HM Treasury

Government as insurer of last resort:

managing contingent liabilities in the public sector

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Executive summary

The UK government takes on risk that others cannot both to protect the population and provide stability when unforeseen events occur. By taking on these risks the government acts as insurer of last resort in a range of domains such as flood risk and supporting lending to small businesses. This can help improve the market for insurance and provide protection against risks where the private sector is unable to provide full insurance cover without some degree of government intervention.

Taking on risk can influence behaviour in undesirable ways. For example, it can reduce incentives to guard against risk (moral hazard) as individuals are protected from the consequences of risky behaviour. It can also discourage people from taking out private insurance if they believe government will cover the risk.

Taking on these risks creates liabilities that are uncertain but might lead to future expenditure if specific conditions are met or specific events happen. These liabilities are known as contingent liabilities. These types of contingent liabilities are an increasingly important policy tool to support economic growth and safeguard the economy in times of stress. The risks need to be managed carefully.

Coronavirus is an example of an external shock that could affect the government's portfolio of contingent liabilities. For example, guarantees are one of the tools used by the government to support businesses in challenging times. Guarantees were also used to support the financial sector during the 2008 financial crisis. The report's proposals aim to ensure that guarantees are well managed so that they are effective in providing such support when it is needed, while minimising the risks.

The costs incurred when risks materialise directly affect the government's ability to spend on essential services and support. Managing these liabilities well is therefore essential for the long-term sustainability of the public finances. In 2017, HM Treasury (HMT) introduced greater controls on the creation of new contingent liabilities and has since recorded around £150 billion of new contingent liability exposure.

International engagement and the Balance Sheet Review has highlighted opportunities to further improve the management of UK government contingent liabilities. This report draws on international best practice to set out the principles and strategy for improvement in order to ensure that the government fully understands the risks that it is exposed to and is well prepared to respond if that risk materialises.

The report identifies four objectives:

1 improve the expertise in the government to quantify and price risk

2 improve compensation for risk taken on by the taxpayer

3 establish the right incentives to reduce both the probability of risk materialising and the cost when it does

4 clarify risk ownership to provide more certainty on how losses will be shared between the Exchequer, departments and the private sector

Table 1 summarises the ten proposals to achieve these objectives. These have been developed in consultation with a range of contingent liability experts in the UK and internationally. The proposals set out principles for how the government will improve the management of its contingent liabilities. The government will take forward work to implement these proposals.

Table 1.A: Summary of proposals

Expertise
Proposal 1: Establish a central capability to support departments with pricing, issuing and managing guarantees and insurance
This central capability will bring together the necessary expertise to quantify and price risk.
Proposal 2: Introduce independent verification of charges for government guarantees and insurance
Guarantees and insurance should be independently verified by the central capability to ensure that risk has been calculated accurately and that fees have been appropriately priced.
Proposal 3: Integrate contingent liabilities with wider fiscal risk management
The central capability should monitor the government's portfolio of contingent liabilities on an ongoing basis and carry out regular stress tests.
Proposal 4: Improve the oversight of the stock of contingent liabilities
The central capability should undertake an exercise to assess, quantify and price the stock of existing contingent liabilities, including estimating unquantified contingent liabilities.
Proposal 5: Improve the reporting on the government's portfolio of contingent liabilities
The government should report regularly on the portfolio of contingent liabilities, including estimates for unquantified contingent liabilities and the results of stress tests.
Compensation
Proposal 6: Seek appropriate compensation when the government provides insurance and guarantees
The government should move towards adopting international best practice of charging fees, covering at least expected loss for guarantees and insurance, where appropriate.
Incentives
Proposal 7: Improve budgetary incentives to make departments indifferent between policies with similar types and levels of risk
Where departments choose to subsidise guarantees and insurance by not passing on the full cost of expected losses to beneficiaries the subsidy should be recognised and budgeted for.

Risk ownership
Proposal 8: Improve risk sharing by formalising the hierarchy of losses between HMT, departments and the private sector
Risk sharing agreements and risk frameworks should be established more widely across the government.
Proposal 9: Improve awareness within the government of implicit risks and establish frameworks for managing them where doing so would reduce the risk
The government should undertake an exercise to systematically identify implicit risks that could be better managed.
Proposal 10: Expand coverage of existing risk management where appropriate
The government should consider its stock of contingent liabilities and investigate where it may be appropriate to expand the scope of current pooling schemes.

Source: HMT

Chapter 1

How the UK currently manages contingent liabilities

1.1 The UK government has a responsibility to protect the population and provide stability. As a result, the government bears risks and incurs costs when unforeseen events occur. These risks and costs typically arise because they cannot be adequately insured by the private sector and the government should take them on. This is known as the government's role as insurer of last resort.

1.2 Historically governments have played a very limited role in guarding citizens and businesses against risk. They provided only national defence to guard against the risk of war and very basic health and welfare provision. The spread of democracy and the rise of the welfare state over the late 19th and 20th centuries saw the government's role guarding citizens against risk grow. As part of its responsibility to citizens the government now plays the role of insurer of last resort in a wide range of markets including flood risk, terrorism insurance, travel protection and supporting lending to small businesses. The insurer of last resort role creates liabilities that are uncertain but that may lead to future expenditure if specific conditions are met or specific events happen. Such liabilities are known as contingent liabilities.

1.3 HM Treasury (HMT) launched the Balance Sheet Review at Autumn Budget 2017 to improve the returns on the government's £2 trillion assets and reduce the cost and risk of its £4.6 trillion liabilities.[1] Work undertaken as part of that review has improved understanding of the scale and variety of the government's contingent liabilities. This report sets out the principles and strategy for improving the management of the government's contingent liabilities, which aim to reduce the risk from these liabilities and support the long-term sustainability of the public finances. The report covers the current landscape of the government's contingent liabilities and draws on international best practice to identify opportunities to improve the management of these liabilities. The proposals of this report will be taken forward and developed by the government.

1.4 Managing risk well is important for the long-term sustainability of the public finances. The government's role as insurer of last resort involves taking on risk that the private sector is unable or unwilling to bear and covering the costs when that risk materialises, where this supports public policy outcomes. The government might need to borrow money from the markets or reduce spending elsewhere to meet the costs if the risks materialise. In this way the contingent liabilities created through the government's role as

[1] 'Whole of Government Accounts 2017 2018', HM Treasury, May 2018

insurer of last resort present a fiscal risk to the government. It is imperative that when the government takes on risk, the risk is well understood and managed.

Why government acts as insurer of last resort

1.5 Government rationale for intervention includes: i) to ensure markets work effectively; ii) to provide goods generally not provided by the market; and iii) to achieve distributional objectives.[2] The government acts as insurer of last resort for similar reasons.

1.6 Although the government can run the risk of creating distortions, by taking on some risk from the private sector it can help improve market efficiency. One example of this is that small and medium sized enterprises (SMEs) often struggle to access finance from commercial banks as they are riskier than their larger and more established competitors. This makes it harder for SMEs to grow and makes markets less competitive. By offering guarantees to the lender, the government can reduce the risk of lending to SMEs to help correct this market failure (see Box 2.A and Annex G) but must be careful to avoid creating other unintended distortions in the market. An example of such a distortion is the creation of a moral hazard, i.e. incentivising lenders to issue an unsustainable level of loans since they know the government bears the risk of defaults.

1.7 There are some risks for which it is not possible for the private sector to provide full insurance cover without some degree of government intervention. An example of such a risk is a terror attack, which has a low probability but a high impact. It is hard to predict the size, timing and location of attacks hence it is impossible for insurance companies to reliably model the risk. There is a very remote risk that an attack would be so large that insurance companies could not afford to cover it. In such circumstances there can be a missing market for insurance against high impact, low probability events. The government can ensure that this risk is covered by taking on the large tail-end risk of an extremely unlikely but catastrophic event (see Annex J).

1.8 There is also a category of risk that, whilst it could theoretically be insured by the private sector, is taken on by the government. An example of this is repatriating holidaymakers who might be stranded abroad if the company they travelled with goes out of business. Although this risk could theoretically be covered privately through travel insurance the government has taken on this risk. It established the Air Travel Organiser's Licence (ATOL) to fulfil its duty to protect UK citizens and ensure all citizens can access this protection.[3] As government policy and wider societal trends evolve, the risks that the government covers to meet policy objectives can change.

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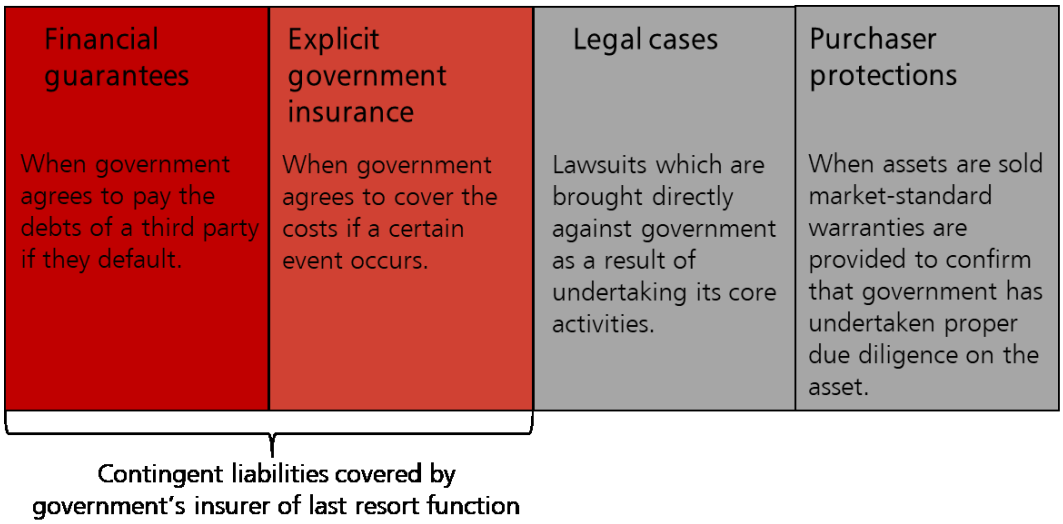
2 'The Green Book', p5, HM Treasury, April 2013 with updates as at March 2019

3 ATOL was originally established by the UK government in 1973. It now fulfils the UK's obligations under the EU Package Travel Directive 2015 to fully protect travellers against a travel organiser's insolvency.

Types of contingent liability

1.9 Contingent liabilities can encompass a wide spectrum of different risks. As illustrated in Chart 1.A there are four broad categories of contingent liability that governments are exposed to:[4]

Chart 1.A: Typology of contingent liabilities



Source: HMT

1.10 Financial guarantees – when government agrees to pay the debts of a third party if they default. This most commonly takes the form of a guarantee for a loan from a financial institution, the debt of an organisation or for another type of financial instrument. An example of this type of guarantee is the Enterprise Finance Guarantee (EFG) scheme run by the British Business Bank (BBB), which provides a guarantee for loans from finance providers to small and medium-sized enterprises (SMEs) (see Annex G).

1.11 Explicit government insurance – when government agrees to cover the costs if a certain event occurs either by providing an indemnity or by acting as an insurer. This type of contingent liability can include a wide variety of risks, for example paying compensation to farmers if certain animals catch particular diseases and need to be put down.

1.12 Legal cases – these contingent liabilities are created when lawsuits are brought directly against government as a result of government carrying out activities. For example, if someone alleges that government has collected the wrong amount of tax from them.

1.13 Purchaser protections – this type of contingent liability is mainly incurred during the disposal of government assets. When an asset is sold, certain market-standard warranties are included to enable the sale. These warranties normally cover confirmation that government owns the asset it is trying to sell, that the information it has provided on the asset is accurate and that government has fulfilled its legal obligations in relation to the asset. The

[4] These contingent liability categories have been established for risk management purposes and are different to accounting categories. Contingent liabilities in any of these categories can be remote or non-remote. Annex A sets out more detail on the accounting treatment of government's insurer of last resort function.

warranties provided will vary depending on the type of asset being sold. Depending on the assets in question, government may also provide indemnities to purchasers.

1.14 The contingent liabilities that fall within the first two categories constitute the government's insurer of last resort function. These contingent liabilities are usually incurred as a result of the government stepping in to correct a market failure. The latter two categories should not be considered part of the government's insurer of last resort function as the risks are controlled directly by the government, i.e. through accurately collecting taxes and undertaking due diligence on assets before a sale. The latter two categories are also contingent liabilities that could be incurred by private sector entities in the normal course of business.

Taking on private sector risk

1.15 Whilst acting as the insurer of last resort can provide benefits to the economy and society, taking on risk from the private sector can have adverse effects that need to be carefully managed. Guarantees and insurance do not usually affect fiscal metrics, such as Public Sector Net Debt (PSND) or Public Sector Net Borrowing (PSNB), when they are issued. However, they can have fiscal impacts in the future if that guarantee is called. Annex B sets out the relative costs of guarantees and loans. Using guarantees due to short term fiscal or budgetary constraints can risk creating higher costs in the longer term.

1.16 Acting as insurer of last resort also creates moral hazard. Providing insurance for the private sector reduces incentives for private sector beneficiaries to guard against risk as they are protected from its consequences. If they act in a riskier fashion this could make the risks more likely to materialise, which in turn increases costs to the taxpayer. It is therefore important to create strong incentives on beneficiaries to monitor and reduce their risk, for example by using risk-based premiums and excess arrangements commonly used in private sector insurance policies.

Improving controls on creating new contingent liabilities

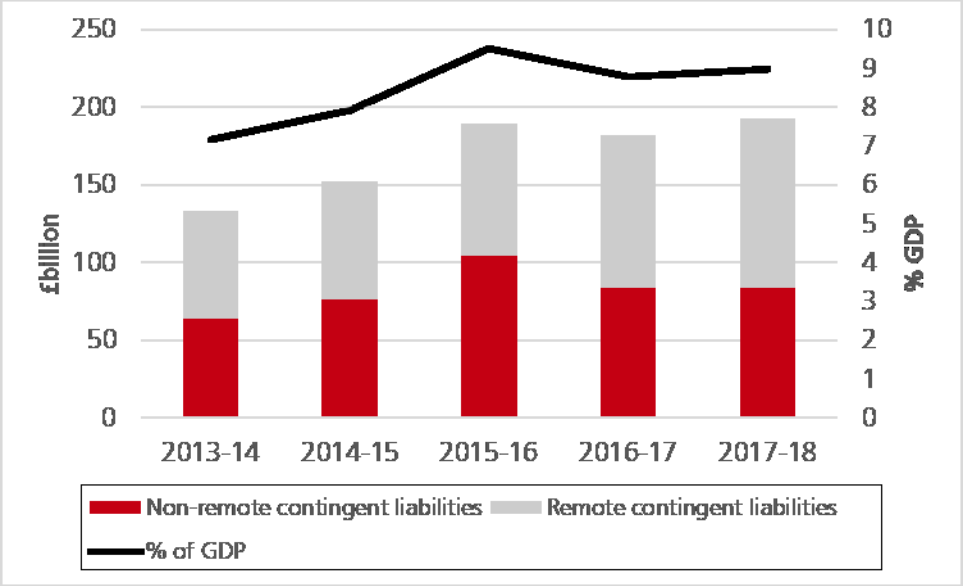
1.17 The Whole of Government Accounts (WGA) provides an overview of the quantifiable stock of existing contingent liabilities. This stock stood at c.£193 billion in 2017-18 (see Chart 1.B).[5] The WGA is prepared according to internationally recognised accounting standards and contingent liabilities are valued with reference to the most likely outcome, which takes into account how likely it is that each commitment will lead to a cost for the taxpayer.

1.18 Government bodies go beyond the requirements of private sector accounting and include a separate category of remote contingent liabilities. These make the public aware of low-probability, high-impact scenarios. Departments provide a description of the nature of each of their material remote contingent liabilities, and where practical, an estimate of its financial effect. Only remote contingent liabilities which have been quantified by

5 'Whole of Government Accounts 2017 2018', HM Treasury, May 2018

departments will therefore be included within WGA figures, although significant unquantifiable remote contingent liabilities are listed within the account narrative. Further details on the accounting treatment of contingent liabilities, and other uncertain future obligations, can be found in Annex A.

Chart 1.B: Stock of contingent liabilities in the Whole of Government Accounts



Source: Whole of Government Accounts

1.19 In response to the growth of contingent liabilities since 2013, in 2017 HMT introduced a new approval framework for contingent liabilities.[6] This framework requires new contingent liabilities that are novel, contentious or repercussive and have a maximum exposure of over £3 million to be evaluated according to five criteria (illustrated in Chart 1.C).

Chart 1.C: Contingent liability approval framework

1.Rationale

a) What is the problem that needs to be solved and why is government intervention necessary?
b) Why is incurring/modifying a CL necessary to address the market failure? Why is it better than increasing spending?
c) What other alternatives have been explored? E.g., subsidies.

2.Exposure

a) What is the maximum size of the CL, if any?
b) Why is this size necessary?
c) What is the maturity of the CL, if any?
d) Why is this maturity necessary?
e) Do we have an exit strategy?

3.Risk and Return

a) What are the triggers for potential crystallisation of the CL?
b) What is the likelihood of complete crystallisation over what timeframe?
c) What is the expected loss associated with the CL?
d) What is the distribution of possible losses over the life of the CL?
e) How do the risks compare to the returns on the CL?

4. Risk Management and Mitigation

a) Who will manage the risks associated with the CL and what is the governance process around the management of these risks?
b) What risk mitigation tools have been explored? E.g., partial guarantees, collateral, controls on risk-taking behaviour, reinsurance, etc.
c) Is the Exchequer being adequately compensated for bearing the risk associated with the CL? E.g., guarantee fees, contingent claims, profit-sharing, etc.
d) How should the Exchequer guard against the residual risk? E.g., contingency fund, setting aside financial assets, hedging, etc.

5.Affordability

a) If the CL crystallised, to what extent would it be possible to meet the required payment out of the department's budget?
b) What is the ratio of the CL's expected loss to the department's available resources?
c) If the CL crystallised, how would it affect PSNB and PSND?

Source: HMT, contingent liability approval framework

6 'Contingent liability approval framework: guidance', HM Treasury, July 2017

1.20 This new approval framework has been featured by both the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) as an example of international best practice in the management of government guarantees.[7] Since the introduction of the framework in 2017, over 100 new contingent liability proposals, with a current exposure of around £150 billion, have been evaluated using it. The framework has helped improve the process for creating new contingent liabilities as the majority have only been approved after:

- more comprehensive information or improved quantification was provided to better understand the risk
- substantial policy changes to reduce the risk or improve compensation to the taxpayer for bearing the risk

A number of contingent liabilities, with a total exposure of over £9.6 billion, have been rejected outright, helping to reduce risk.

1.21 The information from the contingent liabilities that pass through the approval framework is recorded in HMT's contingent liability database and is reported on by the Office for Budget Responsibility (OBR) in its Economic and Fiscal Outlook (EFO). This has provided the first granular view of the make-up of new contingent liabilities created across government. As the database captures new contingent liabilities when they are approved, it does not yet include the entire stock of existing contingent liabilities recorded in the WGA.

1.22 The contingent liability database supports risk management by tracking the maximum potential exposure for government, i.e., what the public sector obligation would be in a plausible worst-case scenario. This approach is different from the WGA quantification of contingent liabilities, which estimates the most probable outcome. The contingent liabilities database therefore provides an estimate of the maximum amount the government may have to cover due to the commitments represented by its contingent liabilities. The IMF recommends focusing on maximum exposure as it is easier to monitor, and easier to apply and communicate limits on, than expected payments.[8]

1.23 Even an estimated value can help the government to manage the risk that gives rise to a contingent liability. For example, in 2014 the Government Actuary's Department (GAD) carried out work on behalf of HMT to quantify the levels of risk inherent in the Pool Re commitment (see Annex J). This process could not give a maximum potential liability for the commitment, but it could and did support HMT to charge Pool Re an appropriate premium for the risk.

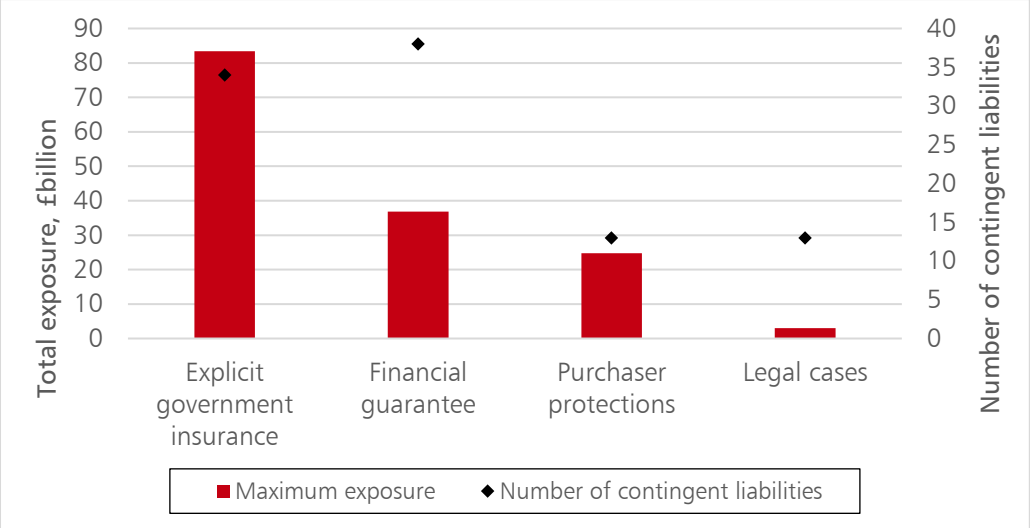
1.24 Chart 1.D shows the number and total exposure for each category of contingent liability that has been through the approval framework. The

[7] 'How to strengthen the management of government guarantees', IMF, October 2017, '18th Annual Meeting of OECD Senior Financial Management and Reporting Officials', OECD Paris, March 2018

[8] 'How to strengthen the management of government guarantees', IMF, October 2017

largest source of risk is from insurance provided by the government, followed by financial guarantees.

Chart 1.D: New contingent liabilities 2017-2019



Source: HMT contingent liability database

1.25 This report focuses on those contingent liabilities where government has explicitly committed to covering the costs of an event occurring. However, government can also be exposed to implicit contingent liabilities (see Box 1.A).

Box 1.A: Implicit contingent liabilities

Implicit contingent liabilities are risks for which there may be no formal legal obligation for government to cover the costs, but where the risk adversely affects the general public and is not covered by the private sector. Governments will often take on responsibility for covering the costs. These risks are not recorded as contingent liabilities in departmental accounts nor the WGA. As there is no explicit commitment, governments can remove implicit liabilities by deciding not to cover the costs when future risks materialise.

The scope of government's implicit contingent liabilities is even harder to quantify than with explicit government insurance as the government does not maintain a record of its implicit risks. This makes it difficult to actively monitor and manage them. It can lead to unexpected costs arising when government must cover the costs of an event it wasn't previously aware would be a potential liability. By virtue of these liabilities being implicit the data collected for this type of risk is usually minimal compared to data available for other contingent liabilities. The OBR identifies and reports on implicit contingent liabilities in its Fiscal Risks Report.[9]

Moral hazard is more difficult to manage for implicit government insurance. Making an implicit liability explicit may create moral hazard as the

[9] 'Fiscal Risks Report', OBR, 2017 and 2019

beneficiaries know that government will cover the cost. Alternatively, if those beneficiaries already expect government to cover the cost, moral hazard may already exist. Such circumstances could also discourage beneficiaries from purchasing private insurance due to the expectation that government will cover the cost regardless (known as a 'free rider' problem).

There can be circumstances where implicit liabilities can be better managed either by making the liability explicit and creating incentives for beneficiaries to reduce risk or ensuring that the private sector can cover the whole risk. The OECD has recommended converting implicit liabilities to explicit liabilities (where practicable), unless the government can reliably pre-commit that it will not take measures in response to the risks stemming from the implicit liability.[10]

Improving the management of the stock of contingent liabilities

1.26 The new framework has been successful in improving scrutiny, understanding and monitoring of the risk from the flow of new contingent liabilities. To support this further this report sets out how the government intends to improve the management of these contingent liabilities after they have been created and improve its understanding of the stock of contingent liabilities.

1.27 This has been highlighted by the OBR's 2019 Fiscal Risks Report: "in preparing this report, we asked the Treasury about how many contingent liabilities entered into before the new approval regime took effect had crystallised and at what cost. It was not able to provide complete information to answer this. This information gap could be important, since it is the stock of all contingent liabilities, rather than just the flow of new ones, that matters in terms of the government's fiscal risk exposure over time". [11]

10 'Budgeting for contingent liabilities', OECD, June 2013

11 'Fiscal Risks Report 2019', OBR, July 2019

Chapter 2

Further improving the management of contingent liabilities

2.1 Contingent liabilities present a significant fiscal risk globally. A 2016 IMF fiscal affairs department study found that the global average fiscal cost of realised contingent liabilities between 1990 and 2014 to be about 6% of GDP.[1] The IMF and OECD have made several recommendations on best practice in managing contingent liabilities.[2] These include:

- developing the expertise to conduct cost and risk analysis before issuing contingent liabilities and monitor and report publicly on the stock of contingent liabilities on an ongoing basis
- being compensated for taking on risk by charging risk-based fees that cover at least expected losses
- establishing good incentives to encourage neutrality between guarantees, loans and grants, for example by budgeting for the potential costs of contingent liabilities when they are issued
- using risk sharing arrangements to mitigate risk; risk frameworks to set limits on exposure and notional funds, i.e. funds returned to the Exchequer where they are tracked (see Box 2.B), to improve the ability to cover future losses

Further detail on international best practice in managing contingent liabilities can be found in Annex C.

2.2 Good management of contingent liabilities requires expertise to assess risk, adequate compensation for taking on risk, strong incentives on parties to manage risk well and clear ownership of risk. The Balance Sheet Review team in HMT has identified opportunities for further improvement in each of these areas and developed ten proposals for realising these opportunities. These are set out in more detail in this chapter. Whilst these proposals provide the foundations for improving the management of contingent liabilities, the application of these proposals to individual contingent liabilities will need to be tailored on a case-by-case basis to reflect the specific circumstance of that contingent liability. A possible example is where a contingent liability arises through a procurement contract.

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1 'How to strengthen the management of government guarantees', IMF, October 2017

2 'Budgeting for contingent liabilities', OECD, June 2013, 'The role of public debt managers in contingent liability management', OECD, February 2017

Expertise

2.3 Issuing guarantees and insurance requires specialist expertise to understand, manage and assess risk as well as to price appropriate fees and premiums. This includes credit risk analysis (covering financial guarantees), actuarial analysis (covering insurance risks), commercial and legal expertise. There are some public-sector organisations in the UK that have built up considerable expertise in these areas (many of which are highlighted in the case studies featured in Annexes D to J of this report).

2.4 This expertise is not just important for reducing the risk and cost to the taxpayer from the government's contingent liabilities. It is also vital for ensuring that government guarantees and insurance achieve their objectives and provide the social and economic benefits they are intended to.

Opportunities for improvement

2.5 **Improving information about the scale and distribution of risk.** Assessing the scale and distribution of risk for a specific contingent liability can be challenging. Often there are a lack of historical events to inform analysis and it can be hard to identify a counterfactual. As there is no comprehensive record of pay-outs made for contingent liabilities issued before 2017 the necessary data may not have been recorded. In other cases, incidents may occur infrequently or randomly, which makes it hard to assess and predict risk. In each of these circumstances specialist expertise is needed to assess risk, which departments often do not have access to.

2.6 **Improving expertise in modelling, monitoring, and managing risk.** Government departments often do not have all the in-house expertise required to quantify and manage contingent liabilities, or to price appropriate fees and premiums for guarantees and insurance. This may arise because the department does not have many contingent liabilities to manage, or that there are few requirements on how they should be managed. Whilst some areas of expertise, such as credit analysts, commercial and legal, are often embedded within certain departments responsible for issuing guarantees and insurance, these are not always readily available to provide support to other departments. Other areas of expertise can be covered on a temporary basis. For example, it is possible to use the expertise of actuaries, such as GAD, on a consultancy basis to help with quantification and pricing (as HMT did for renegotiating premiums paid to HMT by Pool Re, see Annex J). However, departments are not always aware of the services available and there is currently no requirement to seek such expertise.

2.7 **Managing the government's contingent liabilities on a portfolio basis.** The government might issue a dozen guarantees to support a sector of the economy which when looked at in isolation of each other may appear low risk and manageable. But a common trigger across those guarantees, such as a recession in the sector, would cause them all to materialise creating an overall risk much higher than anticipated. There could also be links between different triggers, for example a fall in house prices (causing housing guarantees to trigger), leading to a recession (causing SME support guarantees to trigger). Identifying these is more difficult if the guarantees are issued by different departments. The government does not currently have

the necessary comprehensive understanding of its portfolio of contingent liabilities to identify common triggers and systemic risks. This could exacerbate the fiscal impacts of external events that could cause multiple contingent liabilities to crystallise together.

2.8 **Strengthening institutions for managing private sector risks.** Expertise for managing these risks varies across the government and other public sector organisations. As the government is increasingly exposed to private sector risks, the government needs to ensure that it is equipped to manage the risks.

Proposals

Proposal 1: Establish a central capability to support departments in pricing, issuing and managing guarantees and insurance.

2.9 To address the gaps identified above, the UK should establish a central capability for managing contingent liabilities. The central capability will be able to help departments with assessing, quantifying and pricing risk. There could be economies of scale in centralising the necessary expertise rather than requiring each department to develop it in-house. This could provide greater consistency in the approach and assumptions used when issuing guarantees or insurance across the government. As loans present similar risks to financial guarantees, the central capability's expertise could also help the government with assessing the risk from loans and other financial transactions.

Proposal 2: Introduce independent verification of charges for the government guarantees and insurance.

2.10 The valuation of guarantees and insurance should be independently verified by the central capability to ensure that it has been calculated accurately and that fees for taking on this risk have been appropriately priced. Departments may develop different models and assumptions when quantifying these risks independently. The complexity of the calculations, and the inherent uncertainty of these risks, could mean that even small changes to methodologies or assumptions could have significant impacts on the estimates of expected losses and the price of fees. Consistency of modelling is necessary for stress testing the government's portfolio of contingent liabilities and integrating it into wider fiscal risk modelling (see proposal 3). Independent verification could help provide consistency across the government. This is particularly important where the risks from guarantees or insurance affect more than one department.

Proposal 3: Integrate contingent liabilities with wider fiscal risk management.

2.11 It is important that contingent liabilities are analysed both at initial issuance and throughout the duration of the liability as risk can change over time. The government should actively manage its contingent liabilities on a portfolio basis so that it can adapt to changes in the underlying risk of its contingent liabilities.

2.12 To do this the central capability should monitor the government's portfolio of contingent liabilities on an ongoing basis and carry out regular stress

tests. This will allow it to identify correlations between different contingent liabilities, concentration risks and systemic risks within the portfolio. This would improve the government's understanding of, and ability to mitigate, the impact of economic shocks on its portfolio of contingent liabilities. This analysis of contingent liability risk and exposure should also be integrated with the existing fiscal risk management processes.

Proposal 4: Improve the oversight of the stock of contingent liabilities.

2.13 To be able to manage its portfolio of contingent liabilities the government must first understand the contingent liabilities that make up that portfolio. As no comprehensive, granular record of contingent liabilities entered into prior to 2017 exists, to fulfil this function the central capability will need to undertake an exercise to assess, quantify and price the stock of existing contingent liabilities. Any long-standing contingent liabilities should be challenged to ensure they remain relevant and fit for purpose

Proposal 5: Improve the reporting on the government's portfolio of contingent liabilities.

2.14 The government should report regularly on its portfolio of contingent liabilities. This would complement existing financial reporting by providing additional information on the performance of the portfolio (including losses, revenues and recoveries) on estimates for currently unquantified contingent liabilities and the results of stress tests. This will help improve the transparency and available data on contingent liabilities to aid better policy making. This could be similar to the annual report that the Infrastructure and Projects Authority (IPA) provides to Parliament on the UK Guarantee Scheme (UKGS) (see Annex F).

Compensation

2.15 Whilst some public sector organisations systematically charge commercial fees for the guarantees and insurance they provide this is not universally the case across the government. The Balance Sheet Review has identified several areas in which the taxpayer is either not compensated, or undercompensated, for acting as the insurer of last resort to the private sector.

Opportunities for improvement

2.16 **Charging risk-based fees and taking collateral to set incentives to reduce risk and help meet costs if risks materialise**. Charging a fee to the beneficiary that reflects the expected risk creates incentives for the beneficiary to act responsibly to minimise risk. Since the fee could change over time as the level of risk changes, there is an incentive for good risk management by the beneficiary to reduce the fees they are charged. In this way risk-based fees can be used to mitigate moral hazard and create strong financial incentives for the beneficiaries of government guarantees and insurance to undertake risk reducing behaviour. This in turn reduces risk to the taxpayer by making it less likely that the contingent liability will crystallise and help moderate the demand for guarantees and insurance. Effectively pricing risk will also ensure that the taxpayer will be appropriately compensated for taking on risk.

2.17 However, there may be reasons that charging fees is not possible in some cases, both for policy reasons and practical considerations, and departments are already charging fees in relation to some contingent liabilities. The implications for Overseas Development Aid (ODA) will need to be considered further in order to support the government's commitment to meet its legislative target on ODA spending.

Proposals

Proposal 6: Seek appropriate compensation when the government provides insurance and guarantees.

2.18 The government should move towards adopting the approach recommended by the OECD and IMF of charging fees covering at least expected loss and administration costs for private sector facing guarantees and insurance where appropriate. However, there may be policy reasons why the government would choose to subsidise guarantees and insurance by not passing on the full cost to beneficiaries. For example, fees for affordable housing guarantees are subsidised to encourage the building of houses that can be sold at below market prices.

2.19 As a result, departments should have the flexibility to decide whether to subsidise guarantees and insurance. In situations such as these, if the government decided to offer a subsidy, that subsidy (i.e. the difference between fee income and expected costs) should be recognised and budgeted for. Budgeting for risk in this way reflects the true cost of taking on the risk and will leave the government in a better fiscal position to meet the costs if the risk materialises.

2.20 There can be cases where the government is being undercompensated for holding risk because the adequacy of charges is not regularly monitored. For example, it was only after GAD valued the government's guarantee for Pool Re (see Annex J) that it became clear that the government was being undercompensated for holding the risk. This allowed the government to renegotiate the contract to secure appropriate compensation. More thorough and systematic quantification of existing guarantees and regular monitoring will enable the government to ensure that the compensation received remains appropriate.

Incentives

2.21 Contingent liabilities usually do not directly affect departmental budgets until the risk materialises and a pay-out must be made. Recognising the expected losses of contingent liabilities in budgets can create good incentives on departments to manage risk well.

Opportunities for improvement

2.22 Improving transparency on the costs of contingent liabilities. As contingent liabilities are currently off-balance sheet, they have historically been overlooked as a significant risk for the government. As they do not affect fiscal metrics or departmental budgets at issuance they have also not been managed through fiscal and spending control frameworks. For these reasons, prior to the introduction of the new approval framework there was

insufficient scrutiny applied and data collected on the costs of contingent liabilities. Consequently, there was insufficient understanding of the risks.

Proposals

2.23 **Proposal 7:** Improve budgetary incentives to make departments indifferent between policies with similar types and levels of risk.

2.24 Improving transparency on the expected costs of contingent liabilities by recognising those costs in the budgetary framework will incentivise better decision making in the public sector. By making departments more aware of these costs they will be able to make better judgements about whether to subsidise guarantees and insurance, and how to trade that off against other types of spending to maximise the social and economic benefits they can achieve with their resources.

2.25 In line with OECD and IMF recommendations this would help achieve neutrality between guarantees, loans and grants with similar costs. HMT will review the budgetary treatment of contingent liabilities in the Consolidated Budgeting Guidance.[3] Changes to the budgetary treatment of guarantees and insurance should be considered alongside risk sharing arrangements between departments and the Exchequer.

Risk ownership

2.26 Clear risk sharing between the Exchequer, departments and the private sector can provide certainty, reduce exposure and improve incentives to reduce risk. There are some areas where such clear risk sharing already exists (see Box 2.A), but it is not widespread across the government.

Box 2.A: British Business Bank – ENABLE Guarantee

Risk sharing between the private sector, departments and the Exchequer can set strong incentives to mitigate moral hazard, reduce the government's exposure and provide greater certainty on the scope for losses.

The British Business Bank (BBB), established in 2014, operates several guarantee schemes designed to improve the ability of SMEs to access finance. The two largest schemes are the Enterprise Finance Guarantee (EFG, see Annex G) and the ENABLE Guarantee scheme.

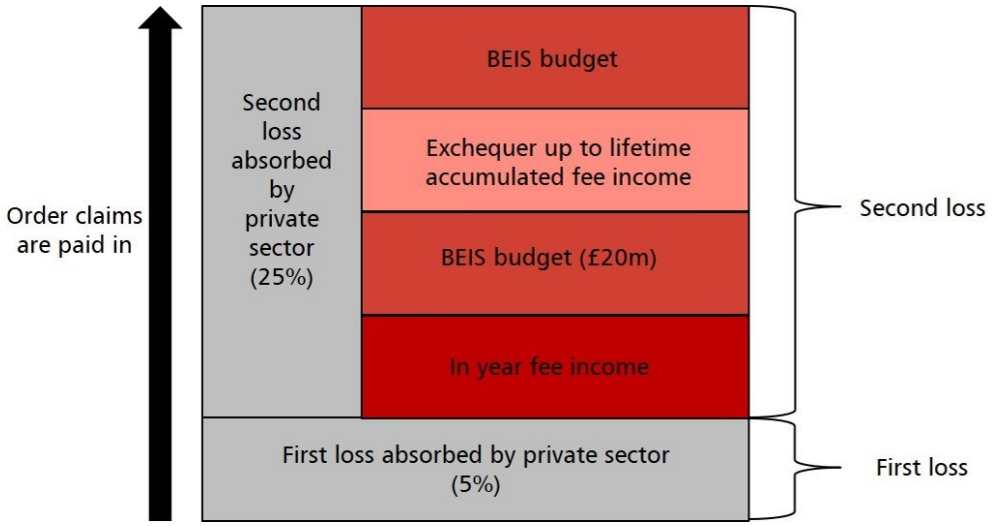
The ENABLE guarantee scheme has a total exposure of £2 billion, of which £1.2 billion has been used so far and is intended to encourage more lending to SMEs by reducing the amount of capital a finance provider is required to hold against such loans. The ENABLE scheme guarantees 75% of the value of a portfolio of loans that meet certain criteria. The finance provider who originates the loans is also required to absorb the first 5% of losses that occur on the guaranteed portfolio and pay a risk-based fee to the government in

[3] 'Consolidated budgeting guidance 2019 to 2020', HM Treasury, March 2019

exchange for the guarantee. These guarantee fees flow back to the Exchequer where they are tracked over time.

The BBB has a risk sharing arrangement in place with its sponsor department, the Department for Business, Energy and Industrial Strategy (BEIS), and the Exchequer. Under this agreement, if the guarantees start making losses in the first instance those losses will be met from fee income earned that year. If the losses exceed fee income in that year the next £20 million of losses will be met by BEIS from its existing budget. The Exchequer will then cover any losses exceeding £20 million up to the value of the lifetime accumulated guarantee fees, with any further losses beyond this amount being absorbed by BEIS.

Chart 2.A: BBB Risk sharing arrangement



Source: BBB

2.27 Accumulated fee and premium income from contingent liabilities can also be used to build buffers to help meet costs if risks materialise in the future. Notional accounts are generally preferred to 'sinking funds' (i.e. funds that contain money set aside to pay off specific liabilities).

Box 2.B: Sinking Funds

Although there are instances where the government has established a sinking fund, for example the Pension Protection Fund (PPF, see Annex I), it will generally not be efficient for departments to establish 'sinking funds'. It is more efficient to pay down debt, meet spending pressures elsewhere and reduce borrowing. Furthermore, lots of separate sinking funds could undermine the ability of the Exchequer to manage its total risk exposure and spread risk across its portfolio.

Sinking funds also generally conflict with the principles of Managing Public Money, which states, "it is essential for central government organisations to minimise the balances in their own accounts with commercial banks. Were each to retain a significant sum in its own account with such banks, the

amount of net government borrowing outstanding on any given day would be appreciably higher, adding to interest costs and hence worsening the fiscal balance."[4]

Notional accounts, i.e. funds returned to the Exchequer where they are tracked, are preferable to sinking funds. The OECD and IMF recommend notional funds over sinking funds as they do not affect debt and are easier to manage.[5]

However, there are examples of sinking funds working effectively in the UK public sector such as the PPF (see Annex I) and there could be limited circumstances when it might be appropriate. If such a fund were to be established it must: i) ensure that the risk is fully covered and minimise the residual risk to central government; and ii) have the ability to share risk with the private sector by increasing fees or reducing pay-outs.

2.28 When the government acts as insurer of last resort it should also carefully consider the role that commercial insurance can play in managing risk. Ensuring the private sector insurance market is viable and competitive can provide a large buffer before public funds are needed. The government should focus on addressing market failures and, wherever possible, should aim to support rather than undermine the private sector market.

Opportunities for improvement

2.29 **Improving clarity about the scope and/or limit of the government's exposure**. The extent of this clarity differs across contingent liabilities types:

- financial guarantees - for financial guarantees the scope of the government's exposure is usually clear, i.e. the exposure is limited by the amount of debt the government has agreed to guarantee
- explicit government insurance – for these types of liabilities the government is aware of the possibility of a cost arising in the future, but it is often unaware of how much it could be liable for in a worst-case scenario. The government could benefit from greater expertise to value such liabilities (as GAD were able to do for Pool Re, see Annex J)

2.30 The creation of the HMT approval framework has significantly improved the government's ability to track the scope of the government's exposure for new contingent liabilities. However, exposure on contingent liabilities created before the approval framework is uncertain. Not knowing the scope of the government's total exposure means that the government might not have adequate mitigation tools in place.

2.31 **Greater pooling of risk across sectors.** The government's role as insurer of last resort covers a wide portfolio of different sectors. Pooling risk across a sector can be an effective way of managing the government's role as insurer

[4] 'Managing Public Money', p.38, HM Treasury, July 2013 with updates as at October 2019

[5] 'Budgeting for contingent liabilities', OECD, June 2013

of last resort as it reduces the impact of losses on any individual contingent liability. For example, by sharing risk across all pension schemes the PPF reduces the impact from the failure of any individual pension scheme (see Annex I). In this way sharing risks across entire sectors, rather than providing insurance to firms on an individual basis, can make it easier to manage risk and reduces the cost and impact when risks materialise. Successfully pooling together risks with different risk profiles would make the government more resilient against crystallisation and shocks within its portfolio of contingent liabilities.

2.32 **Greater ability to build a buffer against future shocks.** Charging fees and premiums for risk when providing guarantees and insurance should enable the government to be in a better financial position to meet future costs if risks crystallise. However, currently when departments charge fees for guarantees and insurance they are not able to retain the income from one year to the next as it goes to the Exchequer. This means departments are unable to build a buffer in case a contingent liability crystallises, leaving them exposed to shocks within their portfolio. It also gives them little incentive to charge fees for guarantees and insurance in the first place as there is little benefit to them from doing so.

Proposals

Proposal 8: Improve risk sharing by formalising the hierarchy of losses between HMT, departments and the private sector.

2.33 The practice of structuring guarantees and insurance, along the lines set out in Box 2.A, so that first losses fall to beneficiaries, should be standardised across the government. Where appropriate, partial guarantees or co-payment arrangements that share second losses between the taxpayer and the private sector should also be used more consistently when providing government guarantees and insurance. This will help to guard against moral hazard, reducing the likelihood of the taxpayer being required to pay out for losses, and reducing the cost to the government if the risk materialises.

2.34 The government should establish risk sharing agreements, similar to the one used for BBB ENABLE guarantees (see Box 2.A), more widely across the government to provide more certainty for departments. This would allow departments to build a buffer through a notional fund with the Exchequer without creating the inefficiencies of having lots of sinking funds spread across the government. For departments with significant portfolios of contingent liabilities, risk sharing arrangements should be accompanied by establishing a risk framework similar to the one established for UKEF (see Annex C). Risk frameworks and risk sharing agreements will need to be tailored to reflect the nature and scale of risks in each department's portfolio of contingent liabilities as well as each department's capacity to afford losses.

Proposal 9: Improve the awareness within the government of implicit risks and establish frameworks for managing them where doing so would reduce the risk.

2.35 HMT's contingent liability approval framework, the WGA and the other proposals in this report cover contingent liabilities that the government has

explicitly agreed to cover. However, there are implicit contingent liabilities (see Box 1. A) that are not captured by any of these measures but that could lead to costs to the government. Some implicit contingent liabilities can be managed better by establishing frameworks that turn them into explicit liabilities.

2.36 The government should build on the reporting already done by the OBR and systematically identify implicit risks that could be better managed by either converting them to explicit liabilities or putting in place measures to ensure there is no residual risk to the taxpayer, in line with OECD recommendations.

Proposal 10: Expand coverage of existing risk management where appropriate.

2.37 Risk pooling schemes exist in many areas where the government has set up a vehicle that acts as insurer of last resort, such as the PPF (see Annex I) and NHS Resolution (see Annex H). Risk pooling of similar guarantees and insurance offers a better layer of protection as it reduces the impact of the individual losses of higher risk individuals, by sharing the potential exposure over a large pool. This usually results in savings on the cost of insurance, more stability on predicted expected loss and the ability to offer insurance to beneficiaries who otherwise would not be able to obtain it.

2.38 The government should consider its stock of contingent liabilities and investigate where it may be appropriate to expand the scope of current pooling schemes. It should also consider whether risk pooling arrangements are appropriate when issuing new contingent liabilities. One example is the Department of Education's risk pooling scheme for academies (the Risk Protection Arrangement), which has saved almost £700 million since it launched and will be expanded to include protection for local authority schools, which is estimated to save an additional £75 million - £125 million per annum for the sector.

2.39 The government should also consider whether it should establish overall limits on contingent liability exposure across the government. As contingent liabilities do not affect fiscal metrics establishing an overall risk framework for the government and pooling risk across the government could help to manage risk more effectively. This should be considered further once the central capability has analysed the government's portfolio of contingent liabilities.

Chapter 3
Summary of proposals

3.1 The proposals in this report (summarised in the table below) set out the principles and strategy for improving the management of contingent liabilities. These proposals are in line with OECD and IMF recommendations on international best practice. The proposals, which will be taken forward by the government, will help to reduce the risk from these liabilities, support the long-term sustainability of the public finances and inform the review of the fiscal framework announced at Budget 2020.

Table 3.A: Summary of proposals

Expertise
Proposal 1: Establish a central capability to support departments with pricing, issuing and managing guarantees and insurance
This central capability will bring together the necessary expertise to quantify and price risk.
Proposal 2: Introduce independent verification of charges for government guarantees and insurance
Guarantees and insurance should be independently verified by the central capability to ensure that risk has been calculated accurately and that fees have been appropriately priced.
Proposal 3: Integrate contingent liabilities with wider fiscal risk management
The central capability should monitor the government's portfolio of contingent liabilities on an ongoing basis and carry out regular stress tests.
Proposal 4: Improve the oversight of the stock of contingent liabilities
The central capability should undertake an exercise to assess, quantify and price the stock of existing contingent liabilities, including estimating unquantified contingent liabilities.
Proposal 5: Improve the reporting on the government's portfolio of contingent liabilities
The government should report regularly on the portfolio of contingent liabilities, including estimates for unquantified contingent liabilities and the results of stress tests.
Compensation for risk
Proposal 6: Seek appropriate compensation when the government provides insurance and guarantees
The government should move towards adopting international best practice of charging fees, covering at least expected loss for guarantees and insurance, where appropriate.

Incentives
Proposal 7: Improve budgetary incentives to make departments indifferent between policies with similar types and levels of risk
Where departments choose to subsidise guarantees and insurance by not passing on the full cost of expected losses to beneficiaries the subsidy should be recognised and budgeted for.
Risk ownership
Proposal 8: Improve risk sharing by formalising the hierarchy of losses between HMT, departments and the private sector
Risk sharing agreements and risk frameworks should be established more widely across the government.
Proposal 9: Improve awareness within the government of implicit risks and establish frameworks for managing them where doing so would reduce the risk
The government should undertake an exercise to systematically identify implicit risks that could be better managed.
Proposal 10: Expand coverage of existing risk management where appropriate
The government should consider its stock of contingent liabilities and investigate where it may be appropriate to expand the scope of current pooling schemes.
Source: HMT

Annex A

Accounting for government as the insurer of last resort

Background

A.1 The government applies International Financial Reporting Standards (IFRSs) to ensure best practice in accounting. HMT reviews these standards and adapts them for the public sector in the Government Financial Reporting Manual (FReM) which is updated for each financial year.[1]

A.2 Applying the accounting framework often means making important decisions about how to interpret requirements. It can also involve choosing between different reporting approaches, within the guidance. HMT appoints Accounting Officers (AOs) in government bodies to take on this responsibility.

A.3 The International Accounting Standards Board (IASB), which develops IFRSs, is in the middle of bringing in a new standard to improve the way organisations account for the insurance contracts they issue.

Current accounting arrangements

A.4 Arrangements that form part of the government's role as the insurer of last resort can be accounted for in several different ways.

Table A.1: Summary of accounting arrangements

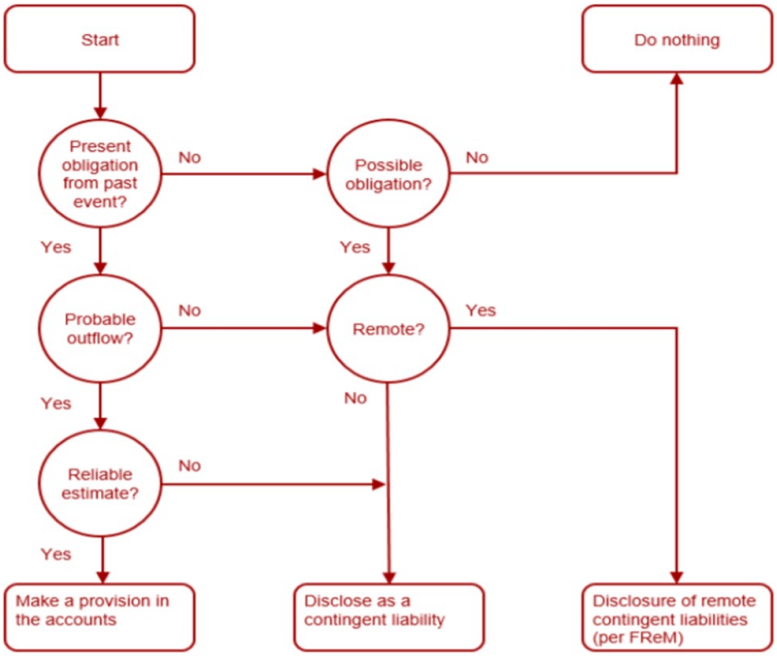
Treated as…	Relevant standard	In practice this means…
An insurance contract	IFRS 4 Insurance contracts	Entities must meet certain minimum criteria when they account for insurance contracts. For example, an insurer must keep insurance liabilities on its balance sheet until they are discharged or cancelled, or expire. Entities can combine IFRS 4 with other accounting standards, or with bespoke treatments, as long as they meet these minimum requirements.
A financial instrument	IFRS 9 Financial Instruments	Guarantees to cover payments can fall into the category of financial guarantee contracts, a kind of financial instrument. For example, a department makes a financial guarantee if it commits to making good losses

[1] 'Government financial reporting manual (FREM)', HM Treasury, January 2014 with updates as at December 2019

		suffered by another entity if a third party defaults on their debt. These liabilities are recognised at fair value and revalued every reporting period, taking into account all the losses expected over the lifetime of the guarantee. In the absence of a detailed accounting treatment for insurance contracts, many entities have opted to apply IFRS 9 in conjunction with IFRS 4 both to financial guarantees and to other insurance arrangements.
A warranty	IFRS 15 Revenue from Contracts with Customers	An entity can take on risk associated with uncertain future events by providing goods or services with a warranty. These arrangements offer a kind of insurance, transferring risk from the customer to the entity providing the goods or services. It becomes a performance obligation of the contract with that customer, affecting when the entity can recognise revenue from that contract. If this gives rise to an uncertain obligation, with a potential net cost to the entity, then it might also give rise to a provision or a contingent liability under IAS 37.
A provision	IAS 37 Provisions, Contingent Liabilities and Contingent Assets	Where an entity is likely to have future expenditure but the obligation is uncertain in timing or amount, it recognises that liability as a provision. To give rise to a provision, an obligation must be probable. As a rule of thumb, this means more than 50% likely to occur. The entity must also be able to make a reliable estimate of its value. The entity recognises the provision on its balance sheet. Chart A.1 sets out the difference between provisions, contingent liabilities, and remote contingent liabilities.
A contingent liability	IAS 37 Provisions, Contingent Liabilities and Contingent Assets	When an entity has an uncertain future obligation that is possible but not likely to lead to expenditure, it recognises a contingent liability. This approach is also used for probable obligations that cannot be reliably estimated. Contingent liabilities are disclosed in notes to the entity's annual report and accounts, but do not appear on the balance sheet. Where possible, the notes include an estimate of the value of the contingent liability.

		Chart A.1 sets out the difference between provisions, contingent liabilities, and remote contingent liabilities.
A remote contingent liability	Managing Public Money	A special category of remote contingent liabilities exists in the public sector. Due to the high level of public interest in government finances, even obligations that are unlikely are recognised as remote contingent liabilities. As a rule of thumb, if the probability of a cost being incurred is less than 10%, the contingent liability is remote. Remote contingent liabilities are also disclosed in the annual report and do not feature on an entity's balance sheet. Like contingent liabilities, they can be disclosed with or without a value depending on whether that information is available or not. Chart A.1 sets out the difference between provisions, contingent liabilities, and remote contingent liabilities.

Chart A.1 Classifying provisions, contingent liabilities and remote contingent liabilities



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

Expected changes to insurance accounting arrangements

A.5 The current accounting standard for insurance contracts, IFRS 4, is a placeholder standard designed to establish a common definition of an

insurance contract and ensure certain minimum disclosure requirements are met.

A.6 The IASB has published a replacement standard, IFRS 17 Insurance Contracts, which sets out a detailed accounting treatment for insurance contracts.

A.7 IFRS 17 is currently scheduled to come into force in the public sector for the financial year 2022-23. HMT will review the standard, consult, and make any adaptations necessary. Guidance will appear in the Government Financial Reporting Manual 2022-23 and in dedicated IFRS 17 Application Guidance.

A.8 Government bodies will need to review their accounting arrangements for insurance contracts and other insurance arrangements. Some contracts that transfer insurance risk may not yet be recognised, and others are currently treated under a different financial reporting standard.

A.9 Once IFRS 17 comes into force, it will apply to most arrangements that transfer insurance risk into the government. An insurance contract does not need to be in writing. It can be a verbal contract, or a constructive obligation created by the way the entity has acted in the past.

A.10 To value an insurance contract under IFRS 17 an entity must identify all future cashflows associated with that contract, adjust them for financial and insurance risk, and discount them to present value. This will give rise to an insurance asset or liability, which will sit on the entity's balance sheet and be revalued every reporting period.

Annex B

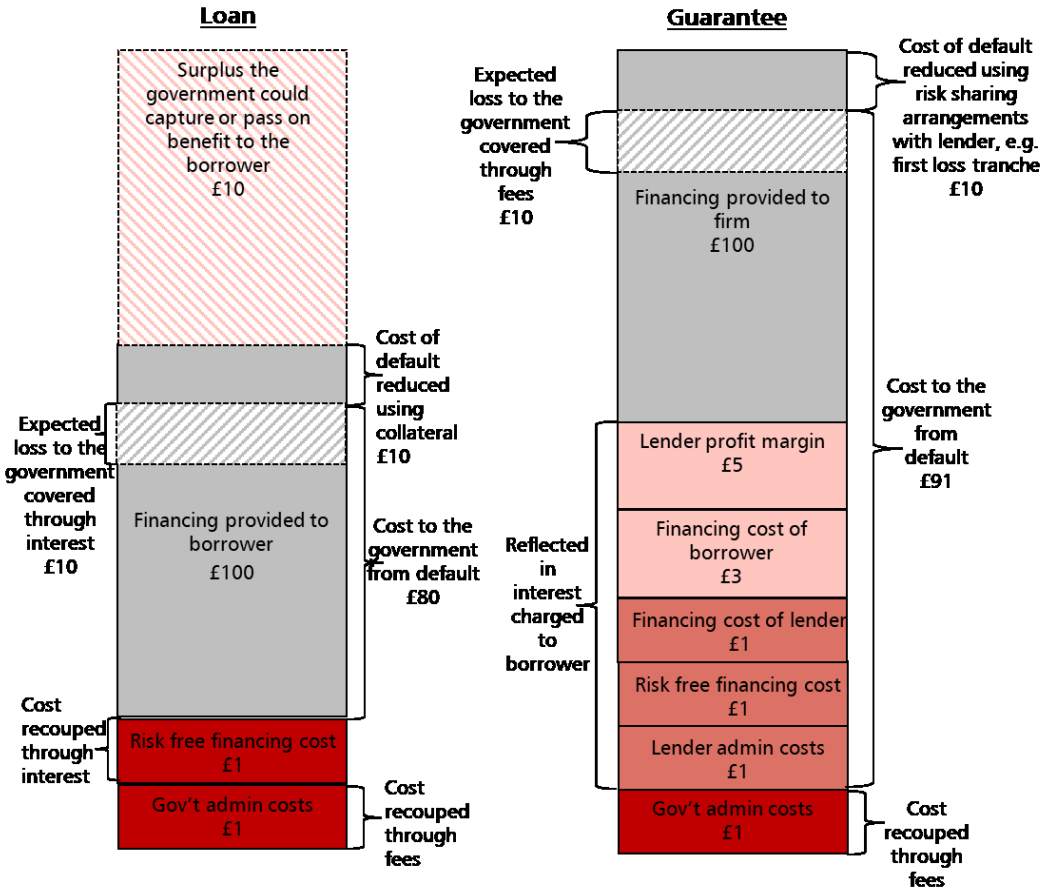
Relative costs of loans and guarantees

B.1 As recognised by the IMF, there are times when direct lending can be more cost-effective than guarantees. When issuing a loan the government faces an admin cost, which can be recouped through admin fees, and the financing cost (equivalent to the risk-free rate of borrowing), which will form part of the interest charged on the loan. If the borrower defaults the government will lose the value of the loan. The cost of default can be reduced using collateral. If pricing the loan on a cost recovery basis, the government will charge interest that reflects the likelihood of the borrower defaulting, i.e. to cover expected loss.

B.2 When providing a guarantee the government faces an admin cost, which can be assumed to be the same as the admin cost for a loan and that can be recouped through admin fees. The lender benefitting from the guarantee will face their own admin cost and a financing cost (which will be higher than the government's financing cost) both of which will contribute to the interest the lender charges on the loan. The interest will also include an additional premium based on the borrower's riskiness and the lenders profit margin. The lender will usually require both the principal and the interest to be guaranteed, as they are unlikely to agree to provide the loan unless there was a benefit to them from the guarantee, increasing the cost to the government if the borrower defaults. The cost of default can be reduced using risk sharing arrangements, such as first loss tranches, and guarantee fees can be priced to cover expected loss to the government.

B.3 Chart B.1 illustrates the relative costs of a hypothetical loan and guarantee designed to provide £100 of financing to a borrower with a 10% probability of the borrower defaulting and assuming a risk-free rate of 1%; that the lender can borrow at 2% and that the government prices the instruments on a cost recovery basis.

Chart B.1 Relative costs of loans and guarantees



Source: HMT

Note: This chart does not include case-specific contractual arrangements that may affect the cost of loans and guarantees.

B.4 In this example if the government prices the instruments on a cost-recovery basis the policy trade-off is between the optionality from additional fiscal headroom of £100 today provided by the guarantee versus the risk of making an £11 higher pay-out in the future if the borrower defaults. With a loan there is the option to raise the interest rate so that cost to the borrower is the same as a guaranteed private sector loan, or to pass the benefit onto the borrower in the form of lower interest rates. If the policy objective is to provide maximum benefit to a single borrower, a loan may be preferred.

B.5 In a scenario where the goal is to provide financing to many firms, the admin costs to the government of issuing loans will rise proportionately to the number of borrowers, as every application will need to be processed by the government. However, a single guarantee to a lender could cover a portfolio of multiple loans, significantly reducing the admin cost on the government. In such a scenario guarantees may be more efficient.

B.6 In addition to the costs described above both loans and guarantees can include other contractual arrangements that affect the risk profile and ability to recover losses in the event of a default. The specific arrangements that could be applied to a loan or guarantee would depend on the context and further analysis would be needed on a case-by-case basis to determine to what extent they would affect the relative costs of a loan or guarantee.

Annex C

International best practice in managing contingent liabilities

C.1 The International Monetary Fund (IMF) and The Organisation for Economic Cooperation and Development (OECD) have acknowledged the growing importance of contingent liabilities in achieving government objectives. They have made several recommendations on best practice in managing contingent liabilities.[1] These include:

- charging risk-based fees that cover at least expected losses and using risk sharing arrangement to mitigate risk
- encouraging neutrality between guarantees, loans and grants. The IMF have warned that because contingent liabilities "do not involve upfront cash outflow, governments may be tempted to use them to circumvent budgetary constraints and prefer them over direct expenditure".[2] Governments may perceive them as free of cost without applying adequate scrutiny or assessment of the risks. To encourage neutrality the OECD and IMF recommend disclosing and budgeting for the potential costs of contingent liabilities at issuance. This neutrality will encourage organisations to choose the tools that are most efficient to them, rather than the ones which give more favourable results from an accounting perspective
- improving the ability to cover future losses through notional funds. If contingent liabilities are sizeable, funds can be built by setting aside resources when issuing contingent liabilities and by accumulating fees. Notional funds, i.e. funds returned to the Exchequer where they are tracked, are preferred for ease of management
- establish exposure ceilings. The issuance of new guarantees should be regulated through a risk framework that specifies limits on exposure and provides guidance on when guarantees can be considered, what fees should be charged, and which risk mitigation measures should be used
- developing the capacity to conduct cost and risk analysis before issuing contingent liabilities and monitor the stock of contingent liabilities on an ongoing basis. The IMF has emphasised the need for governments to develop institutional mechanisms with the capability to evaluate and fully

[1] 'How to strengthen the management of government guarantees', IMF, October 2017, 'Budgeting for contingent liabilities', OECD, June 2013, 'The role of public debt managers in contingent liability management', OECD, Feb 2017

[2] 'How to strengthen the management of government guarantees', IMF, October 2017

understand their portfolio of contingent liabilities and adopt strong budgeting practices that recognise expected costs at issuance

C.2 The OECD has also recommended converting implicit liabilities to explicit liabilities (where practicable), unless the government can reliably pre-commit that it will not take measures in response to the risks stemming from the implicit liability.[3]

C.3 Two examples of international best practice where many of these principles and recommendations are applied in practice are Sweden (see Box C.1) and the Netherlands (see Box C.2).

Box C.1: Sweden

The Swedish National Debt Office (SNDO) has had responsibility for guarantees since the 1960s and the Swedish parliament adopted a formal framework in the mid-90s. The SNDO looks at both loans and guarantees offered by the Swedish government as they require similar analysis. The Swedish framework follows three principles that are designed to make departments indifferent between grants, loans and guarantees from a budgeting perspective as well as incentivising better management capability and accountability for balance sheet risk. These principles are:

- cost recovery: the framework mandates that government charge a fee equal to the admin costs and expected losses (i.e. the expected cost) of the guarantee or loan. If the recipient is afforded a lower premium than the expected cost, the subsidy is financed under current spending and is treated the same as other expenditure
- risk neutrality at the margin: the government would possibly charge an additional risk premium above cost recovery if the loan or guarantee was large relative to the size of the government's balance sheet
- notional accounts: fees are included in the cash flow of central government and help reduce debt. Fee income from guarantees is not built up in hypothecated funds held against those liabilities. However, for each guarantee the income and pay-outs for that guarantee are tracked in a notional account

The SNDO acts as the central hub for issuing, monitoring and reporting on loans and guarantees. There are four other agencies with responsibility for issuing and managing loans and guarantees for specific sectors of the economy, including student loans, international development and housing. For any loans or guarantees outside these four sectors the risk will be assessed and fees priced by the SNDO. The relevant department can choose to subsidise these fees but will need to finance the subsidy from its budget. This model means that risk is managed solely by bodies with the right expertise, offering clear accountability. The SNDO produces an annual comprehensive

[3] 'Budgeting for contingent liabilities', OECD, June 2013

risk analysis report on its portfolio of loans and guarantees, which improves transparency of these instruments.

Introduction of the framework has led to the issuance of new guarantees and the management of existing ones becoming more restrictive from a risk perspective. Whilst the Swedish government has suffered losses on some of its individual guarantees, on average it generates 2 billion SEK per year from guarantee fees (c.170 million GBP). This allows it to recoup losses incurred and leave it in a better position to meet future losses.

Box C.2: The Netherlands

The Dutch government saw a huge rise in the number of contingent liabilities and loans issued after the financial crisis. In order to combat this, the government introduced a new framework that includes the following:

- the government introduced a policy of "no, unless". It does not take on contingent liabilities unless there is an overriding reason to do so
- as a rule, all new guarantee facilities and modifications of existing guarantee facilities are subject to a standardised re-evaluation every five years
- departments that make proposals that might increase the government's contingent liabilities have a limited period of time each year during which they can submit a thorough checklist to the Ministry of Finance for approval. The checklist asks the department to consider multiple factors including alternative options, the level of risk, the premium that must be paid and the relevant ceilings. In many cases the department concludes the contingent liability is not necessary before the checklist is submitted. In others, the checklist itself works as a threshold
- a market-based premium for each liability is paid directly to the Ministry of Finance. They are recorded in a current account and can only be used to pay for losses that occur in relation to that particular contingent liability. If the loss is bigger than the premiums, the department is responsible for this loss and all future losses
- in case of large and complex risks, independent experts are requested to provide a second opinion regarding the level of the premium
- departments may subsidise a contingent liability by reducing the premium paid by the beneficiary. The subsidy must be paid from its departmental budget. The Ministry of Finance and the Council of Ministers need solid arguments to agree to such a proposal
- if a department wants a new contingent liability, it must use existing headroom within its ceiling, including reducing other contingent liability exposure when necessary
- contingent liabilities cannot be granted without permission from the Cabinet. They must go through the Ministry of Finance, be approved by

Cabinet and shared with Parliament, before being published online. This process creates greater transparency

This new policy framework has proved effective. Contingent liabilities are now part and parcel of the decision-making progress. This has caused the value of contingent liabilities to fall. The amount was nearly 64 billion euros in 2008, while at the end of 2012 it peaked at 258 billion euros. The period thereafter shows a downward trend in most years, with a level of 177 billion euros at the end of 2018. Due to this framework the number of non-crisis related domestic contingent liabilities remained stable and decreased to 37 billion euros by 2019, which is equal to the pre-crisis level.

Annex D

Case study: UK Export Finance

D.1 The success of UK Export Finance's (UKEF's) format lies in its strong risk modelling and pricing expertise, transparent framework and pre-defined exposure scope and limits.

D.2 UK Export Finance (UKEF) is the UK's export credit agency and a ministerial government department. It provides insurance, guarantees and direct lending to exporters to fill gaps in the private sector's risk appetite, backed by the strength of the government's balance sheet. UKEF has a statutory mandate to support exports and operates with the consent of HMT, which sets its financial objectives. UKEF operates at no net cost to the taxpayer, charging a risk premium to cover losses from claims and operating costs. Other financial parameters set by HMT include an exposure cap and a portfolio risk appetite limit.

D.3 UKEF has a maximum exposure limit of £50 billion, of which c.£30 billion has been used, with a risk appetite limit based on assessment of future losses at £5 billion. This risk appetite is calibrated so that there is only a 0.9% chance that losses would exceed this figure. UKEF can guarantee financing in more than 60 local currencies and has a maximum country limit of £5 billion, with country limits set individually across the portfolio to reflect the risk profile of each country. UKEF works in partnership with more than 100 banks, brokers and other providers to supply export finance and insurance that complements their commercial business.

D.4 UKEF offers a range of guarantees including:

- Trade Finance support (Bond Support Scheme and Export Working Capital Scheme) – If an exporting company is asked by an overseas buyer to provide a contract bond, or requires a working capital loan to fulfil an order, UKEF can provide a guarantee of up to 80% to the exporting company's bank so the bank can issue the bond/loan
- Export Insurance Policy – Where no cover is available from the private sector, UKEF can provide credit insurance of up to 95% of the contract value to cover exporters against the risk on non-payment or political risks that make performance under the contract impossible
- Buyer and Supplier Credit Facilities – UKEF can provide a guarantee of up to 85% to a bank so that it can provide a loan to an overseas buyer of UK goods and/or services. These loans involve stage payments, which means the exporting company receives payments in line with their contract and their buyer will be given credit to pay over an extended period (typically 2-10 years)

Annex E

Case study: Department for International Development

E.1 Better understanding and management of contingent liabilities can save lives as well as reduce costs. The help of a central hub can be essential in providing expertise and support to implement such risk management practices where expertise is scarce.

E.2 The Centre for Disaster Protection (CDP) is a partnership between the UK government (led by the Department for International Development), the World Bank, the private sector and civil society. It was set up to i) help developing countries to understand and manage their natural disaster risks, ii) improve the limited evidence base on what works, iii) increase awareness and policy discussion.

E.3 Its approach is grounded in the recommendations of "Dull Disasters?", needing to have a coordinated, credible, government-led plan for post-disaster action agreed in advance, a fast, evidence-based decision-making process, and financing agreed so that the plan can be implemented rapidly.[1]

E.4 Kenya's Hunger Safety Net Programme (HSNP) is an example of the sort of risk management programme that can be developed with the help of CDP and DFID. The HSNP improves the understanding and management of natural disaster risks which can lead to better outcomes. Under the HSNP, shock responsive social protection is provided to support chronically poor people in northern Kenya with regular unconditional cash transfers. It can scale up rapidly in response to weather shocks, according to pre-agreed guidelines (e.g. drought, as determined by vegetation condition index), and forecasts (El Nino).

E.5 Under HSNP, DFID offers a range of financial guarantees with scalability costs between $9 million to $60 million per year. DFID provides grant (through World Bank, in arrears) equivalent to average annual loss. The Kenyan government holds the remaining risk on its balance sheet, but this is managed and controlled through a number of instruments.

E.6 HSNP has significantly improved the Kenyan government's management of its drought risk. It reduces the impact of droughts through earlier and quicker action by ensuring that payments are distributed more rapidly to those that need them. It introduces clear plans on how responses to disasters will be financed. Finally, it provides a response mechanism that is more transparent, rules-based and auditable.

[1] 'Dull Disasters', Daniel J Clarke and Stefan Dercon, July 2016

Annex F

Case study: Infrastructure Projects Authority - UK Guarantees Scheme

F.1 Charging appropriate fees for insuring against expected losses and a percentage of unexpected losses, incentivises risk management and ensures the government is in a better position to meet risks if they materialise.

F.2 The UK Guarantees Scheme (UKGS) was designed to enable infrastructure projects to proceed, despite adverse credit conditions. It provides a government-backed guarantee to help projects access finance from investors who do not have the risk appetite or the in-house expertise to invest directly in complex infrastructure projects.

F.3 The UKGS is managed on behalf of HMT by a team of commercial specialists in the Infrastructure and Projects Authority (IPA). The IPA team is responsible for both the initial risk assessment and negotiation of guarantees and the ongoing risk management and oversight of the portfolio of guarantees.

F.4 UKGS guarantees the principal and interest payments due on infrastructure debt issued by the borrower to lenders (banks or investors). HMT issues an unconditional, irrevocable guarantee to the lenders that if the borrower is unable to meet these payments, then the government will make them. This allows the government's credit rating to be substituted (from the lenders' point of view) for that of the borrower.

F.5 All guarantees are issued on a commercial basis, they are not state aid, the UKGS charges each borrower a market-oriented fee. The fee is determined by IPA's assessment (on behalf of HMT) of project risk and prevailing market prices for equivalent risks. The ultimate responsibility for the risks under the UKGS lies with HMT. HMT earns the fee income on guarantees and bears the risk of meeting any claims in guarantees.

F.6 At an overall scheme level, HMT expects taxpayer risk to be minimised because fee income should exceed expected losses and the Scheme's running costs and HMT has standard rights of senior lenders to take action to recover any claims made under the UKGS. To date UKGS issued 9 guarantees totalling £1.8 billion of HMT-backed infrastructure bonds and loans, supporting over £4 billion worth of investment. The fees received to date are in excess of £90 million and over the life of UKGS HMT will earn a total amount of fees in excess of £220 million.

F.7 The UKGS is required to lay a report annually to parliament providing details of: guarantee arrangements entered into in the relevant period; expenditure incurred by HMT in providing guarantees; details of actual or contingent liabilities at the end of that period; and fees and other sums received by HMT in connection with the UKGS.

Annex G

Case study: British Business Bank - Enterprise Finance Guarantee

G.1 Requiring departments and agencies to budget for subsidised guarantees (i.e. the difference between fee income and the expected costs) ensures the government is better able to meet costs when risks materialise.

G.2 As explained in Box 2.A the BBB runs guarantee schemes to support SMEs. One major scheme is the Enterprise Finance Guarantee (EFG) scheme. The EFG scheme currently has a total exposure of £588 million and is intended to help SMEs with insufficient collateral to meet the requirements of commercial finance providers for a loan. The EFG scheme guarantees 75% of the value of an individual loan, with annual losses capped at 15% of the whole EFG portfolio.

G.3 Small businesses interested in EFG can approach one of the over 40 accredited lenders with their borrowing proposal. If the lender can offer finance on normal commercial terms without the need to make use of EFG, they will do so. Where the small business has a sound borrowing proposal but no, or inadequate security, the lender can obtain a guarantee via EFG. All small businesses supported via EFG are required to pay a 2% annual fee to the government, as a contribution towards the cost of the scheme. The scheme is designed to be subsidised, and the difference between fee income and expected losses is budgeted for.

Annex H

Case study: NHS Resolution

H.1 Risk-based fees can be used to create financial incentives for beneficiaries to undertake risk reducing behaviour.

H.2 The risk of claims against the NHS is inherent in the provision of health services. In 1995 NHS Litigation Authority, now operating as NHS Resolution, was formed to take on the management of clinical negligence claims against NHS providers of secondary and tertiary care in England. Previously, clinical claims were managed by individual NHS organisations to varying standards. From 1 April 2019, NHS Resolution has been given responsibility for the administration of a state-backed indemnity scheme for GPs.

H.3 Between 2006/07 and 2017/18, clinical claims payments have quadrupled, from £0.4 billion to £2.2 billion, with the number of reported claims doubling from 5,400 to 10,600 over the same period. The total liability based on the 2017/18 NHS Resolution accounts was £77 billion. Actuarial methods, through GAD, are used to estimate the value those liabilities that could arise from future claims in respect of incidents that may have occurred up to the balance sheet date but that have not yet been reported. This is done through analysis of historical experience and a judgement on future trends in important assumptions such as volume and average cost of claims.

H.4 NHS Resolution manages clinical negligence claims through the Clinical Negligence Scheme for Trusts (CNST). This scheme is funded through contributions from NHS providers that are eligible to join the schemes. The scheme is a risk pool – the annual cost of settling claims (based on actuarial forecasts) is distributed across the membership using experience and exposure factors designed to spread the cost fairly, based on the relative riskiness of each member, whilst protecting individual organisations from the impact of high value settlements.

H.5 Some of the highest clinical negligence claims come from maternity claims that result in payments being made for the claimant's entire life. To help address this issue, in 2018 NHSR also introduced the maternity incentive scheme. This scheme introduced a 10% increase in CNST contributions for NHS trusts that provide maternity services. Upon completion of 10 specified actions to improve patient safety, the trusts will have that 10% returned to them. The scheme was successful with 57% of trusts implementing all 10 actions and is running for a second year.

Annex I

Case study: Pension Protection Fund

I.1 If a sinking fund is established to manage a liability it should have clearly defined rules for entry, operational independence and ensure that the risk is fully covered and minimise the residual risk to central government.

I.2 Pension scheme members faced the risk of losing their pensions if their pension scheme was underfunded when their sponsor became insolvent. The PPF was established in 2004 to manage the risk to pension scheme members of not receiving the benefits promised from defined benefit pension schemes. If the company sponsoring the pension scheme runs into financial difficulties and there are insufficient assets to meet PPF levels of cover, then the PPF takes responsibility for paying compensation to members. The PPF's goal is to provide a substantial level of protection for pension scheme members but not full cover.

I.3 The PPF funds itself in four ways: 1) a risk based mandatory levy that is similar to an insurance premium; 2) taking over assets of schemes that transfer to the PPF; 3) recoveries from insolvent companies; and 4) investment returns on the assets it manages. In the unlikely event that the PPFs assets are ever in danger of being insufficient to cover its liabilities, it has the power in extremis to independently increase the risk-based levy, take more investment risk in search of higher returns, and as a last resort reduce pay-outs to members.

I.4 At the end of March 2019, the PPF has accumulated £32 billion of assets from the above sources to meet future compensation valued at £24 billion. Although the PPF is currently well funded, it continues to provide cover to members of other defined benefit schemes, which together have an aggregate and highly volatile shortfall of around £44 billion.[1] Over the last three years the assets of schemes transferring into the PPF have been £3 billion less than the value of the compensation the PPF provides.

[1] As at the end of March 2019, PPF 7800 Index April 2019 Update.

Annex J

Case study: Pool Re

J.1 Maximising the involvement of private sector insurance to cover non-catastrophic losses helps reduce the government's risk exposure.

J.2 The costs of terrorist attacks by the Provisional IRA in the 1990's led to the insurance industry withdrawing cover for terrorism related damage. Terrorist attacks were difficult to model reliably and the potential costs of large attacks were too high for private insurance companies to take the risk. This meant that there was an unlimited implicit contingent liability to government from terrorism risk. Pool Re was founded in 1993 through cooperation between the insurance industry and HMT to help manage this risk.

J.3 Pool Re is a member-owned provider of reinsurance for terrorism risk and is backed by a government guarantee. If Pool Re is unable to meet the costs of an incident HMT will provide it with a loan to cover the remaining cost. By taking on the tail-end risk of a catastrophic event from the private sector, the government makes it possible for private insurers to re-enter the market. In exchange for this guarantee HMT charges a fee of 50% of Pool Re's premium income and 25% of its dividend income, which generates around £200 million to £300 million per annum in revenue for the taxpayer. While the maximum potential liabilities under this arrangement are unquantifiable, in 2014 GAD estimated a maximum plausible exposure using the risk of a 1-in-200-year event to establish a realistic worst-case scenario. This informed the pricing of the guarantee, which was renegotiated in 2014. Schemes like this are monitored for their effectiveness and can evolve over time.

J.4 The Pool Re model has been successful in maximising the involvement of private insurance to enter the market, creating several layers of defence before the guarantee is called. These include the retentions of commercial re-insurers who purchase insurance from Pool Re; excess of loss reinsurance purchased by Pool Re from other reinsurer's; as well as the fund accumulated by premiums paid to Pool Re. These layers of defence have created a £10 billion buffer between an incident occurring and taxpayer money being called on.

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