

TFHPSA

Topic 5

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Paris

Comments by Philippe de Rougemont

On : « **government guarantees of borrowing** » (ECB) / July 13 Version, and on comments by Kilpatrick dated June 9, by Harper dated July 14 and by Laliberté/Shrestha dated July 19.

Those comments are personal and do not necessarily reflect views of the Banque de France or of Eurostat

To: Jeff Golland, Reimund Mink, Bob Kilpatrick, Peter Harper, Lucie Laliberté, Manik Shrestha, Jean-Pierre Dupuis

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I comment on a recent version of the paper on “government guarantees of borrowing”, which exhibits some improvements on the February version presented by Jeff, but also some deteriorations. I also refer to three useful other comments received so far.

- 1- My immediate comment refers naturally to the exact link between the proposal for change of the SNA (and potentially of IPSASs, in coordination with Working Group 1) and work done by a Eurostat Task Force on interpretation of the current ESA 1995. It seems to me that this latter task force’s point of view, and further Eurostat decisions, adds to the existing European official corpus of interpretations of ESA 1995 / 1993 SNA, as embodied in the Manual on Government Deficit and Debt, which in themselves may or may not be thought as useful additions to the SNA under review.
- 2- Instead, the Working Group 2 should aim at outlining preferred treatments from a conceptual point of view, and treat current interpretations as well as source data issues in a second step. In this respect I fully support **Kilpatrick**’s remark that an ideal target or benchmark ought to be outlined in the paper more clearly, with economic reasoning. The US (and Sweden) recording appears to me a particularly strong candidate for such a benchmark.
- 3- More in general, the paper would usefully refer more explicitly to the governance issue at stake under current *1993 SNA* rules, which is of high GFS relevance: substantial gifts can be granted by governments without any impact on deficit and debt until after many years, an issue altogether eschewed by **Laliberté/Shrestha**.

IPSAS clarification

- 4- The paper draws very much its reasoning on an interpretation of IPSAS 19 following a dual approach where for single obligations no provision is recorded when the event of an outflow is more unlikely than likely, but where for classes of obligations the probability of outflow is determined by considering the class as a whole.

- 5- However, the probability of outflow for a class of small obligations is necessarily close to 1 (because a situation where none of each will ever be enforced is unlikely), but possibly encompassing small amounts, whilst the amounts owed for a big single obligation even with a probability of outflow as low as 1/5 could be many times those small amounts. As a matter of principle, it would seem the market value of each of those packages should provide the more realistic measure of the true expected cost for the guarantor. It is hence not completely clear how to truly interpret IPSAS 19 in this respect. **Kilpatrick** # 7 and # 8 seem to request clarification (note his useful reference to fair value – perhaps by reference to the promising though indeed strangely worded IPSAS 19 # 45), which I support.
- 6- It is less problematic that IPSAS performance reporting only captures in its bottom line the financial impact of guarantees above the 50% threshold at time of inception, as its later passing across the 50% will generate such an impact on the bottom line (interestingly **Laliberté/Shrestha** bullet 3 asks what if the probability oscillates back and forth around those 50%). However, this is more problematic from the SNA perspective, and also from an economic analysis point of view.
- 7- The Working Group 2 could certainly draw these issues to the attention of Working Group 1, and seek clarification, or even advice on the scope for potential interpretations/changes in IPSASs in this respect.

Treatment of other changes in provisions

- 8- I agree with **Harper** that (1) changes in value of the provision due to the unwinding of the discount rate should be property income, similar to zero coupons, (instead of being part of the new redistributive transaction proposed D.82, of dubious need) and (2) other changes should be revaluations (K.11) and not further redistributive transactions (also point of view of **Laliberté/Shrestha** bullets 1 and 2).
- 9- It seems natural that the original granting of a guarantee be a redistributive transaction that leads to the apparition of an asset for the beneficiary. In turn, this asset should lead to appropriate property income and revaluations. There is indeed no reason to prevent those created assets to exhibit the two essential components of asset return: property income and revaluations.
- 10- The paper observes that the revaluation option is rejected because it does not lead, over the life of the instrument, to identical net lending / net borrowing compared with the other option of expensing at time of call. This is correct instrument by instrument, but not on average and over the long run. However this is just one argument. More conceptually, the application of the “**debtor principle**” seems to suppose to consider (1) as a volume element of the guarantee the amounts expected (at time of inception) to be later called, as well as changes due to the unwinding of the discount rate, and (2) as a price element other changes. Deviation from the debtor principle should only be agreed as a last resort, and risks impairing the interpretation of the revaluation accounts.
- 11- The possible argument that measuring the expected loss is too difficult for national accountants seems not particularly impressive: (1) the SNA is about to be changed for the

treatment of insurance/catastrophic losses, which will involve crucially the calculation of expected claims (as noted by **Harper**), and (2) the SNA, a conceptual framework, should not be unduly constrained by the existing/majority source data (a point also made by **Laliberté/Shrestha** bullet 4): (2a) the SNA higher standards should allow using of existing advanced sources (instead of preventing their use, as is now), and hopefully provide incentives for other accountants to establish such advanced sources, and (2b) national accountants will opt for more *ad-hoc* methods (such as continuing existing ones), in case no other source data exist.

12- As far as government is concerned, recording changes in provision in the headline figures opens the gate for manipulations, for instance by initiating early reimbursement of guaranteed debt, particularly where the beneficiary of the guarantee is a public corporation.

13- I would agree with **Laliberté/Shrestha** that it is unpalatable that changes in provision on guarantees be recorded as expense or revenue of the borrower, as per the end of their 3rd bullet. However, I would not agree with the start of their 3rd bullet, because the granting of a guarantee can naturally (and to my mind: should) score as a revenue to the beneficiary.

Public corporations – private corporations

14- The note does not distinguish in between beneficiaries, although this is a dominant GFS issue. There is a GFS concern when governments help out public corporations by providing guarantees with noticeable probability of call. There is a completely different issue related to the appropriate recording of schemes providing guarantees to (often private) corporations or to households (e.g., guarantees of student loans) (often against payments) with much smaller individual probabilities of call.

15- However, it is worth noting that the whole issue is closely linked to topic 1 “accrual of earnings” of Working Group 2. The topic 1’s paper in its draft 2 (February 2004) draws (#38 and #61-68) the attention that current statistical standards on debt assumption (in ESA 1995 and in GFSM 2001) are not unified, are debatable and lack coherence. Separately, the more systematic approach to enforce the accrual of earnings of public corporations into the accounts of government (i.e., apply “reinvested earning” in public accounts, or in other words apply equity accounting), would considerably change the debate in relation to guarantees. This is because any redistributive transaction recorded between government and its public corporations under the headline “guarantees”, would be cancelled by a matching flow under “accrual of earnings”.

16- For the time being, progress on topic 1 notwithstanding, the non distinction between public and private corporations seems a flaw of the paper.

Existence of an asset and its classification

17- The paper eschews the difficult issue of whether the gift is once and for all, or gradually occurring. This closely relates to how a zero interest loan ought to be recorded. The clarifying of the elements of debates (if not the giving of a solution) would greatly help the debate.

- 18- In this respect I support **Kilpatrick** # 14 and his demand of clarification of “subsidy” as being annual (although I agree that national accountants traditionally call “subsidy” those transfers that are of an annual frequency or higher, booking capital transfers for gifts of lower frequency— see SNA 10.141b). I am not sure, though, that the insurance treatment supports best the annual subsidy option instead of the lumpsum gift (see previous paragraph and next).
- 19- I fully support **Harper** when suggesting that the insurance treatment option preferably supposes the existence of a financial instrument (contrary to what is implied in the paper): the prepayment of premium AF.62. One can congratulate him for finding that under the proposed SNA amendment (proposed by another Task Force), insurance output for providing guarantees would then wash out – well done. However, the **Harper**’s other claim that under his recording, the insurance subsidy option would equate that of IPSAS 19 (inclusive of revaluation entries) seems not fully exact: it seems to me that this to be true would suppose that the AF.62 would be recognised for the full amount, at inception of the guarantee.
- 20- With an entry D.71 in year 1 and D.72 in year 5 and D.44 in between, I however wonder if we are still under an insurance scheme.
- 21- On the face of it, it seems that the recording of a provision, IPSAS-like, does not require the creation of a new instrument AF.63. AF.62 as pointed by **Harper** seems to fit the bill.
- 22- The restriction of the financial derivative option AF.34 to tradable guarantees is farfetched, notably in the context of a SNA review. *First* of all, the *1993 SNA* itself recognises “options” because they are stores of value that are evidenced when they are tradable (or offsettable). SNA 11.28 and 13.22. I would venture that as long one can identify value, it seems that asset recognition is possible. *Second*, there are more and more credit derivatives (obliquely mentioned in the **Shrestha** paper “Activation of guarantees” for the BOPTTEG — issue paper # 2 at: <http://www.imf.org/external/np/sta/bop/boptteg.htm>) which function similar to financial guarantees: the buyer will get the repayment from the seller of a loans or bond issued by a third party in case the credit rating of the latter falls too low. The market of credit derivatives emerged and developed considerably in the 90s. Those credit derivatives are already *1993 SNA* financial assets, and it would appear an anomaly if more conventional guarantees would not also be on balance sheet.
- 23- *Third*, the SNA review will encompass the treatment of employee stock options, which are scheduled to be within a more global category that would also regroup “financial derivatives”. Hence, it would seem worth keeping in mind that the item “derivative” may encompass more than “financial derivatives” (the latter being those tradable or offsettable).
- 24- One issue worth noting is the absence of property income applied to the stock of derivatives outstanding (not to confuse with the interest payment on swaps which are financial transactions in *1993 SNA* and rightly so). This leads to a difference with the insurance/Harper option. But the former question may perhaps be reexamined.
- 25- Hence paper’s parts: 4.4 IPSAS, 4.5 Insurance and 4.6 Derivative, could be conceived as essentially variation of the same type of recording, with the fundamental recognition of an asset in the accounts of the beneficiary, with the only difficulty to decide whether the asset

appears at once (4.4 and 4.6 in the current version) or gradually (4.5, in the Harper version; however, this decision is applicable to both 4.4, 4.5 and 4.6). Deciding on the exact instrument classification of the asset is of a lesser importance.

Insurance and derivatives

26- The paper could perhaps look more directly into the potential convergence between insurance and derivatives. The reference of credit derivatives should be explicitly addressed.

27- In particular, it would seem important to identify if guarantees are option-like or forward-like contracts. **Laliberté/Shrestha** (bullet 8) suggests the latter with their reference to recognising both an asset and a liability of zero value at time of inception, similar to swaps or future/forwards. However, it would seem likely that guarantees are more like the former, with the need to record the option premium as an asset. In addition, it is reminded that swaps occasionally involve promises to exchange future cash flows that are not actuarially in equilibrium, leading to exchange of lump-sum payments at inception: those so-called “**off-market swaps**” lead to an entry in the balance sheet even at inception. Arguably, if guarantees that are likely to be called are deemed to be forward-like, they surely would have to be of an “off-market” specie.

Financial guarantees

28- I find it useful that the paper focuses on guarantees on borrowing. How should we called them: “guarantees on borrowing”, “guarantees of borrowing”? Is it the same as “financial guarantees”?

29- The paper does not sufficiently remind the three steps that occur in such events:

- (1) The creation of the guarantee (“inception”);
- (2) The activation of the guarantee (“call”);
- (3) The deletion of the claim acquired by the guarantor against the beneficiary (“write-off”) at time of call.

Another issue is whether the call is “as a bloc” or “on a cash due basis”.

Laliberté/Shrestha also refers to a fourth event: the actual payments on the debt assumed.

30- I have already commented that public / private corporations ought to be distinguished. The GFSM 2001 Appendix II seems also not necessarily fully satisfactory in this respect.

31- It is assumed throughout the paper that under *1993 SNA* the “call” gives rise to expensing. However, the “call” will often (/generally) provide a claim on the beneficiary. The GFSM 2001 Appendix II # 5 clearly indicates that expensing supposes that the claim is not “effective”. Otherwise the expensing would be at time of write-off, and only if there is a bilateral agreement (#9), otherwise it is an other economic flow (#12).

Rerouting

32- **Laliberté/Shrestha** and **Harper** criticise rerouting.

- 33- First, the paper could simply recall that national accounts are economic accounts, which can deviate from the legal representation, with in particular rerouting transactions or asset/liability relationships. SNA 3.24. The Eurostat Manual on Government Deficit and Debt prescribes rerouting in cases where, whilst the legal borrower is a public corporation, the amounts to pay are to be settled by government (*de jure* or *de facto*). See II.4.2.¹ In this context, the rerouting is warranted.
- 34- Second, it is more debatable as to whether the rerouting can treat more normal cases of single guarantees. One weakness is the incapacity to alleviate the governance issue, which is at the origin of the reflection on guarantees.

Bad banks

- 35- The question of guarantees has also cross-topical connections with topic 2, notably “bad banks”, those entities specifically created to purchase impaired assets from banks at noticeable above-market value, with the intention to recapitalize those banks, and boost their solvency ratios (Cooke ratio). *One modality* is to create a unit, deemed non market, which records those acquisitions with a partition between a market value and a transfer (see Eurostat Manual on Government Deficit and Debt – II.5.2). *Another modality* for such recapitalization is simply for government to grant guarantees.
- 36- It would be somehow anomalous that “bad banks” would impact completely differently the accounts of governments solely depending on the legal arrangement retained.

¹ Three conditions are put: the law authorising the borrowing specifies this obligation; the budget specifies the annuities to pay; such a repayment is systematic.