

Task Force on Harmonising Public Sector Accounting

Working Group II: SNA Review Issues: Item 3

Contingent assets (including state guarantees), constructive obligations, and provisions

February 2004

This paper describes some options for extending the SNA asset boundary to include some types of provisions, constructive obligations, contingent assets and guarantees. In general these are not currently recorded in SNA93. It considers the implications for the government sector only. Some of the options considered would reduce differences between SNA and Generally Accepted Accounting Practice (GAAP), and would give a truer record of government liabilities.

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1 Provisions

1.1 Definition under GAAP

Under GAAP, provisions are recorded when an entity has a present obligation (legal or constructive) as a result of a past event; it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation.

Note that the word “provision” here refers to a financial liability. Sometimes the word is used to refer to a stock of assets acquired to meet a particular need (as in “the squirrel makes provisions for the winter”): that is not the meaning in this document.

Provisions should be measured in the balance sheet at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, in other words, the amount that the entity would rationally pay to settle the obligation, or to transfer it to a third party, at that date. The estimate is the net present value of the expected expenditure: future expenditure is reduced by a suitable discount factor¹.

Under GAP various transactions are recorded in *the profit and loss account / operating cost statement / current account*, or similar, to account for the balance sheet movements, and so have an impact on the entity’s *profit / current surplus*. These movements are not treated as *other flows*. There are four reasons why the value of provisions in the balance sheet can change.

- a) A new provision is identified.
- b) New information causes a revision to the estimate. For example, the number of compensation claims is higher than originally expected (provision increases); or there is no expenditure, during the past year, for which a provision existed at the start of the year (provision decreases).
- c) The passage of time brings the expected future expenditure closer in time and so reduces the amount by which it is discounted. This increases the value of the provision².
- d) The release of a provision. This is when the actual expenditure takes place for which a provision was established. The value of provisions decreases.

¹ For example: if the expected future expenditure were 100; if it were expected to be spent in two years time; and if the discount rate were 5%; the value of the provision in the balance sheet would be $100/(1.05)^2 = 90.7$. This paper does not discuss the choice of an appropriate discounts rate.

² The logic of this treatment has some similarity with the way in which the SNA93 category D.44 (property income attributable to insurance policy holders) records the a payment from insurance companies to policyholders for the imputed property income earned over a period of time, and reinvested in the financial asset. It could be argued that the treatment of insurance and funded pensions in SNA93 is a an example of provisions being recorded in national accounts. In this case, an asset holding sector is identified (typically households) as a counterpart to the liability.

The expenditure funded by the provision would generally have no impact on the entity's *profit / current surplus*.

A summary of the International Accounting Standard *on provisions, contingent liabilities and contingent assets* (IAS37) is at annex B.

International Public Sector standards, developed by the Public Sector Committee of the International Federation of Accountants, can be found here

<http://www.ifac.org/Members/DownLoads/2003-PSC-IPSAS19.pdf>

if registered with IFAC, or here if not

<http://www.ifac.org/Store/Details.tmp?SID=105188782956670&Cart=10750514512106106>

Note that under GAAP future expenditure in the normal course of business is not treated as a provision. For example, International Public Sector Accounting Standard (IPSASS) 19 (Provisions, Contingent Liabilities and Contingent Assets) states in paragraph 26:

Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future. The only liabilities recognized in an entity's statement of financial position are those that exist at the balance sheet date.

Paragraph 27 states

It is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its activities) that are recognized as provisions.

1.2 SNA93 treatment

At present, provisions are not, in general, recorded in SNA93. Some types of liabilities with the characteristics of provisions are recorded, such as the pension liabilities of funded autonomous pension schemes. These and other “insurance technical reserves”³ are, like provisions, the financial liabilities of the unit with the obligation to pay.

Not recording provisions means that adjustments have to be made when using GAAP-based accounts to derive national accounts. It also means that some types of transactions, related to provisions can be difficult to describe in national accounts. For example, an entity might make a payment to relieve itself of a provision and transfer the obligation to another entity, but in national accounts the payment would appear to be unrequited because the provision would not be recorded.

³ The use of the word “reserves” in defining F.6 is a little confusing from the point of view of the unit obliged to pay since it represents a financial liability, not a stock of assets (usual meaning of reserves).

Possible reasons why provisions were not included in SNA93 are listed below.

- a) Provisions were thought to be estimated prudently (so too high) so data are unreliable.
- b) They cannot be recorded as financial instruments because in many cases no counterpart sector can be identified to record the asset. Otherwise it would be necessary to allow for financial instruments that exist only as liabilities (similarly to gold and SDRs which appear only as assets).
- c) The notion of intangible non-financial assets with negative value was not thought appropriate.

It could be argued that these reasons are still valid.

1.3 Include certain provisions depending on type of expenditure

Some types of provisions do not have a clear counterpart sector. For example, provisions for restructuring costs, or environmental clean-up, are obligations for future consumption expenditure that might give rise to future increased wages or profits elsewhere in the economy but this would not satisfy the definition of an asset for the entities concerned.

However, some types of provisions relate to obligations to make transfer payments that could be regarded as assets of the recipient sectors. For example, based on legal precedent for similar cases, an entity might know that legal judgements will be made requiring it to make compensation payments to households for some past events, but the amounts are not yet known precisely. Under GAAP, estimates of these amounts would be recorded as provisions (liabilities) of the entity with the obligation. It would be logical to record the same amounts as assets of the household sector assuming that the provision were a best estimate and not a prudent (too high) estimate.

Provisions are recorded in expectation of future actual expenditure. If it were to be decided to include provisions selectively in national accounts, a rule could be established on the basis of the SNA classification of the future actual expenditure. The table overleaf analyses this point.

1.4 Include all provisions recorded under GAAP

Since not all provisions have a clear counterpart asset holder, it would be necessary to invent the concept of intangible non-financial assets with negative value, or financial instruments with no assets, if all provisions recorded in GAAP were to be recorded in national accounts.

Table considering what sort of provisions might be included in a revised SNA

SNA code and description	Comments on recording provisions for future expenditure
D1, P2, K1,..... production costs	No obvious counterpart sector. GDP implications. Would apply say to restructuring of an organisation or environmental clean-up.
D.2 taxes on production	Covered by guidance on recording taxes
D.3 subsidies	Commitments to make future subsidies are part of “normal business” ⁴ . Provisions are not recognized for costs that need to be incurred to continue an entity's ongoing activities in the future. Subsidies seem to fit this description.
D.4 property income	There is already guidance on the recording of interest, reinvested foreign earnings, new proposals on dividends. Could possibly be relevant for rent.
D.5 taxes on income, D.61 social contributions	Covered by guidance on taxes and social contributions
D.62 social benefits	Covered by anticipated new guidance on pensions. Provisions possibly relevant for other social benefits in special circumstances (anticipated court decisions with retroactive effect). ⁵
D.7, other current grants	Record provisions. Can apply for example to payments of compensation
D.91	Covered by guidance on taxes
D.92	Commitments to make future capital grants would be part of “normal business” ¹
D.99	Record provisions: could apply for example to payments of compensation, or debt forgiveness / assumption
P5 capital formation	No obvious counterpart sector. GDP implications
FA, acquisition of financial assets	A commitment to purchase financial assets at above market value (giving soft loans for example) in the future might be treated as a provision for a capital transfer (a gift, plus a loan transaction recorded at market value), or a derivative. So not applicable, probably.

⁴ See IPSASS 19 paragraphs 26 &27. There could perhaps be an exception where subsidies / capital grants are paid specifically (timing and amounts calculated accordingly) to reimburse the debt of a unit and the unit has a government guarantee of its borrowing

⁵ Social benefits (say health care) for which entitlement depends on current contributions should not be recorded as provisions because the obligation depends on a current event (current membership of the scheme) rather than a past event. But are there any social benefits (other than pensions) for which entitlement continues, after leaving the scheme, based on previous contributions?

1.5 Possible accounting treatment

Create a new non-financial transaction (call it D.10 for the purpose of the note) and a financial asset category (call it F.9) to record movements in provisions. Record the actual expenditure, “funded” by the provision, using the usual SNA classification.

The creation of financial assets on an entity’s balance sheet needs to be explained by transactions and other flows. The table below shows how this might be done. This is consistent with the treatment under GAAP.

Event	Proposed recording in the entity for whom the provision is a liability ⁶
Event happens that creates the need for a provision to be recorded	Record expenditure in D.10 U Record acquisition of financial liability in F.9 Increase in F.9 liabilities in balance sheet (The valuation of provision would discount future expenditure at a suitable discount rate).
Further events happen, or there are re-measurements of the likely cost of the events relating to the provision (could be the passage of time reducing the probability of certain costs arising).	Record further expenditure in D.10 U Record further acquisitions of financial liability in F.9 Increase in F.9 liabilities in balance sheet (Note that these amounts could be negative)
Passage of time: impact on the discounted valuation.	Record further expenditure in D.10 U Record further acquisitions of financial liability in F.9 Increase in F.9 liabilities in balance sheet
Actual expenditure for which the provision was established	Record a receipt in D.10 U Record the expenditure funded by provision (D.7 or D.9) Record redemption of financial liabilities in F.9 Reduction in F.9 liabilities in the balance sheet

The impact of this recording ensures that the actual payments, for which a provision is established, do have a net impact on government expenditure of the same value, but at a different point in time to when they actually take place. They are recorded when the need for the expenditure becomes probable and the amount can be estimated. Thereby ensuring a more correct application of the accrual principle.

⁶ Recording in the entity for which the provision is an asset would be symmetrical with this treatment.

The method would rely on a GAAP-type accounting system for government that used the concept of provisions.

2 Constructive Obligations

2.1 GAAP definition

A Constructive Obligation is an obligation that derives from an enterprise's actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently explicit current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Certain types of unfunded pension arrangements are constructive obligations of employers, for example.

2.2 SNA93 treatment

Some types of constructive obligations are recorded as provisions under GAAP. If so, for those types of constructive obligations, the treatment in a revised SNA could depend on whatever is decided for provisions.

It is proposed that other constructive obligations would not be recorded in SNA (unless covered by other topics such as pensions).

3 Contingent assets / liabilities

3.1 GAAP definition

Under GAAP, a contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

A contingent liability is a possible obligation that arises from past events and whose existences will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

a present obligation that arises from past events but is not recognised because:

it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

the amount of the obligation cannot be measured with sufficient reliability.

The definitions of provisions and contingent liabilities raise the question of what to record when the following conditions apply:

- a) there is an possible obligation arising from past events;

- b) the need for expenditure depends on one or more uncertain future events not wholly within the control of the enterprise;
- c) there is a greater than 50% probability that there will be some expenditure;
- d) the amount of expenditure required, and the probability, can be estimated from similar obligations observed in the past.

This seems to satisfy the definitions of both a provision and a contingent liability.

3.2 SNA93 treatment

In SNA93 (see Annex C) arrangements that give rise to contingent assets and liabilities are in general not recorded. This exception is when the arrangement itself has value because it is tradable. ESA95 5.05 says:

5.05 Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities (NIFs) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is tradable or can be offset on the market. Otherwise, a contingent asset is not recorded in the system.

The exception raises some interesting questions such as:

- a) how to define tradable ?
- b) why is tradability needed to define a financial asset in this case but not others ?

The present treatment (not recording contingent liabilities) creates a recording problem when government receives a fee for accepting a contingent liability. A small component of the fee might relate to the administration costs of the arrangements, but if priced economically the larger part would relate to the risk of the conditions being met and the government having to pay. So if the contingent asset is not recorded the fee looks like an unrequited transfer. In such cases, is the tradability criterion satisfied by the payment of a fee to acquire the contingent asset ?

3.3 Contingent assets / liabilities treated as derivatives

SNA paragraphs 11.25 to 11.27 and 11.34 to 11.43 frequently mention the existence of contingent assets /liabilities in the context of financial derivatives (options and warrants).

As noted above, GAAP defines three criteria for contingent assets and liabilities:

- a) those that are conditional on future events
- b) those that are unlikely to give rise to a payment
- c) those that cannot be measured reliably.

The criteria can overlap.

For those that can be measured it would be a small extension of the SNA asset boundary to say that all contingent assets should be treated like derivatives. They would be valued at purchase price (where it exists) or at a statistical estimate of the market value based on the expected amount to be paid. However, this might introduce an inconsistency with GAAP.

There is a problem, in the context of measuring the government deficit, when treating all contingent assets as derivatives. Changes in the value of derivatives are recorded through holding / gains losses (other flows) rather than as transactions. Other flows do not have an impact on the deficit, but transactions do. In other words, under this approach, actual payments under a call on the guarantee would have no impact on the deficit. It is only the initial value of the derivative that counts. This approach looks weak when the initial value is estimated rather than being a genuine market price observed from an actual market transaction.

3.4 Contingent assets / liabilities treated as provisions

The alternative would be to treat contingent assets, for which a value can be estimated, like provisions such that subsequent reassessments of the value (for example as a result of actual payments) would all be recorded as transactions. This means that, over a period of time, recording the contingent asset as a provision, or not recording it all and so recording actual payments instead, would have the same impact on the deficit in total, but in different years.

4 Guarantees

4.1 GAAP definition

Guarantees for the purpose of this paper are understood to be arrangements whereby government promises to pay the debt of another entity if certain conditions are met (such as inability of the entity to pay).

4.2 SNA93 treatment

SNA93 and ESA95 refer to guarantees in the context of contingent assets / liabilities, which means that in general they are not recorded in the system. Government transactions are recorded only when calls are made on the guarantee. These would normally be transactions in government expenditure – typically a capital transfer in respect of debt assumption (treated as government expenditure). An outstanding question, being considered by a Eurostat task force, is whether the capital transfer should be equal to the amounts paid when paid, or be for the full amount of the outstanding debt when a first call on the guarantee is made.

The current SNA treatment (contingent liability not recorded) also seems to be the GAAP treatment.

It is the method described in the EDDM⁷ (part II.4.3)

Reasons for extending the SNA asset boundary to include guarantees when given are:

- a) it could make for a more logical recording of payments for guarantees;

⁷ Eurostat's ESA95 Manual on Government Deficit and Debt

b) it would counter criticism that SNA does not record government liabilities fully.

Four ways of recording methods are described below, that involve recording something when a guarantee is given. They are not mutually exclusive in the sense that different methods might be appropriate for different sorts of guarantees, and so could be part of the same revised edition of SNA.

4.3 Government borrowing for full amount and capital transfer

Record a capital transfer from government to the guaranteed entity for the full amount of the guaranteed borrowing, and record government borrowing from the lender. Government payments under a call on the guarantee would be recorded as payments of interest and capital to the lender. Recording problems arise when the borrowing entity makes debt repayments from its own resources. Would these be negative adjustments to the initial capital transfer ?

This treatment shows government making a gift of the full amount borrowed to borrowing entity. It only seems a suitable method when it is clear that government will be taking responsibility for all/ most of the debt repayments because there is no evidence to suggest that the entity will be able to do so.

This method is described as the “special case” in the Eurostat Deficit and Debt Manual section II.4.3

4.4 Government borrowing for full amount and on-lending

Under this treatment, government would be placed between the unit and lender when recording the borrowing flows (interest and financial transactions). In other words, the borrowing would be re-routed through government and add to government debt.

This works well when there is a mixture of debt servicing paid by government and the borrowing unit.

This treatment increase government’s financial liabilities (and financial assets) when the guarantee is given, but there is an impact on net borrowing (B.9) only when the guarantee is called, and then only for the amounts actually paid.

4.5 Provisions

Record provisions (expenditure and an increase in financial liabilities – transactions and balance sheet) for amounts expected to be called, in line with proposals above for recording provisions. Changes in expectations would be recorded as changes in provisions (more/less expenditure and financial liabilities). Actual payments under a call on the guarantee would be recorded as redemption of financial liabilities.

This means that the deficit and debt would reflect new and changed expectations of amounts to be paid when the guarantees were given or expectations changed.

In national accounts, D7 or D9 could be used for the expenditure and perhaps F.7 could be used for the financial transactions in provisions.

This method would be suitable if the actual accounts of the units giving guarantees were prepared in a way that treated guarantees like provisions, because it would provide statisticians with a data source. This is the case in the USA and Sweden.

4.6 Derivative

Record an imputed subsidy/grant and an increase in financial liabilities (transactions and balance sheet) for amounts expected to be called. Changes in expectations would be recorded as other flows and change the balance sheet, but no transactions. Actual payments under a call on the guarantee would be recorded as redemption of financial liabilities.

This means that the deficit and debt would reflect not new and changed expectations of amounts to be paid when the guarantees were given or expectation changed. This makes the initial valuation very important if the method is to give sensible outcomes.

In national accounts, D7 or D9 could be used for the expenditure and F34 (derivatives) for the financial transactions in provisions.

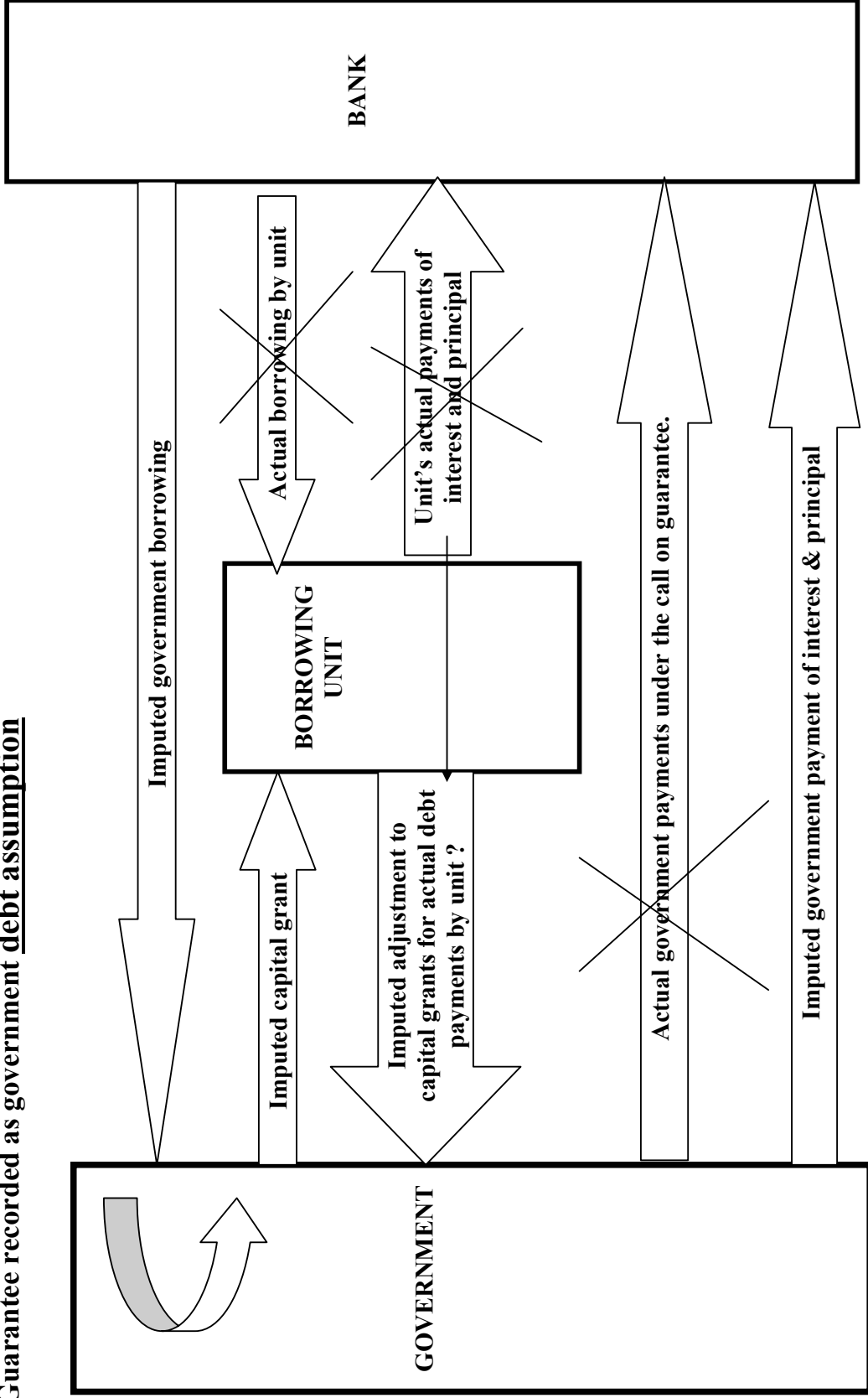
This method would be suitable in cases where guarantees were actually traded, such that market prices could be observed.

5 Diagrams: accounting for guarantees

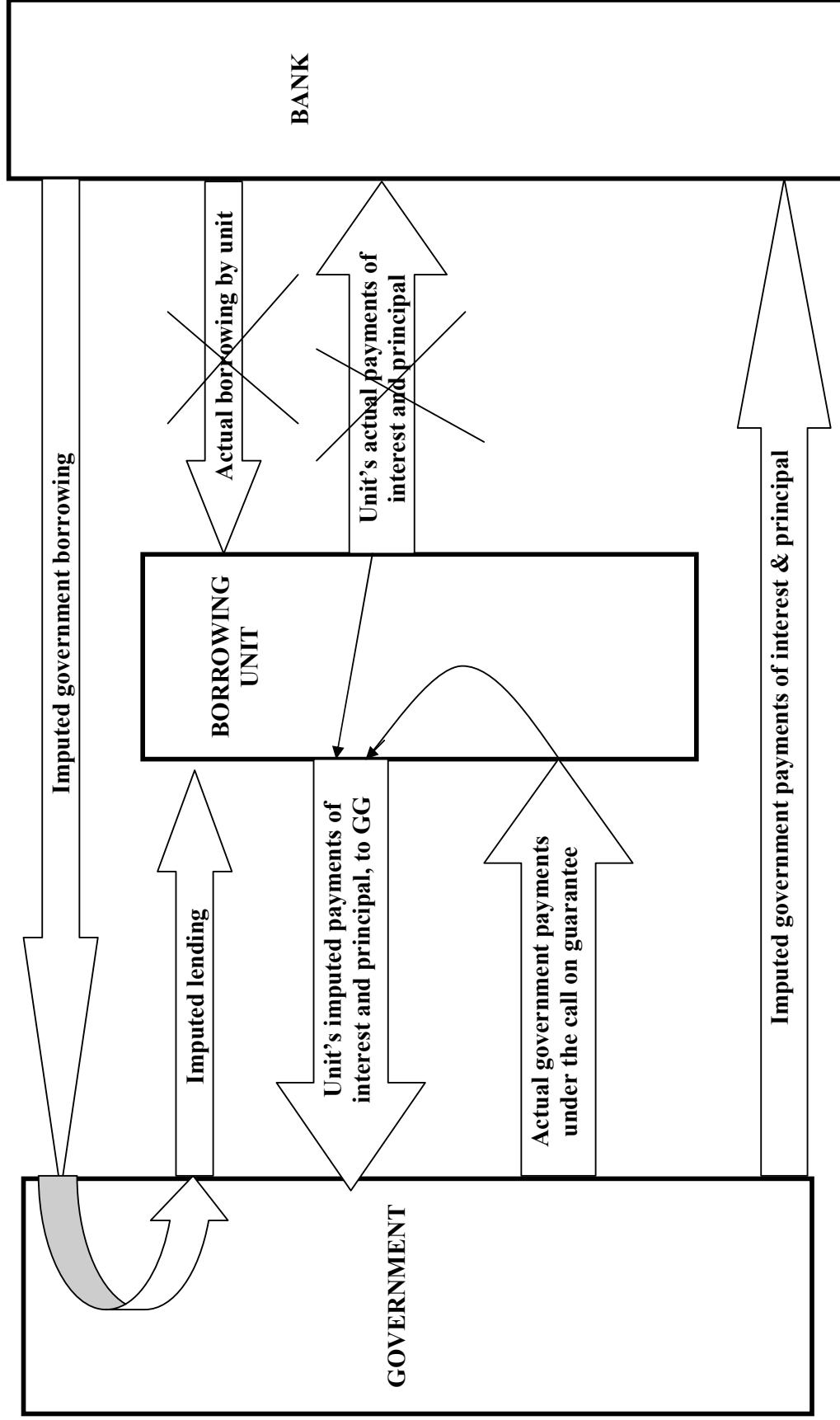
The diagrams on the following pages illustrate the transactions required for each of the methods for recording guarantees discussed above.

Some flows are shown as being crossed out. This indicates a real world flow that would record as something else in national accounts under the proposed treatment.

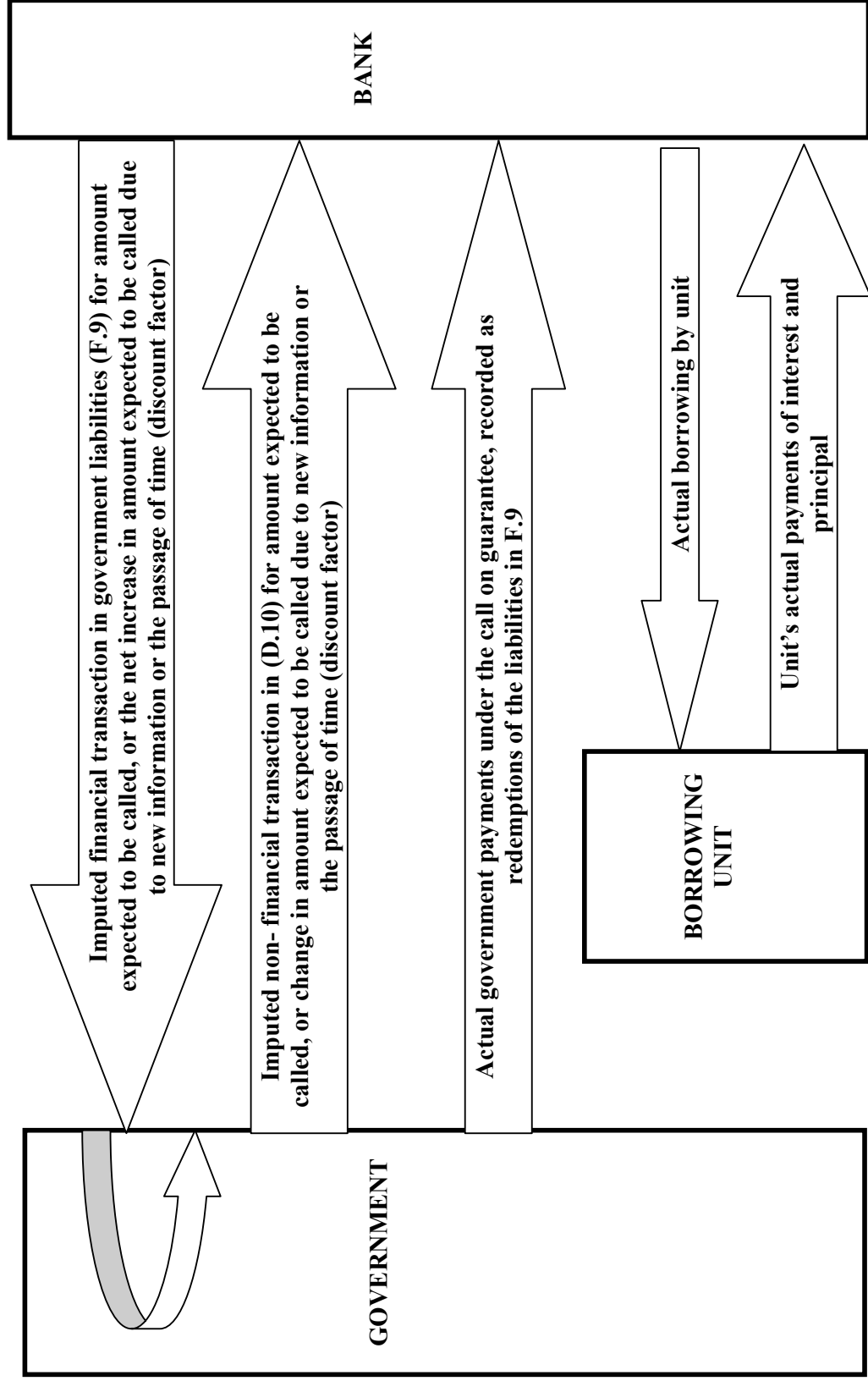
Guarantee recorded as government debt assumption



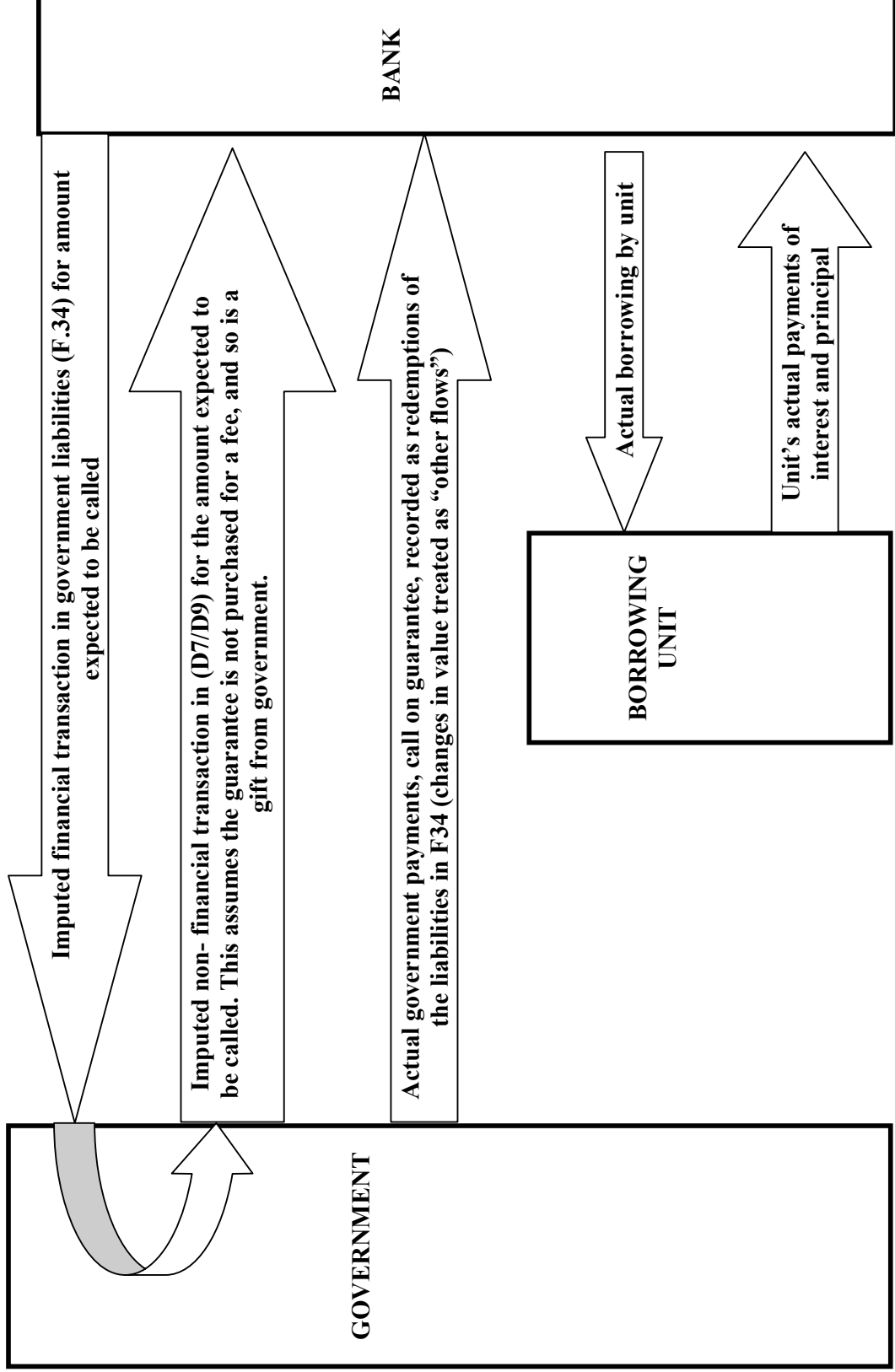
Guarantee recorded as Government on-lending



Government guarantee recorded as a provision. The diagram assumes that the guarantee arrangement is directly with the lender (the bank), and by-passes the borrowing unit.



Government guarantee recorded as a financial derivative. The diagram assumes that the guarantee arrangement is directly with the lender (the bank), and by-passes the borrowing unit.



6 Annex A: OECD short note on WG II 18 December

Item 3: Contingent assets (state guarantees), constructive obligations, and provisions

The issues relate to **contingent assets, liability provisions and constructive obligations [economic asset boundary]**. The economic asset boundary may be relaxed slightly to accommodate contracts which have a market value or which could be transferable.

Governments sometimes provide guarantees that are likely to be called and, accordingly have a substantial market value at the time of creation;

Business accounting recognises as liabilities, obligations that, whilst not legally enforceable, are nevertheless expected to result in outflows: constructive obligations and provisions (other than on assets). For example, pension obligations may well be *de facto* constructive obligations, but this alone should not necessarily prevent expensing them; and

The *1993 SNA* does not recognise provisions (except consumption of fixed capital) because they are not interactions between units, but instead are seen as events internal to a unit. Provisions attached to economic assets of the balance sheet could be conceived as a valuation issue. But recognition of other provisions as liabilities would require finding counterpart holders of the assets—which may be more difficult.

Could not the notion of “past events” for defining liabilities in business accounting be also incorporated in the SNA?

7 Annex B: International Accounting Standard 37

(International Accounting Standards Board)

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

IAS 37 was approved by the IASC Board in July 1998 and became operative for annual financial statements covering periods beginning on or after 1 July 1999.

Summary of IAS 37

IAS 37 requires that:

provisions should be recognised in the balance sheet when, and only when: an enterprise has a present obligation (legal or constructive) as a result of a past event; it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation;

provisions should be measured in the balance sheet at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, in other words, the amount that an enterprise would rationally pay to settle the obligation, or to transfer it to a third party, at that date. For this purpose, an enterprise should take risks and uncertainties into account. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. An enterprise should discount a provision where the effect of the time value of money is material and should take future events, such as changes in the law and technological changes, into account where there is sufficient objective evidence that they will occur;

the amount of a provision should not be reduced by gains from the expected disposal of assets (even if the expected disposal is closely linked to the event giving rise to the provision) nor by expected reimbursements (for example, through insurance contracts, indemnity clauses or suppliers' warranties). When it is virtually certain that reimbursement will be received if the enterprise settles the obligation, the reimbursement should be recognised as a separate asset; and

a provision should be used only for expenditures for which the provision was originally recognised and should be reversed if an outflow of resources is no longer probable.

IAS 37 sets out three specific applications of these general requirements:

a provision should not be recognised for future operating losses;

a provision should be recognised for an onerous contract - a contract in which the unavoidable costs of meeting the obligations under the contract exceed the expected economic benefits; and

a provision for restructuring costs should be recognised only when an enterprise has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. For this purpose, a management or board decision is not enough. A restructuring provision should exclude costs - such as retraining or relocating continuing staff, marketing or investment in new systems and distribution networks - that are not necessarily entailed by the restructuring or that are associated with the enterprise's ongoing activities.

IAS 37 prohibits the recognition of contingent liabilities and contingent assets. An enterprise should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote, and disclose a contingent asset if an inflow of economic benefits is probable.

8 Annex C: US Financial Accounting Standards Board Standard

Treatment of loans and guarantees

EXECUTIVE SUMMARY

Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.

For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability.

Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows.

The subsidy cost allowance for direct loans and the liability for loan guarantees are re-estimated each year, taking into account all factors that may have affected the estimated cash flows. Any adjustment resulting from the re-estimates is recognized as a subsidy expense (or a reduction in subsidy expense).

When direct loans or loan guarantees are modified, the cost of modification is recognized at an amount equal to the decrease in the present value of the direct loans or the increase in the present value of the loan guarantee liabilities measured at the time of modification.

Upon foreclosure of direct or guaranteed loans, the acquired property is recognized as an asset at the present value of its estimated future net cash inflows.

The standards permit but do not require restating pre-credit reform direct loans and loan guarantees at present value.

9 Annex D: The recording of government's contingent liabilities in Sweden

This is the introduction to a paper entitled “Contingent Liabilities in Debt Management” by Lars Hörngren, Chief Economist, The Swedish National Debt Office, prepared for the annual meeting of the OECD Working Party on Debt Management, October 23–24, 2003.

Introduction

In addition to conventional debts, made up of bonds and similar instruments, governments invariably have other liabilities of different kinds. These may range from contracts under civil law – such as credit guarantees – all the way to general commitments to provide various goods and services, including transfer payments, to the public in the future. Moreover, a fundamental role of the state is to protect citizens in case of major unforeseen or otherwise uninsurable events, such as natural disasters.

It is possible to refer to all such liabilities as “contingent” although the contingencies involved vary. A credit guarantee, for example, becomes payable if the creditor fails to meet scheduled interest payments or to pay back the loan. The cost of a commitment to provide care for the elderly, say, is contingent on the number of people in those age groups and their health status.

Liabilities of these kinds are typically not recorded as government debts, i.e., they are off-balance sheet items. In the case of disasters this is unavoidable, since by their very nature disasters are impossible to predict and thus to evaluate. However, even when commitments are based on legally binding contracts, as in the case of explicit guarantees under civil law, it is rare that government's report them as liabilities. At least, they are handled separately from conventional debts. Nevertheless, they may often be as important as, or even more important than, the instruments recorded on the balance sheet under the heading “government debt”.

Analyses of the long-term sustainability of public finances are aimed at capturing the whole range of liabilities and to relate them (in present-value terms) to the whole range of assets, including future tax revenues. Such long-term assessments are essential for decisions on expenditures and taxes. If long-term commitments are deemed to exceed the resources available to the government, something will have to be done, either reducing the commitments or raising the revenues (or both). Moreover, the government should always maintain a safety margin to be able to withstand also the unforeseen or unforeseeable.

Decisions on expenditures and revenues, and consequently on the size of the government debt now and in future periods, are inherently political. They do not form part of *debt management*, defined here in a more narrow sense to describe the process involved in managing a debt of a certain size. Similarly, the government's readiness to intervene in crises of various kinds should be determined in the political sphere.

However, there are contingent liabilities that – once they have been issued – can be seen as just another class of government debt and should be managed accordingly. This applies in particular to explicit guarantees and similar contracts that the government has entered into. By definition, they are claims on the same balance sheet as regular debt instruments. Moreover,

just like government bonds, explicit guarantees are binding commitments under civil law. This means that if the government fails to meet its obligations under a guarantee, it is in default in exactly the same way as if it fails to pay back a loan when it comes due. The similarities are so strong that it makes sense for the government to try to analyze and manage regular debt and contingent debt created via explicit guarantees in a unified framework.

This note discusses some aspects of such a joint management framework, based partly on recent and proposed changes in the rules governing government guarantees in Sweden. The discussion is organized as follows. In section 2, we discuss procedures for deciding when a government guarantee can be issued. This brings budget management into the picture, but this is necessary to have a complete picture including also the origination of contingent debt. Section 3 covers pricing of government guarantees. Section 4 discusses reporting of contingent debt, to the policy makers and to the public. In section 5, we deal with the management of outstanding guarantees. Section 6 offers some concluding comments.

10 Annex E: Text from SNA 93.

Financial claims and obligations

11.17. Many types of financial arrangements between transactors are possible. Financial claims and obligations arise out of contractual relationships between pairs of institutional units. Many of these will result in a creditor/debtor relationship between the two parties. In most cases, the relationship between the creditor and debtor will be unconditional on the part of both parties. Clearly, in such standard financial assets as deposits, securities, and loans, the creditor has an unconditional legal contract to receive property income and repayment of principal, and the debtor has a symmetric unconditional liability. Forward-type derivative contracts are also unconditional financial contracts imposing symmetrical obligations on creditor and debtor, although the changes in the prices of underlying items may change the size (and even the direction) of the symmetrical relationship (see paragraph 11.37). Options-type derivative contracts are conditional in the sense that the purchaser need not exercise its option (see paragraph 11.39). However, options impose unconditional obligation on the issuer (debtor). Unconditional creditor/debtor relationships do not hold for shares. In this case, liabilities are introduced by convention, even though the "debtor" does not have an unconditional liability. A financial claim:

(a) Entitles a creditor to receive a payment, or payments, from a debtor in circumstances specified in a contract between them; or

(b) Specifies between the two parties certain rights or obligations, the nature of which requires them to be treated as financial.

Contingent assets

11.25. Many types of contractual financial arrangements between institutional units do not give rise to unconditional requirements either to make payments or to provide other objects of value; often the arrangements themselves do not have transferable economic value. These arrangements, which are often referred to as contingencies, are not actual current financial assets and should not be recorded in the SNA. The principal characteristic of contingencies is that one or more conditions must be fulfilled before a financial transaction takes place. Guarantees of payment by third parties are contingencies since payment is only required if the principal debtor defaults. Lines of credit provide a guarantee that funds will be made available but no financial asset exists until funds are actually advanced. Letters of credit are promises to make payment only when certain documents specified by contract are presented. Underwritten note issuance facilities (NIFs) provide a guarantee that a potential debtor will be able

to sell short-term securities (notes) that he issues and that the bank or banks issuing the facility will take up any notes not sold in the market or will provide equivalent advances. The facility itself is contingent, and the creation of the facility gives rise to no entry in the financial account. Only if the underwriting institution is requested to make funds available will it acquire an actual asset, which is recorded in the financial account.

- 11.26. For the purposes of the SNA, the treatment of contingencies is clear. Any payments of fees related to the establishment of contingent arrangements are treated as payments for services. Transactions are recorded in the financial account only when an actual financial asset is created or changes ownership. However, by conferring certain rights or obligations that may affect future decisions, contingent arrangements obviously produce an economic impact on the parties involved. Collectively, such contingencies may be important for financial programming, policy, and analysis. Therefore, where contingent positions are important for policy and analysis, it is recommended that supplementary information be collected and presented as supplementary data in the SNA.
- 11.27. Country practices vary in determining which instruments are considered contingent and which are considered actual assets to be recorded in the balance sheet. An example, which is quantitatively important in trade financing, is the bankers' acceptance. A banker's acceptance involves the acceptance by financial institutions of drafts or bills of exchange and the unconditional promise to pay a specific amount at a specified date. The banker's acceptance represents an unconditional claim on the part of the holder and an unconditional liability on the part of the accepting bank; the bank's counterpart asset is a claim on its customer. For this reason, the SNA recommends that the banker's acceptance be treated as an actual financial asset even though no funds may have been exchanged. Flexibility in the application of this recommendation will be required to take national practices and variations in the nature of these instruments into account.

Financial derivatives

- 11.34. Financial derivatives are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right. The value of a financial derivative derives from the price of the underlying item: the reference price. /1 An observable market price or an index for the underlying item is essential for calculating the value of any financial derivative. If a financial derivative cannot be valued because a prevailing market price or index for the underlying item is not available, it cannot be regarded as a financial asset. Unlike debt instruments, no principal amount is advanced to be repaid and no investment income accrues. Financial derivatives are used for a number of purposes including risk management, hedging, arbitrage between markets, and speculation. Financial derivatives enable parties to trade specific financial risks - such as interest rate risk, currency, equity and commodity price risk, and credit risk, etc - to other entities who are more willing, or better suited, to take

or manage these risks, typically, but not always, without trading in a primary asset or commodity. The risk embodied in a derivatives contract can be "traded" either by trading the contract itself, such as with options, or by creating a new contract which embodies risk characteristics that match, in a countervailing manner, those of the existing contract owned. The latter is termed offsetability, and is particularly common in forward markets or where there are no formal exchanges through which to trade derivatives.

- 11.35. The SNA recommends that financial derivative instruments that can be valued separately from the underlying item to which they are linked should be treated as financial assets, regardless of whether "trading" occurs on- or off-exchange. Transactions in financial derivatives should be treated as separate transactions, rather than as integral parts of the value of underlying transactions to which they may be linked. The two parties to the derivatives may have different motives for entering into the transaction. One may be hedging, while the other may be dealing in derivative instruments or acquiring the derivative as an investment. Even if both parties are hedging, they may be hedging transactions or risks that involve different financial assets or even transactions in different accounts of the SNA. Therefore, if derivative transactions were treated as integral parts of other transactions, such treatment would lead to asymmetries of measurement in different parts of the accounts or to asymmetries of measurement between institutional sectors.
- 11.36. Any commissions paid to or received from brokers or other intermediaries for arranging options, futures, swaps, and other derivatives contracts are treated as payments for services in the appropriate accounts. Financial derivatives transactions may take place between two parties directly, or through an intermediary. In the latter case, implicit or explicit service charges may be involved. However, it is usually not possible to distinguish the implicit service element. Therefore, the SNA recommends that net settlement payments under derivative contracts be recorded as financial transactions. However, where possible, the service charge component should be separately recorded. Financial derivatives contracts are usually settled by net payments of cash. This often occurs before maturity for exchange-traded contracts such as commodity futures. Cash settlement is a logical consequence of the use of financial derivatives to trade risk independently of ownership of an underlying item. However, some financial derivative contracts, particularly involving foreign currency, are associated with transactions in the underlying item. A transaction in an asset underlying a financial derivative contract that goes to delivery should be recorded at the prevailing market price for the asset with the difference between the prevailing price and the price actually paid (times quantity) recorded as a transaction in financial derivatives.
- 11.37. There are two broad classes of financial derivatives: forward-type contracts, including swaps, and option contracts. Under a forward contract, the two counterparts agree to exchange a specified quantity of an underlying item (real or financial) at an agreed contract price - strike price- on a specified date. Futures contracts are forward contracts traded on organised exchanges. Futures and other forward contracts are typically, but not always, settled by the payment of cash or the provision of some other financial instrument rather than the actual delivery of the underlying item and therefore are valued and traded separately

from the underlying item. A forward contract is an unconditional financial contract that represents an obligation for settlement on a specified date. At the inception of the contract, risk exposures of equal market value are exchanged and hence the contract has zero value. Some time must elapse for the market value of each party's risk to differ so that an asset (creditor) position is created for one party and a liability (debtor) position for the other. The debtor/creditor relationship may change both in magnitude and direction during the life of the forward contract. Common forward-type contracts include interest rate swaps, forward rate agreements (FRA), foreign exchange swaps, forward foreign exchange contracts, and cross-currency interest rate swaps.

- 11.38. An interest rate swap contract involves an exchange of cash flows related to interest payments, or receipts, on a notional amount of principal, which is never exchanged, on one currency over a period of time. Settlements are often made through net cash payments by one counterpart to the other. Forward rate agreements are arrangements in which two parties, in order to protect themselves against interest rate changes, agree on an interest rate to be paid, at a specified settlement date, on a notional amount of principal that is never exchanged. FRAs are settled by net cash payments. The only payment that takes place is related to the difference between the agreed forward rate agreement rate and the prevailing market rate at the time of settlement. The buyer of the forward rate agreement receives payment from the seller if the prevailing rate exceeds the agreed rate; the seller receives payment if the prevailing rate is lower than the agreed rate. A foreign exchange swap is a spot sale/purchase of currencies and a simultaneous forward purchase/sale of the same currencies. Forward foreign exchange contracts involve two counterparts who agree to transact in foreign currencies at an agreed exchange rate in a specified amount at some agreed future date. Cross-currency interest rate swaps, sometimes known as currency swaps, involve an exchange of cash flows related to interest payments and an exchange of principal amounts at an agreed exchange rate at the end of the contract. There might also be an exchange of principal at the beginning of the contract, and, in these circumstances, there may be subsequent repayments, which include both interest and principal, over time according to the predetermined rules. Streams of net settlement payments resulting from swap arrangements are to be recorded as transactions in financial derivatives and repayments of principal are to be recorded under the relevant instrument item in the financial account (see paragraphs 11.40 and 11.44 for the valuation of transactions in underlying assets).
- 11.39. Options are contracts that give the purchaser of the option the right, but not the obligation, to buy (a "call" option) or to sell (a "put" option) a particular financial instrument or commodity at a predetermined price (the "strike" price) within a given time span (American option) or on a given date (European option). Many options contracts, if exercised, are settled by a cash payment rather than by delivery of the underlying assets or commodities to which the contract relates. Options are sold or "written" on many types of underlying bases such as equities, interest rates, foreign currencies, commodities, and specified indexes. The buyer of the option pays a premium (the option price) to the seller for the latter's commitment to sell or purchase the specified amount of the underlying instrument or commodity on demand of the buyer. While the premium paid to the seller of the option can conceptually be considered to

include a service charge, in practice, it is usually not possible to distinguish the service element. Therefore, it is recommended in the SNA that the full price be recorded as acquisition of a financial asset by the buyer and as incurrence of a liability by the seller. However, where possible, the service charge component should be separately recorded. A major difference between forward and option contracts is that, whereas either party to a forward contract is a potential debtor, the buyer of an option contract acquires an asset and the option writer incurs a liability. However, option contracts frequently expire without worth; options are exercised only if settling a contract is advantageous for the option holder.

- 11.40. The timing of premium payments on options varies. Depending on the type of contract, premiums are paid when the contracts begin, when the options are exercised, or when the options expire. The value of an option at inception should be recorded at the full price of the premium. If the premiums are paid after the purchase of an option, the value of the premium payable is recorded as an asset at the time the derivative is purchased, financed by a loan from the writer. Subsequent purchases and sales of options are also to be recorded in the financial account. If an option based on a financial asset is exercised or if a commodity based option proceeds to delivery, the acquisition or sale of the underlying asset should be recorded at the prevailing market price in the appropriate accounts with the difference between this amount and the amount actually paid recorded as transactions in financial derivatives.
- 11.41. Warrants are a form of options that are treated in the financial account in the same way as other options. They are tradable instruments giving the holder the right to buy, under specified terms for a specified period of time, from the issuer of the warrant (usually a corporation) a certain number of shares or bonds. There are also currency warrants based on the amount of one currency required to buy another and cross-currency warrants tied to third currencies. They can be traded apart from the underlying securities to which they are linked and therefore have a market value. The issuer of the warrant incurs a liability, which is the counterpart of the asset held by the purchaser.
- 11.42. The financial derivatives described in the previous paragraphs are related to market risk, which pertains to changes in the market prices of securities, commodities, interest and exchange rates. Financial derivatives whose primary purpose is to trade credit risk are known as credit derivatives. They are designed for trading in loan and security default risk. Credit derivatives take the form of both forward-type and option-type contracts, and like other financial derivatives, they are frequently drawn up under standard master legal agreements, and involve collateral and margining procedures, which allow for a means to make a market valuation.
- 11.43. Margins are payments of cash or collateral that cover actual or potential obligations under financial derivatives, especially futures or exchange-traded options. Repayable margins consist of deposits or other collateral deposited to protect a counterparty against default risk, but which remain under the ownership of the unit that placed the margins. Although its use may be restricted, a deposit is classified as repayable if the depositor retains the risks and rewards of ownership, such as the receipt of income or exposure to holding gains and losses. Repayable margin payments in cash are transactions in deposits, not transactions in a financial derivative. The depositor has a claim on

the exchange or other institution holding the deposit. Some compilers may prefer to classify these margins within other accounts receivable/payable in order to reserve the term deposits for monetary aggregates. When repayable margin payments are made in noncash assets, such as securities, no entries are required because the entity on whom the depositor has a claim --the issuer of the security-- is unchanged. Nonrepayable margins reduce a financial liability created under a financial derivative contract. The entity that pays a nonrepayable margin no longer retains ownership of the margin nor has the right to the risks and rewards of ownership, such as the receipt of income or exposure to holding gains and losses. A payment of nonrepayable margin is normally recorded as a decline in currency and deposits with a counter entry in the reduction in financial derivative liabilities, and the receipt of nonrepayable margin is recorded as an increase of holdings of currency and deposits with the counter entry in the reduction in financial derivative assets.

Financial assets and liabilities (AF.)

13.20. Financial assets are entities meeting the general criteria for economic assets - i.e., they are entities over which ownership rights are enforced by institutional units, individually or collectively, and from which economic benefits may be derived by their owners by holding them, or using them over a period of time - that differ, except for monetary gold and SDRs, from other assets in the System in that there is a counterpart liability on the part of another institutional unit.

13.21. The classification of financial assets and liabilities is designed to distinguish types of instruments according to the liquidity of the instrument and the legal characteristics of the instrument that describe the form of the underlying creditor/debtor relationship. On this basis it distinguishes monetary gold and SDR, currency and deposits, securities other than shares, loans, shares and other equity, insurance technical reserves, financial derivatives and other accounts receivable/payable. A more detailed level of classification is recommended in the case of instruments for which information about the class of debtor or creditor is of particular importance analytically and is feasible to gather, such as liabilities to, and claims on, non-residents.

13.22. Contingent assets or liabilities are not treated as financial assets or liabilities in the System, as discussed in chapter XI. Sums set aside in business accounting to provide for transactors' future liabilities, either certain or contingent, or for transactors' future expenditures generally are not recognized in the System. (The only "provision" recognised in the System is accumulated consumption of fixed capital.) Only actual current liabilities to another party or parties are explicitly included. When the anticipated liability becomes actual - for example, a tax lien - it is included.