HM Treasury

Contingent Liability Approval Framework:

guidance (updated 2021)

August 2021

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Contents

Chapter 1	Introduction	2
Chapter 2	Defining and classifying contingent liabilities	5
Chapter 3	Overview of the contingent liability process	10
Chapter 4	Completing the contingent liability checklist	17
Annex A	Contingent liability checklist	24

Chapter 1
Introduction

Context

1.1 HM Treasury (the Treasury) is the UK's economic and finance ministry. Central to its role as a finance ministry is the scrutiny of public finances and holding government departments to account for their decisions on spending.

1.2 As is made clear in 'Managing Public Money',[1] Parliament expects the Treasury to set the ground rules for the administration of public money throughout the public sector. The Treasury designs and runs the financial planning system[2] and oversees the operation of the agreed budgets to meet ministers' fiscal policy objectives. This supports the Treasury's mission to promote effective and efficient use of taxpayers' money.

1.3 A core Treasury objective is to "place the public finances on a sustainable footing".[3] Sustainability is fundamental to prudent fiscal policy. Without a focus on sustainability, there would be an incentive to delay spending from today to some point in the future as this would improve public finances today, albeit at the expense of public finances in the future. However, emphasising sustainability avoids such incentives by ensuring that both the short run and long run impacts of spending decisions are appropriately accounted for.

1.4 'Managing Public Money' states that "because commitments can evolve into spending, they should always be scrutinised and appraised as stringently as proposals for consumption".[4] It also makes clear that Parliament expects advance notice of any commitments to future use of public funds. These future commitments are often uncertain and referred to as 'contingent liabilities'. Contingent liabilities recognise that future spending may arise if certain events happen or particular conditions are met (see chapter 2 for further details on defining and classifying contingent liabilities).[5]

1.5 Given that contingent liabilities may affect future spending rather than current spending, they may affect the sustainability of public finances. Therefore, since 2017, the Treasury has taken a number of steps to improve the management of contingent liabilities, including:

- introducing a new process (The Contingent Liability Approval Framework) for approving, monitoring, and managing contingent liabilities in order to

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1 See Managing Public Money www.gov.uk/government/publications/managing-public-money

2 Consolidated Budgeting Guidance https://www.gov.uk/government/publications/consolidated-budgeting-guidance-2020-to-2021

3 https://www.gov.uk/government/publications/hm-treasury-outcome-delivery-plan

4 See "5.5 Commitments" in *Managing Public Money* (pg34)

5 Also see Annex 5.4 in *Managing Public Money* for more information on the treatment of contingent liabilities.

ensure such transactions are consistent with safeguarding the sustainability of public finances

- publishing the 'Government as Insurer of Last Resort' report, which contains a range of recommendations for improving the management of guarantees and insurance provided by the government to reduce cost and risk to taxpayers[6]
- publishing 'The Balance Sheet Review' Report, which highlights significant opportunities identified, reforms undertaken, and savings delivered through the UK's comprehensive review of public sector assets and liabilities[7]
- establishing the Contingent Liability Central Capability (CLCC) in UK Government Investments (UKGI); achieving one of the proposals outlined in the 'Government as Insurer of Last Resort' report. The CLCC will support departments in the design of contingent liabilities (guarantees and indemnities), assist the Treasury in the assessment of new contingent liabilities, and improve the monitoring and management of risk across the government's portfolio of contingent liabilities

1.6 The Contingent Liability Approval Framework, set out in this document, requires that officials responsible for initiating a contingent liability with a maximum exposure of £3 million or more complete the contingent liability checklist in all cases, if the contingent liability is any one of the following:

- novel – the contingent liability is new for the organisation concerned, even if others have done it before
- contentious – the contingent liability is likely to raise debate or criticism in Parliament or more widely
- repercussive – the contingent liability may have consequences elsewhere in the public sector

Aim of the guidance

1.7 This guidance updates the original Contingent Liability Approval Framework, published in 2017. Its objectives are to:

- provide an overview of the updated Contingent Liability Approval Framework
- assist officials in the application of the updated guidance when completing the contingent liability checklist
- signpost officials to the relevant support in the Treasury, CLCC and Government Actuary's Department (GAD)

6 https://www.gov.uk/government/publications/government-as-insurer-of-last-resort--2

7 https://www.gov.uk/government/publications/the-balance-sheet-review-report-improving-public-sector-balance-sheet-management

- This guidance will be kept under review by the Treasury and it will be updated again when necessary

Structure of the document

1.8 The document is set out as follows:

- Chapter 2 defines contingent liabilities and provides guidance on classifying them
- Chapter 3 provides an overview of the contingent liability approval process from inception to publication
- Chapter 4 presents the contingent liability checklist and provides guidance on each question in the checklist
- Annex A provides a copy of the contingent liability checklist

Chapter 2

Defining and classifying contingent liabilities

2.1 This chapter describes contingent liabilities both in simple and technical terms and sets out the classification of contingent liabilities.

2.2 Contingent liabilities can be understood as liabilities that are uncertain but may lead to future expenditure if specific conditions are met or certain events occur. See Box 2.A for the technical definition of a contingent liability under International Financial Reporting Standards.

2.3 Contingent liabilities can come in various forms. There are four main types of contingent liability that the government is exposed to,[1] as set out in Chart 2.A.

Chart 2.A: Typology of contingent liabilities

Guarantees[2]	Indemnities[3]	Legal Cases[4]	Purchaser Protections
When the government agrees to pay the debts of a third party if they default	When the government agrees to cover costs if a certain event occurs	When a lawsuit is likely to be brought directly against the government as a result of undertaking its core activities	Where the government agrees to provide warranties or indemnities relating to asset sales

2.4 Boxes 2.B and 2.C describe the two most common types of contingent liability the government is exposed to: indemnities, and guarantees, and provide more detailed guidance on the specific treatment of each.

[1] These contingent liability categories have been established for risk management purposes and are different to accounting classifications. Contingent liabilities in any of these categories can be remote or non-remote.

[2] There are a subset of guarantees classified as "standardised guarantees" under ESA10. These are issued in large numbers, usually for fairly small amounts, along identical lines and have an upfront fiscal impact at the point of issuance. Contact the Treasury if you think the contingent liability could be classified as a standardised guarantee.

[3] In the *Government as Insurer of Last Resort* report reference was made to 'explicit government insurance'. This can be interpreted as equivalent to the use of the term 'indemnities' in this guidance.

[4] Consult your department's finance team about classifying a legal case as a contingent liability. Legal advice should also be sought.

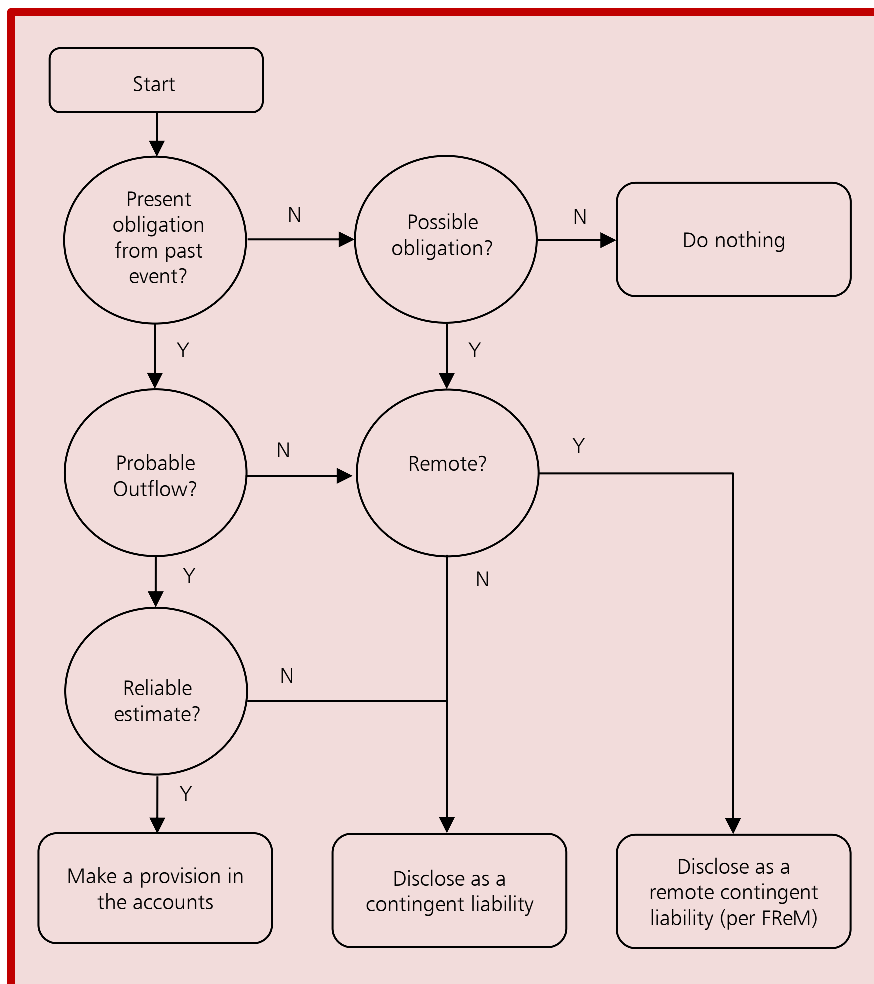
2.5 Note that while contingent liabilities are considered off-balance sheet[5] (i.e. not on the public sector balance sheet), their disclosure is required.[6]

2.6 If a contingent liability is more likely than not to crystallise (that is, requiring a pay-out), then it is brought on balance sheet as a provision (Chart 2.B; subject to there also being a present obligation at the reporting date and it being possible to reliably estimate the amount).

2.7 A contingent liability can crystallise without first becoming a provision. Chart 2.B shows how provisions, contingent liabilities, and remote contingent liabilities are classified, as well as the relevant disclosure requirements.

2.8 The lead departmental policy officials, in conjunction with departmental finance teams, are responsible for determining whether a particular policy gives rise to a contingent liability and subsequently classifying / reclassifying the contingent liability. In cases of uncertainty, the Treasury is available to support departments with this determination.

Chart 2.B: Classifying provisions, contingent liabilities and remote contingent liabilities



5 See IAS 37 https://www.ifrs.org/issued-standards/list-of-standards/ias-37-provisions-contingent-liabilities-and-contingent-assets/

6 See the Financial Reporting Manual https://www.gov.uk/government/publications/government-financial-reporting-manual-2020-21

Box 2.A: Definition of Contingent Liability under IAS 37

A contingent liability is:

> "(a) a possible obligation 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; or (b) a present obligation that arises from past events but is not recognised because:
>
> - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
> - or the amount of the obligation cannot be measured with sufficient reliability" (see IAS 37, paragraph 10).

Difference between a provision and a contingent liability:

In terms of financial reporting, a contingent liability must be disclosed but not recognised in an entity's financial statements. This is to be distinguished from a provision, which must be recognised and will therefore impact the entity's statements of financial position and income or expenditure.

A provision is defined as "a liability of uncertain timing or amount" (IAS 37, paragraph 10). It must be recognised in the financial statements when: "(a) an entity has a present obligation (legal or constructive) as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation" (IAS 37, paragraph 14).

If any of these conditions are not met, no provision is recognised. Accordingly, if an obligation is not present or probable in existence but only possible, or separately, if the occurrence of a future outflow of resources is not probable but only possible, then a contingent liability is disclosed. A contingent liability is also disclosed in cases where the criteria for determining an obligation and probable payment are met but a reliable estimate cannot be made.

Definition of "probable", "possible" and "remote":

In determining the likelihood of making a payment in the future, "an outflow of resources or other event is regarded as **probable** if the event is **more likely than not to occur**, i.e. the probability that the event will occur is greater than the probability that it will not" (IAS 37, paragraph 23).

In determining a present obligation, it may not be clear if one exists at the reporting date. In this case "a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period" (IAS 37, paragraph 15).

It therefore follows in all cases that anything **less than likely** to occur is defined as **possible**. Where the possibility of future settlement is very small, it should be considered **remote**.

Box 2.B: Indemnities

Indemnities are agreements, in which one party agrees to accept the risk of damage or loss suffered by another party, thereby committing to future expenditure in the case that such damage or loss arises.

Indemnities are often associated with larger fiscal risks than other types of contingent liabilities, such as guarantees, because they are more likely to:

- have unlimited or unquantified fiscal risk exposure, and unlimited maturity
- create moral hazard, and incentivise exaggerated risk taking

Considerations when designing indemnities and insurance schemes*:

- Managing Public Money and negligence – it is not good practice to take on liabilities to contractors which would indemnify them in the event of their own negligence or that of a sub-contractor
- Charging for risk – when risk is transferred from the private sector to the government, the government should look to charge a premium for the risk it is taking on
- Capping – the government's fiscal risk exposure should be capped or limited where possible. There should be a clear value for money case for offering uncapped indemnities. The Sourcing Playbook[7] provides advice on identifying when to use liability caps in commercial negotiations and the Commercial Function can support on this
- Maturity – indemnities should include end-dates to limit fiscal risk. When not possible, they should include reviews to monitor unlimited exposures and unquantified maturities
- Scope – the scope of the indemnity should be limited, so that fiscal risk exposure is limited and cover is only provided for damage or loss as is necessary to achieve the policy intent
- Risk pooling and reducing moral hazard - indemnities should include mitigations that limit moral hazard and only incentivise risk to the level that is necessary to solve market failure. Examples of such risk mitigations include:
  - indemnified parties retaining a share of losses if an indemnity crystallises
  - indemnified parties being responsible for an initial cost if an indemnity crystallises (similar to an "excess" in an insurance policy)
  - should an indemnity crystallise, HMG support being in the form of a repayable loan, rather than a grant
- Subsidising risk – particular consideration should be given when sharing risk with third parties through for example, subsidising insurance via grant funding, and then indemnifying risks above the ceiling of the insurance cover. For example, where risks are especially remote and likely to be large, it might be better value for money (VfM) to indemnify the full spectrum of risks rather than subsidising low exposure risks through grant funding and taking on larger exposure risks
- Litigation rights – the government should retain litigation rights in legal proceedings associated with indemnities to the private sector

*It may not be possible to consider all the above when designing an indemnity or insurance scheme.

Box 2.C: Guarantees

A guarantee is a commitment provided by a guarantor (in this case, the government) to take responsibility for the debt or performance obligations of another party in the case of that party defaulting on payments to the lender.

Some guarantees issued are accounted for on-balance sheet rather than disclosed as contingent liabilities. Other guarantees issued by the government may not meet the definition of on-balance sheet guarantees but are disclosed as contingent liabilities instead.

As with all contingent liabilities, guarantees may incur costs at a later date. For example, using guarantees due to short term fiscal or budgetary constraints can risk creating higher costs in the longer term. It is therefore worth considering alternative options to guarantees, such as loans or an upfront subsidy, as well as evaluating the likely costs of the proposed guarantee in the long-term before deciding to issue them.

Considerations when designing guarantees*:

- Limited maturity – all guarantees should have an end date, and the guarantee should not be provided for longer than is necessary to achieve the policy aims. This limits the amount of time the government may be exposed to this risk
- Limited exposure – all guarantees should have a limited exposure. For guarantees with unlimited uptake, there should be a limit on the amount any individual/ entity can borrow. This limits the amount of risk the government is exposed to
- Partial guarantees or deductibles - Offering partial, rather than complete guarantees: for example, guaranteeing 80% rather than 100% of a loan, or requiring the lender to pay the first portion of losses. This incentivises better risk management by the lender
- Charging for risk – when risk is transferred from the private sector/a third party to the government, then the government should look to charge a guarantee fee for the risk it is taking on
- Creditworthiness – when issuing guarantees, consideration should be given to the creditworthiness of the borrowers, to ensure an understanding of the risk of default the guarantee exposes the government to
- Collateral – consider whether it aligns with the policy goals to require guarantee-seekers to post collateral to secure future payments by the government, in the event the guarantee is called

*It may not be possible to consider all the above when designing a guarantee scheme.

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/987353/The_Sourcing_Playbook.pdf

Chapter 3

Overview of the contingent liability process

3.1 This chapter provides an overview of the contingent liability process, of which the checklist process is just one part, required in only some instances. The process and associated checklist increase scrutiny, control, and oversight of public sector contingent liabilities, and applies to both non-remote and remote contingent liabilities. This supports the Treasury in meeting its core objective of placing the public finances on a sustainable footing.

3.2 There are 4 key stages that a contingent liability will go through: policy development; Treasury approval; Parliamentary notification and approval; and reporting. Each of these stages is described below.

3.3 Early engagement with the Treasury is recommended. Note that the timings associated with each stage where the Treasury is involved are indicative and will depend on available resources and the complexity of the policy issue. It is possible that less time could be required to process more routine cases, while more time could be needed for especially complex cases. In particularly urgent cases, some of the stages may be run in parallel.

Policy development

3.4 This is the first stage that a contingent liability goes through. It is at this stage that a policy is being developed which gives rise to a contingent liability. As highlighted in chapter 2, the relevant policy officials, in conjunction with departmental finance teams, are responsible for determining whether a particular policy gives rise to a contingent liability and subsequently classifying or reclassifying the contingent liability.

3.5 At this stage, the relevant policy official should consult this guidance on whether the contingent liability would require the Treasury's approval and be in scope of the checklist and if so, how to complete the checklist (see Section 4).

3.6 If questions remain on completing the checklist, the official should consult the relevant Treasury officials (see Chart 3.A and Box 3.A).

3.7 For contingent liabilities incurred by policies involving contracts with the private sector, policy officials should also consult the Sourcing Playbook.[1] The Sourcing Playbook sets out the approach contracting authorities should take when delivering public services through the private sector. This includes guidance on ensuring that risks sit with the party best able to manage them and the need to set appropriate caps on liabilities, which is central to the government's approach to delivering value for money and partnering with the private sector.

[1] https://www.gov.uk/government/publications/the-sourcing-and-consultancy-playbooks

Treasury approval of contingent liabilities

3.8 The Treasury always requires a checklist to be completed for contingent liabilities that both have a maximum exposure of over £3 million, and are novel, contentious, or repercussive.

Box 3.A: Support available to departments during policy development

Analytical and policy support is available to departmental officials developing policies that will pass through the checklist process from:

- The Treasury – Treasury officials can assist departments with policy development and drafting the checklist, including providing policy support to develop appropriate risk mitigations. Contact can be made with the departmental spending team in the usual way, or with the Balance Sheet Analysis team (contingentliabilitiesbranch@hmtreasury.gov.uk)
- UK Government Investments' (UKGI) Contingent Liability Central Capability (CLCC) – the CLCC can provide a range of support to departments during the policy development and analysis phase of guarantees and indemnities. This support could include analysis of expected losses and the structure of fee-charging regimes. The CLCC can be contacted at clcc@ukgi.org.uk
- Government Actuary's Department (GAD) – GAD can provide additional assistance on risk analysis and modelling, including bespoke modelling services.

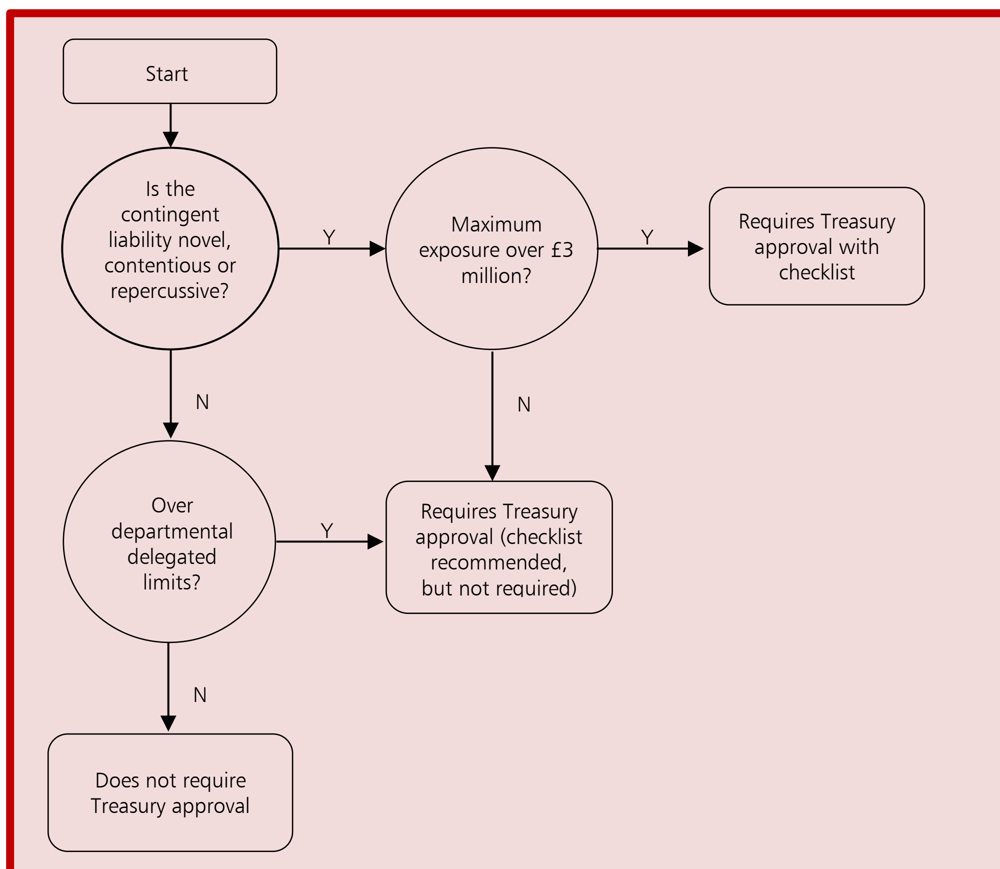
3.9 Contingent liabilities taken on in the normal course of business (business as usual) are therefore exempt from the checklist process. 'Managing public money' explains that in order for a liability to be considered business as usual, the organisation should be able to show that the activity is an unavoidable part of its business and/or Parliament could reasonably be assumed to have accepted that such liabilities can rest on the sole authority of the Appropriations Act. Further information and examples of such liabilities are provided in Annex 5.4 of 'Managing public money'.

3.10 Treasury approval is required for all contingent liabilities that exceed departmental delegation limits, or that are novel, contentious, or repercussive.

3.11 Whilst contingent liabilities requiring Treasury approval, but which are outside of the scope of 3.7, will not necessarily be required to go through the checklist process, it would be considered best practice for policy officials to use this guidance and the checklist as part of the policymaking process. Furthermore, the relevant Treasury official may require the contingent liability to go through the checklist process if it is deemed appropriate.

3.12 For sensitive contingent liabilities in scope of the checklist, the Treasury still requires a checklist to be completed. Policy officials with concerns about sensitive cases should contact the Treasury to discuss appropriate security mitigations.

Chart 3.A: Decision tree summarising Treasury approval requirements for contingent liabilities



Treasury approval of checklists

3.13 Once the checklist is completed, it should be submitted to the relevant Treasury officials for approval (see Box 3.A). The Treasury expects at least 5 working days to assess the completed checklist, although in many cases the process will be iterative and therefore may depend on how quickly officials drafting the checklist are able to provide further information in response to comments. In particularly urgent cases, this timeline can be compressed.

3.14 Treasury officials may consult with the CLCC, drawing on their analytical expertise to inform the Treasury's appraisal of the checklist.

3.15 If the checklist is approved by Treasury officials, the policy official would then be expected to seek final approval from the relevant departmental minister and accounting officer. As part of seeking that approval, the policy official should make clear that the contingent liability has passed the Treasury's internal contingent liability approval process.

3.16 However, if the checklist is not approved and officials proceed with the policy, they should make clear in their advice to ministers and accounting officers that the contingent liability has not been approved and therefore formal Treasury approval of the contingent liability is unlikely.

3.17 'Managing public money' makes clear that departments must obtain consent from the Treasury before making commitments which could lead to

expenditure. Contingent liabilities are commitments which could lead to expenditure. Therefore, once a contingent liability has been approved by the relevant departmental minister and accounting officer, it must be submitted to the Treasury for formal approval. This process is likely to take 5 working days if ministerial approval is judged necessary otherwise it is likely to be less.

3.18 Treasury officials will make a judgement on whether the contingent liability needs approval by the Chief Secretary of the Treasury (and in specific cases, the Chancellor of the Exchequer). If it does, the advice to ministers will be based on whether or not the contingent liability passed the checklist in the first stage. Note that while getting Treasury approval for a contingent liability will be particularly challenging if it has not passed the checklist, ministers may still reject the contingent liability for other reasons even it has passed the checklist.

3.19 Treasury approval of a contingent liability is on the understanding that the department concerned accepts the risk of paying out if the liability crystallises. Departments should include contingent liabilities with the other financial risks they manage. Spending pressures created by an unaffordable contingent liability should be dealt with by the department in discussion with its Treasury spending team in the usual way. Receiving approval for a contingent liability from the Treasury does not affect normal Treasury controls over access to the Reserve.

3.20 If the risk associated with contingent liability differs substantively from the checklist initially approved by Treasury officials, both during approval and over the scheme's lifetime, the Treasury expects to approve the final form of the contingent liability.

Parliamentary notification

3.21 Parliament expects advance notice of any commitments to future use of public funds for which there is no active request for resources through Estimates. Therefore, once the Treasury has approved the contingent liability, a departmental Minute will need to be drafted in order to notify Parliament that the department or its arm's length body (ALB) is incurring a contingent liability (unless the contingent liability is incurred in the normal course of business; is statutory in nature; or is below £300,000 in value).[2]

3.22 Departmental Minutes must be approved by the Treasury and should be accompanied by a Written Ministerial Statement (WMS). As part of this approval, the Treasury will expect assurance that those contingent liabilities within the scope of the checklist have passed it. The Treasury aims to complete this approval within 5 working days. In urgent cases, this approval may be run in parallel with the approval of the checklist. Further information on the Parliamentary notification process and the range of contingent liabilities to which it applies is available in Annex 5.4 in 'Managing public money'.

3.23 If the contingent liability is generated by an asset sale, the WMS should also follow the disclosure guidance set out in HMT's *Asset Sales Disclosure: Guidance for Government.*[3]

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2 See Annex 5.4 of Managing Public Money for more information on notifying Parliament of contingent liabilities https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1000670/MPM_Spring_21_with_annexes_080721.pdf

3 Available at https://www.gov.uk/government/publications/asset-sale-disclosures-guidance-for-government

Reporting

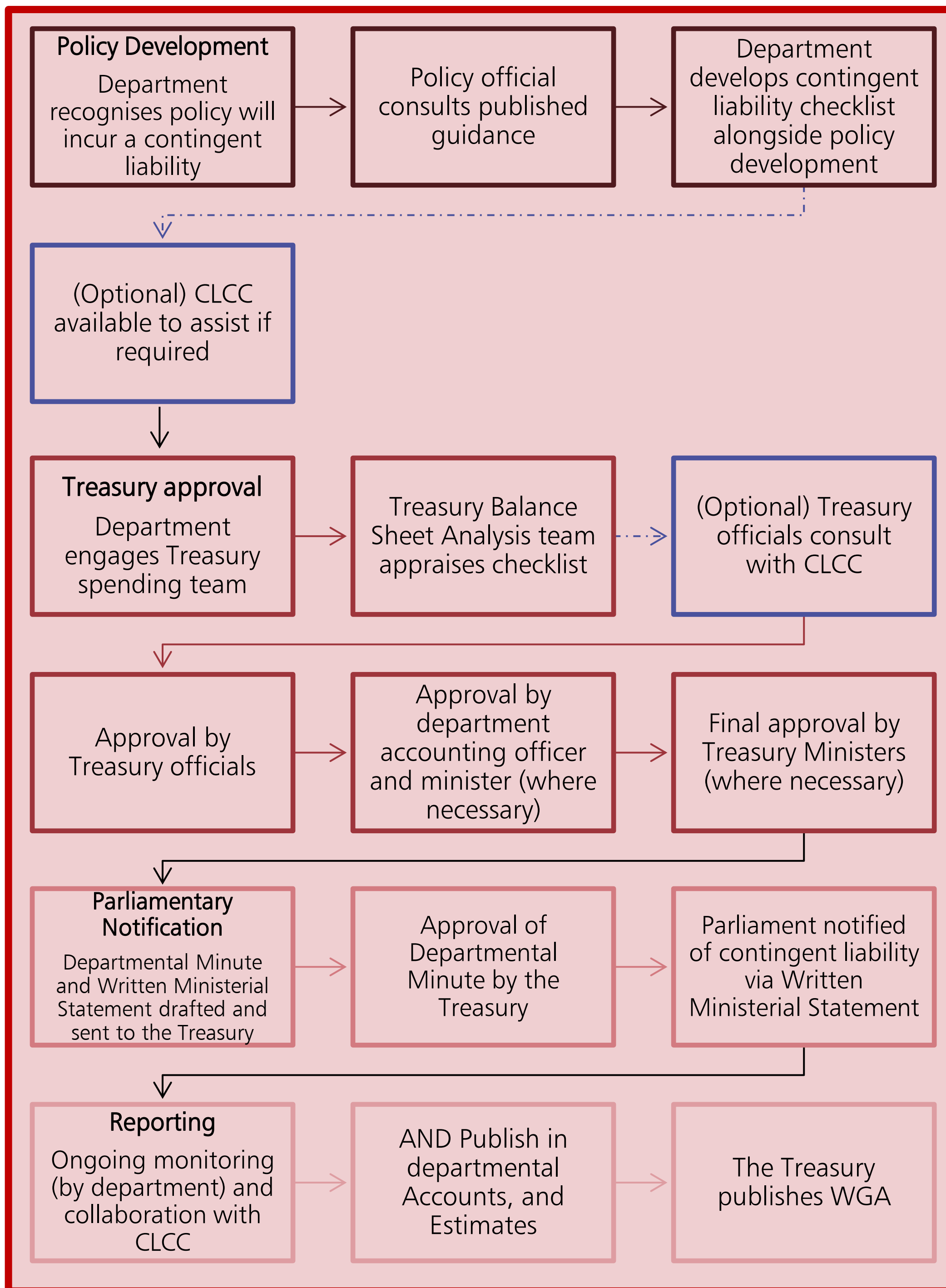
3.24 The final stage of the contingent liability is reporting. The contingent liability will be reported through the Estimates and in departmental or ALB Annual Report and Accounts.

3.25 Following publication in the departmental or ALB Accounts, the Treasury will publish on a consolidated basis, as part of the Whole of Government Accounts (WGA), contingent liabilities for the whole public sector. This will enable an assessment of the risks associated with contingent liabilities for the public sector.

3.26 Ahead of fiscal events, the Treasury will reach out to departments for updates on the key information of contingent liabilities that have been approved.

3.27 Departments should work collaboratively with the CLCC on an ongoing basis, to enable the CLCC to gather information on and monitor the stock of contingent liabilities across the government.

Chart 3.B: Flow-chart summarising contingent liability process (in cases where checklist is required)



Chapter 4

Completing the contingent liability checklist

4.1 This chapter summarises the checklist format and provides detailed guidance, including examples, on how to answer each question in the checklist. The contingent liabilities which must be approved with a contingent liability checklist are set out in Chapter 3.

4.2 As part of the overall policymaking process, officials initiating the policy that gives rise to potential contingent liabilities that are within the scope of this approvals process are expected to complete a contingent liability checklist.

The contingent liability checklist

4.3 The contingent liability checklist has been designed in order to ensure that policies giving rise to contingent liabilities are consistent with the Treasury's objective of safeguarding the sustainability of public finances.

4.4 The checklist is composed of five sections: rationale; exposure; risk and return; risk mitigation and management; and affordability. Each section examines important details about the proposed contingent liability and will be assessed both individually and in conjunction with the other sections.

4.5 The below provides guidance on how to approach completing the checklist.

1. Rationale

4.6 The first section in the checklist relates to the rationale for the contingent liability. The aim of this section is to make sure that the reasons for incurring a particular contingent liability are robust and that the rationale would stand up to scrutiny.

Question A: **What is the problem that needs to be solved and why is government intervention necessary?**

4.7 This question concerns the problem that needs to be addressed. The answer should explain why government intervention is both necessary and likely to address the problem. If the problem could be fixed without government intervention, then the answer should make clear why government intervention would be a more effective solution.

4.8 In some cases, the intervention may not be linked to a market failure. In such cases, a clear explanation should be given as to why the government is intervening despite the lack of a market failure.

Question B: Why is incurring / modifying a contingent liability necessary to address this problem?

4.9 This question focuses on whether incurring a contingent liability is necessary to address the challenge or market failure. Specifically, the answer should explain how it addresses the underlying challenge or market failure (or at least part of it). The answer should also explain why addressing the challenge or market failure is best accomplished through incurring a contingent liability rather than an increase in spending today that would also target the challenge or market failure.

4.10 The creation of a contingent liability with the sole purpose of avoiding an increase in spending today would not be considered a sufficient reason to incur a contingent liability as it creates a potential spending obligation in the future and therefore does not necessarily support the Treasury's objective of ensuring the sustainability of public finances.

Question C: What alternatives have been explored? For example, with indemnities; supporting commercial insurers to deliver a market solution, or for guarantees; providing loans or direct subsidies instead. Why were these rejected?

4.11 An answer to this question should detail the alternatives that have been explored. This could include both alternative forms of government intervention as well as no direct government intervention.

4.12 This answer should also explain why incurring the contingent liability is a more effective solution to addressing the challenge or market failure than the alternatives.

2. Exposure

4.13 The second section of the checklist relates to the exposure created by the contingent liability. This refers to the magnitude of costs the Exchequer would face if the contingent liability was to crystallise and to how long the Exchequer is exposed to such costs.

Question A: What is the maximum size of the contingent liability, if any? Is the exposure capped?

4.14 This answer should state the maximum cost to the Exchequer if the contingent liability crystallised completely. The maximum size is considered the worst-case scenario and is thus useful to provide an idea of the scale of risk potentially facing the public sector. For example, if the government indemnified an entity in the private sector against a risk up to a set cap, the maximum size of the contingent liability would be the full value up to the cap. The answer should also explain how the maximum size was calculated.

4.15 If it is impossible to estimate the maximum size of the contingent liability and it is deemed unquantifiable, the answer should justify why such an estimate cannot be obtained and provide a qualitative analysis of the likely size.

4.16 In many cases, the maximum exposure from a contingent liability may be unlimited, even when an estimate of a worst-case scenario exposure has been made (for example, where a government indemnity is uncapped for legal or contractual reasons). In these cases, it is important to state both the expected worst-case scenario and whether the exposure is technically capped or uncapped.

Question B: Why is this size necessary? If there is no explicit maximum, please explain why.

4.17 This question seeks to understand the rationale behind the size of the contingent liability. As such, the answer should explain why the size chosen is optimal for solving the underlying challenge or market failure.

4.18 If there is no maximum, the answer should make clear why there is no explicit maximum.

Question C: What is the maturity of the contingent liability, if any? Specifically, when does it cease to exist?

4.19 While maximum size gives an idea of the scale of risk, this question seeks to find out how long the public sector will bear that risk (the maturity of the contingent liability).

4.20 The answer should give information on both when the policy giving rise to the contingent liability concludes as well as how long the contingent liability may last. For example, if a government policy running from 2020 until 2025 indemnified future risks for a period of 10 years, the policy would exist for 5 years, but the risk would remain until 2035.

Question D: Why is this maturity necessary? If there is no explicit maturity, please explain why.

4.21 Similar to question 2.B, this question seeks to understand the rationale for the maturity of the contingent liability. The answer should make the case for the maturity stated in response to 2.C.

4.22 If there is no explicit maturity, the answer should make clear why not, and if not, whether the contingent liability has a review clause. It is important to review contingent liabilities that have no explicit maturity to ensure that when they have served their purpose they are allowed to mature.

Question E: If circumstances change prior to maturity, is there an exit strategy? If yes, how would it work? If no, why not?

4.23 Contingent liabilities can have long lifespans and therefore it is important to retain flexibility to deal with changing risks. This answer should make clear whether there is a policy for either relinquishing the obligation associated with the contingent liability or changing the terms of the contingent liability in the future, especially if future circumstances change.

4.24 For example, if a contingent liability became more likely to crystallise, the answer should set out how the Exchequer could reduce or eliminate its exposure to the contingent liability.

3. Risk and Return

4.25 This section of the checklist focuses on the risk and return posed by the contingent liability. It is particularly important in enabling the Treasury to assess the fiscal risks faced by the whole of the public sector and therefore assist it in safeguarding the sustainability of public finances. While section 2 focused on the worst-case scenario, this section aims to understand the *typical scenarios* and their *likely outcomes,* as well as the causes of such scenarios.

4.26 Many of the questions in this section seek numbers that may be difficult to estimate. Officials should provide quantification wherever possible and if necessary, provide ranges to indicate the uncertainty associated with the estimate. The CLCC is available to support departments in deriving the estimates sought in this section and GAD can provide additional assistance and bespoke modelling if required.

4.27 If numbers are not provided, the answer should make clear why it was not possible to provide any estimate and provide a qualitative analysis instead. These estimates are required by the Treasury in order to approve the contingent liability, approval without such estimates will only be considered in special circumstances.

4.28 It should be made clear if estimates are provisional and dependent on the outcome of commercial negotiations. In such cases, if there are material changes to the estimates following a negotiation, the Treasury would expect to see the revised estimates.

Question A: What are the triggers for potential crystallisation of the contingent liability?

4.29 The response to this question will be helpful in assessing which factors could trigger realisations in the government's portfolio of contingent liabilities.

4.30 Therefore, the response should list all events that could cause crystallisation, giving an indication of proportion that would be expected to crystallise as a result of the event. For example, a specific event could cause 10% of crystallisation.

4.31 Responses should avoid simply saying a particular event would lead to crystallisation of the contingent liability but focus on what factors could cause the particular event.

Question B: What is the likelihood of crystallisation? Can the risk be quantified over a timeframe? For example, year 1 = X%, year 2 = Y%, year 3 = Z%. Please distinguish between partial and complete crystallisation.

4.32 This question seeks to understand the likelihood of crystallisation over the lifespan of the contingent liability. For example, if an indemnity had a maturity of 10 years, this answer would provide the probability that the indemnity crystallises in year 1, year 2, year 3, and so on.

4.33 If the contingent liability had a maturity of just 1 year, it would be more appropriate to use monthly or quarterly figures for the probability. A judgement should be made on using an appropriate timeframe. An indication should be provided of the uncertainty associated with the probability estimates.

4.34 Where the contingent liability covers multiple people, organisations, items, or events, it will usually be appropriate to indicate both the number covered and the likelihood of crystallisation per unit. Please provide any information on expected changes over time for both factors.

Question C: What is the estimated cost of the contingent liability if it were to crystallise? For example, year 1= £X, year 2= £Y, year 3= £Z, and so on. What is the distribution of possible losses? How does the distribution of possible losses change over the lifespan of the contingent liability?

4.35 For instance, if the government indemnified risks with a maximum exposure of £10 million, the response to this question could explain that if the indemnity were

to crystallise in year 1 there is expected to be a 50% chance of a £1 million loss, a 45% chance of a £3 million loss and a 5% chance of incurring the maximum £10 million loss. This gives an expected cost of the indemnity if it were to crystallise in year 1 of £2.35 million (50% x £1 million + 45% x £3 million + 5% x £10 million). The response should describe how this distribution is expected to change in subsequent years.

4.36 Question D: **What is the expected loss associated with the contingent liability?**

4.37 The expected loss is a particularly important summary statistic. It is calculated by using the information in the response to questions 3.B and 3.C. Specifically, it is calculated by multiplying the potential losses with their respective probabilities and then taking the sum of them.

4.38 For instance, building on the example in 3.C (taking the expected cost for a given year) and assuming there is a 2% probability of crystallization in year 1, the expected loss for year 1 would be 2% x £2.35 million = £47,000. This calculation should be repeated for each year the indemnity could crystallise. The overall expected loss for the indemnity will be the sum of the corresponding amounts for each year.

Question E: **If risk is being transferred from the private sector to the government, will the Exchequer be compensated for holding this risk, for example by charging a premium for indemnities, or a guarantee fee for guarantees? If yes, what is the profile of income from compensation? If no, what are the reasons for not seeking compensation in this case?**

4.39 If the Exchequer is charging a fee for holding a risk, then the answer to this question should set out how that fee has been calculated.

4.40 If no fee has been charged, the answer should set out why this is the case (e.g. for policy or logistical reasons).

Question F: **Comparing answers to 3.D and 3.E, how do the risks compare to the returns on the contingent liability?**

4.41 The answer to this question should summarise the risks to the Exchequer and compare them against the returns, building on the answer to questions 3.D and 3.E.

4.42 The above would give an indication of how the risks compare with the returns in financial terms. However, there will also be wider policy benefits which should also be summarised and quantified where possible.

4. Risk management and mitigation

4.43 Good management and governance arrangements may lead to a reduced likelihood of a contingent liability crystallising. It may also mean that the public sector is better able to react to changing circumstances.

4.44 This section focuses on the policies for risk management and mitigation associated with the contingent liability.

Question A: Who will manage the risks associated with the contingent liability and what is the governance process around the management of these risks? Specifically, if litigation is likely to be involved, who will defend HMG's interests?

4.45 If the body immediately in charge of managing the risks is not a government department, the answer should then state the lead government department (that is, the department to which the body reports to), whether the Treasury has any oversight in the process and, if so, how that oversight is structured.

4.46 Furthermore, the answer should explain how the governance process works around managing the risks. For example, if the contingent liability suddenly becomes more likely to crystallise, it should make clear what the body responsible for managing the risks is able to do and how it would make such decisions.

4.47 If the crystallisation of the indemnity might be linked to litigation proceedings, the Exchequer should be responsible for decisions taken during litigation.

Question B: What risk mitigation tools have been explored? For example, with indemnities: sharing risk with the private sector (Box 2.B), or with guarantees: using a risk sharing mechanism to incentivise the lender to minimise losses (Box 2.C).

4.48 While question 4.A focuses on the processes set up to manage the risks associated with the contingent liability, this question seeks to understand which measures have been taken to reduce the risks.

4.49 For example, an indemnity may induce moral hazard if indemnified parties pass on all risk to the government, due to the absence of risk they hold.

4.50 Risk mitigation tools come in various forms but the aim of such tools will be to reduce the likelihood that the indemnity crystallises or, in the case that it does crystallise, reduce the loss from crystallisation (for example, by charging an excess or sharing risk).

4.51 Therefore, the response to this question should explain which risk mitigation tools are being used and why. Furthermore, it should describe other tools that were considered but not utilised and explain why.

5. Affordability

4.52 This section assesses the impact of crystallisation of the contingent liability on departmental budgets. Evaluating the affordability of a contingent liability in this way is similar to evaluating the affordability of public spending.

Question A: If the contingent liability crystallised, to what extent would it be possible to meet the required payment out of the department's existing budget?

4.53 A response to this question should make clear the impact on the department's existing budget if the contingent liability completely crystallised.

Question B: What is the ratio of the contingent liability's expected loss to the department's available resource?

4.54 This question uses the expected loss determined in section 3 and takes a simple ratio of that to the department's available resources. This is intended to provide a straightforward and consistent metric on affordability.

4.55 For example, if the expected loss is £1 million and the department's available resources are £100 million, the metric would be 1%.

Question C: What will the impact of this contingent liability be on the department's aggregate risks from its portfolio of contingent liabilities?

4.56 This question seeks to understand the impact of this contingent liability on the resilience of the department's portfolio of contingent liabilities to particular risks. For example, when considered alongside existing contingent liabilities, will this new contingent liability expose the department to greater risks in a particular sector, or if a particular shock were to occur?

Question D: If the contingent liability crystallised, how would it affect fiscal aggregates, in particular, public sector net borrowing (PSNB) and public sector net debt (PSND)?

4.57 Depending on the specific circumstance, the crystallisation of contingent liabilities may impact on PSNB and PSND. The response to this question should explain the ways in which crystallisation may impact on PSNB and PSND.

4.58 For example, if crystallisation of the contingent liability is met completely through the department's existing budget without any knock-on impacts, it will not impact on forecast PSNB and PSND. However, if a claim is made on the Reserve, then depending on the nature of the contingent liability, it may impact both PSNB and PSND.

Annex A
Contingent liability checklist

1. Rationale

A: What is the problem that needs to be solved and why is government intervention necessary?

B: Why is incurring / modifying a contingent liability necessary to address this problem?

C: What alternatives have been explored? For example, with indemnities; supporting commercial insurers to deliver a market solution, or for guarantees; providing loans or direct subsidies instead. Why were these rejected?

2. Exposure

A: What is the maximum size of the contingent liability, if any? Is the exposure capped?

B: Why is this size necessary? If there is no explicit maximum, please explain why.

C: What is the maturity of the contingent liability, if any? Specifically, when does it cease to exist?

D: Why is this maturity necessary? If there is no explicit maturity, please explain why.

E: If circumstances change prior to maturity, is there an exit strategy? If yes, how would it work? If no, why not?

3. Risk and return

A: What are the triggers for potential crystallisation of the contingent liability?

B: What is the likelihood of crystallisation? Can the risk be quantified over a timeframe? For example, year 1 = X%, year 2 = Y%, year 3 = Z%. Please distinguish between partial and complete crystallisation.

C: What is the estimated cost of the contingent liability if it were to crystallise? For example, year 1= £X, year 2= £Y, year 3= £Z, and so on. What is the distribution of possible losses? How does the distribution of possible losses change over the lifespan of the contingent liability?

D: What is the expected loss associated with the contingent liability?

E: If risk is being transferred from the private sector to the government, will the Exchequer be compensated for holding this risk, for example by charging a premium for indemnities, or a guarantee fee for guarantees? If yes, what is the profile of

income from compensation? If no, what are the reasons for not seeking compensation in this case?

F: Comparing answers to 3.D and 3.E, how do the risks compare to the returns on the contingent liability?

4. Risk management and mitigation

A: Who will manage the risks associated with the contingent liability and what is the governance process around the management of these risks? Specifically, if litigation is likely to be involved, who will defend HMG's interests?

B: What risk mitigation tools have been explored? For example, with indemnities: sharing risk with the private sector (Box 2.B), or with guarantees: using a risk sharing mechanism to incentivise the lender to minimise losses (Box 2.C).

5. Affordability

A: If the contingent liability crystallised, to what extent would it be possible to meet the required payment out of the department's existing budget?

B: What is the ratio of the contingent liability's expected loss to the department's available resource?

C: What will the impact of this contingent liability be on the department's aggregate risks from its portfolio of contingent liabilities?

D: If the contingent liability crystallised, how would it affect fiscal aggregates, in particular, public sector net borrowing (PSNB) and public sector net debt (PSND)?

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk