33.494
Américas 1	Land tax	\$ 8.606
	No installation of booths	\$ 69.079
Total (COP\$ billion)		0.574
Total Total (USD\$ billion)		0.322

* Using a official exchange rate (TRM) of 1,783.25 (COP/USD)
Source: Contribution Plans approved by DGCPN
Constant billions of pesos (COP) in December 2010

Within the review and update contribution plans, the Bogotá – Girardot grant can be highlighted, which presents a focused plan contributions between 2010 and 2011, to support the geological risk of the tunnel at Sumapaz and the acquisition of the properties activities, according to the schedule of works will be carried out until the end of 2011. On the other hand, an update to the contribution plan for the Ruta del

Sol Sector 3 was made, given that the initial tender for the road San Roque sector - Ciénaga swamps - Carmen de Bolivar had been declared void, which required an adjustment in the corresponding contribution plan, thus increasing the contingency quota in COP\$ 35,732 million (USD\$ 19,875 million) for this concept. Following is the overall profile of contributions to the Contingency Fund.

FIGURE 1. ANNUAL CONTRIBUTIONS TO THE CONTINGENCY FUND



Constant Millions of pesos (COP) in December 2010
 Source: Contribution Plans approved by DGCPTN

In addition to contingent liabilities related to road infrastructure, monitoring and assessment of the contingent liabilities of railway concessions, airports, electrical and hotels has been performed.

Currently, there are two railway concession projects: the Railway Concession of the Atlantic and the Pacific Railroad. Regarding the Atlantic Railway Network, a contingent valuation analysis was made for additions maintenance additions in 2009, 2010 and 2011, which determined that it is not necessary to contribute to the Contingency Fund due to the contractual structure and risk allocation. In particular, the risk analysis of this project states that the risk of traffic, cargo volume and number of passengers carried in each period are charged to the dealer and also the risks assumed by the State are not within the assess risk area, according to the impact and likelihood score given by the grantor.

Moreover, the risk analysis of all projects reviewed airport concessions²⁴ concluded that the risks assumed by the Nation (regulatory and uninsurable force majeure) are not subject to payment through the

²⁴ Sixteen airports have been evaluated. Airport José María Córdova in Rionegro, Olaya Herrera in Medellín], Los Garzones in Montería, El Caraño in Quibdó, el Antonio Roldán Betancourt in Carepa and Las Brujas in Corozal, all of which are regulated in one same contract. Similarly, the International Airport Gustavo Rojas Pinilla in San Andrés and el Embrujo de Providencia are regulated under one same contract. Finally, the contract of Aeropuerto Internacional El Dorado, Aeropuerto Internacional Rafael Nuñez de Cartagena and Aeropuertos de Nororienté was also evaluated: Bucaramanga, Barrancabermeja, Santa Marta, Riohacha, Cúcuta y Valledupar.

Contingency Fund, in accordance with the guidelines of risk management policy of the State contract, CONPES 3107, and 2001 and 3133 arrays delivered by the Aerocivil risks.

Within the electricity sector assessments of contingent obligations of the concessions of the non-interconnected areas of San Andrés, Vaupés and Amazonas were approved, in which the dealer is exclusively responsible for developing the activities of generation, distribution and marketing of energy in each one of the areas assigned. Thus, in the risk allocation of this project the risk of demand was transferred to the dealer in the case of San Andrés, and transferred to users, by increasing or decreasing the subsidies they receive in the case of Vaupés and Amazon; therefore established that contributions were not required for the Contingency Fund.

On a different issue, the following analyses were performed for the hotel industry on the territorial level: Islander Hotel in San Andres, Hoteles Sochagota Sochagota, Casona del Salitre, Tenza Hotel Tourist, Hotel and Cabins Tourist Soatá Kanwar in Boyacá, what which concluded that no contributions to the Contingency Fund were required, as the only risk borne by the grantors is uninsurable Force Majeure, meaning the possibility of terrorist attacks, sabotage, or changes in public policy, risk Contract Policy as the State cannot be addressed through the Contingency Fund.

Challenges

Taking into account the dynamic nature of the risks, it is vital to make a continuous updating of the valuation methodologies. In this article we present a challenge to study the correlation between the contingent liabilities as at the present valuation is performed by entity and by type of risk, the overall value is the sum of all entities and risks discussed. A more accurate result would be obtained by taking into account the possible correlations between the probability of occurrence of events giving rise to the different contingencies.

Moreover, and in order to obtain results closer into line with reality, an interagency effort is needed to create databases that gather historical performance of the risk variables generating different infrastructure contracts, held by state organisms.

Also, the possibility of broadening the spectrum analysis of contingent liabilities arising from state contracts is being evaluated, given that currently only those contingent liabilities generated by concession contracts and contracts which develop public - private partnership schemes, in projects of infrastructure sectors for transportation, energy, sanitation, water and communications. In this sense, it is necessary to include in the analysis, those contingent liabilities generated under any government contract and that could pose a high fiscal impact.

Finally, there is the need to issue a CONPES document, to direct the foreseeable risk policy and good government procurement practices for State contracting, to promote culture within the State to identify, assign and estimate contingent liabilities in contracting with public resources with a view towards transparency and fiscal responsibility.

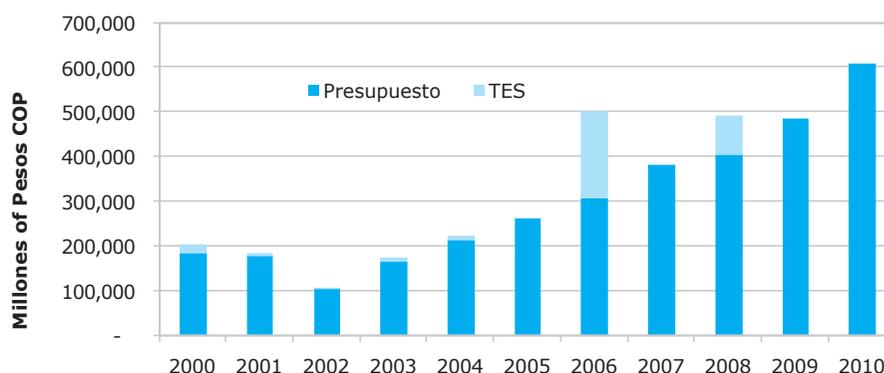
CONTINGENT LIABILITIES DUE TO JUDICIAL PROCEDURES AGAINST THE NATION

History

Since the late 90's the authorities began to identify various problems in the legal defense of the state and its impact on public finances. At the time, different factors that cause inefficiencies in the management of litigious activity were identified. Among them were: i) increasing the unlawful damage caused by the Colombian State to individuals and therefore an increase in the number of lawsuits against of the Nation, ii) the inefficient management of state litigation defense, iii) the greater responsibility of the State since the 1991 Constitution, as it has a larger structure that provides guarantees of fundamental rights, iv) organizational deficiencies defense offices, v) lack of uniform criteria to address litigation and vi) little use of alternative dispute resolution²⁵.

As shown in Figure 2, since 2000 there has been a growing trend in the payment of claims against the Nation. The resources to meet these obligations come from both the National Budget and the issue of TES²⁶.

FIGURE 2. ANNUAL PAYMENT FOR STATEMENTS AND RECONCILIATIONS



Constant Millions of pesos (COP) in December 2010.

Source: Deputy Directorate of Analysis and Budget Consolidation – DGPN and Deputy Directorate of Internal Financing - DGCPNT.

Calculations: Deputy Directorate of Risk – DGCPNT.

²⁵ CONPES 3250

²⁶ According to Article 29 of Law 446 of 1996, the MHCP will recognize as public debt court judgments and settlements when: Nation or one of the organs that are part of the General Budget of the Nation are forced to pay amounts of money and may be met by issuing bonds..

Given this fiscal impact, there was a need for a system that will consolidate information from all litigious state entities that would measure the problem, identify causes and implement corrective actions. In this regard, Law 790 was passed in 2002, which is implemented by an integrated information system, which aims to bring together litigious information of state entities that can be powered by the agents, through a web platform. This system, called LITIGOB, has evolved continuously. Today, thanks to a joint effort between the Ministry of Finance and the Ministry of Interior and Justice, the system is on phase II.

One year after the issuance of this law, Law 819 of 2003 comes into effect, defined as one of the generating sources of contingent liabilities, the potential fiscal impact of any judicial rulings against the Nation, which should compensate a third party.

Indeed, in 2004 began the assessment of processes dealt with at the higher courts - tribunals from the State Council and the Supreme Court, using the contingent valuation model in judgments and settlements of the District secretary of Finance, which seeks to determine the probability of conviction in each of the instances of the process for the subsequent calculation of the total probability of failure against each of the active judicial process.

Since then, the Deputy Directorate of Risk, has made significant efforts that allowed: firstly, the implementation since 2010 of a methodology for the valuation of contingent liabilities by activity litigation of the Nation;²⁷ and secondly, to support the structuring of a robust database and material that allow the estimation of the contingent liabilities arising from litigation activity of the different law enforcement agencies nationwide.

Methodology and assessment of contingent liability for litigation activity.

The lawsuits against state entities of central order have different jurisdictions ruled by the State Council and the main law courts of the Republic of Colombia. For effects of the analysis of contingent liabilities the following jurisdictions are taken into account:

The ordinary jurisdiction, ruled by the Supreme Court, which administers civil, labor and criminal. This jurisdiction falls to the ordinary courts. Thus within the classification used for modeling are: ordinary labor, labor executive, and other ordinary trade union.

Administrative Jurisdiction, where the maximum institution is the Council of State. This jurisdiction rests with the administrative judges. Within the classification of the model are the following processes: simple nullity, annulment and restoration of the right, direct reparation, electoral acts of appointments, administrative and other administrative contracts.

²⁷ This methodology may be consulted at the website of the Ministry of Finance.

The Constitutional jurisdiction which is governed by the Constitutional Court. Within the classification of the model are the processes: class action, class action, enforcement action and other constitutional requirements.

Alternative Mechanisms for Conflict Resolution, established in Law 446 of 1998. Within the model we find: conciliation, arbitration and amicable transaction.

And finally also include claims in international courts which issue opinions or judgments on contentious disputes. In the classification of the model we find: International Court of Human Rights (IACHR) and other international courts.

The methodology for assessing the current litigious quota is based on a probability tree that represents the dynamics of the processes undertaken in litigation against the nation. These processes begin when the entity is sued and developed according to the failure that occurs in each of the instances that must fill up the final decision either for or against the Nation. The main objective is to estimate the probability of failure against, for each of the processes where the state has fiscal responsibility in the payment of the sentence. Based on historical information of the processes in jurisdictions and similar actions, historical frequencies of the failures are calculated, and this gives the probability of failures against final procedures. Additionally, incorporating qualitative information on each of the processes, which provide proxies in the LITIGOB System.

For the assessment of risks in litigation activity against the nation, is of great importance the identification of the claims against (collection, standardization and consolidation of this information), to make an estimate of the probability of failure against and the final value of the contingencies. In a proper valuation, you can set policies to prevent and mitigate the fiscal impact that would have payments resulting from judgments against it.

The following table summarizes the main statistics of the contingent valuation of lawsuits against the nation, with cut to April 30, 2011²⁸. Importantly, the increase in the number of entities reported phase II LITIGOB information compared to that reported in the MFMP 2010. Based on statistics provided as follows, you can demonstrate a greater commitment of banks to report the active lawsuits against it, a greater degree of standardization of information within LITIGOB, and the fiscal problem facing the State.

²⁸ To calculate the quota of disputes, the information registered is used by ninety-one (91) entities that are part of the General Budget of the Nation, Single Information System Litigation - LITIGOB phase II, administered by the Ministry of Interior and Justice.

²⁹ The most important cases are: 1) Corporación Autónoma Regional del Tolima – CORTOLIMA, who last year reported eighty-nine (89) processes for COP\$54.08 billones of constant pesos to December 2010, and this year, after having corrected the mistakes, reported one-hundred fifty-four (154) processes for COP\$65,230 million pesos in December 2010; 2) the Ministry of Agriculture and Rural Development, reported eight-hundred fifty five processes for COP\$m 839.30 billions pesos, and for 2011 reported one thousand one hundred and twenty (1,120) processes with pretensions for COP\$839.30 billion constant pesos on December 2010 and 3) The Superintendence of Societies reported in the previous year COP\$8.96 billions out of 250 processes, and on its current term reported COP\$8.59 billions of constant pesos to December 2010 in two-hundred seventy nine (279) processes.

TABLE 8. STATISTICS FROM THE DATABASE

	2010	2011	Variation
Number of Entities	76	91	19.74%
Number of reported processes	72,318	146,508	102.59%
Valued Processes	60,195	143,528	138.44%
Relation of Valued / Reported	83.24%	97.97%	17.70%
Total Pretensions (COP\$ billion)*	1,033.86	981.71	-5.04%
Total Pretensions (USD\$ billion)	579.73	550.48	
Total Contingent (COP\$ billion)*	433.33	408.12	-5.82%
Total Contingent (USD\$ billion)	242.99	228.85	
Relation Pretension / Contingent	41.91%	41.57%	-0.81%

Using a official exchange rate (TRM) of 1,783.25 (COP/USD)
Source: Database support to the Unique System of Litigation Information.
Calculations: Deputy Directorate of Risk – DGCPNT.
*Values in COP\$ billions of constant pesos in December 2010.

To calculate the quota, a minute analysis of the database was carried out, and duplicate processes were found, given that the same process was reported by main agencies as well as by secondary ones. Typing errors were identified in the claims²⁹ of the proceedings of various entities, and included new processes for illegal money collection.

The contingent liability for verdicts and settlements is COP\$ 408.12 billion pesos as of December 2010 (USD\$ 227.01 billion), for the period 2011-2021, as shown in Table 9, showing a decrease of 5.82% compared to that reported in the Medium Term Fiscal Framework the previous year. Although the number of processes included in the computation considerably increased, the value of the claims does not behave in a similar manner due to errors found in the database within the deputation process described above.

TABLE 9. CONTINGENT VALUE PER SENTENCES AND CONCILIATIONS

Contingent liabilities	2010-2020 with INCORA*		2010-2020 without INCORA*		2010-2020 with INCORA*		2010-2020 without INCORA*	
	COP\$ Billions	% of GDP	COP\$ Billions	% of GDP	COP\$ Billions	% of GDP	COP\$ Billions	% of GDP
Verdicts and conciliations	433.33	79%	96.28	18%	408.12	71%	70.40	12%
	USD\$ Billions		USD\$ Billions		USD\$ Billions		USD\$ Billions	
	242.99		53.99		228.85		39.48	

Using a official exchange rate (TRM) of 1,783.25 (COP/USD)
* Process No. 2003 - 0230801 whose contingency represents 61.75% of the GDP
GDP Real base 2010 (Millions of pesos) \$546,951,000
*Values in COP\$ billions of constant pesos in December 2010.

Included in the calculation process No. 2003-02308, representing 82.75% of the quota (COP\$ 337.73 billion, USD\$ 189.38 billion), which is a proceeding brought against the Colombian Institute of Agrarian Reform (INCORA) in liquidation now by the Ministry of Agriculture and Rural Development. This process has a value of COP\$ 594.24 billion claim of constant 2003 pesos (USD\$ 333.22 billion), which indexed to December 2010 amounted to \$ 834.12 billion (USD\$ 467.73 billion).

The reason for this demand is compensation for the alleged inability of economic exploitation of 1,926 square kilometers, comprising the estate called "Land of Eastern Antioquia", on which was established for the Nation in 1964, the extinction of right domain. The claims are supported by a historical assessment of the full basement coalfields located in the municipality of Venecia, Antioquia. In addition to this, it is sued for damages due to late payments in the process.

According to the defense, the process was favorable ruling for the Nation in the first instance by the Administrative Tribunal of Antioquia, a decision appealed by the applicant. Currently, the process is in the State Council Administrative Litigation Section Room 3rd awaiting for sentence; in addition, the applicant has not provided evidence showing the ownership of large estates. The following entities are presented with the highest concentration of the quota.

TABLE 10. ENTITIES WITH A GREATER CONCENTRATION OF CONTINGENCIES

Entity	2010-2020 with INCORA*				2010-2020 without INCORA*			
	Pretensions		Contingent		Pretensions		Contingent	
	Billions	%	Billions	%	Billions	%	Billions	%
Ministry of Agriculture and Rural Development	839.30	85.49%	340.14	83.34%	5.19	3.51%	2.41	3.43%
Financing Superintendence of Colombia	46.23	4.71%	32.71	8.01%	46.23	31.32%	32.71	46.47%
Attorney General Office	15.24	1.55%	4.17	1.02%	15.24	10.32%	4.17	5.93%
Military Forces Pension Fund	6.97	0.71%	2.89	0.71%	6.97	4.72%	2.89	4.11%
National Police	7.01	0.71%	2.66	0.65%	7.01	4.75%	2.66	3.78%
Superintendence of Companies	5.08	0.52%	2.52	0.62%	5.08	3.44%	2.52	3.59%
Colombian Institute for Rural Development - INCODER	4.83	0.49%	2.48	0.61%	4.83	3.28%	2.48	3.53%
Ministry of Transportation	5.36	0.55%	2.31	0.57%	5.36	3.63%	2.31	3.28%
Ministry of National Defense	8.36	0.85%	2.22	0.54%	8.36	5.66%	2.22	3.15%

Entity	2011-2021 con INCORA*				2011-2021 sin INCORA*			
	Pretensions		Contingent		Pretensions		Contingent	
	Billions	%	Billions	%	Billions	%	Billions	%
Ministry of Communications	6.68	0.68%	2.14	0.52%	6.68	4.53%	2.14	3.04%
Superintendence of Public Residential Utilities	6.13	0.62%	1.81	0.44%	6.13	4.15%	1.81	2.57%
Higher Judicial Council	6.31	0.64%	1.66	0.41%	6.31	4.28%	1.66	2.36%
Ministry of Interior and Justice	2.54	0.26%	1.32	0.32%	2.54	1.72%	1.32	1.87%
Ministry of Finance and Public Credit	2.75	0.28%	1.06	0.26%	2.75	1.86%	1.06	1.51%
Ministry of Mining and Energy	1.99	0.20%	0.90	0.22%	1.99	1.35%	0.90	1.28%
Superintendence for Solidary Economy	1.96	0.20%	0.81	0.20%	1.96	1.33%	0.81	1.15%
Ministry of Environment, Housing, and Territorial Development	1.78	0.18%	0.81	0.20%	1.78	1.21%	0.81	1.15%
Comission for the Regulation of energy and gas - CREG	1.64	0.17%	0.79	0.19%	1.64	1.11%	0.79	1.13%
Institute for Social Security	1.40	0.14%	0.75	0.18%	1.40	0.95%	0.75	1.06%
Ministry of Social Protection	2.42	0.25%	0.71	0.17%	2.42	1.64%	0.71	1.01%
Subtotal (COP\$ billion)	973.98	99.21%	404.88	99.20%	139.87	94.77%	67.15	95.39%
Subtotal (USD\$ billion)	546.15	99.21%	227.03	99.20%	78.43	94.77%	37.65	95.39%
Total (COP\$ billion)	981.71	100%	408.12	100%	147.59	100%	70.40	100%
Total (USD\$ billion)	550.49	100%	228.85	100%	82.76	100%	3.48	100%

*Process No. 2003 – 02308 whose pretensions amount \$834.11 billions.
Calculations: Deputy Directorate Risk – DGCPNT.
Using a official exchange rate (TRM) of 1,783.25 (COP/USD)
*Values in COP\$ billion of constant pesos in December 2010.

Significant Processes

The high concentration of contingent entities is explained in turn by a small number of processes, which is an important tool to focus on legal defense policies of the state. Among the reported claims, be able to identify the following processes which account for 16.06% and 13.60% of the claims and the quota respectively (See Table 11):

TABLE 11. TEN MOST SIGNIFICANT PROCESSES

No. of the Process	Entity	Pretensions	%	Contingent	%
2008-00252	Colombian Institute for Rural Development - INCODER	4.46	3.02%	2.28	3.39%
2007-00726	Superintendence of Public Residential Utilities	5.61	3.80%	1.56	2.32%
2007-00726	Ministry of Communications	5.05	3.42%	1.48	2.20%
2006-02065	Ministry of Agriculture and Rural Development	1.77	1.20%	0.94	1.40%
2006-02065	Ministry of Transportation	1.51	1.02%	0.61	0.91%
2006-00561	Ministry of Communications	1.36	0.92%	0.54	0.81%
2002-00358	Ministry of Finance and Public Credit	1.37	0.93%	0.53	0.79%
2007-00163	Ministry of Transportation	1.05	0.71%	0.43	0.63%
2003-00538	Commission for the Regulation of energy and gas - CREG	0.78	0.53%	0.40	0.59%
2008-00312	Ministry of Environment	0.75	0.51%	0.37	0.56%
Subtotal (COP\$ billion)		23.70	16.06%	9.13	13.60%
Subtotal (USD\$ billion)		13.29	16.06%	5.12	13.60%

Source: Database support to the Unique System of Litigation Information.

Calculations: Deputy Directorate of Risk – DGCPTN.

Using a official exchange rate (TRM) of 1,783.25 (COP/USD)

*Values in COP\$ billions of constant pesos in December 2010.

* Excluding process No. 2003 – 02308 against INCORA

- i) The application No. 2008-00252 filed against the Colombian Institute for Rural Development - INCODER for awarding land and claims with a value of COP\$ 4.46 billion (USD\$ 2.51 billion). This process is in first instance at the Administrative Tribunal of Norte de Santander, expecting sentence.
- ii) Case No. 2006-02065, against the Ministry of Agriculture for COP\$ 1.77 billion (USD\$ 0.99 billion) and the Ministry of Transportation for COP\$ 1.51 billion to date (USD\$ 0.85 billion). This process was filed for the wrongful damage caused to the plaintiff by the acts, events and omissions in the area of the eastern plains. This process is currently under appeal and was favorable to the State in 2010.

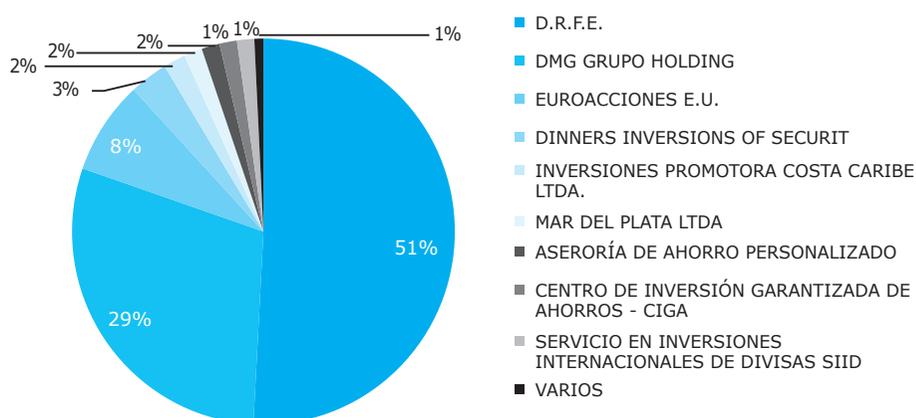
- iii) Lawsuit No. 2007-00163 against the Ministry of Transportation for COP\$ 1.05 billion (USD\$ 0.59). The process was ruled preliminarily as favorable to the interests defended by the State in 2010. It is currently at the Administrative Court of Tolima.
- iv) Lawsuit No. 2007-00726 against the Superintendent of Public Services, for COP\$ 5.61 billion (USD\$ 3.14 billion) against the Ministry of Information Technologies and Communications by COP\$ 5.05 billion (USD\$ 2.83 billion). This lawsuit was filed under the facts of omission to the duty of surveillance and control related to the application of the modified Karlsson basic public telephony. In 2009, the state obtained a favorable verdict in the ruling by the 30th Administrative Court from Bogotá;
- v) Lawsuit No. 2006-00561 against the Ministry of Information Technologies and Communications, for a group action of collective interest, worth COP\$ 1.36 billion (USD\$ 0.76). To date, the process is at the Agreement Covenant Committee.
- vi) Lawsuit No. 2002-00358 against the Ministry of Finance and Public Credit for nullity on the act of distribution liquidation of the fiscal years 2000 and 2003. The claims in this lawsuit totaled COP\$ 1.37 billion (USD\$ 0.77 billion) and the process is at first instance at the Administrative Tribunal of Cundinamarca, 1st Section;
- vii) Lawsuit No. 2003-00538 instituted against the Energy and Gas Regulatory Commission - CREG for revocation and restoration of the right of resolution No. 082 of 2002 filed by the Electro Costa Group. The claims in this lawsuit are of COP\$ 0.78 billion to date (USD\$ 0.44 billion).
- viii) Lawsuit No. 2008-00312, filed by the American Port Company Society against the Ministry of Environment, Housing and Territorial Development, requesting the annulment and restoration of the right of the July 1286 resolutions 2006 and 433 in March 2008, which imposed a sanction for breach of the environmental license for the operation of the coal port in Santa Marta. The claims totaled COP\$ 0.75 billion (USD\$ 0.42 billion).

Cases of Illegal Collection

Equally important are the high claims against the Finance Superintendence of Colombia, explained by two hundred fifty-eight claims brought by illegal collection cases³⁰. The claims of these processes amount to COP\$ 45.08 billion (USD\$ 25.27 billion), 97.52% of the claims of the entity (COP\$ 46.23 billion, USD\$ 25.92 billion) and 30.55% of the claims of the nation, excluding INCORA process. Figure 3 presents the share of each of the collectors of the total of the claims of the proceedings brought by illegal acquisition of resources.

³⁰ The database of these judicial processes was provided by the Financial Superintendence of Colombia..

FIGURE 3. PARTICIPATION OF COLLECTORS WITHIN THE CLAIMS OF ILLEGAL



Source: Financing Superintendence of Colombia
Calculations: Deputy Directorate of Risk – DGCPNTN.

The illegal collection processes are driven by an inter-institutional work team which includes: the Financial Superintendence, the Ministry of Finance and Public Credit, the Information and Financial Analysis Unit, and the Superintendent of Financial Companies. According to the defense, none of these processes has failed, despite the creation of expedite courts, which arose because the majority of judges have been declared unable. Additionally, these processes have a high procedural risk, related to the lack of jurisprudential level, which can lead to similar processes brought in various courts getting totally contradictory rulings.

Following is the distribution of the processes by Jurisdiction and the participation of each within the claims and contingent liabilities.

TABLE 12. PROCESSES OF ILLEGAL COLLECTION BY JURISDICTION

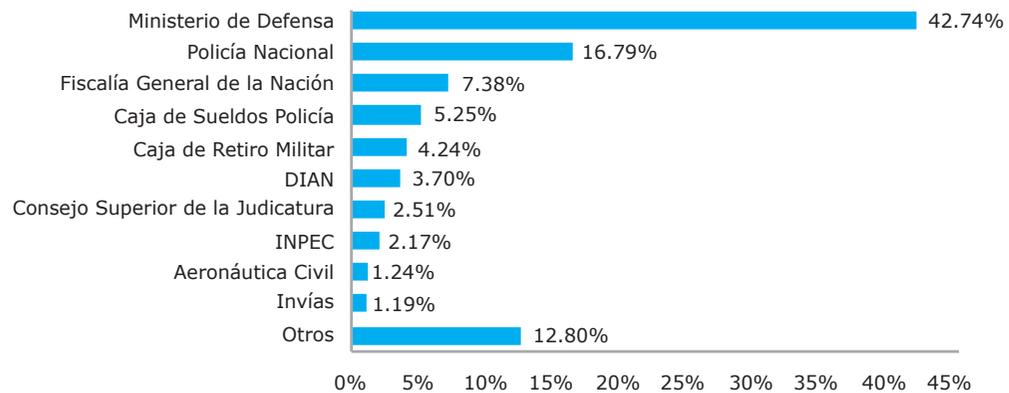
Jurisdiction – Action	Processes	Pretensions	Contingent
ADMINISTRATIVE	59.69%	0.14%	0.12%
Simple Nullity	0.39%	0.00%	0.00%
Nullity and Reestablishment of the Law	1.16%	0.04%	0.04%
Direct Reparation	58.14%	0.09%	0.08%
CONSTITUTIONAL	40.31%	99.86%	99.88%
Group Action	38.37%	99.85%	99.86%
Popular Action	1.94%	0.01%	0.01%
GENERAL TOTAL	100.00%	100.00%	100.00%

Source: Financing Superintendence of Colombia
Calculations: Deputy Directorate of Risk - MHCP

In addition to the lawsuits filed to date, approximately nine hundred seventy (970) are in the process of pre-judiciary conciliation, which can bring a potential increase in this contingent liability.

Based on statistics obtained from monitoring payments made by the state due to trials and settlements and the evolution of the quota, you can show that both payments and contingencies have a high concentration in a few entities. Thus, in the term of 2010, the defense sector accounts for 69.02% of the payments made. As can be seen in the chart below, 87% of the payment made will be concentrated in just ten (10) entities.

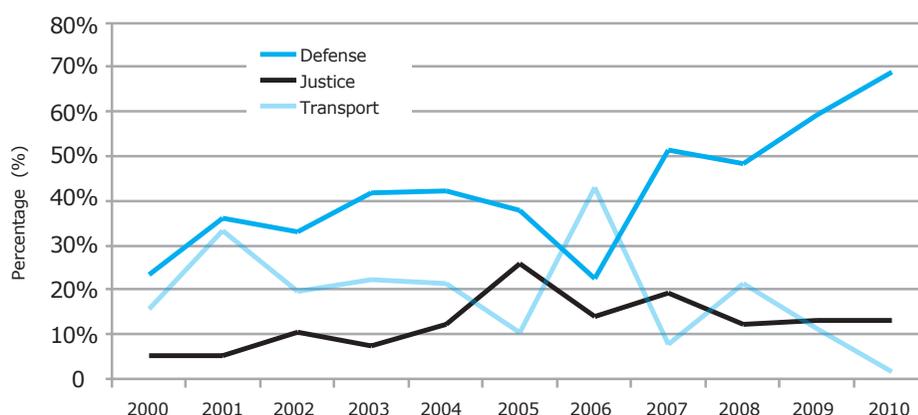
FIGURE 4. CONCENTRATION OF PAYMENTS EFFECTED DUE TO COURT PROCEEDINGS IN 2010.



Source: Deputy Directorate of of Budget Analysis and Consolidation – DGPN.
 Calculations: Deputy Directorate of Risk - MHCP

Similarly, the figures reflect the growth of the participation of the defense sector in the total payments due to trials and settlements, contrary to what was registered by the Transportation Sector (National Roads Institute, National Institute of Concessions, Ministry of Transport and Railways) which present a decline in the share of the total paid.

FIGURE 5. HISTORICAL PARTICIPATION BY SECTORS



Source: Deputy Directorate of Budget Analysis and Consolidation - DGPN and Deputy Directorate of Internal Financing - DGCPTN.
Calculations: Deputy Directorate of Risk - DGCPTN.

Faced with the figures reported in Latin America, it may be observed in the table below that the stock of claims against the state varies widely from country to country, being the most significant case that of Peru, where an estimated 42,000 claims enter the judicial system annually, versus 16,000³¹ processes which reach a final decision.

TABLE 13. JUDICIARY PROCESSES IN LATIN AMERICAN COUNTRIES

Country	No. of lawsuits	Pretensions (USD millions)	% of GDP	Contingent liabilities (USD millions)	% of GDP	Favorability rate
Brazil ¹	-	-	-	20,253	5.4%	-
Chile ²	26,675	10,691	5.28%	8,094	4.0%	95%
Colombia ³	146,508	550,558	171.03%	228,882	71.1%	-
Colombia* ³	146,507	82,772	25.79%	39,480	12.3%	-
Ecuador ⁴	86,000	-	-	-	-	69%
Peru ⁵	320,000	-	-	620	1.4%	81%

* Excluding process No. 2003 – 02308 against INCORA

1 Estimated non official Credit Suisse, UBS Warburg and Citibank, 2001 data. <http://www.eclac.org/de/noticias/paginas/0/9200/2rozenwurcel.pdf>

2 Contingent Liabilities Report 2010, Budget Department, Ministry of Finance.

3 Medium Term Fiscal Framework 2011-2021, Ministry of Finance and Public Credit.

4 Accountability Attorney General, September 2010. <http://www.pge.gob.ec/index.php/es/rendicion-de-cuentas.html>

5 The Trade (Press) 2006 data. <http://elcomercio.pe/edicionimpresa/html/2007-10-07/imeclima0795272.html> and "Report on Debt Obligations and Contingencies of State," 2001 data.

³¹ "High number of trials to the State is caused by a law which forces it not to conciliate", El Comercio. <http://elcomercio.pe/edicionimpresa/html/2007-10-07/imeclima0795272.html>

Currently, Colombia began a process of strengthening the legal defense of the state, for which it is structuring the creation of an entity dedicated to legal defense, which will contribute to its efficiency and effectiveness, through the centralization of lawsuits and specialization of the professionals in charge of the processes.

Challenges

Considering the dynamics of the processes against the state, monitoring processes for the continuous improvement of the methodology, the rules for court efficacy, the sentences of Jurisprudential unification issued by the Council of State, among others, it is necessary to have a consolidated database of claims against the State in the short term.

On the other hand, improvements can be implemented to the valuation methodology, incorporating possible correlations between the different processes against the state, considering that from sentences in similar processes may give way to same or similar verdicts.

Also, it is necessary to create policies, guidelines and valuation methodologies for reconciliations. Currently, most of the lawsuits filed against the nation where there is a legal dispute that could be negotiated, should go to conciliation court through alternative mechanisms for conflict resolution that established by law.

Finally, in order to avoid fiscal volatility, the technical evaluation is necessary for use of the Contingency Fund for State Agencies as a means of mitigating contingent liabilities arising from litigation activity. In order to prevent that the Fund may become the prey of legal wrangling after regulation, the Code of Administrative Procedure determined that the Contingency Fund resources be unattachable property.

CONTINGENT LIABILITIES BY PUBLIC CREDIT OPERATIONS

Since 1993, the 2681 Act empowered the nation to provide guarantees to state agencies, requiring, for granting such a favorable opinion of the National Council Economic and Social Policy (CONPES), the concept of the Inter-parliamentary Commission on Public Credit (CICP) and the formation of counter by the entity benefiting from the support of the Nation, among other formalities.

At present, there is a significant number of credit transactions held by different state entities, in which the nation acts as guarantor, and as such is in constant fiscal risk before the event that debtors may not comply with the payments.

Therefore, from a legal standpoint, there are certain guidelines and restrictions for the state to grant guarantee of credit operations entered into by state agencies. On one side are the provisions established in the Decree aforementioned which may be summarized as follows:

- In no case may the state guarantee internal payment obligations by the territorial and decentralized, agencies, nor payment obligations of individuals.
- Titles cannot be assured by the state.
- The state cannot guarantee the payment obligations of state agencies that are not in good standing in their commitments to it, nor can it extend its warranty to contract operations already contracted, if they originally were hired without warranty from the state.

While this Decree provides that (...) "In no case may the state guarantee internal payment obligations by the territorial and decentralized agencies", temporarily, Law 617 of 2000, wishing to execute actions to strengthen decentralization and rationalization of public expenditure by local authorities, in articles 62 ° and 63 ° authorized the state to provide assurance to those agencies for the collection of new credits destined to fiscal adjustment and restructuring of the existing debt to December 31, 1999, thus:

- Warranty of up to 100% to those credit operations whose resources are devoted to fiscal adjustment.
- Guarantee of up to 40% for those credit operations destined to the debt that was current on December 31, 1999 and which was restructured.

And -on the other hand-, the Government has a legally authorized quota which, previous relevant formalities, the state may use. Currently there is a licensed capacity by Act 533 of 1999, amounting to USD\$ 4,500 million, with a balance of USD\$ 2,614 million to be used, to April 2011.

The quota authorized by law to the National Government to provide guarantees to entities which may legally benefit from it, has experienced several increases as it decreases. In this process the legal authorization of the quota and its use thereof, are subject to the requirements of the institutions and analysis of the policies, risk and suitability of the project to be financed, which the Government submits to consideration by the inter-parliamentary Commission of public credit for its concept. This quota is affected by the approval of the minutes of the loan contract by the Ministry of Finance and Public Credit; however, it can recover from the non-use cancellations and refunds to borrowers engaged in conduct of operations guaranteed.

Under this scenario, the MHCP Deputy Directorate of Risk attempts to measure the credit risk exposure of public finances, which originated in a common practice in some countries of Latin America by which the central government acts as guarantor of credit agreements between lending institutions and organizations at the national and subnational levels. In general, the guarantee provided takes the form of liquid collateral in credit agreements with national or international banks.

Entities that have credit operations secured by the nation, are located in different rating scales, which involve different levels of risk for the nation as a guarantor and different magnitudes in the quota that each of them means for government finances.

As hedging mechanisms against the risk that the state is exposed to by granting its guarantee are the counter-guarantees and the payments which the agency under guarantee effects to the Contingency Fund of state agencies. Each of these mechanisms is described below:

Counter-guarantees

At the policy level, the General Directorate of Public Credit and National Treasury MHCP has established as a means of coverage, the counter-guarantee that the agency is in favor of the state, which should be: i) sufficient, ii) unsure liquidity, and iii) easily attainable. Sufficiency is verified by the existence of a counter-guarantee which must be at least 120% of the semester service of the debt. To ensure liquidity and easy performance, the Ministry of Finance has signed with the entity concerned a contract of indemnity in which among other things, the entity agrees to pledge a revenue stream and manage it in a mechanism that will assure General Directorate of Public Credit and National Treasury to make effective if necessary. This mechanism may be account management or a fiduciary account.

In any case, "the state cannot sign the document which gives its guarantee to a loan, until the counter-guarantees have been established in its favor." (Paragraph, art. 24º, Decree 2681 of 1993.

Payments to the Contingency Fund of State Agencies

Another mechanism to hedge against these contingent liabilities are the payments which the entities guaranteed by the state must make to the State Contingency Fund. In 2005, the General Directorate of Public Credit and National Treasury MHCP, issued Decree 3800, regulated by Laws 448 of 1998 and 819 of 2003, forces all beneficiaries of the guarantee to contribute to the Contingency Fund.

Whenever an entity enters into a credit agreement secured by the state, it is also committed to design and follow a plan of contributions which is considered by the General Directorate of Public Credit and National Treasury. Two key variables are taken into consideration for the estimation of the conversion plan: the maximum amount in annual exposure and a value on basic points to apply. Resolution 2818 of 2005 by the aforementioned entity defines the methodology of calculation of these points and how to estimate the contribution plan, which is directly associated with the risk of each entity guaranteed.

Given the crucial interest portrayed by the topic for an adequate performance of the Treasury, it was vital to continue working on its control and treatment. Thus, in the country people have been working on the development of an appropriate scheme in order to minimize the problems associated with events which are hard to monitor and verify, which generally relate to environments where there is asymmetrical information.

It should not be ignored that upon replacing expenses for contingent liabilities, fiscal deficit would be reduced fiscal deficit artificially. By way of example, mention can be made of two cases: replacing public investment in infrastructure for private investment, the latter being stimulated with the grant of guarantees of income which may involve increased spending if they do come be effective in the future. A similar situation occurs when the government instead of transferring resources to public entities guarantees their debt, as indeed has happened in cases like the Medellín Metro, Carbocol, and recently with local authorities through the enactment of Act 617 of 2000.

In such cases, if the contingent liabilities are not properly valued and recognized, they may endanger the expected benefits of substituting expenditure for contingent liabilities and consequently would be contrary to the principles of accountability and fiscal transparency.

Methodology and assessment of contingent liability for public credit operations

The current regulations allow us to understand and contextualize the fiscal risks to which the state is exposed when acting as a guarantor of public credit operations. In this sense, it is important to evaluate the current exposure amount in credit operations both internal and external public meetings, with the backing of the Nation, which explicitly imply a probability of default by the debtor.

In general, the risk faced by a creditor and a guarantor arises from two sources: the possibility of default by the debtor or credit risk and market risk, whose origins lie in macroeconomic factors that affect the behavior of the debtor. Each of these sources has different risk factors, but it is important to note that the credit risk is not independent of systemic or market risk on the contrary, especially in Colombia, has been observed that the overall level of the economy affects credit behavior of the sub-national authorities significantly, so a model that takes these peculiarities into account is needed.

Given the need to estimate the contingent to which the state is exposed by granting guarantees to entities which have contracted with the multilateral bank loans and foreign trade, after the issuance of Law 448 of 1998, began a process of technical development in which the General Directorate of Public Credit, with the assistance of external consultants, developed an estimation model that was used for contingent valuations reported in the Medium Term Fiscal Framework, from 2003 until 2009.

In 2010, the MHCP Deputy Directorate of Risk, developed its own model for estimating contingent public debt operations, a model that was used for evaluation of the past two Medium Term Fiscal Frameworks.

Methodological guidelines for the valuation of contingent liabilities in public credit transactions are based on the fundamental criterion for the estimation of default by the debtor with respect to compliance in the debt service, thus, a central element credit rating is the beneficiary of the guarantee of the nation. The theoretical framework underlying the assessment of expected losses is the estimated solvency probability curve (CPS), a tool that allows us to know the probability of each entity to default and the medium-term estimate using transition matrices.

The valuation in 2011 of the contingent liabilities of the Nation guarantees generated by operations of public credit, was performed for 43 entities, 21 decentralized entities at the national and territorial local authorities and 22 central level (Departments, Municipalities and Districts). The total of guaranteed public credit operations is 162, a number which represents an amount in exposure³² of COP\$ 4.13 billion (USD\$ 2.26 billion).

³² Exposure is the possible value of public credit operations in a future moment. It is calculated through the valuation of the standing balance of credit and the result is a distribution of possible values of exposure.

**TABLE 14. CONTINGENT LIABILITIES
BY PUBLIC CREDIT OPERATIONS**

Contingent liabilities	2010 - 2020		2011 - 2021	
	COP\$ billion	% of GDP	COP\$ billion	% of GDP
Operations of Public Credit	5.28	0.92%	4.13	0.72%
	USD\$ billion		USD\$ billion	
	2.96		2.32	

Using a official exchange rate (TRM) of 1,783.25 (COP/USD)

Source: Deputy Directorate of Risk – DGCPTN.

*Values in COP\$ billion of constant pesos in December 2010.

This figure compared to the amount stated in 2010 (COP\$ 5.28 billion, USD\$ 2.96 billions), reflecting a decrease of 21.7%, which is due to three reasons: i) the completion of 7 credits guaranteed³³; ii) a decrease of 73.8% of the amount in CCC-rated exposure (triple C) and ii) the amortization of existing operations have been carried debtor banks. The weighted average of the guaranteed portfolio for the nation in each year, according to the classification of the entities guaranteed shown in the table below.

**TABLE 15. AMOUNT IN EXPOSURE DUE TO
PUBLIC CREDIT OPERATIONS**

Year	Exposition
2011	4.136.316
2012	5.020.648
2013	5.104.880
2014	5.609.106
2015	5.734.191
2016	5.374.575
2017	4.981.042
2018	4.535.745
2019	4.093.291
2020	3.687.916
2021	3.309.084

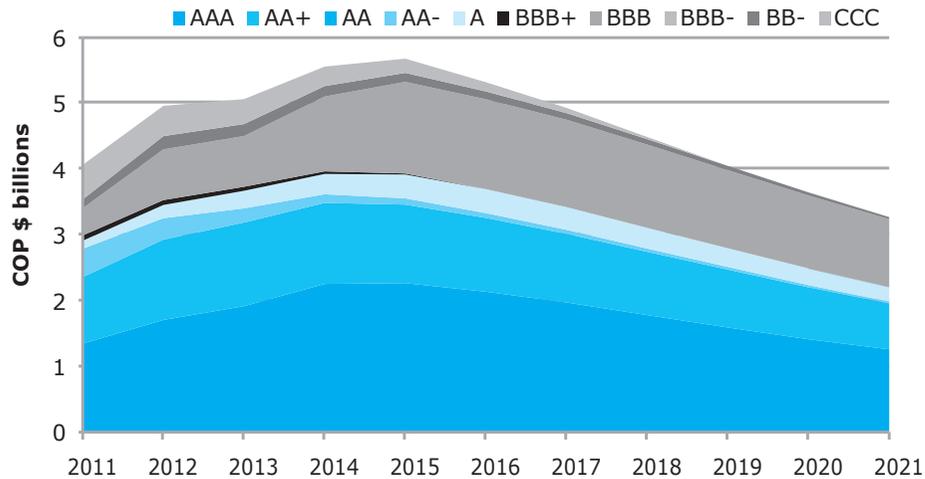
Data in millions of Pesos (COP)

Source: Deputy Directorate of Risk – DGCPTN.

To assess the contingent liability exposure in addition to the amount exposed, the probabilities of default for each of the entities guaranteed is estimated based on their risk ratings. The following shows the amount of secured credit exposure classified according to their credit rating.

³³ Two (2) credits of the Empresa de Acueducto y Alcantarillado de Bogotá, dos (2) credits of Interconexión Eléctrica S.A, two (2) from Centrales Eléctricas del Cauca and one (1) credit by Empresas Públicas de Medellín.

FIGURE 6. AMOUNT IN EXPOSURE ACCORDING TO THE CREDIT RATING.



Source: Deputy Directorate of Risk – DGCPNTN.

More than half of the amount guaranteed of loan exposure (56.9%) is associated to entities classified as AAA (triple A) and AA (double A). It is important to highlight that compared to what was reported in 2010, there is a decrease of 73.8% in the exposure amount associated to triple-C rated entities, which have an exposure value of COP\$ 525,251 million (USD\$ 294,531 million). This greatly lessens the contingent liability because it reduces the probability of default showing the entities listed on that scale.

Finally and according to the amount in exposure and the probability of default of the various entities guaranteed, you obtain the value of the quota for the period 2011-2021 amounting to COP\$ 1.22 billion (USD\$ 0.68 billion), 23% less than reported in 2010, for the reasons already stated.

Challenges

According to the dynamics of the assurances given to public credit operations it is necessary to integrate within the System of Public Debt by the General Directorate of Public Credit and National Treasury, a module that allows access to any information of guarantees and counter-guarantees by entity, so that it complements the update method considered by Deputy Directorate of Risk.

This update of the assessment methodology and analysis of the counter-guarantees, driven by the need to incorporate new information, such as the annual update on the value of the guarantee granted and the correlation of collateral and / or indemnity from credit operations, allowing knowledge to greater detail the actual ability to pay of the entity and the improvement in the calculation of payment of contributions to the nation should be performed at the State Contingency Fund.

CONTINGENT LIABILITIES ARISING FROM NATURAL DISASTERS

In Colombia, great importance has been given to the identification, assessment, management and control of contingent risks within the principles of fiscal discipline and to the sustainability of debt and fiscal risk reduction. Thus, after the earthquake of magnitude 5.5 on the Richter scale of March 31, 1983, which affected the city of Popayán, leaving a toll of 12% of homes destroyed and 34% of all homes with structural damage and economic cost of approximately USD\$200 million, the Colombian government realized the importance of implementing a risk-management system for natural disasters. From this tragic event, the application of earthquake-resistance standards in all buildings in Colombia came as a strategy for risk management for natural disaster risks. Based on the economic and social effects that this tragedy had, management of natural disaster risks began through the creation of the National Calamity Fund through Decree 1547 of 1984.

Then, from the disaster of the flood caused by the volcanic activity of Volcano - Nevado del Ruiz on November 13, 1985, which caused 25,000 victims and economic loss of about USD\$ 211.8 million dollars, it was deemed as a priority of the country to have a system to coordinate actions aimed at the prevention and management of natural disasters. As a result, the System for Disaster Prevention and Attention (SNPAD) was created, additionally implemented to the Land Management Plans (POT), Sector Development Plan (PDS) as a risk-mitigation strategy by Decree 919 of 1989.

Likewise, the National Plan for Prevention and Attention of Disasters - PMPAD was adopted by Decree 93 of 1998, under a comprehensive risk management, defining four strategies: 1) Risk identification and monitoring, 2) Risk reduction and 3) Institutional strengthening and 4) Socialization of disaster prevention and care.

Three years later, the 3146 CONPES document of December 20, 2001, "Strategy to strengthen the enforcement of the National plan for prevention and disaster-PNPAD - in the short and medium term", presents a set of priority actions to improve the development of the four lines of PNPAD program. That same year, through Law 715 Article 76.9, organic rules are dictated regarding available resources for prevention and attention of disasters. Municipalities, co-funded by the Nation and the Department, may: prevent and act on disasters within their jurisdiction, adapt urban and rural areas in high risk areas and relocate their settlements.

In parallel, thanks to international commitments on the management of contingent liabilities by natural disasters (vulnerability reduction) in the development of risk transfer schemes, MHCP together with DNP, Banco de la República, Superintendency of Banks, La Previsora Trust SA, and the Directorate General for Disasters Prevention and Attention (DGPAD), advanced a study of risk transfer including underwriting guidelines to promote mass of public and private disaster and catastrophe bond issue (Cat Bonds). From the CONPES document 3146 of 2001 the first steps were taken to identify this type of risk, supplemented by studies of fiscal responsibility of the Nation, as part of the strategy to strengthen implementation of the National Plan for Prevention and Care Disasters - PNPAD - in the short and medium term.

In September 2002, the Center for Disaster and Risk (CEDERI) of the Universidad de los Andes, performed a study entitled "Retention and Transfer of Seismic Risk in Colombia - Preliminary assessment of a possible financial strategy and market potential" with resources from the World Bank and the National Planning Department (DNP). The work approaches the problem of financial protection required by the government in case of earthquake disasters, such as a complementary policy to the state's actions in relation to the traditional approach to risk management and disaster prevention. Furthermore, it is concluded that in Colombia disaster losses not being considered properly, and that as a result of the experience of previous events, it is worrisome that there be no clear strategies for dealing with such losses. It is necessary to count with careful studies from the economic point of view and therefore specialists in vulnerability and risks to budget and planning studies must be linked.

A year later and within the framework of Japanese Grant No. TF 052529 and inter-administrative agreement Donation Subsidiary 065 signed by the Colombian Cooperation Agency (ACCI) and the National Planning Department (DNP), the preparation of the program to Reduce state vulnerability to natural disasters is coordinated with resources granted by the Japanese Government (PHRD) and the World Bank's technical assistance. This initiative is part of national government policies on prevention and mitigation of natural hazards reflected in the program for prevention and mitigation of natural disasters of the "National Development Plan 2002 - 2006 Towards a Community State."

In October 2004, the report "Study on disasters in Colombia: is delivered. Loss Estimation and quantification of costs, ex post state liabilities: the case of Colombia and other international models." The study concludes that the national legal system was designed for disaster response and not to the ex ante risk management, therefore they propose to modernize the SNPAD³⁴, the proposed changes were of a paradigmatic and non-organic nature. These changes were aimed at increasing the notions of risk and its management to the rank of cardinal principles of the system, replacing those of disaster and calamity. This shift in

³⁴ National System for Prevention and Attention of Disasters.

emphasis does not mean that the system deviates from the original target consisting on the prevention, mitigation and cope with disasters and public calamities as far as possible.

Also, it proposes the creation of a new National Risk Management, which incorporates the principles of decentralization and autonomy enshrined in the Constitution of 1991. It also proposes the creation of two independent systems, a National Plan for Risk Management and National Emergency Plan. It is also proposed that disasters should be handled as matters of public policy, i.e., the ordinary means available to the authorities.

Subsequently, the CONPES document 3318 of 2004 was issued, which stated that during the period between 1970 and 2000, more than fifteen million people were affected in Colombia by natural disasters and damages of nearly USD\$ 4,576 million were caused, of which 49% correspond to events of low and medium intensity (see table below).

TABLE 16. EFFECTS CORRESPONDING TO LOW AND MEDIUM INTENSITY EVENTS.

Classification of the Intensity	Disaster	Deaths	Destroyed (D) or affected (A) dwellings	Persons affected	Damages*
Great intensity events	Tsunami on the coast of Nariño (1979)	672	3,081(D)	1,011	17
			2,119(A)		
	Earthquake at Popayán (1983)	300	2,470(D)	20,000	378
			11,722(A)		
	Eruption of Volcán del Ruiz and mudslide at Armero (1985)	Between 23.500 and 28.000	4,700(D)	200,000	246
			5,150(A)		
	Earthquake and avalanche in Cauca - Río Páez (1994)	1,100	Not available	8,000	150
Earthquake at the Coffee Region (1999)	1,186	35,949(D)	166,336	1,558	
		43,422(A)			
Subtotal	28,258	89,337(D) 62,143(A)	395,347	2,349	
Events of low and medium intensity	Accumulation of slides, floods and other phenomena (1970 - 2000)	9,954	89,337(D)	14.8 millones	2,227
			185,365(A)		
Total	Great and minor events	38,212	135,537(D) 247,777 (A)	15,195.347	4,576

* Amounts in millions of American Dollars (USD)

Additionally, the CONPES document gave guidelines for the execution of the processing of an external credit with multilateral banks for the amount of USD\$ 260 million to partially finance the Adjustable Program for Vulnerability Reduction with an implementation period of 10 years from fiscal year 2005, to finance the different targets proposed in the framework of national policies and disaster prevention.

The plan for the Implementation of the Project for the Reduction of fiscal Vulnerability of the State facing Natural Disasters is divided into 5 basic components developed by different institutions³⁵:

TABLE 17. STRUCTURING OF THE PROJECT FOR THE REDUCTION OF FISCAL VULNERABILITY

Component	Currency	Amount
A. Risk identification and monitoring: DNP, IDEAM, INGEOMINAS.	US\$	5.60
B. Reduction of risk: MAVDT, MPOS AND DPTOS, ECOPETROL, INVIAS	US\$	103.10
C. Development of policies and institutional strengthening: DPAD, DNP, MAVDT	US\$	0.80
D. Information and sensitizing on risk management: MEN, MAVDT	US\$	0.20
E. Risk transference and retention: MHCP	US\$	150.30
E.1 Deployment of a risk coverage and transference strategy.	US\$	0.30
Subtotal	US\$	260.30
E.2 Mechanisms for quick disbursement.	US\$	150.00
Total	US\$	410.30

* Amounts in millions of American Dollars (USD)

The various actions contained in these components are designed to help reduce fiscal vulnerability in a particular state, and collectively generate additional contributions due to the interrelationship between them.

Thus, as the component E “risk transfer”, designated as the unit responsible before the Ministry of Finance and Public Credit for the design of public policies that the national government should put in place to encourage the development of insurance market natural disasters as a strategy for reducing fiscal vulnerability of the state.

E.1 The component will be developed through consultations whose implications are clearly identified elements:

- Develop a policy of hedging residual state.

³⁵ DNP: Departamento Nacional de Planeación. DPAD: Dirección para la Prevención y Atención de Desastres. DGPAD: Dirección General de Prevención y Atención de desastres. IDEAM: Instituto de Hidrológica, Meteorología y Estudios ambientales. INGEOMINAS: Instituto Colombiano de Geología y Minería. MAVDT:

- Ministries and Municipalities support the development of coverage policies.
- Develop a potential “pool” of reserves for reinsurance of catastrophic risks.

On March 30, 2005, the consulting firm Natural Risks Assessment (RNA) concluded, the study “Definition of the state’s responsibility, exposure to natural disasters and mechanism design to cover the residual risks” that the aggregate maximum loss can be around USD\$ 4,759 million for a return of 100-year event. In April 2005 the company RNS, delivered the consultancy report “Strategy for financial protection and risk reduction of public and private buildings of Manila.” The conclusion is that a collective insurance system proved to be a good idea, taking into account the experience of its operation during the past five years. In accordance to the evaluation., this instrument should be reviewed and adjusted based on new information.

Additionally, in order to determine the magnitude of fiscal exposure, the values exposed of public and private property were estimated, and the potential losses were identified which could occur in the country due to natural disasters. Similarly, various financing alternatives to transfer losses in agreement with the mechanisms available at the moment.

The following table presents the results of the values set for national public goods, departmental and municipal and private property specifying levels 1 and 2, the probable maximum loss (PML)³⁶ And the primes estimated with a 0% deductible³⁷, for different return periods-TR-(100, 500 and 1000 years).

TABLE 18. EXPOSURE AND POTENTIAL LOSS FOR COLOMBIA.

	Total Public	National Public	Department Public	Municipality Public	Socio-Economic ranking 1-2	Socio-Economic ranking 1-2 and National Public	Premium	Total
Expuesto	24,092	8,432	3,613	12,046	25,900	35,137	126,985	151,078
PML TR100	1,850	647	277	925	1,436	2,040	7,244	9,006
PML TR500	2,923	1,023	438	1,461	2,566	3,460	11,842	14,602
PML TR1000	3,384	1,184	507	1,692	2,967	4,022	13,822	17,003
PRIMA (%)	9.36	9.36	9.36	9.36	5.10	6.13	6.45	6.92
PRIMA	225	78	33	112	132	215	820	1,045

Numbers in Millions of Dollars US\$

³⁶ PML: The Probable Maximum Loss of a group of buildings is an estimator of maximum losses which would be reasonable to expect in such a portfolio during the occurrence of an extreme event. It is used to determine the size of the reserves which should be kept and is calculated as the average loss which would take place for a determined period of return, identifying the zone that generates the greatest losses concentrated in different regions of the country.

Using the methodology for estimating the Disaster Deficit Index, DDI, developed in the framework of risk indicators and management for the Americas of the IDB, the plan for Colombia as follows:³⁸

TABLE 19. INDEXES OF DEFICIT BY DISASTER, COLOMBIA 2003.

IDD ₁₀₀	IDD ₅₀₀	IDD _{1.000}	IDD _{1.500}
1.28	2.07	2.37	2.53

From the table above, we conclude that the current national government could not cover the cost of extreme disasters; i.e., it could not do the replacement of items for which it is responsible.

In Colombia, after reviewing the responsibilities assumed in past disasters, two responsibilities assigned to the state stand out: on the one hand, the case of the state's public buildings, i.e., buildings of national entities, which are clearly a responsibility of the National Government, and on the other buildings for strata 1 and 2 of the population, over which it is said that given the inability of local authorities to cover the losses of the poorest, who have not the ability to insure themselves, the Government would have to assume or take the risk, given the responsibility that is established from the legal and political standpoint.

As a major conclusion of the consultancy for Colombia, insurance, reinsurance and catastrophe bonds are the relevant mechanisms for risk transfer³⁹, and contingent claims and reserve funds to finance retained layers⁴⁰.

Moreover, in May 2005, a consultancy was performed by the Universidad de los Andes, at the Center for Disaster and Risk (CEDERI), with funds from the World Bank, International Cooperation Agency and National Planning Department, entitled "Preparation of the project to reduce vulnerability to natural disasters."

This consultancy is part of the study "Strategy for transfer, retention, and mitigation of seismic risk in indispensable buildings and buildings for community attention belonging to the Capital District." The objectives of the study were: to design an efficient strategy for retention and transfer of seismic risk of indispensable buildings and buildings for community attention "CIS" located in the Capital District. Simultaneously, a plan for mitigation of seismic risk associated with public buildings of the city was developed. The study recommends the reduction or mitigation of

³⁷ The priority or deductible is the amount up to which the insured retains the totality of the risk, that is, to what extent the insured will respond for the total losses.

³⁸ El IDD se entiende como la relación entre las pérdidas probables (con los períodos de retorno indicados), y la capacidad o los recursos propios o externos a los que podría acceder (su resiliencia económica).

³⁹ The transfer of risks involves the strategies for the transfer of of the risk of loss or responsibilities assumed to a third party.

⁴⁰ The distance between the amount deductible and the limit amount is known as layer. According to the size of the financial structure to be used, several internal levels can be used or layers of transference or risk retention.

physical risk through the intervention of vulnerability, since it is the most effective mitigation measure that exists. A carefully designed insurance program can stimulate mitigation measures, assigning a price to risk and creating financial incentives through discounts applicable to premium rates.

In September 2006, together with the IDB and ECLAC within the framework of the Information Risk Management, a consultant who diagnosed the state and institutional information on disaster risks was hired. This consultation indicated that: i) It is important to have a system of indicators to size the degree of resilience of communities at risk in order to define the scope of recovery and reconstruction processes taking into account the need to identify measures that go beyond physical recovery of property and housing; ii) The Colombian legal system is generous, for example, in granting aid for physical reconstruction, but not for the restoration and strengthening of the revenue stream from the affected community; iii) There should be a joint effort between the System for Disaster Prevention and Attention and the Ministry of Finance in order to determine the probable losses and the resources necessary to tackle the problem, as well as funding sources.

In this vein, there was a need to gauge the exposure of the nation facing a disaster, so in November 2007 a consultant was hired to produce maps and geo-referencing of state property who concluded that there are 5,530 properties to be evaluated, concentrated among 140 entities. Given the inventory of property of the state, visits to those properties to make appropriate assessments and establish the value at risk were scheduled.

Later in December 2007, the final report of the consultancy "Implementation of mechanisms to ensure the property owned by the nation that allow its financial protection against catastrophic risk" was delivered by the Natural Hazard Assessment (RNA) - consortium - Disaster and Risk Consultants. The study's main conclusion is that the best alternative for risk management for natural disasters is the assurance of public real estate portfolio through a single policy with an insurer or temporary union of insurers to ensure fire and catastrophic risk transfer for any type of natural disaster to reinsurers through an offshore captive of the National Government.

It was proposed that the implementation of a risk transfer strategy be done by stages: estimate the values of premiums per agency; perform a single negotiation of insurance for all of the state's buildings by signing a single insurance policy; perform the design process and incorporate an offshore captive. And bring out the whole process described above to determine the requirement for the insurer. Additionally, it concluded that the CAT bond issue does not appear to increase the financial efficiency due to the type size of the portfolio of properties. However, it is possible that with the passing of the years, this instrument can

ever be more competitive and feasible. The following table roughly summarizes the recommendations of the consultancy by ERN.

TABLE 20. RECOMMENDATIONS BY ERN CONSULTING

Recommendations by ERN Consulting	
Include probable disasters as contingent liabilities in the state's balance.	Fiscal Impact
Protection of public buildings of National Order	Law 42 of 1993 Ley 734 de 2002 Fiscal Impact
Protection of public buildings of territorial entities.	Strategy to promote Territorial Entities to assume responsibility. Performance of micro-zonification studies. Co-financing strategy - Fiscal Impact
Protection of buildings of lower-income strata	Cover losses without a financial strategy is not sustainable pay the premium to cover the segment is not feasible for the degree of vulnerability of buildings. Complementary role of the Government.

Swiss Re, represented in Colombia by Delima Marsh, conducted a study in August 2007 where it noted the importance of risk management in the public sector giving examples of the economic and social effects of earthquakes. The study concluded that the parametric "Triggers" allow to offer coverage to goods and parts of the population which were previously uninsurable and also to ensure transfer of risk from the public to the private sector. Finally, it sets out the steps to follow, among which it recommended the definition of priority areas for the Government, the adequacy of coverage areas to consider, selecting limits and "Triggers" by zone, type of solution and define the financial structure that best suits its needs, and last, to evaluate the possible participation of other non-governmental organizations.

Challenges

Designing a financial strategy to decrease the fiscal vulnerability of the nation upon the occurrence of natural disasters is one of the strategic themes of the Minister of Finance, in charge of the Directorate General of Public Credit and National Treasury today.

In this respect, the Deputy Directorate of Risk is working on designing a financial strategy that involves different instruments for withholding and transfer risk, so that the state can get the most coverage at minimum cost. In this respect, the management of these risks can be developed by defining the levels of loss, coverage and management capacity that may allow them to count with optimal funding sources and appropriate to high-impact events.

For this reason, a set of financial instruments such as the implementation of a fund, a new contingent credit, a program of collective insurance

against natural disasters for public buildings, and the design of safe public infrastructure is currently being evaluated. The first layer of natural disaster losses will be covered with instruments of restraint, the second layer shall cover transfer instruments such as insurance and reinsurance, and in the last layer financial instruments in the capital markets as bonds or weather derivatives should be developed.

To meet this objective, the challenge will be to consolidate information from different interdisciplinary groups that make up the National System for Disaster Prevention and Response, so that they can estimate the probable maximum losses upon the occurrence of a natural disaster.

CONTINGENCY FUND FOR STATE AGENCIES

In order to avoid large volatilities in the budget generated by contingent liabilities and their consequent impact on debt planning, the Contingency Fund for State Entities was established through Law 448 of 1998, as a special account with no juridical person administered by the Trust La Previsora S.A. The main purpose of the Fund is to meet the contingent liabilities of state agencies while providing a mechanism that prevents liquid payment of default interest at the time of meeting these obligations. Furthermore, the Contingency Fund provides an essential advantage over the previously existing budgetary provision, since as an extra-budgetary fund it allows for the aggregation or disaggregation of contributions within lifetimes, making it easier to track risks and their corresponding inter-temporal adjustment to their dynamic behavior.

The resources managed in the Contingency Fund⁴¹ correspond to the contributions made by state agencies, contributions from the national budget, the financial returns generated by these resources, and recovery product portfolio. The resources that fuel the Fund have been determined by the General Directorate of Credit and National Treasury, Ministry of Finance and Public Credit, through the approval of the various contribution plans, in accordance with the powers granted by Decree 423 of 2001 and 3800 of 2005.

These decrees, which partially regulate Law 448 of 1998 and 819 of 2003, state that the entities guaranteed by the Nation in public credit operations and entities that contract contingent liabilities in public-private participation contracts should make contributions to the Contingency Fund as a hedging mechanism.

Currently, the Contingency Fund for State Entities is not used as a mitigation mechanism of contingent liabilities due to litigation activity. Therefore, each entity must appropriate the necessary resources for the payment of trials and settlements in each period. These resources should be appropriated in the budget for debt service, in category of trials and settlements. By March 2011, the Contingency Fund had an available balance of COP\$ 260,281 million as of December 2010 (USD\$ 145,951 million), of which \$ 208.028 million (USD\$ 116.651 million), corresponded to the contributions due to highway infrastructure concessions and COP\$ 52.252 million (USD\$ 29.300) to the contributions by guarantees of public credit operations. See Table 21.

⁴¹ According to article 7 of decree 423 of 2001, these resources were invested exclusively in TES titles at the primary or secondary markets.

TABLE 21. ACCUMULATED BALANCE FOR THE CONTINGENCY FUND

Period	Contributions	
	Infrastructure	Guarantees
2007	50,905	11,797
2008	23,270	7,998
2009	24,645	12,897
2010	84,098	15,339
2011	25,112	4,222
Total (COP\$ million)	208,029	52,252
Total (USD\$ million)	116,651	29,300

Balance accumulated to March 2011
Constant Millions of pesos (COP) in December 2010
Source: Fiduciaria La Previsora S.A.

Furthermore, the General Directorate of Public Credit and National Treasury, Ministry of Finance and Public Credit in its monitoring, has been reviewing contribution plans, in order to suit them to reality in terms of any eventual obligations. Only in cases where contracts have been executed in full, or that the possibility of occurrence of the hazard covered has disappeared, can the contributions originally registered in the plan of contributions of each contract be transferred. For example, in the case of the concession contract Bogotá-Girardot there was a contract modification in which the licensee assumes the exchange and demand risks, therefore the resources that supported these risks must be released.

BIBLIOGRAPHY

- DNP (1.999) Archivos de Macroeconomía, El Balance del Sector Público y la Sostenibilidad Fiscal en Colombia.
- International Monetary Fund (2007), Code Of Good Practices On Fiscal Transparency
- International Monetary Fund (2007) ,Manual on fiscal transparency Fiscal affairs department 2007
- International Monetary Fund- Aliona Cebotari (2008) Contingent Liabilities: Issues and Practice
- CRT 200, El Sector De Las Telecomunicaciones en Colombia en La Década De Los 90.S C
- BID -Jaime Millán 2006, Entre el mercado y el Estado: Tres décadas de reformas en el sector eléctrico de América Latina
- International Monetary Fund- Aliona Cebotari, Jeffrey Davis, Lusine Lusinyan, Amine Mati, Paolo Mauro, Murray Petrie, and Ricardo Velloso (2008) , Fiscal Risks
- International Monetary Fund- Ricardo Velloso (2008) Good Practices in Fiscal Risks: Disclosure International Experience.
- Consultores ERN (2005): "Definición de la responsabilidad del Estado, su exposición ante desastres y diseño de mecanismos para la cobertura de los riesgos residuales del Estado"; Bogotá.
- Ministerio de Hacienda de Chile-Dirección de Presupuestos, Informe de Pasivos Contingentes 2007.
- Lienert, Ian, and Jung, Moo-Kyung, 2004, "The Legal Framework for Budget Systems, An International Comparison," OECD Journal on Budgeting, Special Issue, Vol. 4, No. 3.



Ministry of Finance and Public Credit
Republic of Colombia