

February 2005

A questionnaire on the treatment of guarantees and other contingent liabilities

Following the discussion of the draft paper on 'Activation of guarantees (contingent assets) and constructive obligations – TF HPSA' at the meeting of the Task Force on the Harmonisation of Public Sector Accounting (TF HPSA) in September 2004, it has been suggested to further assess the views of the members of the Task Force (and of other interested parties) on some key issues on guarantees. In this context, a questionnaire has been prepared, which has been attached to this letter - together with the updated draft paper.

The questionnaire is divided into two parts. Part A deals with the typology of guarantees and its possible implications for the recording of guarantees in the new SNA. Part B refers to the possible features of the envisaged recording of contingent assets. It asks for information allowing to better assess the options or the combinations of options which are seen as the most appropriate accounting treatments.

We would be grateful to receive your reply by 21 February 2005. Please send your answer, preferably in an electronic format to the following e-mail address: Pierre.sola@ecb.int - with a copy to Reimund.mink@ecb.int.

Best regards,

Reimund Mink and Pierre Sola

Name:

Country:

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PART A

1. GUARANTEES AS A SUB-CATEGORY OF CONTINGENT ASSETS

The SNA93 provides a definition of “contingent assets” and refers to guarantees as an example: “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.”

Other contingent assets are also described in the SNA93, such as lines of credit (which provide a guarantee that funds will be made available), letters of credit (promises to make a payment only when certain documents specified by contract are presented) and underwritten note insurance facilities (NIFs). NIFs provide a guarantee that a borrower 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.¹ The ESA95 mentions that, in addition to these arrangements, many of the derivative instruments are contingent assets.²

Based on the examples provided in the SNA93 and in the ESA95, and on various other sources, it is useful to mention, in addition to guarantees, other contractual arrangements which are similar to these instruments.³ They may be grouped into credit risk transfer instruments, liquidity management instruments, and other instruments. Credit risk transfer instruments may be related to one or to various debtors. Instruments related to one debtor are guarantees,⁴ letters of credit, insurance policies such as surety bonds,⁵

¹ See SNA93, paragraph 11.25. Similarly, the International Accounting Standards (IAS37) 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”. The IPSAS15 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 See ESA95, paragraph 5.05.

³ 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.

⁴ According to the Exposure Draft of amendments to the IAS39 and IFRS 4 “Financial Guarantee Contracts and Credit Insurance” (issued in July 2004), “financial guarantees” are contracts that “require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument.” 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

credit insurance and financial guarantee insurance, credit derivatives (e.g. credit default swaps⁶ and total return swaps), or collateral such as mortgages or repurchase agreements.⁷ Instruments related to various debtors may be portfolio credit default swaps. Liquidity management instruments may include lines of credit and NIFs.⁹ Financial derivatives related to interest rate or foreign exchange risk (e.g. options) may be regarded as other types of contingent assets.⁸

2. TYPOLOGY OF GUARANTEES

2.1. Guarantees by type of guarantor

The questionnaire focuses on guarantees, which may be classified according to different criteria. Guarantees may be split by the **type of guarantor**. General government may grant guarantees as a means of facilitating the financing projects or activities, or entities which may be in line with some of its objectives. Non-financial corporations may provide guarantees to facilitate the financing of entities of their group, while financial corporations may grant guarantees to other units against a specific remuneration.

2.2. Guarantees by type of object

Guarantees may also be distinguished by the **type of object**. Related to a specific project, guarantees are given when goods are sold. It means that, 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 accounting, a provision would be recorded for the expected cost of meeting called guarantees (as a liability to purchasers). Guarantees may also be given for some infrastructure projects. For instance, central government may provide a guarantee to some private corporations whose debt refers to a specific project, e.g. a large bridge.

Guarantees related to more general **activities** or to some **entities** may be given by general government to help groups of corporations or households. These may be schemes that are available to a wide variety of corporations or households that meet the eligibility conditions. The government's objective is to support certain types of corporations, households or activities (for example small firms, exporters, home mortgages, research and innovation) by providing bank with guarantees enabling the corporations or households to borrow at interest rates lower than they would be without any government guarantee or to make credit available that otherwise could not be obtained at all. For example, a corporation borrows a loan from a credit institution and general government gives a guarantee such that government agrees to pay the credit institution if the corporation defaults. The corporation may pay a fee to government for this agreement and benefits from a lower rate of interest charged by the credit institution. If government pays

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.”

⁵ 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.

⁶ 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 accounting the market value is recorded in the balance sheet and changes to that value are routed through the profit and loss account.

⁷ As outlined 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 repurchase agreements may therefore be regarded as including some “embedded” contingent assets.

⁸ Though being recorded as financial assets, when they are tradable and can be offset on the market: cf. the above-mentioned paragraph 5.05 of the ESA95

under the guarantee it may acquire a claim on the defaulting corporation and may foreclose on collateral or assume the defaulted guaranteed loan. The fee charged by government is usually proportional to the risk.

One-off guarantees given to public corporations and other bodies refer to cases in which government units give a guarantee to a public corporation, 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 that receive guarantees are genuinely self-financing and the government guarantee is given as a sort of subsidy to help keep prices down or support production. An actual call on the guarantee could be either a government grant or a government loan.

2.3. Guarantees according to the time of expected payments

Some guarantees are associated with a relatively clear set of expected claims and of the 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 corporations will not default on their payments.

2.4. Explicit and implicit guarantees

A distinction is also made between explicit and implicit guarantees.⁹ Explicit guarantees are those recognised by law or contract, while implicit obligations of government mainly reflect public expectations. One example of implicit guarantees refers to banks and corporations that may be deemed “too big to fail”.

⁹ As suggested in the Exposure Draft 1 on “Guarantees by Governments” issued in May 2003 by the Government Accounting Standards Advisory Board.

Question 1 – Typology of guarantees

Would you agree with the typology of guarantees as proposed above?

Yes ☐

No ☐

If not, which typology of guarantees would you suggest as the most appropriate typology?

Question 2 – Impact of the typology of guarantees on the possible recording of transactions

For the time being, non-traded guarantees are not recorded in the core accounts in the SNA93 (cf. paragraph 11.26) and ESA 95 (cf. paragraph 5.05). Credit and some other derivatives would be booked separately as “financial derivatives” under the condition that they are traded on financial markets¹⁰ (cf. SNA93 paragraph 11.34), and guarantees sold would be recorded under services for the amount of the corresponding fee.

Do you think that the typology of guarantees as described in section 2 (or the typology, which you have proposed under question 1) should lead to further options of the accounting treatment of guarantees?

Yes ☐

No ☐

If yes, please explain the additional options of the accounting treatment that should be considered for the main categories of contingent assets.

¹⁰ “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”.

PART B

3. OPTIONS HOW TO RECORD GUARANTEES IN THE SNA

This part of the questionnaire describes the various options how to record guarantees in the SNA. At this stage, guarantees are not treated differently depending on the various types as described in section 2. It may be recalled that seven options of the recording of guarantees have been identified so far by the TF HPSA. They are also described in the attached note. These options are:

- 1 No recording in the core accounts (information on guarantees as a memo item¹¹);
- 2 Record a 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 (possibly as in IPSAS19);
- 5 Impute annual subsidies to purchase annual insurance policies;
- 6 Treat as a purchase of an insurance contract; and
- 7 Treat as a financial derivative (for traded contracts).

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

¹¹ This option would leave the SNA unchanged. A variant of this option would be to require (possibly on a mandatory basis) more detailed information on guarantees in a satellite account.

Question 3 – Usefulness of summarising information on contingent assets through one number easily available to analysts

The discussions during the TF HPSA meeting in September 2004 showed a broad consensus on the usefulness of providing data to users, at least on the amount of contingent liabilities incurred by 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 unit has given four guarantees, for respectively EUR billions 10, 4, 5 and 6 during the year N. At the time of reporting its annual stocks at the end of the year N, it deems that the probabilities of the guarantees to be called are 99%, 80%, 60% and 20%, respectively.

	Amount of each guarantee (EUR billions)	Expected timing of the contingent payments ¹	Discounted value of each payment based on a discount rate of 5% p.a. (EUR billions)	Probability to be paid according to the entity	Expected value of the discounted 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
Total	25	N.A.	23.6	N.A.	16.3

¹ It is assumed that guarantees cover clearly identified claims, which would give rise to one-off payments so that expected dates of payments are clearly specified.

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

- Guarantees for which it is evident that the guarantor will have to pay: EUR billions 10 (1a);
- The discounted value of guarantees for which it is evident that the guarantor will have to pay: EUR 9.5 billions (1b).
- Only guarantees for which it is very likely that the guarantor will have to pay (probability at least 80%): EUR billions 10 + EUR billions 4 = EUR billions 14 (2a).
- The discounted value of guarantees for which it is very likely that the guarantor will have to pay (probability at least 80%): EUR billions 9.5 + EUR billions 3.6 = EUR billions 13.1 (2b).
- The expected value of (discounted) guarantees (= discounted values of guarantees for which it is very likely that the guarantor will have to pay (probability at least 80%) multiplied by the respective probabilities of realisation): EUR billions 9.5 * 0.99 + EUR billions 3.6 * 0.80 = EUR billions 9.4 + EUR billions 2.9 = EUR billions 12.3 (2c).
- Only guarantees for which it is likely that the guarantor will have to pay (probability higher than 50%): EUR billions 10 + EUR billions 4 billions + EUR billions 5 = EUR billions 19 (3a).
- The discounted value of guarantees for which it is likely that the guarantor will have to pay (probability higher than 50%): EUR billions 9.5 + EUR billions 3.6 + EUR billions 4.8 = EUR billions 17.9 billion (3b).

- The expected value of (discounted) guarantees (discounted values of guarantees for which it is likely that the guarantor will have to pay (probability higher than 50%) multiplied by the respective probabilities of realisation): EUR billions $9.5 * 0.99 + \text{EUR billions } 3.6 * 0.80 + \text{EUR billions } 2.8 * 0.60 = \text{EUR billions } 9.4 + \text{EUR billions } 2.9 + \text{EUR billions } 2.9 = \text{EUR billions } 15.2$ (3c).
- All guarantees: EUR billions 25 (4a).
- The discounted value of all guarantees: EUR billions 23.6 (4b).
- The expected value of all (discounted) guarantees: EUR billions $9.4 + \text{EUR billions } 2.9 + \text{EUR billions } 2.9 + \text{EUR billions } 1.1 = \text{EUR billions } 16.3$ (4c).

Which of these methods (or any method other than proposed above) would you consider as the most appropriate one?

Please explain.

Question 4 - Collection and compilation of data

Is statistical information available (or could it be collected relatively easily):

(a) On the individual amounts of guarantees given by government and/or other institutional units?

Yes ☐

Partially ☐

No ☐

If yes or partially, please specify which information could be collected from what source:

(b) On the expected timing of these individual guarantees given by government and/or other institutional units?

Yes ☐

Partially ☐

No ☐

If yes or partially, please specify which information could be collected from what source:

(c) On the expected values of the payments (and therefore on the probability of guarantees to be called)?

Yes

Partially

No

If yes or partially, please specify which information could be collected from what source:

(d) What would be the most appropriate discount rate?

(e) Who compiles/could compile the probabilities for the guarantees to be called?

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

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

In the core accounts:

1

As a mandatory memo item (or in a satellite account)

7

As a voluntary memo item (or in a satellite account)

10

Please explain your answer, specifying whether it applies to all guarantees, or only to some of them (e.g. depending on the probability of being called: cf. question 3):

[illegible]

Questions 6 to 12 should be answered with reference to either the core accounts or satellite accounts, depending on your answer to question 5.

Question 6 – As described under question 5, the recording of guarantees would imply to record symmetrically a liability of the debtor, which reflects the guarantee given, and an asset of the creditor, which reflects the guarantee received (at the same time and for the same amount). Do you regard this “symmetric recording” as feasible, or should the recording be done only in the government or, in general, in all guarantor accounts?

The symmetric recording is generally feasible

7

The symmetric recording is not feasible

7

If not feasible,

the recording should only be done in the government accounts

10

the recording should be done in all guarantor accounts

7

Other (please explain)

1

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

Question 7 – While a guarantee given by an entity is clearly a liability for that entity (guarantor), would you regard the corresponding assets as those of the unit which granted the corresponding loan (lender) or as those of the unit which received that loan (borrower)?

Lender

Borrower

Other (please explain)

Please explain.

Question 8 – Should flows related to guarantees be recorded as transactions with a corresponding impact on net lending/net borrowing (B.9)

Yes

No, but they should be recorded as other flows impacting net worth

No, but they should be recorded in a new ‘other flow’ account

No, they should not be recorded as flows

Please motivate your answer.

Question 9 – In which asset category should these guarantees be recorded?

A new asset category ‘provisions’ (cf. “provision option” described in the attached note) ☐

A new asset category, similar to insurance contracts (cf. options “Impute annual subsidies to purchase annual insurance policies” and “Purchase of an insurance contract” of the attached note) ☐

Other (please explain) ☐

Please motivate your answer, possibly distinguishing several types of guarantees or probabilities that the guarantees will be called.

Question 10 – Should the following events be treated as non-financial transactions (NF), financial transactions (F), revaluations (R), or other changes in the volume of assets (OCIV)?

Issuance of the guarantee ☐

Change in the estimated probability that guarantees will be called ☐

Unwinding the discount ☐

Change in the discount rate ☐

Modification to the loan guarantee contract ☐

Guarantee being called/activated ☐

Assumption of a defaulted guaranteed loan ☐

Guarantees being cancelled without being called ☐

Please motivate your answers, specifying if they refer to all guarantees or only some of them (e.g. depending on the probability of being called: cf. question 3).

Question 11 – Consistency with similar instruments/scope of the guarantees to be covered

As described in the introduction to this questionnaire, collateral is not a guarantee in itself, but is a similar contingent asset. Should collateral be recorded in the same way as guarantees?

Yes

☐

No

☐

Please explain.

Question 12 – Collection of data on guarantees

Would any of the steps envisaged in questions 5 to 11 raise practical difficulties for the data collection and compilation?

Yes

☐

No

☐

Please explain.

Question 13 Treatment of guarantees fees

Fees paid/received in exchange for a guarantee are currently recorded as services (cf. SNA 11.26: “any payment of fees related to the establishment of contingent arrangements are treated as payments for services”). Would you see a need to modify this treatment taking into consideration your answers to the previous questions?

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11

Please explain.

[illegible]

Question 14 – What is your preferred option for the recording of guarantees?

On the basis of your answers to the previous questions, would you follow one of the seven options described in the attached note entitled “Activation of guarantees (contingent assets) and constructive obligations – TF HPSA”, or another one (possibly being a modification of the seven options of the attached note, or a mix of these options)?

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11

Please explain.
