Comments on Task Force on Harmonising Public Sector Accounts, Topic 5.1: government guarantees of borrowing

We read with much interest the very good paper. “Government guarantees of borrowing”. Please find below comments/queries presented according to the structure of the paper.

Background to the issue

Guarantees involve three events (i) when a guarantee is created and remains in force, (ii) when it is activated, and (iii) when actual payments are made. The paper mentions only the first and third.

For event (ii), you may be interested in how the Balance of Payments Technical Expert Group (BOPTEG) at its July 2004 meeting considered treating activation of the guarantee (last paragraph of this note).

For event (i), the creation of guarantees, you may also want to explore how the event may be accommodated by the existing statistical guidelines (see Link with existing guidelines below under Eurostat Task Force Method).

Disadvantages in applying IPSAS 19 in statistical guidelines

The following conceptual rationale could be used for not adopting IPSAS 19.

- The so called expense that give rises to the provision is of “other events” nature rather than a “transaction”. This is acceptable in accounting since the income statement includes both “transactions” and “other events”. This reporting differs from that in statistical guidelines, where only transactions are recorded in the current accounts. The changes in value of financial assets would be treated as revaluations in statistical guidelines since they do not result from transactions with another unit.

- In IPSAS 19, “other events/other flow”, recorded as expense, results in the creation of asset/liability provisions. Statistical guidelines, on the other hand, imply that the creation of assets/liabilities result only from transactions, except in four specific cases: nonfinancial-nonproduced assets, valuable assets, SDR and monetary gold. The IPSAS19 provision does not meet any of these four cases.\(^1\)

- In IPSAS 19, the so called provisions are shown as government liability and government expense. The entries for the other reporting unit are revenue and claims of the borrower (as shown in Tables on pages 19-21 of the paper). While this recording conforms to the symmetrical treatment of the SNA, the rationale for these entries seems artificial: this becomes more obvious in cases when net present value of provisions decreases leading to a revenue of the government guarantor and a counterpart expense of the borrower. As noted in the first bullet, the SNA treats such flows as valuation changes.

\(^1\) There is one instance noted in the 1993 SNA para 12.59 where appearance of financial instruments due to splitting of an institutional unit is treated as changes in classification.
The IPSAS 19 method would apply separate treatment for guarantees with a greater than 50% chance of being (as provisions) called and those with a less than 50% chance (as contingencies). What happens if guarantees are not called? According to the proposed approach, all expenses recorded in previous periods will be recorded as revenues? What happens when the expectation moves above and below 50%? We flag these issues as concerns though we do not have solutions to propose.

The paper identifies two disadvantages in applying IPSAS to statistical guidelines:

- countries where the government accounts do not apply IPSAS 19 or similar provisions. As this is a practical concern, it should not be presented as the main criterion to reject the adoption of the IPSAS treatment in statistics. (In any cases, the Eurostat method entails that the estimates would be made by statisticians and not by accountants.)

- would involve recording the changes in provisions as redistributive transactions. The issue is not so much how the changes in provision are to be recorded. At issue, as noted in the first two bullets above, is what (transactions or other flows) create the provision. Furthermore, the changes in provisions would not need to be recorded as redistributive transaction as stated in the paper. Such changes could easily be recorded as other flow, and this would accord with the existing statistical guidelines.

**Eurostat Task Force Method**

- **Measurement of “likelihood of a guarantee being called”**. Will the measurement be based on the borrowing institutional units or the guarantor institutional units? Will it be based on guaranteed provided to specific borrowing instruments? In other words, will all guaranteed borrowing of an institutional unit be part of the “likely to be called” or will each guaranteed borrowing instrument be the basis for measurement? As in the case of IPSAS 19 method, the Eurostat method treats different guarantees differently. Clearly guarantees for the repayment of debt are covered but would other debt related guarantees also be covered, such as guarantees for exchange rate losses?

- **Rerouting** would involve creating a claim and a liability on government book in addition to the claim and liability, respectively, of original creditor and the ultimate borrower. Unlike, for instance, direct investment where rerouting involves two institutional units, the rerouting proposed here would require changing the books of three institutional units: government, borrower, and creditor (the connection to or contrasting with direct investment is not clear). If a guarantee is classified as likely to be called, then it is rerouted through government (otherwise treated as contingency, and not rerouted). How would one know at the creation of guarantees, which of them are likely to be called? And what happens if guarantees likely to be called become not likely to be called? It may happen that a guarantee considered likely to be called may be reclassified, at a later date, as not likely to be called as situation may change. For rerouting, how can we ascertain that the creditor would show a claim on government and not on the borrowing entity?

- **Link with existing guidelines**: It could be argued that a guarantee is a contract involving three institutional units, with the guarantor having both claims on the borrower and liabilities to the creditor with zero value at the time the guarantee is provided. This treatment would bring all guarantees within the asset boundary (as they would be recorded in balance sheets
and not as contingencies). While all recognized as balance sheet items, valuation would differ among guarantees, with some having a zero value (as is the case for forward contracts that have a zero value at the time they are created). If guarantees are treated as assets, two situations can be envisaged:

- First, theoretically the asset will derive value as chances of guarantee being called changes. This would assume that corresponding changes in value of the original instrument will occur. Both can be regarded as other changes. At the time the guarantee is called, the guarantee as a financial instrument will have a full value (the amount called) and the original instrument’s value will be reduced by the same amount. However, for loan borrowing, this would require the introduction of market valuation (otherwise, there will not be symmetrical measurement of loans among the three units).

- Second situation is a practical one. One can regard that the guarantee as a financial asset has zero value until it is activated at which time it will derive a full value. But the situation is no different from the first one (except continuous vs. one time valuation), and the change in value would be regarded as other changes, just prior to calls being made.

**Note: BOPTEG suggestion of treatment for activation of guarantees (July 2004 meeting)**

The BOPTEG’s suggestion for the treatment of flows arising from an activation of guarantee follows from the current statistical treatment of guarantees that they are contingencies until activated. For reasons of consistency and practical considerations, the BOPTEG suggested that it would be appropriate to record all flows arising from the activation of guarantees at the time of activation as “other changes”. The treatment of activation of guarantees in the existing guidelines is only partial as they do not provide guidance on how to record flows among all three involved parties. Depending on circumstances, the current treatment records, from the perspective of guarantor, either a financial transaction, or a transfer, or an other change in assets. (GFSM Appendix II paras. 4-6 and ESA95 paras. 4.165 and 5.16). BOPTEG issues papers and outcome papers can be found at IMF website [http://www.imf.org/external/np/sta/bop/bopteg.htm](http://www.imf.org/external/np/sta/bop/bopteg.htm).