

November 18, 2004

Comments on the Issues Raised by Jeff Golland's paper before the September 2004 meeting

Jeff Golland sent an excellent memo to the TFHPSA team on guarantees just before the September meeting, in which he presented key issues arising from the responses to the earlier ECB issue paper he sent us in April on guarantees in the national accounts. The Task Force did not have time at the meeting to discuss most of these issues, so I thought it might be useful to write comments. I am sorry that I was not able to do this much earlier, as I had intended.

I have copied and pasted Jeff's issues onto this memo and commented on them one-by-one. I followed his organization by dividing them into three sections: Section I, approaches preferred by a majority of the replies; Section II, arguments against treatment as provisions; and Section III, issues to resolve. Within each section, I followed his numbering issue-by-issue. I also added two other issues in Section IV.

For reference, I have also attached the Word file with Jeff's original memo as a whole and have included Jeff's email at the end of mine.

**I. Approaches Preferred by a Majority of the Replies**

- a) record a government liability, through a transaction, for the net present value of the statistically expected future cash flows under the guarantee, when the guarantee is given / becomes active;

**Comments.** Yes, but allow other methods of estimation that are consistent with the measurement objective.

A guarantee of borrowing (lending) meets the definition of "liability" in IPSAS 19 and other standards. It is a present obligation of the entity, it arises from past events, and its settlement is expected to result in an outflow from the entity of resources embodying economic benefits. It should therefore be recognized as a liability on the balance sheet.

The guarantee should be recognized through a transaction, not an "other economic flow." See Section II(iii) below.

The measurement objective for the liability, as Jeff wrote later, is "the estimated market price that would have been paid had it been bought." Market prices of

identical or similar liabilities should be used if available, but they might rarely be available for government guarantees. When they are not available, the expected value of the guarantee is a generally accepted method sanctioned by IPSAS 19 and other standards. More precisely, as Jeff writes, this estimate is “the net present value of the statistically expected future cash flows under the guarantee.” This is the concept underlying the measurement of the guarantee liability and expense in US federal budgeting and federal GAAP. I agree that the guidance should focus upon it.

However, other methods besides the expected value might be used to calculate “the estimated market price . . .” In particular, the New Zealand delegates have discussed using options pricing, and some analysts in the US are also interested. I would therefore suggest that the guidance focus on present value but explicitly allow other methods of estimation that are consistent with the measurement objective.

- b) the expected cost would be recorded by the guarantor as an expense affecting its surplus/deficit<sup>1</sup>.

**Comments.** Yes. The government has incurred a liability through a transaction with another institutional unit.

- c) the exact recording of this<sup>2</sup> in the non-financial account depends on whether it is treated as insurance, or in a new category for provisions, or as a derivative;

**Comments.** Yes.

- d) it was better to include the expected cost of all guarantees not just those that are expected to be called as in IPSAS19<sup>3</sup>;

**Comments.** Yes. See discussion in Section III(a) below.

- e) when treated like insurance or a provision the unwinding of the discount should count as a property income expense;

**Comments.** Yes. See discussion in Section III(b) below.

- f) other changes to the value of the liability should be recorded in other flows;

**Comments.** I agree for the most part. However, I would distinguish between modifications of the guarantee and revaluations. See the discussion in Section III(b) below.

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<sup>1</sup> But offset by a receipt if the guarantee were sold at a fair price. No expenditure or receipt if treated as a derivative, just financial transactions as, for example, the treatment of a credit default swap.

<sup>2</sup> The acquisition of a financial liability

<sup>3</sup> But the IPSAS19 restriction can be overcome by grouping guarantees where they are similar.

- g) whether the guarantee is paid for, or given free, the treatment is the same. Just record a subsidy for the estimated market price that would have been paid had it been bought (the value of the financial liability acquired).

**Comments.** See discussion of fees in Section IV(b) below.

## **II. Arguments against Treatment as Provisions**

- i) insufficient data: but this does not normally stop national accountants from introducing complicated new ways of recording economic activity;

**Comments.** I defer to the national accountants about whether the available data would be sufficient. I understand that this should not be a problem in preparing estimates in the US for the national income and product accounts. As a general matter, potential difficulties might be alleviated:

- Flexibility might be permitted in adopting these principles with respect to (1) the extent to which liabilities and expenses would be recognized and measured in the “ideal way” as opposed to the best approximation that is possible and (2) how soon the guidance is put into effect after the SNA update is issued in 2008. Flexibility might be viewed as a good way to make the transition from not recognizing any guarantee liabilities at all to recognizing and measuring all guarantees ideally; it might also be viewed as comparable to the flexibility that is permitted for recording income tax revenue in ways other than the accrual basis.
- If more governments adopt IPSAS 19 or similar standards for financial accounting, more data will be available when the update is issued than are available in 2004.

- ii) too fundamental change for an “update” (rather than revision) of SNA;

**Comments.** This would seem to be a decision for the AEG. The role of the Task Force, as I understand it, is to determine the best possible accounting treatment for guarantees.

I would wonder why guarantees are on the Task Force agenda if this option is too fundamental to consider for an update. The other options would also seem to make fundamental changes (insurance and derivatives) or not be worth doing (debt assumption and re-routing).

- iii) contrary to some of the principles of national accounts: for example there is a view that giving a guarantee is not a "transaction", and so should not be recorded as expenditure. This line of argument seems incompatible with the case when the guarantee is actually paid for, and even when given free,

guarantees are evidenced by in actual signed legal contracts otherwise the market would have no faith in them

**Comments.** Providing a guarantee is a “transaction” as defined by statistical guidelines. It is “an economic flow that is an interaction between institutional units by mutual agreement”.

It is first of all an “economic flow,” because (1) it reflects the creation and the exchange or transfer of economic value (i.e., the guarantee); and (2) it increases the liabilities of the guarantor and the assets of the institutional unit obtaining the guarantee. The economic value of a guarantee is demonstrated in private business, where one institutional unit guarantees the borrowing (or lending) of another in exchange for a fee. A government guarantee may be in exchange for a fee that is expected to cover some or all of the costs, and any fee at all provides evidence of economic value. The government may also give a guarantee without charging a fee. However, the nature of the guarantee, which legally obligates the government to make payment under specified conditions, means that economic value is being transferred. The institutional unit obtaining the guarantee receives a resource from which future economic benefits are expected to flow. It would not take the trouble of obtaining the guarantee if it did not convey economic value.

The guarantee is, furthermore, a “transaction” and not an “other economic flow.” The guarantee agreement requires an interaction between institutional units by mutual agreement. The signed legal contracts to which Jeff refers are evidence of the interaction and the mutual agreement.

### **III. Issues to Resolve**

- a) Should it be applied only to guarantees with a greater than 50% chance of being called (as in IPSAS19 and UK GAAP)? The 50% cut-off does not seem logical; perhaps it is there to limit accountants’ work. One option for SNA would be to adopt IPSAS19 but to apply it to government guarantees as a whole, rather than individually, such that the 50% test for the group would almost certainly be passed. But could lead to inconsistency with public accounts if SNA does not apply the 50% rule.

**Comments.** The same accounting treatment should be applied to all individual guarantees (one-off guarantees) regardless of whether their chance of being called is more than 50%. The definition of “liability” in IPSAS 19 depends on whether the entity has a present obligation, the present obligation arises from past events, and its settlement is expected to result in an outflow from the entity of resources embodying economic benefits; and the definition of “provision” depends on whether the liability is of uncertain timing or amount. These characteristics do not include whether the guarantee is above or below the 50% cut-off line.

Therefore, to exclude guarantees below the 50% cut-off line is to omit some liabilities and expenses from the national accounts.

The proportion of liabilities omitted under IPSAS 19 would depend in part on how many of the government's guarantees were in groups of similar guarantees. "When there are a number of similar obligations . . . the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole." In such cases, the 50% criterion might be easily met. If US experience is typical (and it may not be), most guarantees are in classes of similar obligations. Nevertheless, the omitted liabilities would not necessarily be very small. If US experience is typical, a one-off guarantee is likely to be made for a relatively large amount, such as for an airline loan. The liability in that case, even if the 50% cut-off is not met, might exceed the liability for a very large number of guarantees in groups of similar guarantees (such as guarantees of home mortgages).

The 50% cut-off would also produce some specific undesirable results, as Task Force members have pointed out:

- The same guarantee would be treated differently depending on whether it was a one-off guarantee or was part of a group of similar guarantees. For example, a liability for a one-off guarantee would not be recognized if the probability of an outflow of resources was 10%. If the government made a small number of similar guarantees with similar risk, however, the probability of an outflow of resources from the group as a whole would be more than 50%. A liability would be recognized for the very same guarantee that would not be recognized if it was evaluated separately.
- Insignificant differences in the estimate of probability could determine whether a liability was recognized. A liability would be recognized if the chance of the guarantee being called was 51% but not if it was 49%.
- A liability would switch back and forth from being recognized to not being recognized if the estimated probability switched back and forth across the 50% line. The revaluations would exaggerate the actual change in the estimated liability.
- A liability, if recognized at all, might often be recognized in the wrong year. If US experience is typical, a single guarantee rarely meets the 50% criterion at its inception. It would meet this criterion subsequently if the probability of default increased enough. In that case, the liability would be recognized in the national accounts in a later year than when the guarantee influenced lending and real economic activity.

The only rationale for the 50% cut-off would seem to be consistency with IPSAS 19 and similar standards and the availability of data from governments that have

adopted these standards. However, there are indications that accounting standards are moving in the direction of recognizing a liability for all guarantees.

- In the US federal government, the principles adopted in the budget for 1992 and in financial accounting (federal GAAP) for 1994 recognized a liability for all guarantees. (See summary in annex 8 to the ECB issue paper, which is attached to this memo with a revised and more complete heading.) (Note: The US has three sets of GAAP: for non-governmental entities, for federal governmental entities, and for state and local governmental entities.)
- In US GAAP for non-governmental entities, the Financial Accounting Standards Board (FASB) issued an interpretation in 2002 that required entities to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This is not a provision, but it serves the same purpose and the accounting is the same. (See summary in annex 1 of this memo.)
- The IASB issued an Exposure Draft in July 2004 that would require the issuer of a financial guarantee contract to measure the contract initially at fair value. This is not a provision, but it serves the same purpose and the accounting is the same. (See summary in annex 2 of this memo.) The IASB has received many comment letters and, of course, may revise its proposal, combine it with others, or not issue a standard at all.

The Exposure Draft appears to say that IAS 39 (Financial Instruments: Recognition and Measurement) and IFRS 4 (Insurance Contracts) already require financial guarantee contracts to be recognized as a liability and measured at fair value if they are standalone contracts issued at arm's length to an unrelated party. These standards do not have counterparts in the IPSASs. I do not know IAS 39 and IFRS 4 well enough to judge their relationship to this Exposure Draft.

- Accounting standards seem generally to be moving in the direction of recognizing many liabilities at fair value. They also seem to be moving away from bright lines, such as the 50% cut-off, and toward more principle-based standards.

Paul Sutcliffe confirmed at the September meeting that the IFAC-PSC still has in place the principle of convergence with the IASs and IFRSs. Updating the IPSASs for changes in the international standards is a question of resources, he said. Thus, depending on the IASB's next steps and the IFAC-PSC's resources, the IPSASs may be revised some time in the future to recognize a liability for all financial guarantee contracts.

- b) Should other changes in the value of the provision (for the guarantee) be treated as expenditure/income above the line? Most task force members have argued against this. The argument is that such changes are that SNA treats holding gains and losses below the line. They are outside government's control and not foreseeable (unlike the discount unwinding) and so should be treated as holding gains and losses. However some other changes are foreseeable. For example, if the guarantee covers events occurring over a period of five years with equal probability and cost, at the end of each year the value of the provision will be reduced because of the fact that one less year of activity is at risk. For financial assets traded on a market it is correct to treat the holding gains and losses below the line because the initial price is a genuine price. In the case of provisions for guarantees given free this is not the case since the initial value is an estimate. So it could be argued seems reasonable to treat that estimate, and changes to the estimate, both as expenditures, to avoid manipulation of the accounting through a low initial value of the provision, or preferring calls on the guarantee to giving a grant. Treatment as other flows could cause data problems because IPSAS19 treats all movement in the same category. On the other hand one needs to consider the impact on the accounts of the asset holder, not just government (the liability holder).

**Comments.** I would divide the changes in a provision among three categories, the second of which has not been previously mentioned.

1. Unwinding the discount. – As stated in Section I(e), I agree that unwinding a discount should be a property income expense (recorded above the line). This is like the interest on a zero-coupon bond and many other liabilities. The liability increases over time as the expected future cash flows are discounted over fewer years, and a corresponding interest expense should be reported.
2. Modifications of the guarantee. – The government may take an action that differs from the actions assumed in the previous estimate of cash flows and that changes the cost of an outstanding guarantee. In particular, it may alter the terms of existing contracts (by mutual agreement) or change the way it administers its portfolio of guarantees. A modification should be treated as a transaction in the same way as the initial issuance of a guarantee.
3. Other changes in the value of a provision. – If I understand the statistical definitions correctly, other changes in the value of a provision are an “economic flow” because (1) they reflect the creation or extinction of economic value and (2) they involve a change in the assets and liabilities of institutional units. They are not a “transaction,” because they are not “an interaction between institutional units by mutual agreement or an action within an institutional unit . . .” They are therefore an “other economic flow.” This is an appealing conclusion, because they appear to

be a revaluation of the liability (a holding gain/loss). In particular, they appear to be analogous to an actuarial gain/loss for a defined benefit pension plan that is attributable to a change in assumptions about future wage growth, retirement age, or mortality.

What about the danger of manipulation if other changes in a provision are recorded as other economic flows? I agree with Jeff that this is a valid concern. However, the only way of fully avoiding manipulation is not to recognize any liability for guarantees at all. I would also suggest that under some circumstances the incentive to manipulate would be less if other changes in the value of the provision are classified as other economic flows than if they are classified as transactions. If the probability of repaying a guaranteed loan lessens, the government might be more likely to recognize an increase in liability if it did not have to recognize an increase in expense at the same time.

- c) How to record a claim on the guarantee when it leads to the acquisition of a financial claim rather than just being an unrequited transfer? This could be straightforward: the release of the provision would equal the expected loss on the financial claim. The rest of the cash outflow would represent the acquisition of a financial asset. However, this depends on being able to value loans at their fair value rather than the nominal value.

**Comments.** It should not be much more difficult to estimate the future cash flows for acquired financial assets (such as defaulted guaranteed loans) than to estimate the future cash flows for the guarantees *per se*.

- d) Who holds the asset? There are good arguments for saying it is the lender not the borrower: a guarantee given for free would be viewed as a subsidy to a bank to enable it to lend more cheaply than normal.

**Comments.** The lender holds the asset, not the borrower. This is in spite of the fact that the guarantee primarily encourages real economic activity by the borrower and provides the borrower with economic benefits. The answer is different from what I thought at the end of the September meeting.

The guarantee transaction itself is an interaction between the government and a lender, who enter into a contractual arrangement by mutual agreement. As a result, the government creates something of value (the guarantee) and exchanges or transfers it to the lender. The government's obligation is contractually defined with respect to the lender; and the expected outflow of resources embodying economic benefits is an outflow from the government to the lender. This in itself is evidence that the lender holds the asset.

The lender's balance sheet, if defined in economic terms, should reflect the government's obligation. The lender has a loan asset, net of an allowance for losses. If the asset was valued at market price, it would be less than the amount of



the loan disbursed by more than the initial loss allowance. Depending on circumstances, the market price would reflect a low interest rate on the loan, a low creditworthiness of the borrower, or some other characteristic that might have made the loan unprofitable in the absence of a guarantee. The guarantee serves to “fill in the gap” -- albeit in a very rough manner that may not even be an approximation -- between the market price of the loan and the value at which the loan would be economically viable on its own. This is because it provides the lender with “resources controlled by an entity [the lender] as a result of past events and from which future economic benefits . . . are expected to flow to the entity” – the definition of an asset in IPSAS 1, paragraph 6.

The borrower, on the other hand, has a legal obligation for the full amount of the money borrowed. The borrower owes the entire amount of the loan regardless of whether it borrowed at less than the competitive interest rate or is not very creditworthy. This obligation is recognized as a liability on its balance sheet. The borrower does not have any kind of asset on its balance sheet, even implicitly, that directly reflects the guarantee – resources it controls from which future economic benefits are expected to flow. The lender controls the resources represented by the guarantee, and any future economic benefits from the guarantee will go to the lender. The borrower received a flow of economic benefits when it borrowed the money, but they are represented by any assets that it bought with the loan or expenses that it paid. It will not receive any future economic benefits from the guarantee, so it does not hold an asset.

Therefore, from the perspective of either the transaction or the balance sheets, the lender is the institutional unit holding the asset that is the counterpart to the government’s guarantee liability.

#### **IV. Other Issues**

##### (a) Moral guarantees and institutions “too big to fail”.

**Comments.** An issue raised at the meeting was how to treat moral guarantees and institutions “too big to fail”. I believe that the SNA guidance should be explicitly limited to recognizing legally binding, or contractual, guarantees. It would be speculative to estimate the expected costs for moral guarantees and institutions “too big to fail”; there would be little evidence as time passed to evaluate the accuracy of the initial estimates unless the government actively intervened; little confidence could be placed in the results; and the estimates could easily be manipulated with little hard evidence to refute them.

This limitation would be consistent with the present or proposed accounting standards that I know about. US federal government budgeting and Federal GAAP, the US GAAP for non-governmental entities, and the IASB Exposure Draft on financial guarantee contracts all apply only to “binding agreements” or “contracts”. They do not recognize constructive obligations.

(b) Fees.

**Comments.** The treatment of fees has not been discussed, although it appears to be included in the issue Jeff raised that I have labelled Section I(g) above. It should be made clear to avoid any possible misunderstanding. Fees could be recognized either (1) as revenue or (2) as an offset in calculating the cost of a guarantee that is reported as liability and expense.

I defer to the statisticians about the appropriate treatment in the national accounts, but I would make a few observations about treatment elsewhere. Financial accounting seems generally to recognize fees as revenue in some way. IPSAS 19 (page 43, which is illustrative rather than authoritative) says that guarantee fees are revenue. In US GAAP for non-governmental entities, EITF 85-20 appears to require that fees be recognized as revenue.

US federal government budgeting and federal GAAP are different. The principles were developed for the budget so that the full cost of a guarantee to the government could be compared with the benefits; with the costs of alternative means of providing credit assistance; and with the costs of alternative types of programs. To satisfy this purpose, the guarantee transaction must be evaluated as a whole. All cash flows attributable to the guarantee transaction are combined into one single, comprehensive estimate of the expected value of the cost. Fees that the government collects from the lender are as much a part of the estimated cash flows as the payment that the government makes if the borrower defaults.

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## **Annex 8 (revised) US Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards (SFFAS) 2**

### **SFFAS 2: Accounting for Direct Loans and Loan Guarantees**

SFFAS 2 is consistent with US federal government budgeting for direct loans and loan guarantees, which has been conducted on a present value basis since the budget for fiscal year 1992.

SFFAS 2 was issued in August 1993 and became effective for fiscal years ending September 30, 1994, and thereafter.

#### **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.

## Annex 1 US Financial Accounting Standards Board (FASB), Interpretation No. 45

### FASB Interpretation No. 45: Guarantor's Accounting and Disclosure Requirements for Guarantees

The recognition and measurement provisions were applicable to guarantees issued or modified after December 31, 2002.

#### Summary

This Interpretation . . . clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This Interpretation does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee [The recognition and measurement principles do not apply to guarantees accounted for as insurance or derivatives and to some other guarantees.]

Paragraph 9: Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of paragraphs 8-12 of Statement 5 regarding the guarantor's contingent obligation under a guarantee should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is *not* probable that payments will be required under that guarantee. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 10, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

- a. When a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor.
- b. When a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm's-length transaction with an unrelated party. In the absence of observable transactions for identical or similar guarantees, expected present value measurement techniques as set forth in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, will likely provide the best estimate of fair value. Concepts Statement 7 states in its glossary that "*expected present value* refers to the sum of the probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention." . . .
- c. When a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee should be measured at its fair value . . .

## **Annex 2 International Accounting Standards Board (IASB) Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts**

### **Federal Guarantee Contracts and Credit Insurance**

IASB issued the ED on 8 July 2004.

### **Introduction**

IN1. Financial guarantee contracts (sometimes known as ‘credit insurance’) 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. These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Some financial guarantee contracts result in the transfer of significant insurance risk and thus meet the definition of ‘insurance contract’ in IFRS 4 *Insurance Contracts*.

IN2. This Exposure Draft contains proposals by the International Accounting Standards Board to amend IAS 39 *Financial Instruments: Recognition and Measurement* to define ‘financial guarantee contracts’ and amend the requirements for their treatment by the issuer. Under the proposals, the legal form of such contracts would not affect their accounting treatment.

IN3. The proposals would require the issuer of a financial guarantee contract (other than those contracts described in paragraph IN6) to measure the contract:

(a) initially at fair value. If the financial guarantee contract was issued in a stand-alone arm’s length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(b) subsequently at the higher of (i) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

These requirements would apply even if the contract meets the definition of an insurance contract in IFRS 4.