UK Government Investments

CLCC GUIDANCE

Charging for Guarantees and Indemnities

Guidance on charging for contingent liabilities

The Contingent Liability Central Capability (CLCC)

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CONTACTS

Contact us: clcc@UKGI.org.uk

Credit Branch

Marc Ellsmore
Assistant Director

Marc is an experienced credit analyst and joined UKGI in October 2021 from Fitch Ratings Ltd, where he was a Director focused on UK and Middle Eastern banks and non-bank financial institutions.

Insurance Branch

Jonathan Day
Assistant Director

Jonathan joined UKGI in 2023, on secondment from GAD, to work in the insurance branch of the CLCC. Jonathan is an actuary with over 12 years' experience in financial services.

The Contingent Liability Central Capability (CLCC) is an analytical and advisory unit within UK Government Investments (UKGI). The CLCC has been established to strengthen contingent liability expertise within government and improve how government manages its portfolio of risk arising from contingent liabilities.

This document is part of a series to provide guidance to departments regarding the establishment and management of contingent liabilities. The guidance is not exhaustive, and each case may have specific and/or additional considerations that need to be addressed. For more information on this document or the others in the series contact clcc@ukgi.org.uk.

PURPOSE AND SCOPE

1.1 What is this guide about?

This guide is designed to help government departments decide on charging policy for financial guarantees and indemnities. Departments should consider charging parties when accepting risk from the private sector, for instance, when granting indemnities or guarantees, as these risks could lead to costs falling on government in the future.

This guide should be useful for completing the HMT Contingent Liability Approval Framework checklist, but also outside of the checklist process when a department would like to develop a particular charging approach. This guide should be read in conjunction with the high-level guidance for filling in the checklist in these documents:

Contingent Liability Approval Framework
Managing Public Money Annex 5.4
CLCC's expected loss guidance.

1.2 Limitations and compliance

This note is intended to provide suggestions on potential approaches to charging policies in respect of financial guarantees and indemnities and is accurate as at the date it has been prepared. However, it may not exhaustively cover all possible approaches and considerations and each case may have specific and/or additional considerations that need to be addressed. The CLCC accepts no liability to any person or third party for any action taken or for any failure to act, either in whole or part, based on this paper.

You should carefully consider obtaining further specialist credit or insurance expertise to help support policy decisions on charging and the implementation of appropriate charging structures. The CLCC will be pleased to discuss how we can support you in this regard.

You should approach CLCC with all issues related to contingent liabilities, particularly in the case of large risks (e.g., with a maximum size larger than £1bn) that require more thorough analysis or for complex risks (e.g. pension fund guarantees). CLCC can provide support regardless of whether the contingent liabilities are inside or outside the scope of the HMT contingent liability checklist process.

Where a department can adequately assess risk charges without specialist assistance, the CLCC is still interested to review its analysis and learn from it, as this may be beneficial to other departments with similar issues. You can contact CLCC by email at clcc@ukgi.org.uk.

INTRODUCTION TO THE CLCC

2.1 What is the role of the CLCC?

The CLCC is an analytical and advisory unit formed within UKGI – the government's centre of excellence for corporate finance and corporate governance – to strengthen contingent liability expertise across government.

The CLCC assists departments and arms-length bodies with assessing, quantifying, and pricing risk arising from contingent liabilities, allowing departments and government to better understand the scale and distribution of their risk exposure from contingent liabilities. Working closely with departments, the CLCC aims to provide guidance, promote best practice, and build capability across government.

2.2 When should I approach the CLCC?

Departments are encouraged to come to CLCC with all issues related to contingent liabilities, with early engagement particularly helpful. In addition to providing advice on checklists completed as part of the Contingent Liability Approval Framework, the CLCC can provide insights which support the policy making process, including when departments are:

- extending contingent liabilities associated with large fiscal risk, but which are not necessarily novel, contentious, or repercussive;
- developing risk frameworks to delegate authority to take on risk, e.g. to their arm's length bodies (ALBs);
- conducting early-stage policy thinking, for example, research into fee charging regimes to transform implicit liabilities into explicit contingent liabilities; and
- considering the impacts of policy changes on existing contingent liabilities.

The CLCC will either be able to provide advice and support itself or will signpost you to other experts (such as the Government Actuary's Department (GAD)) if specific policy support or more detailed analysis is required.

2.3 Which contingent liabilities are the CLCC focusing on?

The CLCC can assist departments with the following contingent liabilities:

- **Financial guarantees** - Where government agrees to pay the debts of a third party if they default, for example guarantees provided to commercial banks to cover a portion of the first losses on 95% loan-to-value mortgages in the event of a repossession of the underlying property under HMT's Mortgage Guarantee Scheme.
- **Indemnities** - Protection similar to insurance where government agrees to cover costs if a certain event occurs, such as the Production Restart Scheme which provided cover for Covid-19 related costs to film and TV productions.

2.4 Not in scope of CLCC's responsibilities

Examples of contingent liabilities that are normally outside of the CLCC's remit include:

- legal cases and purchaser protections; and
- risks associated with implicit liabilities that sit with government as part of its insurer of last resort function (e.g. risk of extreme natural disasters) unless they are being transformed into explicit liabilities.

REASONS FOR CHARGING

3.1 Taking on risk from the private sector

There are times when government agrees to the transfer of risk from the private sector to the public sector, in order to deliver public policy objectives. The HMT Contingent Liability Approval Framework requires submissions to consider whether government should be compensated for accepting this risk. The starting basis in these cases should be that a risk-based fee is charged to the private sector (analogous to a guarantee fee or insurance premium). Charging fees in this way compensates the public sector for the risk taken on and ensures the private sector has an incentive to mitigate risk.

In some cases, the risk transfer will be bundled into the terms of a contract. For example, vaccine procurement contracts which allowed for government indemnities for medical liabilities to manufacturers supplying vaccines. Similarly, defence contracts and warranties for purchasers of government assets often incorporate contingent liabilities into the overall transaction price without identifying charges explicitly.

As part of contractual negotiations, departments should understand the expected loss from any indemnity or guarantee included in the agreement. The expected loss should be calculated so that the overall cost-benefit of the agreement can be assessed. It might also be possible to discover a contractor's view of risk by asking for contract prices with and without indemnities, which should be helpful in reaching the best negotiated solution for both parties.

Sometimes charging will be necessary to ensure fair competition. It may also be necessary to justify the particular rate charged to prevent accusations of state subsidies. Subsidy control regimes are subject to change so you should check compliance with the latest guidance.

It may not always be possible or desirable to charge the private sector a fee. For example, if the department does not have the legal power to do so, or because the policy intervention is counter-cyclical (i.e. being delivered to provide support when the economy is experiencing difficulties). In these cases, you should record the reasons why a fee was not charged, as HMT will need to be satisfied with the reason(s) why not charging a fee was appropriate and justified in that instance.

3.2 Indemnities for individuals

You should not charge for indemnity liabilities in respect of an individual's compensation, where such liabilities are an integral part of that person's employment or appointment. For example, indemnities to official receivers are not charged for. However, in some cases charging might be appropriate, for instance, if government were to provide insurance for optional additional activities, a commercial rate would be expected to be charged.

3.3 Taking on risk from the public sector outside central government

The starting point would be to charge for any risk taken on from public corporations, or other parts of the wider public sector. Often these entities will buy commercial insurance to mitigate risk, and so should be expected to pay reasonable charges for risk mitigation from central government.

3.4 Risks within central government

On rare occasions there could be large indemnity and guarantee related risks that cannot be absorbed by the originating department's budget in the event of crystallisation. Departments and HMT should be clear on what these risks are and where they sit, and the expected and maximum losses should be calculated to inform the management of these risks within government.

HOW MUCH TO CHARGE

4.1 Charging rationales

The main options for charging are, in descending order of remuneration:

- Above commercial rate
- Commercial rate
- Expected loss
- Partial subsidy
- No charge

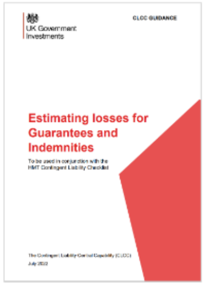
The normal approach is to charge at an amount equal to the expected loss, so that there is no gain or strain on public funds over the long term, relative to not taking on the risk. However, alternative approaches, as outlined above, can be considered. In particular, if government is taking on the CL as a last resort, and would prefer private sector involvement, there are good reasons for charging more than the expected loss. These are outlined in the table below, with some examples and considerations. Other approaches and rationales may also be viable depending on circumstances.

Charging approach	Rationales	Considerations
Above commercial rate	Government can be the insurer or guarantor of last resort at a penal rate to discourage the expectation of bailouts; encourage commercial entrants to replace public sector involvement	• Why doesn't the market work? • How can government exit if it wishes to? • Will high charges be unfair to some people or organisations? • Will expected profits be remitted to HMT or the department?
Commercial rate	Commercial services are normally charged at commercial rates	• Government should not generally provide commercial services if the private sector is more efficient • A strategy for encouraging private sector participation and exit from intervention should be developed • Government might be more efficient at guaranteeing loan defaults or indemnifying large tail risks (i.e. unlikely but large costly events) • There might be reasons to charge between expected loss and commercial rate e.g. if government is committed to long term involvement, more efficient than the private sector and efficiency savings are passed on (e.g. Pool Re)
At expected loss	Normal approach for government as described in Managing Public Money	• Expected loss includes all costs such as overheads and administration • Worth comparing what commercial providers are charging for similar risks as a sense check on EL estimates
Below expected loss (partial subsidy)	Desire to subsidise or make affordable	• Possibly difficult to justify a particular level of subsidy • Undercharging might be illegal state aid • A reasonable approach for some types of overseas aid

Charging approach	Rationales	Considerations
No charge	Beneficiaries unable to pay; legal constraints; desire to provide aid (e.g. to developing countries); charging may be administratively inefficient	• Can be a policy decision to help disadvantaged groups • Dilutes incentives (moral hazard) • Cost of funding • Prevents private sector risk sharing

4.2 Determining the expected loss

Methods of determining expected loss are outlined in the CLCC's guidance for estimating losses for guarantees and indemnities: [CLCC Guidance – Estimating losses for Guarantees and Indemnities - UK Government Investments (UKGI)])



Charging should always allow for overheads and administration costs in collecting money and paying claims.

Where there is a long time-lag between receiving charges and paying losses, time value of money considerations could be material. CLCC can advise on this point.

4.3 Determining the commercial rate

There are two main ways to determine a commercial rate for a guarantee or indemnity:

- Collect prices from commercial providers
- Mark up expected loss to allow for commercial risk and profit margins

Both methods should give similar results, and one method can be used to check the other.

4.4 Charging for indemnities

Price comparisons

Insurers or insurance brokers can sometimes provide indicative quotes for policies providing similar cover to an indemnity being contemplated. These can be used to determine commercial pricing. Note that insurance premium tax (if applicable) will affect the price to consumers. Also, terms and conditions such as exclusions and deductibles can materially influence pricing so like-for-like comparisons are best.

If government is acting as insurer of last resort there might not be a market. In such cases the commercial price is theoretically unlimited, and the price will need to be set using other criteria such as fairness, affordability and a reasonable mark up to expected loss.

Mark up from expected loss

On average, and very broadly, the expected loss can represent between 50% and 70% of the insurance premium, with the remaining proportion covering expenses and returns on capital. So, if expected losses are known the commercial premium can be roughly estimated.

Different lines of business can have very different loss ratios. More granular data is available from PRA statistics. For example, if liability insurance is being offered, the loss ratio for that line of business can be used.

The loss ratio approach will only give approximate results. It might be possible to refine it if there is more data. For example, if government is paying a claims administrator or fronting insurer, their fees can be taken into account when calculating a reasonable mark up. Similarly, an allowance for returns on capital could be calculated.

If government is offering reinsurance to insurers, pricing is likely to be more complex and specialist advice should be sought.

The crystallisation of a contingent liability could occur many years beyond when a party is charged for transferring the risk. Departments should allow for the time value of money when determining the amount to charge (as the value of money in the future could be different to what it is worth now). Discount rate assumptions are typically used to explicitly allow for the time value of money as part of charging calculations. The CLCC can support departments with discount rate assumptions based on government guidance.

4.5 Charging for guarantees

Market data

UK government bond yield curves are typically used as a benchmark for other debt on the market, such as mortgage loans or bank lending rates. The yield curves could also be used, in certain situations, as a benchmark for pricing guarantees. Yield curves are published daily by the Bank of England on its website.

Another approach is to study the market prices of fixed income securities (e.g. corporate bonds or credit default swaps) with the same or similar credit rating. It is sometimes possible to observe yields on guaranteed bonds and similar unguaranteed bonds to observe the market value of the guarantee. One option could be for the department to ask the commercial bank providing the loan to quote a price with and without a guarantee.

Mark up from expected loss

On top of the expected loss purely from defaults, the price for a guarantee should usually include a component for the administrative costs associated with the processing and monitoring of the underlying loan(s)/guarantee. These could be calculated by the department based on previous experience.

Commercial pricing will also include a profit component, which will tend to be higher for riskier loans. Measuring the risk is a technical activity often involving value at risk statistics, which CLCC would be able to advise on.

If a risk-based pricing model is not available, one suggestion is to use the components of the expected loss calculation (exposure at default, probability of default and loss given default) and overlay these with several plausible downside scenarios.

We recommend taking the average expected loss rate under these scenarios and deducting it from the baseline expected loss scenario. The difference would represent the unexpected loss (or risk premium) and a proportion of this could be charged for. CLCC would be happy to advise on these calculations.

As discussed for indemnities, consideration should be given to the time value of money when charging for guarantees. The CLCC can support departments with these considerations in the context of government guidance.

MECHANISMS FOR CHARGING AND PRACTICAL ISSUES

5.1 Indemnities

Charging intervals

Once the charging basis has been determined there is a choice of charging mechanisms. An indemnity for a single activity such as a procurement contract might be charged a single fee commensurate with the risk, whereas for a recurring activity the charge might be annual.

Annual charges provide flexibility to react to emerging experience if the risk varies over time, because of inflation or other changes in the amount of risk exposure. If the risk is volatile, it might be necessary to adjust charges more frequently than annually.

Charging administration

Charges can be collected and compensation claims can be dealt with centrally by the department if the number of counterparties is small. However, administration of premiums and claims for wider market indemnities might be better outsourced. One party might be willing to take on both premiums and claims administration, or it might be possible to outsource premium collection to one contractor and claims administration to another.

Regulation, accounting and tax

Indemnity schemes that are effectively insurance policies might require treatment similar to insurance company regulation. This could involve Solvency II regulation, IFRS 17 accounting and insurance premium tax. Expert advice should be sought where appropriate. If the intention is that commercial insurers will take the liability over from government, these factors should be considered in the long-term charging strategy.

Incentives to reduce risk

Charging for risk should naturally encourage risk reduction, as this will result in lower charges: those managing the indemnified risks should be made aware that risk reduction will be rewarded, and it should be possible to indicate the charging impact of any risk reduction initiatives.

5.2 Guarantees

Charging Intervals

Departments should consider whether fees should be charged upfront or annually or financed from the facility itself. The advantage to setting an annual charge is that it provides flexibility to revalue and adjust terms if required, such as to reflect changes in credit risk. Ideally, fees for guarantees that are being provided into competitive markets should be set at a commercial rate with higher rates charged for riskier activities.

Accounting treatment

Guarantees that fit the recognition criteria for a financial instrument under IFRS 9 are required to be valued by the issuer initially at the premium received plus the present value of any future premium payments payable, which may be zero, and subsequently measure it at the higher of:

- the expected credit loss; and
- the amount initially recognised, if any, amortised on a straight-line basis over the life of the guarantee.

Guarantees that do not fit the recognition criteria should be measured in accordance with IAS 37.

Other considerations

Thought should be given to whether additional fees should be charged for guarantees with longer term maturities. This may incentivise parties to avoid unnecessary long maturities. In some jurisdictions, fees are specified as a function of the term-to-maturity of the bond to be issued with a guarantee.

BEST PRACTICE SUMMARY

- Charge for contingent liabilities wherever practicable, especially where risk is transferred from the private to the public sector.
- The rationale for the charge (or its absence) should be explained.
- Expected loss charging is the norm according to Managing Public Money, but other approaches can be justified.
- Longer term strategy should consider whether the CL should sit in the public or private sector, and if public sector involvement is temporary there should be a plan to exit, which will often involve pricing above expected loss for greater consistency with commercial rates.