Activation of Guarantees


The Statistics Department
International Monetary Fund

(1) Recommendations by BOPTEG:

(i) The group agreed with the current treatment in international statistical guidelines. This is that a guarantee is a contingency until it is activated at which time the old liability is eliminated from the balance sheets of the original creditor and the original debtor, and a new liability is recorded in the balance sheets of the original creditor and the guarantor.

(ii) Concerning the treatment of flows arising from the activation of a guarantee, a strong majority of the group proposed that all changes in balance sheets of all involved parties (original creditor, original debtor, and guarantor) be shown through the Other Changes in Volume of Assets Account. However, some members suggested that the flows between the creditor and guarantor should be treated as transactions. The group recommended that for the reason of consistency and practical considerations, it would be appropriate to record all flows arising from the activation of guarantees in the Other Changes in Volume of Assets Account (also see section 2 for various reasons). One argument advanced was that the terms and conditions of the activation of the guarantee, and the flows that arise, are set at the time the guarantee is agreed and not on activation. It would also be useful to consider arrangements and implications of guarantees arising from direct investment relationships. It was clarified that the actual payments between the creditor and guarantor are financial transactions. One practical problem was noted that might appear in those cases where data on flows are derived from stocks. In the absence of additional information, the changes in positions would include, among other things, changes due to activation of guarantees.

(iii) The group noted some similarities between guarantees, insurances, and credit derivatives; but concluded that guarantees should be treated as distinct from insurances and credit derivatives.
(2) Alternatives rejected by BOPTEG:

A strong majority of the group did not support the treatment of flows arising from the activation of guarantees as transactions. Several arguments were raised, including that the activation of guarantees reallocates the sectoral distribution of existing claims/liabilities; guarantees cross the asset boundary from being a contingency to an actual claim/liability; treatment as transactions would involve imputations; treating one leg (say, between the creditor and the guarantor) as transactions and another (say, between the creditor and the original debtor) as other volume changes would require imputations of contra entries; and activation may often be related to the liquidation of a debtor.

(3) The Committee’s decisions:

The Committee supported the BOPTEG recommendations. It, however, noted the work being undertaken on this topic by TFHP5A and suggested that the BOPTEG recommendations be taken as provisional until a decision on TFHP5A work is taken.

(4) Implications for the SNA

Clarification

(5) Questions for the AEG:

(i) Does the AEG agree with the retention of the current treatment of guarantees (that a guarantee is a contingency until it is activated)? See 1(i) above.

(ii) Does the AEG agree with the recommendation that all flows arising from the activation of guarantees be treated as other changes in volume of assets? See 1(ii) above.
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUES PAPER (BOPTEG) # 2

ACTIVATION OF GUARANTEES

Prepared by Manik Shrestha, IMF Statistics Department

April 2004
Liabilities can be guaranteed by a third party. Guarantees are arrangements whereby the guarantor commits to pay or assume the liability of another entity (the original debtor) if certain conditions are met (such as inability of the original debtor to pay). Guarantees may include repayments of principal and/or interest payments. A debt guarantee involves three institutional units: original creditor, original debtor, and guarantor. Activation of a debt guarantee creates a new liability and the guarantor now becomes the new debtor. This raises issues on how to treat flows between the original debtor and creditor and between the original debtor and the guarantor (the new debtor).

Activation of guarantees affects transactions or other economic flows. Usual cases of guarantees in terms of institutional units involved and motivations may be:

- (1) government providing guarantees for borrowing by public enterprises or private enterprises (for example, to encourage certain types of activities),
- (2) financial intermediaries providing guarantees as services for payment of a fee, and
- (3) parents providing guarantees for their subsidiaries (for example, to cut interest costs).

The treatment of flows arising from an activation of guarantees may also need to consider whether the original debtor continues to exist or disappears as an institutional unit. Three cases could be distinguished:

- (1) the original debtor unit continues to exist and the guarantor strengthens its balance sheet,
- (2) the original debtor unit continues to exist, but the guarantor seeks repayment later, and
- (3) the original debtor unit is liquidated.

This paper discusses recording of flows arising from the activation of a guarantee within the 1993 SNA scope of asset boundary (that is, contingencies are not included in the asset boundary). The Task Force on Harmonising Public Sector Accounts (TFHPSA) is also examining various options, in addition to the 1993 SNA treatment of guarantees as contingency, for the treatment of guarantees. These options, however, would require changes to the time of recording principles and/or scope of asset boundary.

I. Current international standards for the statistical treatment of the issue

A. Making of guarantees

The 1993 SNA states that guarantees are contingencies (para 11.25), which means that they are not recorded in the system. Any payments of fees related to the establishment of
contingent arrangement are treated as payment for services. Transactions in financial accounts are recorded only when an actual financial asset is created or changes ownership (para. 11.26). The BPM5 para. 314 states that assets must represent actual claims that are legally in existence. Credit derivatives are treated as financial assets.

The GFSM 2001 suggests that aggregate data on all important contingencies should be recorded as memorandum items (para. 3.96).

The Annotated Outline (para. 6.3) defines assets boundary as in the 1993 SNA, but notes that the new manual will encourage compilers to provide information on important off-balance sheet obligations as supplementary items\(^1\).

B. Activation of guarantees

The 1993 SNA and BPM5 do not specifically discuss the treatment of activation of guarantees. The External Debt Statistics: Guide for Compilers and Users (External Debt Guide) notes that “once the guarantee is called, the debt payment is attributed to the guarantor, and the arrear of the original debtor is extinguished, as though repaid” (para. 2.30). When a government decides to repay specific borrowing or payments on behalf of another institutional unit without the guarantee being called or the debt being taken over, the External Debt Guide states that the debt stays recorded solely in the balance sheets of the original debtor (para. 8.49).

The Government Finance Statistics Manual 2001 (GFSM 2001) deals with activation of guarantees in the context of government guarantees and debt assumption by government. Appendix II (paras. 4-6) of the GFSM 2001 describes the treatment of debt assumption involving the general government. When a debt is assumed, the flows between the government and the original debtor depend on whether the government obtains an effective financial claims (effective in the sense that there is a realistic probability that the claims will be paid), relationship between the government and original debtor, and other situations (for example, the context of debt assumption). If the government acquires an effective claim on the unit whose debt is assumed, the government records an acquisition of a financial asset with the original debtor. If the government does not acquire an effective claim on the unit whose debt is assumed, two possibilities are discussed in the GFSM 2001. If the original debtor is an on-going public corporation the government records an acquisition of equity. It records a capital transfer if the original debtor is bankrupt or is not owned and controlled by government.

\(^1\) In the new Balance of Payments Manual, a distinction will be made between memorandum and supplementary items. Memorandum items are considered as a part of the standard components whereas supplementary items are raised as options that may be considered when a particular issue is of interest to analysts and policy makers.
The *European System of Accounts 1995 (ESA95)* mentions that the counterpart transaction of debt assumption and debt cancellation is classified as capital transfers except for the following three cases (paras 4.165, 5.16).

- If the owner of a quasi-corporation assumes liabilities from or cancels financial claims against the quasi-corporation, the counterpart is a transaction in shares and other equity.
- If government assumes or cancels debt from a public corporation which disappears as an institutional unit, flows are recorded in other changes in volume of assets account.
- If government assumes or cancels debt from a public corporation as part of an ongoing process of privatization to be achieved in short-term perspective, the counterpart is a transaction in shares and other equity.

The activation of a guarantee may or may not require repayment of debt at once. The accrual principle for time of recording suggests that the total amount of debt assumed should be recorded at the time the guarantee is activated and the debt assumed, but not when actual payments are made by the guarantor. Principal repayments by the new debtor (guarantor) and interest accruals on the assumed debt should be recorded when these flows occur.

The *Annotated Outline* (para. 3.11) noted that when a debt guarantee is activated, it will create a new liability. It also pointed out that guidance is needed on how to treat various flows between the parties involved in the activation of a guarantee.

**II. Concerns/shortcomings of the current treatment**

Concerning the data on positions, the discussion in the *External Debt Guide* seems sufficient. The original creditor and the original debtor would eliminate the claim/liability from their balance sheets. The original creditor and the new debtor (guarantor) would record a new claim/liability in their balance sheets.

However, the existing statistical manuals do not cover comprehensively the treatment of flows arising from an activation of guarantees. The *GFSM 2001* and *ESA95* deal mainly with debt assumption by a guarantor (particularly by government). When a guarantor assumes debt as a result of an activation of a guarantee, flows of all three parties involved in that guarantee are affected. Furthermore, the *GFSM 2001* and *ESA95* guidelines for debt assumption by government seem to differ in some respect.
III. Possible alternative treatments

A. Making of guarantees

*Annotated Outline* (para. 6.3) suggests recording significant off-balance sheet obligations as supplementary items.

B. Activation of guarantees

Flows between the original creditor and the guarantor (new debtor) arising from an activation of a guarantee:

- Creation of a new financial claim on the guarantor by the original creditor, or
- Other changes in the volume of assets (as guarantees cross the asset boundary from contingency to actual claim/liability).

Flows between the original creditor and the original debtor arising from an activation of a guarantee:

- Extinction of the liability of the original debtor (a part or whole for which a guarantee is called) as if it is repaid (financial account transaction), or
- Extinction of the liability of the original debtor as if it is written off (other changes in the volume of assets), if original debtor-enterprise is liquidated.

Flows between the original debtor and the guarantor (new debtor) arising from an activation of a guarantee:

- In general, the treatment of these flows between the original debtor and the guarantor should be determined on the basis of agreement between the involved parties, if such exists.
- When the original debtor continues to exist:
  - If the guarantor (new debtor) acquires financial claims on the original debtor as a result of the activation of a guarantee, an acquisition of financial claim, including increases in the existing equity participation, by the guarantor on the original debtor seems appropriate.
  - If the guarantor does not acquire financial claims on the original debtor as a result of the activation of a guarantee, a capital transfer from the guarantor to the original debtor may be considered. Capital transfers should be rare in business situations. Usually, there are financial claims (particularly in cases of public enterprises, quasicorporations, and subsidiaries).
• When the original debtor does not exist, both the increase in assets and the removal of this claim could be recorded in other changes in the volume of assets².

IV. Points for discussion

(1) Do the BOPTEG considers that the treatment of the activation of guarantee is appropriate (that a guarantee is a contingency until it is invoked at which time the old liability is extinguished and a new liability is created)?

(2) What are the views of the group on the treatment of flows arising from an activation of a guarantee?

References

Annotated Outline for the Revision of BPM5, IMF, April 2004 (Chapters 3 and 6).

1993 SNA (paras. 11.25, 11.26, 12.4, 12.6).

BPM5 (para. 314).


European System of Accounts 1995 (paras. 4.165, 5.16).


---

² This is because other changes in the volume of assets record changes between opening and closing positions that are not due to transactions or revaluation (1993 SNA paras. 12.4, 12.6). This means that the other changes in the volume of assets are recorded when either new assets that were not in the opening balance sheets appear or existing assets disappear in the closing balance sheets. As guarantees are contingencies, no existing claim exists that could be eliminated through other changes in the volume of assets.