ENTERPRISE RISK MANAGEMENT

Marking guide

1. Estimates the Internal Rate of Return over 6 years of the programme allowing for the Government payoff.

At this stage they have the outgos and they know the benefit to be paid and when it will be paid (50% of $730 000 per participant meeting the success measure 12 months after completion).

Candidates need to correctly identify that figure from the data in App 1.

A number of assumptions need to be made:

- What proportion of people will actually make it to the 12 month point for success?
- Is there a return on the bond principal while invested?
- Assumption on costs provided, inflation
- Specify assumptions on lump sum and success rate given information

If they assume 100% success without comment, this is borderline.

A strong answer would highlight the importance of these assumptions and provide a range of possible ROIs.

2. Proposes a bond structure (principal amount, coupon rate and triggers, structures and triggers for return of principal) for investors.

The principal amount: could be the amount of cashflow required by the provider before govt success payments are expected to flow. This would ease the cashflow management for the provider. Other options are possible, but would need reasoned comment.

Coupon: also has a connection with cashflow management, so they could be delayed to the latter part of the transaction or they could be incorporated to allow smooth emergence of returns to investors, although the cost of this would need to be allowed for. Triggers for coupons should principally relate to the success rate. A common approach would be a floating structure eg RFR + spread.

Return of principal: timing: could be 7 years rather than 6 to allow for final govt payment. Could be in four tranches to reflect the four expected govt payments. Hence triggers are related to success measure.

Default will be defined by the success measure of proportion of people making it to the 12 month point.

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There are lots of possibilities, a stronger answer will make a coherent proposal across the structure, that doesn't have to be same as this one.

3. Identifies and describes the principal risks for investors and provides quantification of each of these risks where appropriate.

- Usual risk of default and opportunity cost of alternatives
- Novelty and challenge of assessing the risk in a consistent way with remainder of portfolio
- Balance of upward/downward triggers against risk of early repayment (if included)
- Success of the programme: Hasn't been tried in Capland before. Sensitivity testing around proportion
- Commitment of the govt to pay: contract requirements
- Continuity and quality of provider: early trigger points for termination for poor execution
- Insufficient participants: sensitivity
- Higher/lower dropout rate before completion of programme: could build sensitivity here also. Lower dropout rate combined with low success rate will stress the bond as drawdown will be quicker and payout lower.
- Ethical concerns and reputation risk: negative perception around private involvement/profit from people in need. Need to manage communication and joint positive messaging from govt, provider and investors.
- No secondary market: likely to have to hold to maturity
- Squeezing out by the govt: (don't expect candidates to think of this, but it has happened a couple of times where a programme has been so successful govt has taken it back in house, including early termination of the bond)

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Other risks identified by candidates and quantified if appropriate will be given credit.

4. Considers the risks for the provider and suggests possible mitigation strategies for these risks.

Some of the risks are similar to those for investors, but from a slightly different angle.

Delivery risk: being able to build process to receive people into the programme, treat and monitor afterwards (ie not lose track of people). Robust planning and fallback resourcing. Clear access to cohorts. Clear pathway to staying in touch with people (data access through Capland govt)

Consent risk: ie will participants consent to the programme and how much will they understand about the bond structure and the payoff: could they ask for a share of the savings? An interesting challenge in communication, explaining who has paid for the programme in the first place.

Scaling up: provider will be keen to extend programme if its working, need to work on this while providing existing programme. Need to manage rollout in proportion to their own resources.

An example from scrutineering, which covers some of these risks:

Risk	Mitigation strategy
Program is not successful in Capland	Do sufficient research or pilot tests before commencing
Program running costs may be higher than expected	Detailed cost analysis and close monitoring to control costs
Borrowing costs could drop significantly	Could allow early redemption if interest rates drop
Government may have different success definition	Clarify definition of performance payments upfront

END OF MARKING GUIDE

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