



HM Treasury

Contingent liability approval framework:

guidance

July 2017



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ISBN 978-1-912225-02-6

PU2089

Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Defining and classifying contingent liabilities	5
Chapter 3	Overview of contingent liability process	9
Chapter 4	Completing the contingent liability checklist	11
Annex A	Contingent liability checklist	19

1 Introduction

Context

1.1 HM Treasury (the Treasury) is the UK's economic ministry 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 system² and oversees the operation of the agreed multiyear 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. 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).

1.5 Given that contingent liabilities may affect future spending rather than current spending, they may affect the sustainability of public finances. Therefore, the Treasury has introduced a new process for approving, monitoring, and managing contingent liabilities in order to ensure such transactions are consistent with safeguarding the sustainability of public finances.

1.6 The new process requires that officials responsible for initiating a contingent liability with a maximum exposure of £3 million or more will need to complete a checklist 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

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

² See the Consolidated Budgeting Guidance <https://www.gov.uk/government/publications/consolidated-budgeting-guidance-2017-to-2018>

³ See HM Treasury Objectives <https://www.gov.uk/government/organisations/hm-treasury/about/objectives>

Aim of the guidance

1.7 This guidance is published with two main objectives:

- The first is to provide an overview of the new contingent liability approval process
- The second is assist officials in the application of the new contingent liability checklist

1.8 This guidance will be kept under review by the Treasury and it will be updated when necessary. When the guidance is amended, the date of the amended guidance will be clearly noted.

Structure of the document

1.9 The context above broadly sets out the importance of scrutinising and managing contingent liabilities in order to ensure the Treasury is able to meet its core objective of maintaining sustainable public finances. The remainder of this document is set out as follows:

- Chapter 2 provides a definition of contingent liabilities and guidance on classifying them
- Chapter 3 provides an overview of the new 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 includes a copy of the contingent liability checklist

2 Defining and classifying contingent liabilities

2.1 This chapter describes contingent liabilities in simple terms as well as providing the technical definition. Furthermore, it sets out, the classification of contingent liabilities.

2.2 Contingent liabilities can be thought of as liabilities that are uncertain but may lead to future expenditure if specific conditions are met or certain events happen. 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. For example, a government guaranteed loan could pose a contingent liability as a payment would only be required in the event that the body covered by the guarantee was unable to repay the loan. Some common types of contingent liability are the following:

- guarantees
- letters or statements of comfort (including verbal agreements)
- indemnities (in particular, those embedded in contracts for procurement with the private sector which may include contracts of difference)

2.4 Note that while contingent liabilities are considered off-balance sheet¹ and therefore are not on the public sector balance sheet, their disclosure is required.²

2.5 If a contingent liability is deemed more likely than not to crystallise (that is, requiring a pay out), then it is brought on balance sheet as a provision (subject to there also being a present obligation at the reporting date and the amount can be reliably estimated). For example, using the case above of a government guaranteed loan, if it estimated that it is now more likely that not that the body covered by the guarantee will be unable to repay the loan, the government would need to provision for this on the balance sheet. Therefore, the guarantee would be reclassified from previously being a contingent liability off-balance sheet to being a provision on the balance sheet. A contingent liability can crystallise without first becoming a provision. Chart 2.A depicts a simple schematic which shows how provisions, contingent liabilities, and remote contingent liabilities are classified as well as the relevant disclosure requirements.

¹ See IAS 37 <http://www.ifrs.org/IFRSs/Documents/English%20IAS%20and%20IFRS%20PDFs%202012/IAS%2037.pdf>

² See the Financial Reporting Manual <https://www.gov.uk/government/publications/government-financial-reporting-manual-2017-to-2018>

Box 2.A: Definition of contingent liability

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:

- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- (ii) 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.

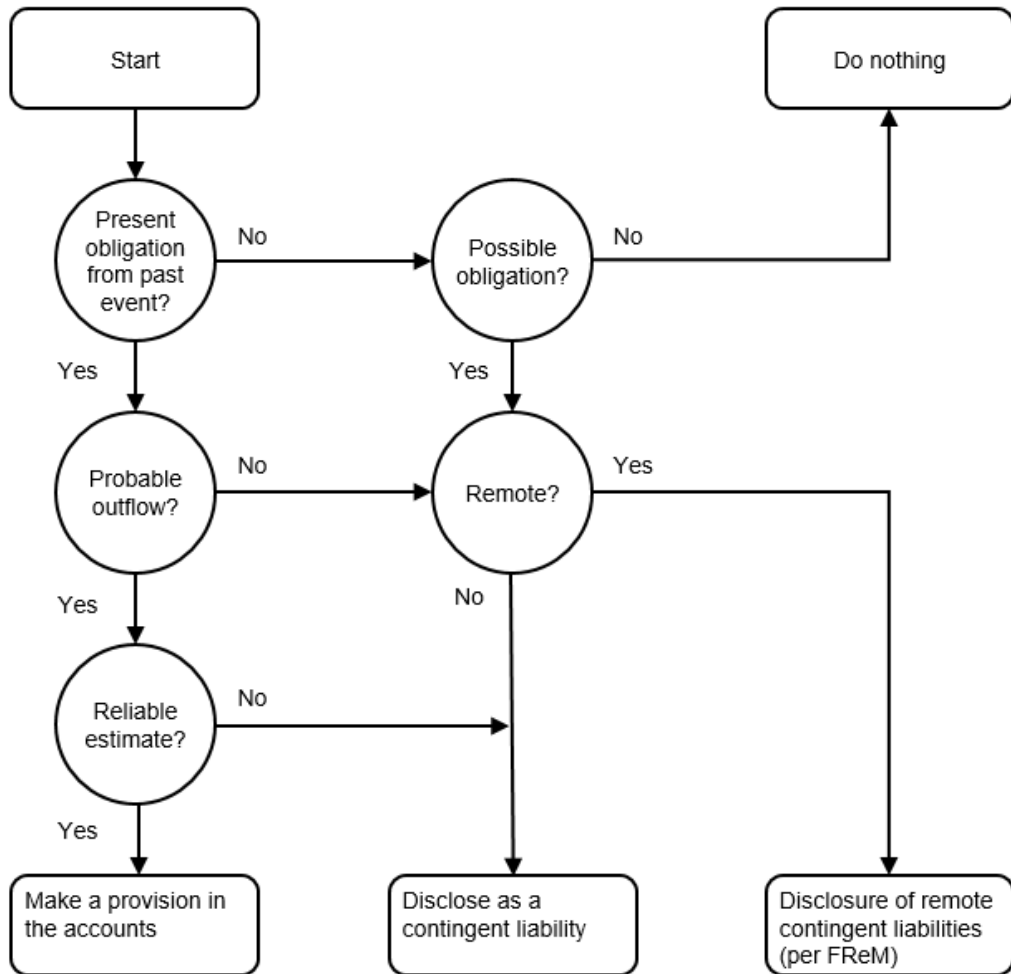
Definition of “probable”, “possible” and “remote”

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**.

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



Source: *International Accounting Standards and Financial Reporting Manual (FReM)*

2.6 The lead 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.

2.7 While this chapter has described the classification and relevant disclosure requirements of contingent liabilities, the new process does not affect reporting obligations in Estimates and Accounts which remain the same.

Overview of contingent liability process

3

3.1 This chapter provides an overview of the contingent liability process of which the checklist process is just one part. The process and associated checklist increase scrutiny, control, and oversight of public sector contingent liabilities. This will support 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. Note that the timings associated with each stage where Treasury is involved are indicative and will depend on available resources and the complexity of the policy issue. Therefore it is possible that less time could be required to process more routine cases while more time could be needed for especially complex cases. Furthermore, in particularly urgent cases, some of the stages may be run in parallel.

Policy development

3.3 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 / reclassifying the contingent liability.

3.4 The Treasury's checklist process becomes relevant as soon as it has been determined that a contingent liability may be incurred as a result of the policy. Therefore, at this stage, the relevant policy official should consult this guidance on whether the contingent liability would be in scope of the checklist and if so, how to complete the checklist. If questions remain on completing the checklist, the official should consult the relevant Treasury officials (in most cases, this will be a member of the associated spending team in the first instance).

3.5 Once the checklist is completed, it should be submitted to the relevant Treasury officials for approval. 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 light of comments.

3.6 If the checklist is approved, 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.

3.7 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.

3.8 The checklist may not be approved for several reasons. For example, it might be the case that Treasury officials feel that they do not have sufficient information to make a judgement as the checklist has not been answered as comprehensively as expected. It might also be the case that the Treasury officials do not consider the contingent liability to be consistent with the Treasury's core objective of ensuring the sustainability of public finances. This could be the case

if, for example, the expected loss in the future is particularly large and not supported by a strong rationale or value for money assessment.

Treasury approval

3.9 'Managing public money' makes clear that departments must obtain Treasury consent 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.

3.10 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.

3.11 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. Treasury agreement to a contingent liability does not affect normal Treasury controls over access to the Reserve.

Parliamentary notification

3.12 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).

3.13 Departmental Minutes must be approved by the Treasury and should be accompanied by a written ministerial statement. 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'.

Reporting

3.14 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.

3.15 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.

4 Completing the contingent liability checklist

4.1 This chapter first sets out the scope of the contingent liability checklist. It then describes each section of the checklist providing detailed guidance on every question with examples where necessary. It is expected that officials initiating the policy that give rise to potential contingent liabilities that are in scope of this process will complete the contingent liability checklist as part of the overall policymaking process.

Scope of the checklist

4.2 In all cases, relevant Treasury officials should be made aware of any potential contingent liabilities that could be considered novel, contentious, or repercussive. The relevant Treasury official will usually be a member of the associated spending team.

4.3 Of the contingent liabilities with a maximum exposure of £3 million or more, only those that are considered novel, contentious, or repercussive will be in scope of this checklist. As such, contingent liabilities taken on in the normal course of business (that is, those that are business as usual) will be exempt from this process and will not require a checklist to be filled out. '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'.

4.4 Furthermore, 'Managing public money' makes clear contingent liabilities with a maximum exposure of less than £300,000 do not need to be notified to Parliament. As such, such small contingent liabilities are also exempt from the checklist process.

4.5 Contingent liabilities with a maximum exposure of £300,000 or more but less than £3 million will still need to be approved by the Treasury and notified to Parliament but will not be required to go through the checklist. Nonetheless, for this class of contingent liabilities, the relevant Treasury official may require the contingent liability to go through the checklist process if it is deemed particularly novel, contentious, or repercussive.

4.6 While many contingent liabilities would not be required to go through the checklist process, it would be considered best practice for policy officials to use the checklist as part of the policymaking process.

The contingent liability checklist

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

1. Rationale

4.8 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 (the market failure) and why is government intervention necessary?

4.9 This question concerns the problem that needs to be addressed. A market failure is a situation in which the free market is unable to allocate resources efficiently. Market failures come in many different forms. For example, the market may not result in an efficient outcome due to an information asymmetry (that is, when one party has more information than the other). For instance, when making a loan, the lender knows less about the likelihood of repayment than the person they are lending to. This may lead to a situation where lending is either less in volume or higher in price than that would be achieved if there was perfect information. If it is not possible to achieve perfect information, the government may provide a guarantee to encourage lending.

4.10 The answer should explain why government intervention is 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.

4.11 In some cases, it may not be possible to link the intervention 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 the market failure?

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

4.13 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.

4.14 In cases where it is not possible to link the contingent liability to a market failure, a clear explanation should be given as to why the contingent liability is more effective than an equivalent increase in spending in solving the underlying problem.

Question C: What other alternatives have been explored? For example, direct spending such as subsidies. Why were these rejected?

4.15 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.

4.16 This answer should also explain why incurring the contingent liability is a more effective solution to addressing the market failure than the alternatives. If a market failure is not possible to identify, then this answer should explain why the contingent liability is the most effective form of government intervention.

2. Exposure

4.17 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?

4.18 This answer should state the total 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 guaranteed losses on a portfolio of loans, the maximum size of the contingent liability would be the cost the government would face if all the loans in the portfolio defaulted completely.

4.19 The answer should also explain how the maximum size was calculated. Using the example above, this would be the maximum number of people that could take out a loan multiplied by the maximum size of each of those loans.

4.20 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.

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

4.21 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 market failure.

4.22 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?

4.23 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 (that is, what is the maturity of the contingent liability?).

4.24 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 the government provided a 10-year guarantee from the year 2000 up until the year 2020, the policy would exist for 20 years but the risk would remain until the year 2030 (if a 10-year guarantee was provided on a loan given in 2020, the contingent liability would exist until 2030).

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

4.25 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. For instance, using the example above, the answer to this question should explain why a 10-year guarantee was required to address the market failure and why the policy needs to exist for 20 years.

4.26 If there is no explicit maturity, the answer should make clear why not and if not whether the contingent liability has a review clause (for example, that the contingent liability will be reviewed at a particular date in the future). It will be 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, prior to maturity, the contingent liability no longer proves to be value for money, is there an exit strategy? If yes, how would it work? If no, why not?

4.27 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.

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

3. Risk and return

4.29 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 *most likely* scenario as well as the causes of such scenarios.

4.30 Many of the questions in this section seek numbers that may be difficult to estimate. Officials should provide quantification as much as possible and if necessary provide ranges to indicate the uncertainty associated with the estimate. The Government Actuary's Department (GAD) is a non-ministerial department that provides bespoke modelling services and may therefore be able to assist in deriving the estimates sought in this section.¹

4.31 If numbers are not provided, the answer should make clear why it was not possible to provide any estimate and provide a qualitative analysis. The Treasury will require the estimates requested in order to approve the contingent liability and will only consider approving contingent liabilities without such estimates in special circumstances.

4.32 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?

4.33 The response to this question will be helpful in assessing which factors could trigger realisations in the government's portfolio of contingent liabilities. For example, it would allow the Treasury to ascertain what proportion of contingent liabilities crystallise following a fall in the price of a particular commodity or a change in a particular macroeconomic variable.

4.34 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 fall in the price of a particular commodity of 25% would cause crystallisation of 50%, or a 1% rise in inflation in a particular region would cause 10% crystallisation.

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

Question B: What is the likelihood of complete crystallisation over what timeframe?

For example, time $t = X\%$, time $t+1 = Y\%$, time $t+2 = Z\%$, etc

4.36 This question seeks to understand the likelihood of complete crystallisation over the lifespan of the contingent liability. For example, if a contingent liability had a maturity of 5 years,

¹ For more information on how GAD may be able to provide support please visit www.gov.uk/gad or email enquiries@gad.gov.uk.

this answer would provide the probability that the contingent liability completely crystallises by the end of year 1, by the end of year 2, by the end of year 3, by the end of year 4, and by the end of year 5. Note that the probability of complete crystallisation by the end of year 5 cannot be lower than that by the end of year 1 because the probability of complete crystallisation in year 5 would include the probability that the contingent liability crystallised in year 1, year 2, year 3, and year 4.

4.37 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 on the uncertainty associated with the probability estimates.

Question C: What is the distribution of possible losses over the life of the contingent liability? For example, loss of A with likelihood of B, loss of C with likelihood of D, etc

4.38 The distribution of possible losses is very helpful in assessing the risks to the Exchequer. For example, if the government guaranteed losses on a portfolio of loans with the maximum exposure as £10 million, the response to this question should explain that there is a 55% of no loss, a 5% of a £2 million loss, a 20% chance of a £5 million loss, a 15% chance of a £8 million loss, and a 5% chance of a £10 million loss (that is, a 5% chance of complete crystallisation). Note that the distribution is used to given the range of all possible outcomes so the probabilities should sum to 100%.

4.39 The above example has provided five scenarios with the associated probabilities and losses. While more scenarios would generally be preferred as they provides greater information, the policy context will largely determine what is feasible. For example, it might be the case that there are only two scenarios (either there is no loss or complete crystallisation). If we use the same example as above, it could be that there is 72% chance of no loss but a 28% chance of a £10 million loss (that is, a 28% chance of complete crystallisation).

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

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

4.41 For instance, building on the first example in 3.C, the expected loss would be £2.8 million ($[55\% \times \text{£}0 \text{ million}] + [5\% \times \text{£}2 \text{ million}] + [20\% \times \text{£}5 \text{ million}] + [15\% \times \text{£}8 \text{ million}] + [5\% \times \text{£}10 \text{ million}]$).

4.42 Note that the second example in 3.C also has an expected loss of £2.8 million ($[72\% \times \text{£}0 \text{ million}] + [28\% \times \text{£}10 \text{ million}]$). While expected loss is a very useful summary statistic, these examples show that even if expected losses are the same on two different transactions, the underlying distributions may be quite different.

4.43 It is unlikely that the expected loss will be exactly zero as this would imply that either the probability of complete crystallisation is zero or the maximum exposure of the contingent liability is zero or that both are zero.

Question E: How do the risks compare to the returns on the contingent liability?

4.44 The answer to this question should summarise the risks to the Exchequer and compare them against the returns. For example, using the contingent liability described in 3.C, the risks would be the distribution of losses (as well as the expected loss). The returns would be the fee that the government may have charged in order to provide the guarantee.

4.45 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

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

4.47 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?

4.48 The answer should make clear the body immediately in charge of managing the risks associated with the contingent liability. This could be an agency, a government department, or indeed the Treasury. It could also be a specific committee within a government department.

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

4.50 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.

Question B: What risk mitigation tools have been explored? For example, partial guarantees, collateral, controls on risk-taking behaviour, reinsurance, etc

4.51 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. For example, a government guarantee of a bank loan may result in moral hazard as banks will have less incentive to robustly screen borrowers given that if they default, the government will pay. Therefore, in this case, as part of the guarantee, the government could set controls on risk-taking policy ex-ante. This could include setting conditions on the credit-worthiness of borrowers or setting minimum requirements on the loan (for example, a minimum loan-to-income ratio).

4.52 Risk mitigation tools could come in various forms but the aim of such tools will be to reduce the likelihood that the contingent liability crystallises or in the case that it does crystallise reduce the loss from crystallisation (for example, through requiring collateral).

4.53 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.

Question C: Is the Exchequer being adequately compensated for bearing the risk associated with the contingent liability? For example, guarantee fees, contingent claims, profit-sharing, etc

4.54 This is similar to question 3.E as it seeks to understand the return to the Exchequer but also explores what mechanisms can discourage poor management. The answer should set out how the Exchequer is being compensated for bearing the risks in monetary terms. For example, the

answer could explain that the Exchequer is receiving guarantee fees. If this is the case, it should also make clear the size of such fees. The answer should then explain how the fees were calculated and whether the compensation is calculated on a commercial basis. If the fee is calculated on a commercial basis, it must be greater than the expected loss associated with the contingent liability.

4.55 If the Exchequer is not being compensated on a commercial basis, then the answer should clearly set out why.

Question D: How should the Exchequer guard against the residual risk? For example, contingency fund, setting aside financial assets, hedging, etc

4.56 This question follows on from questions 4.B and 4.C. If not all of the risk has been mitigated through utilising risk mitigation tools and the compensation received also does not cover all of the risk associated with the contingent liability, then the Exchequer will bear some risk (residual risk). This answer should explain how best the Exchequer should guard against the residual risk by providing several options (for example, one option is having a contingency fund to cover the residual risk).

5. Affordability

4.57 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?

4.58 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?

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

4.60 For example, if the expected loss is £1 million and the department's available resources are £100 million, the metric would be 1%. If the expected loss is only £500,000, this may appear smaller, but if at the same time the department's available resources are £2 million, the metric would be much higher at 25%. All else constant, the latter case would be more risky in terms of affordability even though it has a lower expected loss.

Question C: If the contingent liability crystallised, how would it affect public sector net borrowing (PSNB) and public sector net debt (PSND)?

4.61 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.

4.62 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.

Contingent liability checklist

A

1. Rationale

- A: What is the problem that needs to be solved (the market failure) and why is government intervention necessary?
- B: Why is incurring / modifying a contingent liability necessary to address the market failure?
- C: What other alternatives have been explored? For example, direct spending such as subsidies. Why were these rejected?

2. Exposure

- A: What is the maximum size of the contingent liability, if any?
- 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, prior to maturity, the contingent liability no longer proves to be value for money, 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 complete crystallisation over what timeframe? For example, time $t = X\%$, time $t+1 = Y\%$, time $t+2 = Z\%$, etc
- C: What is the distribution of possible losses over the life of the contingent liability? For example, loss of A with likelihood of B, loss of C with likelihood of D, etc
- D: What is the expected loss associated with the contingent liability?
- 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?
- B: What risk mitigation tools have been explored? For example, partial guarantees, collateral, controls on risk-taking behaviour, reinsurance, etc
- C: Is the Exchequer being adequately compensated for bearing the risk associated with the contingent liability? For example, guarantee fees, contingent claims, profit-sharing, etc
- D: How should the Exchequer guard against the residual risk? For example, contingency fund, setting aside financial assets, hedging, etc

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

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