

February 2005

RESPONSE TO
A questionnaire on the treatment of guarantees and other contingent liabilities

As a follow-up to the discussions held in the meeting of the Task Force on the Harmonisation of Public Sector Accounts held in September 2004, it has been suggested to further assess the views of the members of the Task Force (and possibly other interested institutions) on the key issues under discussion.

In this context, this questionnaire has been prepared on the basis of the discussions held in the TFHPSA in September 2004, and taking into account the paper presented on that occasion entitled "Activation of guarantees (contingent assets) and constructive obligations - TFHPSA"). An updated version of this paper has been attached to this questionnaire.

The questionnaire is divided into two sections. The first refers to a typology of guarantees, and its possible implications for the recording of such instruments in national accounts. The second refers to the possible features of the envisaged recording of contingent assets/liabilities, and requires information on which of the envisaged options (or which combination of these options) described in the above-mentioned note is seen as the most satisfactory.

We would be grateful to receive your reply by 15 February 2005. Please send your answer to the following e-mail address: Pierre.sola@ecb.int

Best regards,

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A. Typology of guarantees/contingent assets

The SNA provides a definition of “contingent assets/liabilities” rather than of guarantees, and describes guarantees as one example of contingent assets/liabilities¹: “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.” (SNA 11.25)

Based on the examples provided in the SNA93 and various other sources², it may be useful to clarify the various categories of instruments (“contingent assets/liabilities”) which are similar to guarantees, but :may be regarded as different

❖ credit risk transfer instruments

These would include all instruments intended to transfer credit risk from one entity to another:

- instruments related to one identified debtor
 - guarantees³, letters of credit;

¹ Similarly the International Accounting Standards (IAS) define a contingent asset as “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 entity.”¹ IPSAS 15 clarifies that “a contingent right and obligation meet the definition of a financial asset and a financial liability, even though many such assets and liabilities do not qualify for recognition in financial statements”.

² In particular the analysis of “credit risk transfer instruments” in the report “Credit Risk Transfer”, dated January 2003, by the Committee on the Global Financial System.

- insurance policies such as surety bonds⁴, credit insurance and financial guarantee insurance;
 - credit derivatives (e.g. credit default swaps⁵ and total return swaps);
 - furthermore, as pointed out in the BIS Guide to the International Banking Statistics (BIS Paper 16, page 57), collateral (...) may be considered in the same manner as guarantees” in terms of risk reallocation. Collateral, as included in e.g. mortgages or repos may therefore be regarded as including some “embedded” contingent assets;
- instruments related to a portfolio of debtors
 - e.g. portfolio credit default swaps;
- ❖ instruments related to liquidity management
 - lines of credit (cf. SNA93, paragraph 11.25);
 - note issuance facilities (cf. SNA93, paragraph 11.25);
- ❖ other instruments
 - instruments related to interest rate or FX risk: e.g. some financial derivatives (e.g. options).

³ According to the Exposure Draft of the IAS39 (dated October 2004), “financial guarantees” are contracts that provide for specified payments to be made to reimburse the holder for a loss it has incurred because a specified debtor fails to make payment when due should be initially recognised and measured by the issuer in accordance with IAS 39. Similarly, the CGFS report on credit risk transfers states that “a guarantee is a bilateral contract under which the risk taker (guarantor) has an obligation to perform for the benefit of the risk shedder (obligee). Performance is typically triggered by the non-performance of a third party (obligor) under a specified contract between the obligor and the obligee. Usually the guarantor is obliged to fulfil the obligor’s obligations if the latter cannot perform, with amounts payable limited to losses on the underlying exposure. Guarantees follow closely the nature and content of the contract between the obligee and the obligor. Guarantees are flexible instruments to transfer risk because they can be tailored to cover specific exposures or transactions. On the other hand there is currently no internationally agreed documentation or confirmation framework and guarantees are not traded”.

⁴ In the US, such bonds are issued and then provided to an “obligee”, as a guarantee for a debt or an obligation to this entity.

⁵ These are derivatives that are purchased through regular payments to the selling financial institution, which agrees to pay out if a particular reference bond defaults. Typically this would be a government bond. They provide insurance against the risk of sovereign default. They are (to some extent) standardised, and traded on financial markets. In business accounts the market value would be recorded in the balance sheet and changes to that value would be routed through the profit and loss account.

This questionnaire focuses on one of these contingent assets/liabilities, i.e. guarantees. Among guarantees, the following distinction may be relevant for the assessment of the correct recording to be booked in national accounts:

- Distinction by type of guarantor:

Guarantees are in general granted by:

- government, as a means of facilitating the financing projects or activities, or entities which may be in line with some of its objectives;
- corporations, often in order to facilitate the financing of entities of their group;
- financial corporations, usually against a specific remuneration;

- Distinction by type of object:

- Guarantees related to a specific project

- Guarantees given when goods are sold

This is where, for example, a manufacturer agrees to replace a product if it does not function correctly. The value of this asset to the purchaser would be reflected in the price paid. In business accounts a provision would be recorded for the expected cost of meeting called guarantees (as a liability to purchasers).

- Guarantees given on some large infrastructure projects

A central government may provide a guarantee to some private corporations that debt related to a specific project and possibly incurred by local government or even private corporations (e.g. large bridge...) will be paid.

- Guarantees related to specific activities or entities

- Guarantees sold by government to help businesses

We consider here schemes that are available to a wide variety of business that meet the eligibility conditions. The government's objective is to support certain types of business and activity (for example small firms, exporters, research and innovation) by providing bank guarantees to enable the businesses to borrow at lower rates of interest than would be available without a government guarantee.

For example, a business borrows from a bank and government gives a guarantee such that government agrees to pay the bank if the business defaults. The business pays a fee to government for this agreement and benefits from a lower rate of interest charged by the bank. If government pays under the guarantee it acquires a claim on the defaulting business. The fee charged by government is usually proportional to the risk.

- One-off guarantees given to public corporations

This is where governments give a small number of heterogeneous guarantees to public corporations, and other bodies acting in the public-interest, so that the corporations can borrow more cheaply. In some cases the corporation would not be able to borrow at all without the guarantee. Often the corporations receive large subsidies from government that enable them to repay the guaranteed borrowing. On the other hand some public corporations are genuinely self-financing and the government guarantee is given as a sort of subsidy to help keep prices down.

An actual call on the guarantee could be either a government grant or a government loan.

- Guarantees given by central government to local government

In some countries, the central government may provide guarantees to local governments, related e.g. to some of their activities.

- Distinction according to the timing of expected payments:

- Some guarantees are associated with a relatively clear set of expected claims and (timing of) payments.
- Others are not related to specific claims, so that in particular no specific timing of potential payments may be associated with the guarantee. This may be the case for instance of guarantees that some public companies will not default on their payments.

Question 1 – Typology of guarantees

Would you agree with the typology of guarantees proposed above?

Yes

No

If not, would you suggest a more appropriate classification?

[A typology of guarantees is useful and the one proposed above is a good start. In our view, a three-tier hierarchy would be useful to understand guarantees: \(1\) guarantees within the risk management system \(there are a broad range of instruments that are used to trade and transfer risks, and guarantees are among them\), \(2\) guarantees within the contingent liabilities \(there are various types of contingencies and guarantees are among them\), and \(3\) guarantees themselves. Within the first and second, the typology should clarify why guarantees are similar to and different from other instruments and arrangements \(such as from credit derivatives or insurance\). For the third, the typology proposed above could be extended to cover purposes and consequences of activation on the relationship between the guarantor and the borrower. The *External Debt*](#)

[Guide \(Chapter 9\), Compilation Guide on Financial Soundness Indicators \(Chapter 3\) and the International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template \(page 30\) provide some useful breakdown of contingencies.](#)

Question 2 – Impact of this typology on the possible recording of such transactions

For the time being, non-traded guarantees are not recorded in national accounts. Credit derivatives would be booked separately as “financial derivatives”, and guarantees sold would be recorded under services for the amount of the corresponding fee.

Do you think that the typology described under question 1 (or the one which you have proposed when answering that question, if applicable) should result in a further differentiation of the statistical treatments?

Yes

No

If yes: please explain the different accounting treatments that should be considered for the main categories of contingent assets/liabilities

[First of all, credit derivatives and insurance should not be mixed up with guarantees when determining statistical treatment \(please see also the answer to question 1 regarding the three-tier approach where guarantees can be viewed as risk managing instruments together with derivatives and insurance\).](#)

[Although there may be a stronger need for information for certain types of guarantees than others, this does not warrant differing statistical treatment among various types of guarantees.](#)

B. Options for recording guarantees in national accounts and government finance statistics

This part of the questionnaire analyses the various features of the possible recording of contingent assets/liabilities, as a basis for the assessment for the best final compromise. At this stage, it does not make a difference according to the types of guarantees identified above in section 1. Answers may of course propose some differentiation by type of guarantee.

It may be recalled that 7 options have been identified so far by the TFHPSA for the possible recording of guarantees (cf. attached note):

- 1 No recording in the core accounts (and showing information in memo items)
- 2 Full debt assumption when guarantee is given for some unusual guarantees
- 3 Re-route the guaranteed borrowing through government when call very likely
- 4 Record provisions as in IPSAS 19

- 5 Impute annual subsidies to purchase annual insurance policies
- 6 Purchase of an insurance contract
- 7 Financial derivative (for traded contracts)

The following questions intend to distinguish various features of these options, which may be combined together, before asking for a conclusion on the preferred option for recording guarantees.

Question 3 – Usefulness of summarising contingent liabilities through one number easily available to analysts

Discussions held in the TF HPSA in September 2004 suggested a broad consensus on the usefulness of providing data to users on at least the contingent liabilities of general government.

Various methods may be envisaged to provide such information: the following example may clarify the possible amounts to be recorded;

Example: a government has given four guarantees, for respectively EUR 10, 4,5 and 6 billion during year N. At the time of reporting its annual stocks at year-end N, it deems that the probability of the guarantees to be called is 99%, 80%, 60% and 20%, respectively.

	Amount of each guarantee	Expected timing of the contingent payments ¹	Discounted value of expected payments (under assumption of discount rate of 5%)	Probability to be paid (according to the entity) – EUR billions	Expected value of the payments (EUR billions)
Guarantee 1	10	End-N+1	9.5	99%	9.4
Guarantee 2	4	End-N+2	3.6	80%	2.9
Guarantee 3	5	End-N+1	4.8	60%	2.9
Guarantee 4	6	End-N+1	5.7	20%	1.1
Totals	25	N.A.	23.6	N.A.	16.3

¹ This simplified example assumes that guarantees cover clearly identified claims, so that expected dates of payments are clearly specified.

The following (stock) measures of the overall contingent liabilities of this government may be as follows:

- Method 1a: only guarantees for which it is evident that the guarantor will make the payments: here EUR 10 billion
- same as method 1a, but referring to the discounted value: here EUR 9.5 billion.
- Method 2a: only guarantees for which it is “very likely” that the guarantor will pay (assumed to be here a probability of at least 80%): $10 + 4 =$ EUR 14 billion
- Method 2b: same as method 2a, but referring to the discounted value: $9.5 + 3.6 =$ EUR 13.1 billion.
- Method 2c: same as method 2b, but referring to the expected value of payments, i.e. discounted amounts pondered according to the probability of realisation:
here: $9.4 + 2.9 =$ EUR 12.3 billion
- Method 3a guarantees deemed likely to materialise (i.e. probability higher than 50%): $10 + 4 + 5 =$ EUR 19 billion
- Method 3b same as method 3a, but referring to the expected (and discounted) value:
 $9.4 + 2.9 + 2.9 =$ EUR 15.2 billion.
- Method 4a: total amount:
in the example: EUR 25 billion
- Method 4b: discounted value of the total amount, in the example:
EUR 23.6 billion
- Method 4c: discounted expected value of all guarantees:
 $9.4 + 2.9 + 2.9 + 1.1 =$ EUR 16.3 billion

Which of these methods (or any other than those proposed above) would you consider as the most suitable?

Please explain.

[The IMF’s Statistics Department supports the continuation of the existing treatment of not recognizing contingent assets, including guarantees, in the core accounts of macroeconomic statistics. At the same time, recognizing the importance of information on guarantees, there should be additional supplementary information. Generally preferred are memorandum items of net present value \(accounting method called IPSAS 19\) and/or nominal values of amounts guaranteed— the maximum exposure loss \(see *External Debt Guide* para. 9.23\).](#)

[Also, as a medium term objective, it may be useful to work towards a full satellite account for contingencies, including a wider range of indicators of guarantees. The *External Debt Guide* \(Chapter 9 -- Contingent Liabilities\) provides some basis for classifying and measuring explicit](#)

and implicit contingencies. Likewise, the *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template* provides guidance on recording contingent liabilities.

One main concern regarding the TFHPSA proposals is that the issue of guarantees needs to be viewed in a wider context than is apparent in the TFHPSA paper. The proposal to recognise certain government guarantees as actual liabilities would involve an extension to the existing national accounts asset boundary. A question arises as to how to draw the line among types of contingencies, as others may also be likely to be “called” (such as penalties arising from court cases or from regulatory action), and between sectors -- if a bank provides a guarantee should that be recognized? Further, if a probability threshold of being called is introduced it may be difficult to implement in practice, while recording would become complex if a guarantee deemed likely to be called initially becomes not likely to be called at a later date. Also, the guarantor and creditor may have different views on the probabilities, undermining the symmetric recording in the national accounts.

Rerouting would involve creating a claim/liability on the guarantor’s book in addition to the books of the creditor and borrower. It not only masks the financing arrangement by imputing the intermediary, but also breaches the ownership principle. Also, how can we ascertain that the creditor would show a claim on the guarantor, but not on the borrowing unit?

As mentioned in the response to question 1 above, although guarantees have some similarities with credit derivatives and insurance, they do not have important characteristics of financial derivatives (trading financial risk in its own right) and of insurance (pooling of resources involving service fees and transfers for providing protection against certain risks). The imputation of guarantees as if they were financial derivatives or insurance would reduce the analytic usefulness of the present data categories.

Furthermore, all proposals require several imputations.

The TFHPSA paper describes mostly government guarantees. For a proposal to change the existing treatment, it would be necessary to consider all guarantees and investigate the implications of the different recording proposals for them.

Concerning the activation of guarantees, the paper does not fully elaborate the consequences on all three parties involved in a guarantee. Mostly, the paper's proposals envisage transfers (capital or current) from the government to the borrower. Present manuals proposed various options for government (capital transfers, or financial claims, or other changes). The Balance of Payments Technical Expert Group investigated all possible alternatives of recording flows by the three parties arising from the activation of guarantees (<http://www.imf.org/external/np/sta/bop/bopteg.htm>; see papers for Issues # 2).

Finally, 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.](#)⁶

Question 4 (only for statistics compilers) – Practicalities of the collection of data

Would any of the methods envisaged in question 3 raise strong practical difficulties for the data collection and compilation?

Yes (please specify which options)

No

Please explain.

[Please see response to question 3 above for some practical problems.](#)

Question 5 – Recording within the core accounts or as supplementary items

The SNA93 recommends in paragraph 11.26 not to show contingent liabilities in the core accounts, but to collect and present supplementary data “where contingent positions are important for policy and analysis”.

Modifying the SNA to record contingent liabilities in the core accounts would have the advantage of including their assessment (cf. calculation method discussed under question 1 above) within some of the (key) aggregates of the system, and would result in the systematic availability of both stocks and flow data. They would also imply a consistent recording of not only liabilities, but also corresponding assets, and seem to imply to perform this recording for all involved institutional sectors. They may also foster a more systematic and internationally comparable compilation of such data.

Among the drawbacks which were highlighted in the latest discussions in the TF HPSA are the uncertainties in the measurement of these guarantees, based on a subjective assessment of the probability that they will be called, which may make aggregates more volatile and less ‘transparent’, and the difficulty to ensure the quadruple accounting principle of the SNA (symmetry principle as described in SNA 2.60 to 2.62): it appears rather unlikely that debtors and creditors will have the same assessment of the probability of the guarantees to be called. Of course, statistics compilers could ensure consistency within domestic accounts by amending some of the reported values, but this would not be possible for the rest of the world account, and may not fully reflect reality for domestic accounts. Furthermore, the concern that memo items might be seen as secondary and therefore may not be compiled has been highlighted in various discussions. The following questions focus on each of these issues.

⁶ 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.

Are you in favour of recording contingent assets and liabilities in the core accounts or as a memo item (or satellite account) ?

In the core accounts

As a memo item (or satellite account)

Please motivate your answer.

[Prefer memo item/s.](#)

Questions 6 to 10 should be answered only if the answer to question 5 is “in the core accounts”.

Question 6 – Do you regard the symmetric recording of assets and liabilities (i.e. by the debtor and the creditor) as feasible, or should the recording be performed only in the government accounts (rather than in national accounts as a whole)?

Yes, the symmetric recording is feasible

No, it is not feasible

Other (please explain)

Please explain (taking into account the explanations provided above).

Question 7 – While guarantees given by an entity are clearly a liability for that entity (guarantor), would you regard corresponding assets as those of the lender or those of the borrower?

Lender

Borrower

Other (please explain)

Please explain.

Question 8 – Should guarantees be included in key aggregates (for stocks and flows)

Yes, they should be part of the main aggregates, i.e. deficit (B9) and debt

They should be part of the debt, but not of the main deficit B9, and rather be in a separate (new?) account

No

Please motivate your answer.

Question 9 – In which accounts should these guarantees be recorded?

- They should be shown as provisions
- They should be shown as similar to insurance contracts
- Other (please explain)

Please motivate your answer.

Question 10 – Should the following events be regarded as non-financial transactions, financial transactions, revaluations or other changes in volume?

- Issuance of the guarantee
- Change in the estimated probability that guarantees will be called
- Change in the discount rate
- Guarantee being called/activated

Please motivate your answers.

Question 11 (only for statistics compilers) – Practicalities of the collection of data

Would any of the steps envisaged in questions 5 to 10 raise strong practical difficulties for the data collection and compilation?

Yes

No

Please explain.

Question 12 – Conclusion: what is your preferred option for the recording of guarantees?

On the basis of your answers to the previous questions of this questionnaire, would you propose to follow one of the 7 options described in the attached note entitled “Activation of guarantees (contingent assets) and constructive obligations – TFHPSA”, or another one (possibly being a mix of the 7 options of the attached note)?

One of the 7 options of the attached paper: please specify which option

Other option - to be specified

Please explain.

[No change to the existing treatment and memo item/s for the amounts of guarantees.](#)

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