Strengthening Democracy through Government Financial Management: Greece and the EU

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SLIDE ONE

First, I'd like to congratulate The Accountant and the International Accounting Bulletin for organizing such an impressive conference. Today's content was of very high quality and practically insightful. Also, thank you for the invitation to speak on a topic of critical and on-going importance: the topic of my slides and comments is "Strengthening Democracy Through Government Financial Management: Greece and the EU". As you may know, our firm's - JAPONICA PARTNERS - core competency is discovering, investing in, and then turning around large multi-national conglomerates. However, in 2012, we extended our reach to become one of the largest private investors in Greece government bonds with a goal of helping to accomplish one of the greatest financial turnarounds in history.

SLIDE TWO

Over the past four years, we have built a team of over 100 professionals to assist in our Greek investment. As an aside, over the past four years, we've worked with almost 30 accountants from EY, Deloitte, KPMG, and PWC; several dozen economists; half-a-dozen statisticians; a dozen lawyers; five PR firms; and, scores of former government officials. Also of interest, our team has made more than 250 presentations and we've worked with more than 80 members of the media. Based on our team's extensive work during the past four years, we've concluded that democracy is strengthened through better government financial management for three reasons: 1. It can advance transparency and accountability of government financial reporting. 2. It can win the trust and confidence of taxpayers, which is a corner stone responsibility of government. And 3., it can improve government financial performance.

SLIDE THREE

It is distressing but hard to otherwise conclude that the status quo is increasingly becoming destructive populism. From our work over the past four years, we have found that: governments see cooking the books after the outcome as the goal, rather than better financial management; fictional fabrication of government numbers is the norm; media, think tanks, rating agencies, and economists have a counter-productive understanding of international accounting standards and economic reality; and citizens have almost zero education in understanding a balance sheet, their own or their government's. The Alternative is effective management and communication of government balance sheets prepared in accordance with International Public Sector Accounting Standards (IPSAS).

SLIDE FOUR

Many have suggested the IMF as the lead steer on improving government financial management and reporting. What we have found is that the IMF has the tools and the potential but struggles with implementation. Point worthy of note: the IMF's Fiscal Affairs Department has the publications and technical expertise for report compilation, there is a long list of statements of support for IPSAS, but there is little evidence of assisting in using IPSAS to improve decision-making, and there is political application of rules and guidelines.

Those who have read the fact sheet contained in Appendix Two have found the "IMF and Greece: 12 Helpful Facts to Better Understand Greece Government Debt Sustainability (Part 2 of 4)", to be very revealing as to both the strongly siloed functioning of the IMF and the politcalization of the promulgated noble principles of the IMF. The IMF has the infrastructure. It's not being implemented.

SLIDE FIVE

To understand the role of government financial management in strengthening democracy and combating destructive populism, we provide two examples from our team's work over the past four years. The first example is the Greece government debt and debt relief.

SLIDE SIX

Let's first set the background on key stakeholder views on Greek government debt and debt relief. The Prime Minister in a September speech in New York City said, Debt relief by year-end is an "indispensable condition" to returning to the markets. The Greek Finance Minister yesterday in Parliament said, If Greece's EU partners kick the can two years down the road on debt relief, then investors will remain far away, it will be bad for the government and the country, and there should be a discussion about Greece's place in Europe. Yet again, the government is stoking populism by seeking to blackmail Europe. In the government budget submitted this week, the official position is that : "Talks on the restructuring of public debt will play a decisive role on the developments of 2017 as they are a crucial step in restoring investor confidence, the (country's) long-term credit rating and the credibility of the economy." The IMF recent Article IV on Greece concluded, Greek government debt remains unsustainable and requires substantial debt relief. The rating agencies have followed the official pronouncements with headline comments on Greek Government debt. S&P writes that Greece has the highest debt/GDP ratio of all sovereigns we rate. The Fitch headline sound bite is that Greece has the second highest debt to GDP ratio of all the countries we rate. And, representing the international talking head community, a well-known international commentator and banker writes last week that, Greece government debt is the barrier to confidence and debt relief is essential. You will often here the kicking-the-can-down-the-road comment about Greek debt restructurings, as if the time value of money and economic reality did not exist when measuring debt.

SLIDE SEVEN

As one more point of background on debt relief, let's review the actual text from the 3rd Programme. The actual text from the May 2016 EU-Greece agreement on short-term measures contains no debt relief despite Greek government statements to the contrary.

Eurogroup Statement: “For the short-term, the Eurogroup agrees on a first set of measures which will be implemented after the closure of the first review up to the end of the programme and which includes:

- ✓ Smoothening the EFSF repayment profile under the current weighted average maturity;
- ✓ Use EFSF/ESM diversified funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries;
- ✓ Waiver of the step-up interest rate margin related to the debt buy-back tranche of the 2nd Greek programme for the year 2017.”

Dijsselbloem Statement: “The short term is basically a debt management... The possible debt relief -- mainly talking about the medium term package -- will be delivered at the end of the programme, so we are talking mid-2018.”

Regling Statement: “Under the short-term measures, the ESM in our own responsibility will do debt management exercises.” As these measures include lengthening maturities, "in the short run, interest costs may go up.”

SLIDE EIGHT

At the heart of the matter is how Greek debt and debt relief are measured and reported. This table illustrates the current political accounting for Greek debt and debt relief. By way of background facts: Greece bonds are rated CCC and its 25-year bond has a yield to maturity of approximately 8%. The European Stability Mechanism (ESM), which provides much of Greek funding at close to its cost of funding has 30-year bond borrowing costs of less than 1%. The table provides seven transactions and the current political labeling. Transaction number one is 60 billion euro of 30-year below 1% loans mostly to refinance existing debt. Under the current political accounting, this is not called debt relief nor is it considered a deduction in debt. The same is true for rebates on interest and principal as well as concessional loans to purchase financial assets. Restructured loans with lower interest, grace periods, and maturity extension, are called debt relief but do not have any reported reduction in Net debt. The same is true for changed terms on bonds to reduce interest rates and extend maturities, as well as paying more interest (yes, actually paying more) by using swaps to change interest rate profile. The only transaction called both debt relief and reported as a reduction in net debt is a haircut to the face value of debt. When, in fact, all of these items, except number 6, are actually debt relief in economic reality and reduce net debt.

SLIDE NINE

In stark contrast, the real calculations of debt relief can be found on this slide nine. Since 2010, Greece has received 354 billion euros in debt relief, which is 17 times more than the Eurozone programme country average.

SLIDE TEN

As slide ten indicates, the 2015 ESM 3rd Programme by itself has the potential to provide debt relief of 46 billion euros, which from a balance sheet perspective will increase Greece government net worth. What is particularly surprising here is that for the current government so desperately seeking to gain some kind of political win from debt relief, they do not acknowledge this as debt relief. A recent Harvard Business School article by a London Business School

professor, Michael Jacobides, explains this by saying it is byzantine not classic Greek logic where the current government would rather not take credit for having new concessional loans so as not to have to give credit to prior governments for their much larger success on winning debt relief.

SLIDE ELEVEN

This slide eleven, which has taken an enormous effort by our team, shows the gross and net debt of the Greece government debt under six different debt measurement frameworks. As you can see, Greece government 2015 year-end balance sheet net debt, correctly calculated in accordance with international accounting standards or international statistics rules is 41% and 58% of GDP, respectively. To increase our confidence in our analysis, one of the big four confirmed our debt numbers following an almost half-year assignment and a 54 page Expert's Opinion. The international accounting standards are IPSAS and IFRS. The international statistical frameworks are 2008 SNA and ESA 2010. Under the IMF debt sustainability guidelines, Greece government net debt is higher but is still only 104%. Under the Lisbon Treaty, there is the EDP headline measurement, which uses face value, and for Greece is the more familiar 177%. However, EDP submission forms also have a table for the disclosure of present value of gross debt, under ESA 2010, which for Greece would be 88%. It is worth noting that the Greece government has left this table blank with no present value of debt number inserted where required. Debt metrics for Greece EZ member state peers are not reduced under ESA 2010, 2008 SNA, or IMF DSA as there is no qualifying concessional or reorganized debt; and under IPSAS/IFRS, Portugal, Spain, and Ireland would report lower debt by approximately €23 billion, €18 billion, and €12 billion, respectively.

SLIDE TWELVE

To put these debt numbers in perspective, our team compared the Greek numbers to four peer countries, and we also expanded the comparison to include three additional debt metrics. As you see, Greece has been given a significant debt competitive advantage, with a debt burden of about 50% of investment grade Eurozone member state peers, but earns worse ratings and higher borrowing costs. Not only is Greece government net debt 52% of peers, but Greece is also 50% of 2016 annual debt service, 57% of 2016 net cash interest, and 27% of next 5-year unfunded debt service.

SLIDE THIRTEEN

To overcome the lack of a government balance sheet, our team developed an estimate of major balance sheet categories and an estimated net worth for the Greek general government. As you see, at year-end 2015, the Greece government had over ½ trillion euros in assets and liabilities to manage, which is 48,060 euros per citizen. To state what should be obvious, these are enormous amounts to manage without proper financial statements.

SLIDE FOURTEEN

One last slide of importance is our team's historical analysis of Greece government assets. The analysis indicates that 69 billion euros, or on average 625 million euros per week, of Greece government asset value was lost from 2014 to August 2016 (which is the latest date of our analysis). The significance of this loss is breath taking. Additional details on this loss can be found on the Most Important Reform website. Now, let's move on to example two.

SLIDE FIFTEEN

Example 2 of 2 contains work in progress with the EU CEPS (Centre for European Policy Studies) balance sheet task force.

SLIDE SIXTEEN

To put the importance of the government's role within Europe in perspective, let's look at the contribution to GDP. On average, EU general government total expenditures are 46% of GDP. Greece general government is 55% of GDP. To put this is layman's terms, how government finances are managed or mis-managed really matters.

SLIDE SEVENTEEN

Let me review the team's summary of what they found in terms of the status of government balance sheets in the EU. Consolidated balance sheets are the exception not the rule. Single-entry accounting (in contrast to double-entry) is the most common. Cameralistic accounting is nothing more than legislating whatever rules suit the political purpose at the time. Knowledge of consolidated financial statements as a management tool to improve performance and minimize risk is almost non-existent. Limited management capability exists to realize better balance sheet performance. And, significant performance gaps exist between potential balance sheet performance and current status.

SLIDE EIGHTEEN

Let me take a minute to review a few of the many examples our team found of government actions designed to misrepresent reporting economic reality. 1. Concessional loans without recognition. 2. Expensive PPPs to avoid budget costs. 3. Sale and leasebacks. 4. Government employee pensions non-reporting. 5. Impaired financial and fixed assets not recognized. 6. Primary balance illusions. 7. Delayed payments on asset procurement of defense assets. 8. Excluding capital grants from expenses. 9. Excluding new borrowing to fund "temporary" investments. And, 10. Issuing premium bonds and booking at par.

SLIDE NINETEEN

A primary goal of the Task Force is to develop key balance sheet metrics that can be used to highlight potential performance gaps. To advance this mission, the team began by identifying those countries, anywhere in the world, that had government financial statements of sufficient quality to make comparisons. The team identified the following countries: Australia, Canada, France, Israel, New Zealand, the Swiss Federation, the United States, and the UK Whole of Government.

The next step was to identify a handful of key performance metrics (KPIs) that had the balance sheet at the core and combined these numbers with other financial statements as well as with one of the most economic statistics, GDP. As an aside, some of our analyses use GNI, when the GDP number appears to be statistically misleading. The six KPIs we settled on are: 1. A Value Creation Ratio, defined as change in GDP per unit change in net worth start point to end point. 2. Return on assets, defined as average annual change in net worth as a % of total assets. 3. Net worth as a percentage of GDP (latest available). 4. Net worth Annual percentage

change. 5. GDP change to debt change ratio. And 6., net debt as a percentage of GDP, latest available.

As you can see, all the KPIs have a very wide range from those ranked number one to those ranked number 8 (last among the group). Let me take a minute to review the medians for each of the six KPIs. The average Value Creation Ratio is 2.0 times, which means that GDP increases at twice the rate of the decline in net worth. You can think of this as the price paid for the growth in national wealth. Yes, this gives the government the full credit for the GDP growth that is overly generous. And yes, this ratio compares a flow and a stock number, but so does the debt to GDP ratio.

The median return on assets was a not very impressive negative 7%. The median net worth as a percentage of GDP is a negative 66%. The median annual change in net worth was a negative 4%. The GDP change to debt change ratio was 147%, which means that GDP increased by a multiple of debt. And, net debt as a percentage of GDP was 30%.

SLIDE TWENTY

Slide twenty provides additional details on the Value Creation Ratio for each benchmark. As you can see, New Zealand and The Swiss are top ranked with both a GDP increase and a net worth increase. The UK and France are the bottom with only 0.4 and 0.3 increases in GDP as percentage of the decline in net worth.

SLIDE TWENTY-ONE

Slide twenty-one provides additional details on the Return on Assets for each benchmark. Once again, New Zealand and the Swiss take top ranked with positive historical averages. The United States is at a distant bottom with a minus 38%.

SLIDE TWENTY-TWO

Given that the Task Force mission is to educate a very wide range of individuals, an early step in the process was to develop a one-page sheet that facilitated communication and education on why and how a balance sheet is important. As a result of a long collaborative process, the Task Force developed a slide titled: A Framework to Understand How Knowledge and Management of a Government Balance Sheet Improves Financial Performance and Risk. The framework has four quads. The two column headings are Financial Performance and Risk. The two rows under each column heading are Knowledge and Management.

Let me take a minute to read the very brief text within each quad.

Quad 1. Financial Performance/Knowledge: To have true and fair internationally comparable knowledge of government financial performance, the balance sheet, the supporting consolidated financial statements, and notes are the starting point for decision-making and accountability.

Quad 2. Financial Performance/Management: Capable management using three balance sheet related decision-making tools (T-accounts, financial statements, and performance gaps) can improve financial performance and changes in net worth, and minimize errant decisions.

Quad 3. Risk/Knowledge: The balance sheet at the core of consolidated financial statements provides standardized and quantified knowledge of risks (especially large, complex, and expanding liabilities) and helps expose masking of financial risks.

Quad 4. Risk/Management: Early risk management of potential asset impairment or opaque liabilities is an effective process to reduce costs by limiting or avoiding the materialization of these risks and strengthens accountability.

SLIDE TWENTY-THREE

The Task Force knows that an important part of its role is to make its work immediately implementable. To advance this outcome-focused goal, the Task Force selected three basic decision-making tools. The first two you will be familiar with, 1. A modified T-account and 2. The four financial statements. The third tool, performance gaps, uses the KPIs we discussed earlier.

SLIDE TWENTY-FOUR

Let me take a minute to explain the third tool, the performance gap. To develop an early working draft performance gap analysis, the Task Force selected two KPIs: The Value Creation Ratio KPI and the Return on Asset KPI. The next step in this process was to develop EU aggregated member states financial number estimates. These estimates are in row one titled EU Current (estimate). The next step was to identify a credible benchmark proxy. The proxy selected was a combination of the better performing countries in the group of eight benchmarks.

The performance gap is the difference between the EU current numbers and the benchmark. Using the Value Creation Ratio KPI, the performance gap is an additional GDP of 516 billion euros. Using the Return on Assets KPI, the performance gap is an additional 454 billion euros. The numbers are close at around 3 to 4% of GDP.

SLIDE TWENTY-FIVE AND TWENTY-SIX

As part of its education role, the Task Force has developed a database on best practices and worst practices. The practices are filed into four groups: financial assets, non-financial assets, financial liabilities, and non-financial liabilities. As your time allows, I recommend you review these slides and please feel free to contact us if you have additions or clarifications you'd like to suggest.

SLIDE TWENTY-SEVEN

One last point to make regarding the Task Force is its work in developing a government financial management index to be included into the credit rating agency sovereign rating frameworks. The Task Forces has and continues to carefully study the sovereign government rating frameworks of the four majors rating agencies: Moody's, S&P, Fitch, and DBRS. Using existing framework precedents, the Task Force has a first draft proposed Sovereign Index to be included as a significantly weighted component of the main rating framework, which has dozens of other factors. As you can see, there are two parts, qualitative factors and quantitative factors. Within each, there are seven component factors. As a preliminary start, all factors have been given equal weighting. We have recommended that this index be given a 20% weighting. In

order for this to index to become operational, a database on at least 40 sovereign governments will be necessary.

SLIDE TWENTY-EIGHT

That concludes my main slide comments. Before closing, I'd like to note that the slides contain three appendices.

SLIDE TWENTY-NINE

Appendix 1 contains "The Facts on Greek Government Financial Sustainability and Stability (Part 1 of 4). Here you will find a useful summary and some additional detail on the points related to Greece government covered in the slides.

SLIDE THIRTY-ONE

Appendix 2 contains "IMF and Greece: 12 Helpful Facts to Better Understand Greece Government Debt Sustainability (Part 2 of 4)." I totally recommend that you review these facts as they will provide an education on the wide chasm between the IMF available best practices and the non- and mis-application to Greece, which is creating destructive seismic consequences.

SLIDE THIRTY-FIVE

Appendix 3 contains five suggested readings. Also, we suggest you visit www.MostImportantReform.info for additional material on Greece.

I hope you found this material useful and please let us know your thoughts. And, again, thank the organizers for the opportunity to discuss the importance of strengthening democracy through government financial management.