Agenda paper 5: Government guarantees

This paper has been prepared for discussion purposes only.[1] [2]

Objectives of this agenda item

1. Consider the accounting for government guarantees held by public sector entities with insurance activities, including the impact on amounts recognised and measured under AASB 17 *Insurance Contracts*.
2. Most public sector entities have the backing of some form of government guarantee, particularly with respect to the expenditures they incur in their operations.
3. Guarantees might be explicit under legislation or contractual arrangements, or they might be implicit.
4. The entity may pay a fee for an explicit guarantee.
5. Practice is typically that a public sector entity, including a public sector insurer does not report on an implicit guarantee.
6. Governments may disclose specific types of guarantees they issue and similar items.[3]
7. In some cases, any cash received under a guarantee might need to be repaid.

Background

8. There are no specific references to government guarantees in AASB 17.
9. However, the Basis for Conclusions to AASB 2022-9 *Amendments to Australian Accounting Standards – Insurance Contracts in the Public Sector* identifies government guarantees (both explicit and implicit) as a possible key driver of the different perspective that a public sector insurer may have in determining risk adjustments under AASB 17 relative to a private sector insurer [AASB 2022-9.BC5 and BC110(b)(ii)].
10. From the perspective of the governments issuing the guarantees, disclosure is usually made when material, but guarantees do not give rise to recognised amounts in the issuer's financial statements. Although there is often accounting symmetry between counterparties to the same arrangement, this is not always the case, and each entity needs to consider its accounting policies from its own perspective. In addition, a particular transaction may be more material to one counterparty than to the other.

Analysis

11. Entities that hold government guarantees might need to consider the accounting (including classification, disclosure, recognition and/or measurement) for:

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2 This paper references AASB 17 *Insurance Contracts* and AASB 2022-9 *Amendments to Australian Accounting Standards – Insurance Contracts in the Public Sector*, but is intended to apply equally in the context of the New Zealand XRB's PBE IFRS 17 *Insurance Contacts* and XRB's *Insurance Contracts in the Public Sector (Amendments to PBE IFRS 17)*.

3 Refer to the Appendix 1 for an example of financial statement disclosures by the Australian Government.

- 'unused' guarantees;
- amounts received under guarantees; and
- any fees paid for guarantees.

Financial instruments

12. AASB 9[4] defines 'financial guarantee contract':

> A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. [AASB 9, Appendix A]

13. This definition only relates to:
    - an issuer (not a holder of a guarantee); and
    - specified debtors failing to make a payment to a third party, rather than insured events.
14. If cash received by an entity under a guarantee needs to be repaid to the relevant government, that suggests unused guarantees could be akin to 'loan commitments'.
15. AASB 9 addresses some forms of loan commitment, but only from the perspective of the issuer, not from the holder perspective and only in respect of loan commitments designated as financial liabilities at fair value through profit or loss that can be settled net in cash or by delivering or issuing another financial instrument [AASB 9.2.3].

Contingent assets

16. A guarantee that, if triggered, does not need to be repaid may be a 'contingent asset' [AASB 137.10[5]]:

> A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

17. Items that are contingent assets are not recognised [AASB 137.31].
18. If an inflow of benefits becomes probable, contingent assets are the subject of disclosure [AASB 137.89].
19. If inflows of benefits become virtually certain, the asset and the related income are recognised [AASB 137.35].

insurance contracts

20. To be treated as a reinsurance contact held, a guarantee would need to meet the 'insurance contract' definition and guidance, including transferring significant insurance risk – please see Appendix 2.
21. Even if the likelihood of triggering a guarantee is remote, provided there is a commercial scenario in which the issuing government would need to pay the holder, a guarantees could be a reinsurance contract held.
22. Although it would be expected that an insurer would cede premium for reinsurance coverage, ceding premium or paying premiums is not an essential feature of an insurance contract.

4 AASB 9 *Financial Instruments*.

5 AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.

23. Any fees paid for holding a guarantee might be regarded as akin to 'ceded premium' or some other form of insurance-related expense.

Financial instrument disclosure

24. AASB 7[6] requires a wide range of disclosures about financial instruments, including information

25. AASB 7.B11F helps to explain the disclosure required in AASB 7.39 (emphasis added):

> B11F Other factors that an entity might consider in providing the disclosure required in paragraph 39(c) include, but are not limited to, whether the entity:
>
> (a) has **committed borrowing facilities** (eg commercial paper facilities) **or other lines of credit (eg stand-by credit facilities) that it can access to meet liquidity needs**;

26. From an insurance entity perspective, untriggered guarantees could be regarded as being in the nature of a stand-by credit facility and the subject of disclosure.

Questions

Question 1 – do you have a view on how public sector entities should account for (classify, disclose, recognise and/or measure) guarantees in the circumstances identified in the table below:

Guarantees	Implicit		Explicit	
	Existing	AASB 17	Existing	AASB 17
Unused – no repayment expected	?	?	?	?
Unused – repayment expected	?	?	?	?
Triggered – no repayment expected	?	?	?	?
Triggered – repayment expected	?	?	?	?
Fees paid – classification	?	?	?	?

Question 2 – is your determination of a risk adjustment for non-financial risk under AASB 17 likely to be affected by the existence of:

(a) an implicit government guarantee?

(b) an explicit government guarantee?

6 AASB 7 *Financial Instruments: Disclosures*.

Appendix 1 – Example of reporting by the Commonwealth as an issuer of the Guarantees

27. The Commonwealth of Australia financial statements 2022-23 [pages 130 to 131] include disclosures about '**Unquantifiable indemnities, guarantees and warranties**', including:
    - Terrorism and cyclone related under the *Terrorism and Cyclone Insurance Act 2003* and
    - medical indemnities under the *Medical Indemnity Act 2002* and the *Midwife Professional Indemnity (Commonwealth Contribution) Scheme Act 2010*.
28. The Commonwealth of Australia financial statements 2022-23 [page 131] include disclosures about '**Significant but remote indemnities, guarantees and warranties**', including:
    - Financial Claims Scheme – Deposits under the *Banking Act 1959*; and
    - Financial Claims Scheme – Insurance under the *Insurance Act 1973*.
29. The Guarantees are not recognised or measured in the Commonwealth of Australia financial statements. Although there is often accounting symmetry between counterparties to the same arrangement, this is not always the case, and each entity needs to consider its accounting policies from its own perspective. In addition, a particular transaction may be more material to one counterparty than to the other.

Appendix 2 – extracts from AASB 17 on transfer of significant insurance risk

Insurance contract	A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. [AASB 17, Appendix A]

B17 A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs B7–B16 discuss insurance risk. …

B18 Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (ie no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (ie probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

B19 In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. …