Treatment of loan guarantees:

International Accounting Standards

UK public accounts

Proposal for an updated SNA93

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International Accounting Standards

Relevant International Accounting Standards

- **IA37 “Provisions, Contingent Liabilities and Contingent Assets”** *Non-tradable long term guarantees*
- **IAS39 “Financial instruments: recognition and measurement”** *Tradable guarantees, derivatives*
- **IFRS 4 “Insurance contracts”** *Interim standard while fuller guidance is developed*
- **IPSAS19 “Provisions, Contingent Liabilities and Contingent Assets”** *Non-tradable guarantees given by public sector*
- **IPSAS 9 Revenue from Exchange transactions** *Recording fees for guarantees*

IAS - International accounting Standard

IFRS - International Financial Reporting Standard

IPSAS – International Public Sector accounting Standard

IPSAS19

Obligations of uncertain timing or amount (because they depend on future events):

If a payment is probable, a provision is recorded in the balance sheet

If payment is improbable, it is treated as a contingent liability and not recorded in the balance sheet.

IPSAS19 applies this distinction to the treatment of guarantees.

IPSAS19 based on IAS37. IASB wants to change IAS37 such that all obligations would be recorded as provisions

The word “Provision”

Used by accountants to mean a liability:
a future expense of uncertain quantity and timing

Used in other contexts to mean a stock of assets
“The squirrel makes provisions for the winter”

Perhaps this is not a problem in other languages

Treatment of guarantees in IPSAS19

- Guarantees are treated as provisions if a call is likely (typically numerous similar guarantees treating as a group)
- Guarantees are treated as contingent liability and not recorded in main accounts if a call is not likely (typically one-off guarantees)

Balance sheet

- **Financial liability (a provision) recorded in the balance sheet**
  = Expected cost of calls on the guarantee (net present value)
- **Subsequent movements in the balance sheet arise from:**
  - **Difference between risks expiring and actual claims paid***
  - **Passage of time unwinding the discount**
  - **Reassessment of risk**
- **Provision released**
  - **Guarantee payments are redemptions of the liability**

* "risks expiring" is the cost of expected calls in the time period when the provision was initially assessed
* sometimes called "provision not required written back", or "reversed unused during the year".

Profit & loss account

- **Expense recorded in profit and loss account for new provision**
  = Expected cost of guarantee payments, as in balance sheet
- **Expense / income recorded for subsequent movements in the balance sheet due to**
  - **Difference between risks expiring* calls and actual claims paid**
  - **The passage of time unwinding the discount (expense like interest)**
  - **Any reassessment of future risks**
- **Provision release is <u>not</u> recorded in P&L account**
  - **Guarantee payments are redemptions of the liability**

* "risks expiring" is the cost of expected calls in the time period when the provision was initially assessed

UK public accounts

UK public accounts

- **UK government departments produce annual accounts according to UK Generally Accepted Accounting Practice (UK GAAP)**
- **Financial Reporting Manual (FREM): UK GAP with some additions for the nature of the public sector**
- **UK GAAP follows the international accounting standards**
- **Guarantees are recorded as either provisions or contingent liabilities depending on whether calls are likely.**

Provisions in UK public accounts: examples

- **Clinical negligence**
- **Student loan bad debt**
- **Small firms loan guarantee scheme**
- **Nuclear decommissioning**

These liabilities are recorded in the relevant department's balance sheet. The amount equals the net present value of expected future payments. This is a probability weighted concept.

Example of guarantee recorded as a provision

Small firm loan guarantee scheme

P&L account: impact of new guarantees given:

Income: fees charged for new guarantees

Expense: provision recorded for estimated cost of calls on guarantee

If the expected future costs are greater than the fees charged there is a net cost to the department, recorded in its budget just like real expenditure.

Contingent liabilities recorded in the notes to UK public accounts: examples

- **Guarantee of loan for Channel Tunnel Rail Link**
- **Guarantee of loan to Network Rail**

Recorded in the notes to the accounts not balance sheet

Amount recorded is the total possible cost.

No impact on department’s budget, unless there is an actual payment under the guarantee.

Guarantees in UK public accounts

Payment improbable: contingent liability, not in balance sheet

Payment probable: provision recorded

Derivative: record at fair value (credit default swaps)

Export Credit Guarantees: Insurance "fund accounting" is applied, but this is under review.

System of National Accounts 1993 (SNA93)

System of National Accounts 1993 (SNA93)

Provisions, in the accounting sense, are not recorded.

Consequently, guarantees are not recorded in main accounts, unless they are traded like financial derivatives

Insurance technical reserves (AF.6), a liability of financial institutions, are recorded as the value of the assets held to finance future costs, rather than being an estimate of those future costs. So AF.6 is not presently recorded like a provision in the accounting sense.

Reasons to change SNA93

- Guarantees are significant
- Giving or selling a guarantee is a transaction
- Harmonisation with accounting standards
- More coherence within SNA by identifying the counterpart to a payment for a guarantee

Proposals for SNA update

AEG decision July 2005

Distinguish between:

Guarantees that are financial derivatives *no change*

- credit default swaps

Standardised guarantees (many of similar type) *new treatment*

- student loans
- loans to small businesses
- loans to finance exports

One-off guarantees *reroute certain cases ?*

- loans to state railway companies

Indents are examples, not complete list

Standardised guarantees in an updated SNA93

- Record a liability in the balance sheet of the guarantor

- Value like a provision under IPSAS19

- New instrument F.63 “guarantee provisions”

- Impute subsidies for free guarantees

- Record an asset in balance sheet of lender

AEG meeting in February 2006 will consider some further details explained in paper circulated by ECB to AEG on 22 November 2005 and subsequent E-discussion

Standardised guarantees in an updated SNA93
The guarantor's accounts

- **Balance sheet: record in AF.63 the amounts recorded under IPSAS19**

- **Record financial transactions in F.63 for movements in provision**
  - New guarantee.
    - Counterpart receipt of cash for fee.
  - Difference between expected calls and actual claims paid
    - Counterpart D71 resource: expected calls
    - Counterpart D.72 use: claims paid
  - Unwinding of the discount
    - Counterpart D4: interest

- **Record output equal to the fee charged less value of the F.63 liability**
- **Impute subsidy and extra fee if actual fee insufficient to cover costs**

Standardised guarantees in an updated SNA93

Key message

Standardised guarantees are like insurance policies

The logical coherence and economic reality of the methodology for recording provisions, as in IPSAS19, can be brought into national accounts by adapting the insurance instruments F6, D71 and D72.

IPSAS19	Proposed updated SNA
Profit and loss account	**Transactions and other flows**
Fees received	In calculation of output Output = fees received[1] minus value of financial liability incurred in F.63
Movement in provisions in P&L account: of which:	
New contracts	Transaction (increase) in F.63 liability, and transaction (increase) in F.2 asset (the fee paid)
Unwinding of discount	Transaction (increase) in F.63 liability, and transaction in D.44x (property income)
{ Provision reduced as risks expire }	Decrease in F.63 liability, and D.71 insurance premium receipt
{ Provision increased due to claim paid }	Increases F.63 liability, and D.72 insurance claim
Reassessment of provisions due to other reasons	Other volume change K.10 (or add to D.71 ?)
Not in P&L account	
Release of provision to pay claim	Decreases AF.63 liability Decrease in AF.2

Other issues for the recording of guarantees in an updated SNA93

- Discussed in paper for AGE
  - Recording in the accounts of the borrower and lender
  - Recording payment of claims when an asset is acquired
- Other issues
  - Property income, discount factor to be used
  - Accruing premium and output over the life of a guarantee