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The Credit Crunch
Risks to the public sector

Alarm South East seminar

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PRICEWATERHOUSECOOPERS

This paper helps risk managers understand the threats posed by the credit crunch to the public sector.

The sector relies on the private sector to deliver services and projects, this paper focuses on these risks.

We are not considering the risk of reduced income from taxes and other sources.

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Risk managers need to consider risks from the credit crunch in a number of areas

- Suppliers
- Procurement
  - Existing contracts
  - New contracts
- Investments
- Insurance

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The paper looks at the risks in these areas and potential actions to mitigate these risks.

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Equipment and service suppliers are under threat

Reduced availability and increased cost of credit will:

- Increase costs and reduce working capital

Some suppliers will go out of business

In the short-term costs may fall due to “competitive tension”

- Public sector is seen as stable and an attractive customer
  - But suppliers will be “working their resources harder”, quality may fall

Longer term costs will increase as supplier market shrinks

Actions:

Revisit procurements – repeat PQQ financial checks before appointment

Exercise any rights to audit suppliers

Monitor stock exchange announcements and quarterly reports

Talk to suppliers: explore how you could help, including raising rates

Prepare contingency plans, including bringing services in house.

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All suppliers rely on credit to fund their businesses, for example most construction contracts specify payment for key stage completion. Very few contractors fund this from cash reserves.

Not only will credit be harder to obtain it will also be more expensive.

Clearly some suppliers will go bust

The public sector is a good client and lower prices will be available as suppliers compete to maintain or increase their share of the market.

But most suppliers will have cut resources and this may reduce quality and increase hiccups in delivery. But in the longer term costs will rise.

The checks you conducted early in a procurement may no longer be valid, we have one example where between preferred bidder and close an addional £700 million of debt had appeared on the supplier’s books.

Some financial checks used in the past, for example Dun & Bradstreet, are based on historical data and may not be up to date, alternatives to consider include:

-Review of management accounts

-Letters from banks

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Existing procurement contracts are vulnerable

Private sector funding is under threat:
- Some banks have already gone out of business
- Others may seek to withdraw from existing deals
- Restructuring of finance deals will be more difficult

Without security of funding
- Some contractors will fail
- Others will withdraw from contracts

Actions:

Understand supplier business model
- Look at cash and debt positions, don't rely on out-of-date ratings
- Check who holds guarantees and contract

Revisit financial checks regularly – the situation is changing continually
- PwC recently found a contractor with an additional £700m debt on their balance sheet

Prepare contingency plans

Be ready to renegotiate

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The threat is not limited to new contracts, banks may exercise options to withdraw, restructure or otherwise change the terms of funding. These changes will, in turn, impact service delivery.

And in some cases will lead to contractors going out of business.

It is important to understand how exposed suppliers are – Are they cash rich (unlikely) or over-exposed to debt?

As for new contracts keep up-to-date with current security and don't rely on rating agencies.

Often contractors set up special purpose vehicles for contracts, these are independent of the parent. You may have little or no recourse if an SPV goes out of business – contracts and guarantees may be worthless. Contracts and guarantees should include the parent.

If you find your supplier is getting into difficulties it may be in your best interest to renegotiate the terms (within the rules of procurement).

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Obtaining funding for new contracts will be much more difficult and more expensive

Deals are already stalling because funds are not available

- PPP deals have been particularly hit
- The cost of funding is destroying the economics
- Deals are taking longer to agree
  - As banks' appetite falls more banks are needed for each deal
  - Structuring deals has become more difficult

Actions:

Consider alternative financing models, for example:

- PFI/PPP alternative models: multiple partners for example
- Borrow against future income/tax streams

Seek options for reducing the risk to funders, for example:

- Restructure programmes into more smaller elements
- Increase public sector funding

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PFI/PPP contractors are finding that the number of funders needed to pull a package together is increasing significantly and, unsurprisingly, the cost of deals are rising sharply.

These also means it takes longer to put the deals together – you may need to be sympathetic to this in your timetable.

PFI/PPP are not the only procurement options, it is likely that banks will be more confident in public sector bodies than private sector. You might consider funding it yourself. Such arrangements will also make it easier for contractors to raise the debt funding for project stages.

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Investment funds are under immediate threat

Some banks have already gone out of business:

- A number of bodies have lost funds

Falls in share values have dramatically reduced the value of investments

- Investment income will fall significantly

Actions:

Review treasury management

Seek to spread risks wherever possible

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It seems that the risk from the Icelandic banks was generally reasonably well managed with very few having significant exposure. However, we must not be complacent and must regularly review treasury management policies: over reliance on out-of-date rating agency reports for example.

The value of investments have fallen, this reduces the resilience of your finances to any further financial shock – internal or external. Your credit rating may have fallen – making it even harder to secure PPP funding for example.

Spreading risk is achieved by spreading investments across sectors and investment funds. Generally your treasury department will be familiar with these techniques but in a very fluid market place it is important that they are regularly updating their view and, if necessary modifying their position.

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Insurance will be harder to find

Already seen AIG come close to collapse

- As a major UK public sector insurer this would have been a large reduction in market capacity
  - As a minimum this would drive prices up and make some risks uninsurable

Falls in the value of investments reduces the capacity of the insurance market

- Some risks will become harder to insure, for example: schools
- Some insurers may withdraw from the public sector market

Actions:

Review the ratings of your insurers

- Work with your brokers to understand the risks

Consider joining current initiatives to establish “mutual” insurers

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There are only a few major players in the public sector insurance market: Zurich Municipal, St Pauls-Travelers and AIG. Loss of any of these would have a major impact on the UK public sector insurance market.

Other insurers have been reluctant to enter the public sector market and have generally sought high rates when they do. The capacity of insurers is related to the value of their investments – as the investment markets have fallen so has insurance capacity. This makes it less likely that new insurers will enter the public sector market.

Some risks are less attractive than others, schools are a good example – they are prone to arson and damage. These are likely to become harder to insure.

The major insurance brokers (AON, Marsh, Willis and JLT) all maintain their own ratings of insurers, review these regularly.

There are initiatives to set up mutual insurance arrangements, PwC is aware of at least two such initiatives. For example, a group of local authorities may set up their own insurance company which is capitalised by each authority making a contribution. The mutual then provides cover based on this capital and by accessing the reinsurance markets. Historically these arrangements have not been able to undercut the commercial markets, but this may change.

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The current situation is very fluid, you need to monitor it continuously

PwC has seen sudden and dramatic deteriorations in the positions of listed companies in all sectors

You need to continually update your view of the risks you are facing

You should prepare contingency plans in the event of the failure of a supplier or contractor

Your treasury departments should be working overtime!

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