

PRIME MINISTER

CONTINGENT LIABILITIES

I would be somewhat less dismissive than the Policy Unit of the Treasury's efforts in controlling and monitoring contingent liabilities. The Government's contingent liabilities are amorphous, hard to define and hard to control. But the tin experience shows that greater efforts are needed.

It would be better for Departments themselves to be given the primary responsibility for monitoring their contingent liabilities, rather than setting up a new centrally managed bureaucratic exercise.

Agree that the Treasury should consider a more comprehensive annual assessment to be carried out by each Department on its own behalf and, as necessary, the public sector organisations which it sponsors. ~~(and that you would be prepared to write to colleagues if need be to start this off?)~~

Yes - but not for me to write

DL

me

DAVID NORGROVE

25 April 1986

CJ41



10 DOWNING STREET

From the Private Secretary

28 April 1986

Dear Jill,

CONTINGENT LIABILITIES

The Prime Minister was grateful for the Chief Secretary's minute of 4 April about contingent liabilities, and for the full report which was attached to it.

The Prime Minister appreciates that the Treasury have increased their efforts to ensure proper control and monitoring of contingent liabilities. However, the Prime Minister believes there is a case for departments to be made still more aware of their own primary responsibilities for contingent liabilities the Government takes on in their areas of responsibility. She has asked that consideration should be given to an annual assessment - more comprehensive than that at present reported to Parliament - to be carried out by each department on its own behalf, and, as necessary, the public sector organisations which it sponsors.

Yours,
David

DAVID NORGROVE

Ms. Jill Rutter,
Chief Secretary's Office,
H M Treasury

6

18 April 1986

PRIME MINISTER

CONTINGENT LIABILITIES

The Treasury's advice has recently been overhauled but it remains a complacent, unsatisfactory document. Control is patchy and bound to be less than adequate unless people know the amount of their contingent liabilities and commitments. The way to achieve this, as is normal in industry and commerce, is to establish a proper procedure for an annual review in each Department. This necessary discipline would be comparable with assessments of loan losses and commitments regularly made by commercial banks.

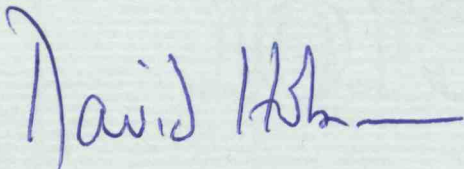
This should already happen.

The accounting procedures should require an annual assessment in respect of each Department and public sector organisation as to the nature and amount of contingent liabilities and the amount of any such contingencies which may have crystallised during the year. Provision should be made in the public expenditure round for liabilities likely to be called. We believe that a system on these lines would both discourage the assumption of contingent liabilities and improve their control. It would also focus the minds of those concerned on the need to assess the possible financial consequences and risks of decisions to assume commitments.

Recommendations

Ask the Chief Secretary to:

1. establish an annual review of contingent liabilities by department;
2. introduce accounting control of contingencies augmenting the present system of reporting to Parliament.

A handwritten signature in blue ink, appearing to read 'David Hobson', with a horizontal line extending from the end of the name.

DAVID HOBSON

CONFIDENTIAL

DN 015

CC BS



FROM: CHIEF SECRETARY

DATE: 4 April 1986

PRIME MINISTER

BF for PU
Comments.

CONTINGENT LIABILITIES

... I enclose a report which my officials have prepared on this subject as requested in your Private Secretary's letter to mine of 10 March.

2 The subject of contingent liabilities has been taken very seriously by my department since the Crown Agents affair. As a result, advice went out to departments generally which was aimed at avoiding the kind of surprise with which that episode confronted the Treasury. Unfortunately, however, it failed to prepare us for the potential liability in respect of the recent failure of the International Tin Agreement, mainly because the guidance did not stress clearly enough the need for good detailed legal advice before we sign international economic agreements.

3 The Treasury's advice has recently been overhauled and a copy is attached at Annex A of my officials' report to me. I do not suggest that you need read it in detail but you will see that Annex C of the report promises a further submission on international economic commitments and commodity policy in particular.

Tin is
discussed
in
annex C.

4 Departments are required to obtain Parliamentary authority for contingent liabilities, and to keep Parliament informed of outstanding liabilities outside those which arise incidentally to the normal course of their business.

5 Contingent liabilities which are undertaken as a deliberate act of policy are dealt with very much like actual expenditure. ECGD whose purpose is specifically to accept such risks in

CONFIDENTIAL

CONFIDENTIAL

return for premiums is the most obvious example. The amount they can take on is controlled by statute and by an overall objective of no net cost to public funds taking one year with another. The commercial and political risks taken on are therefore carefully assessed country by country and since 1983, under guidelines approved by Ministers, there has been an increasingly rigorous approach. But ECGD do have a substantial overhang of liabilities taken on much earlier which cannot now be discarded and that is what is causing their present cash flow problems.

6 Where the undertaking of contingent liabilities is not controlled by statute there is a "by your leave" procedure agreed with the PAC, which gives both the Treasury and Parliament an opportunity to comment. The Department proposing to undertake the liability has to lay a Minute before Parliament and leave normally 14 days while Parliament is sitting before committing itself. A recent example is an MOD Minute covering the Defence Export Services Organisation's arrangements with Pakistan for the supply of warships.

7 There are also procedures for recording and reporting to Parliament the accumulated totals of such liabilities. These are separate from our systems for planning and controlling public expenditure which are based on cash. I agree with the assessment of my officials (paragraph 17 of the report at Annex A) that a notional insurance scheme within the public expenditure Survey is not a good idea. But if a liability matures into public expenditure I would expect the Minister concerned to find the money from within his PES plans, if necessary by making offsetting savings. Only if I was convinced that spending priorities could not be adjusted would I agree to charge expenditure to the Reserve within the planning total.

8 The possibility of a contingent liability occurs with almost everything the Government does or says. There is little real scope for controlling a contingent liability once it has

CONFIDENTIAL

CONFIDENTIAL

been incurred. The main burden of the Treasury's advice is therefore that Departments should avoid them wherever possible and minimise them when they are unavoidable. Letters of comfort are firmly discouraged.

A handwritten signature in blue ink, appearing to be 'Jm' or 'John MacGregor'.

JOHN MacGREGOR

CONFIDENTIAL

CONTINGENT LIABILITIES

The Treasury guidance to departments on contingent liabilities is contained in "Government Accounting". It has recently been revised and the new version is attached as Annex A.

2. In essence departments are required to obtain some form of Parliamentary authority for contingent liabilities, and to keep Parliament informed of outstanding liabilities outside those which arise incidentally to the normal course of their business.

Statutory liabilities

3. ECGD liabilities are much the biggest item under this head. They are reported annually in the Department's Trading Accounts and also quarterly, in bulk, in British Business. Otherwise liabilities taken on under statutory powers are reported both at the time and annually thereafter (for the total amounts outstanding) in the Supplementary Statements to the Consolidated Fund and National Loans Fund Accounts (HC 117 for 1984-85)*. For completeness the ECGD figures are also included in the Supplementary Statements. ECGD's monitoring and control arrangements are described in Annex B.

Non-statutory Liabilities

4. Non-statutory liabilities generally require notification to Parliament under a Departmental Minute procedure which, wherever possible, allows time for Parliament to react before they are undertaken. The procedure also requires Treasury consent in each case. It has been agreed with the PAC. Amounts outstanding are reported each year with the main Estimates, and Parliament is assumed to take note of them when voting these Estimates.

5. There are a few exceptions to these arrangements as follows:

*For NI guarantees the liabilities are noted in the Supplementary Statements to the Public Income and Expenditure Account of Northern Ireland

CONFIDENTIAL

- (1) British Leyland
- (2) Rolls-Royce Limited
- (3) Short Brothers
- (4) Harland and Wolff

In each of these cases the Government has made a public statement of support to enable the company to continue trading. The affairs of the companies are monitored by the responsible departments and, as public companies, they report publicly to their shareholders in the normal way.

6. International agreements too may impose contingent liabilities. The tin agreements are dealt with in Annex C. The Government has also accepted an unquantifiable liability to stand behind British Aerospace in relation to its commitments to Airbus Industrie which matches the commitments of the Governments of the other participants. Another example is the European Investment Bank where we are not only contingently liable for the uncalled capital but also guarantee certain loans outside the Community which are reported to Parliament annually in the introductory note to the Overseas Aid Vote.

7. Indemnities given (in lieu of insurance) by the museums and galleries in respect of items borrowed are reported annually to Parliament even though such borrowings may be seen as part of their "normal course of business" as in para 2 above.

"Letters of comfort"

8. Contingent liabilities deriving from "letters of comfort", where these have been issued, are treated in the same way as non statutory liabilities. The issue of letters of comfort is, however, strongly discouraged (paras 46-49 of the attached guidance).

NDPBs

9. Departments are enjoined to see that any NDPB's they sponsor follow similar disciplines and report any outstanding contingent liabilities in their accounts.

Other potential liabilities

10. There may even be latent contingent liabilities deriving from the mere fact that some institution has enjoyed Government support for a long time and so imposed an unspoken and unacknowledged liability for continuing support or winding up without loss to anyone. An important example is the universities, which are formally private sector institutions but which in practice are very largely dependent on public funds.

11. Even what might be called "letters or messages of discomfort" such as the warnings given about the pre-ratification period for the Channel Tunnel or about the Government's support for Birmingham's application to host the 1992 Olympic Games, may not in the end prove to have been effective in avoiding contingent liabilities. That is the thinking behind para 49 of the attached guidance. Ultimately, indeed, practically nothing can be said or done by Government without at least risking some sort of moral liability.

12. There is obviously some danger in admitting the possibility of a contingent liability outside the categories described in paras 2-7 above because the admission would be usable by a claimant in support of his claim. That is why the explicit recognition and reporting to Parliament of contingent liabilities is confined to cases where there is no doubt that a liability has been assumed.

Resources to meet maturing liabilities

13. In the case of ECGD payments are borne on Votes but the whole operation is a trading one intended to be in balance in the long run. The net result in any year is not classified as public expenditure (positive or negative). Otherwise, unless there is statutory authority to meet liabilities direct from the Consolidated Fund (e.g. s.14(3) of the Civil Aviation Act

CONFIDENTIAL

1982), the funds to meet maturing liabilities would have to be provided on votes. They are subject to PES limitations but, in practice, a large demand would be likely to involve a call on the Reserve provided within the planning total.

14. There has sometimes been a temptation, outside the Treasury, to regard guarantees as an easier option for supporting an increase in public sector activity, at the same time avoiding an increase in recorded public expenditure (at least until any guarantee is cashed). But such devices are not acceptable unless they are justified on their own merits, e.g in terms of the efficiency and management benefit that the private sector involvement can bring. In most such cases conventional public sector financing will be more cost effective for the taxpayer; and our procedures for handling proposals are framed accordingly.

Control and monitoring

15. The only effective control over contingent liabilities is not to assume them in the first place. Departments should take as much care in assessing the potential costs and benefits of such action as they do over any expenditure proposal. To the extent that Departments are vulnerable to claims on their PES provisions for maturing liabilities this will be a useful discipline, but only insofar as it is realistic to expect the PES programme to bear the full cost of an unforeseen claim.

16. Once the liability has been assumed, the arrangements for Parliamentary reporting and the noting of liabilities in the Estimates should ensure that the liability is kept under review, although this is of limited utility once the liability has been incurred. Knowledge of the liability does not always mean that there are practical steps which can be taken to remedy any emerging risk of a demand for payment. It is however incumbent on the Department to take whatever steps are available to it to avoid any emerging risk turning into an actual liability.

17. To guard against the risk that some liabilities will mature, one possibility would be to charge Departments a "premium" in the Public Expenditure Survey, against the risk that a claim would arise requiring some call on the Reserve. The calculation

CONFIDENTIAL

of such a "premium" would however be intrinsically difficult, and it would have the disadvantage that the Department would then expect to disclaim responsibility for meeting claims from its own PES programme. It might therefore have less disincentive effect than at present to the assumption of bad risks. It would also seem inappropriate to ECGD, where the whole business is in any case the insurance of risks for a premium.

18. The most difficult area to guard against is where liabilities have not deliberately been undertaken by the Government, but it is simply assumed in the public mind that some liability, at least of a moral kind, may exist (see paragraphs 10-12 above). Such cases could not be covered by the system of notifications to Parliament without increasing the risk of claims being made. The only safeguard against these is vigilance to spot them emerging, and being prepared to issue a disclaimer in appropriate cases (eg as in the White Paper on the Channel Tunnel).

CONCLUSIONS

19. 1. Statutory liabilities are recorded and monitored in the same way as actual expenditure - particularly those of ECGD which reflect the whole purpose of the department.
2. The only effective control over specific and acknowledged non statutory liabilities is at the moment they are assumed. They are subjected to appropriate Parliamentary disciplines and reporting. Once they have been undertaken, assessment of the likelihood of expenditure must rely largely on departmental alertness and Treasury questioning.
3. Unacknowledged liabilities cannot be formally controlled and monitored but Departments and the Treasury must be vigilant to avoid such risks and consider the issue of disclaimers where practicable.

CONTINGENT LIABILITIES

26. This section is concerned with the contingent liabilities on the Consolidated Fund which arise when government departments and those non-Exchequer bodies (76) for which they are responsible accede to requests to give guarantees, indemnities or other assurances. Because of the risk that such assurances may have to be honoured and payments made, there should be a general predisposition against giving them.

27. However, where a body is effectively backed by government credit the long term interest of the taxpayer is likely to be best served by guaranteed borrowing (if not by direct government lending) since non-guaranteed borrowing is likely to be more expensive. Departments should ensure that the rate of interest on government-guaranteed borrowing is as low as possible and reflects the rate at which the government itself can borrow. Departments should not agree to borrowing on terms more costly than those available to the government without first consulting the Treasury.

28. This is particularly true when foreign borrowing is involved as any higher rate could reflect on the credit standing abroad by the United Kingdom public sector as a whole. All foreign borrowing by bodies for which departments have financial responsibilities must therefore be cleared with the Treasury in advance. (N 121).

29. In addition to the general policy considerations, departments should have close regard to the Parliamentary control aspects and to their responsibilities in relation to sponsored bodies, as indicated below.

Framework of Parliamentary control

30. Parliament authorises the issue of cash from the Consolidated Fund in two main forms. One is permanent legislation authorising issues directly. The other is through the annual Supply procedure leading eventually to the Appropriation Act, which completes the provision of specific amounts for specific purposes in specific financial years (B73).

31. A guarantee given by a Minister of the Crown is a legally enforceable undertaking that he will perform the promise or discharge the obligation of a non-Crown body in the event of that body's default. Although a Minister has freedom to give such guarantees, provided no statute expressly or implicitly precludes his doing so, he will only be able to pay for what he does if Parliament authorises the issue of the necessary funds (K5). Parliament is not bound in advance to authorise funds needed to honour a contingent liability assumed by a Minister of the Crown or his department unless the

liability has been charged by statute directly on the Consolidated Fund. This limitation, where it applies, must be made clear to the recipient at the time the guarantee is given. He may be told, in appropriate cases, of the existence of the Contingencies Fund (B101), from which it may be possible for the Treasury to make immediate payment in advance of vote authority.

32. Agreements between the government and the Committee of Public Accounts (PAC) have established conventions which ensure, so far as possible, that Parliament is not asked to authorise the provision of funds to meet liabilities of which it has not had reasonable notice and for which no justification had previously been provided. In order to respect these conventions, departments should be guided by the following considerations:

- (a) **Inter-departmental liabilities** Because the Crown is indivisible, government departments cannot guarantee or indemnify one another, nor is it appropriate for them to issue letters of comfort or similar assurances to one another. Apart from any legal or constitutional implications, such a practice could be taken as anticipating the authority of Parliament to charge future expenditure to a particular vote, or to prejudice the government's decision on the question of replacement of a lost or damaged asset. Assurances required by the Export Credits Guarantee Department (ECGD) under recourse agreements are an exception to this rule necessitated by the statutory constraints within which that department is required to conduct its business. The resulting contingent liabilities are recorded in ECGD's annual trading accounts. In addition, departments which have given explicit assurances of this nature should take appropriate action to implement the guidance contained in sub-paragraph (c) below and succeeding paragraphs.
- (b) **Normal course of business** A department's acceptance of a contingent liability in the normal course of business is not subject to any special procedures for notifying Parliament. Liabilities in this category will normally be between the Government and one other party and be connected with the supply of goods and services for which Parliament already votes money, eg procurement, construction, trading activities, etc. For example, a department might accept an advance payment on a contract on condition that it will be refunded if the department is unable to provide the service paid for. Any payments in satisfaction of the liabilities would normally be chargeable to a subhead relevant to the service in question. In any case of doubt, the Treasury should be consulted. See also paragraph 45 on indemnities.

(c) Other contingent liabilities

- (i) if a need to incur contingent liabilities arises from a continuing policy requirement, eg the giving of guarantees in support of borrowing by nationalised industries or companies in the private sector, the sponsor department should ensure that it has adequate statutory powers to provide guarantees with the consent of the Treasury.
- (ii) Parliament should be given the earliest and clearest possible notice of a decision by a department to put public funds at risk by the assumption of a contingent liability.
- (iii) Departments should make adequate arrangements for control and monitoring of contingent liabilities. They should report regularly to Parliament on the resulting exposure of public funds.
- (iv) Most contingent liabilities in the industrial field are self-liquidating. Where this is not the case, the effective duration and extent of the guarantee or other form of commitment should be minimised and clearly stated as part of the express terms of the guarantee. This helps to restrict the total liabilities outstanding and ensures that fully considered solutions to industrial problems are not delayed because the immediate financial crisis is overcome.
- (v) Departments should always consider whether some form of commitment fee, payable by the beneficiary of the guarantee or indemnity, would be appropriate, or a charge be established in the form of a deferred payment that could be reduced if the beneficiary was able to dispense with the guarantee, or any part of it, at an earlier date than agreed.

Reporting to Parliament

33. The following paragraphs describe the various types of contingent liability to be reported to Parliament⁽¹⁾ and explain how they bear on departments' responsibilities noted in paragraph 32(c)(ii) and (iii).

(1) Unless the relevant statute requires otherwise, departments should interpret the guidance on reporting to Parliament in the following manner. Departmental minutes on non-statutory guarantees should be laid before the House of Commons only; all other statements and reports provided for Parliament's information on contingent liabilities should be laid before both Houses of Parliament.

Statutory guarantees

34. Statutory guarantees are those where a Minister's powers to give guarantees are defined (and, by implication, limited) by statute. Some statutes provide for calls on a guarantee to be borne directly on the Consolidated Fund; others provides for any calls on the guarantee to be met from monies provided by Parliament, ie under the annual Supply procedure.

35. The statutory provisions governing the guarantees generally set out the responsible Minister's obligations to report to Parliament (33N) on his exercise of a guarantee power. The normal requirement is for a statement to be laid before both Houses of Parliament immediately a guarantee is given.⁽¹⁾ In addition, it may be necessary, particularly in the case of guarantees met directly from the Consolidated Fund, for statements to be laid in respect of any guarantees called, either at the time or subsequently. There may also be a requirement to report to Parliament annually or periodically on outstanding sums issued in respect of guarantees. Departments should ensure that the relevant reporting provisions in existing statutes are scrupulously observed. The proposed reporting arrangements should be set out explicitly in draft Parliamentary Bills (118). If no statutory procedure is laid down and the contingent liability could exceed £100,000, a statement should be laid before Parliament immediately a guarantee is given. The statement should indicate whether the liability is charged directly on the Consolidated Fund or whether the funds to meet it would require Parliament's approval through votes.

36. In all cases information about contingent liabilities resulting from statutory guarantees is published in the annual Supplementary Statements to the Consolidated Fund and National Loans Fund Accounts⁽²⁾. Departments are required to submit a return to the Accountant, HM Treasury by the end of June each year, showing the nature of the liability, the relevant statute and the amount of the liability outstanding at the preceding 31 March.

-
- (1) None of this applies to ECGD, which provides much the largest volume of statutory guarantees, to which separate Parliamentary reporting arrangements apply.
- (2) Guarantees given under Northern Ireland legislation will be recorded in the section headed "Contingent Liabilities of the Consolidated Fund" in the Finance Accounts for Northern Ireland.

Non-statutory guarantees

37. Although specific statutory authority is desirable before any guarantee is issued, circumstances may arise, either at short notice or in circumstances unlikely to be repeated, where it is in the national interest for a guarantee to be given without statutory backing. In such cases the liability will be that of the sponsor department, and any payments required to meet a liability which is called will need to be charged to its vote. This should be acknowledged in the departmental Minute to be laid before Parliament (38).

38. Where the contingent liability could exceed £100,000, the following procedure, which has been agreed with the (PAC)⁽¹⁾, must be adopted. After obtaining Treasury approval, a department which proposes to give a guarantee must lay before Parliament a Minute describing the amount and duration of the guarantee and the body or bodies involved, and any other information relevant to the guarantee. Where the potential liability cannot be accurately quantified, an estimate should be given. In particularly large or complex cases it may be desirable for the Minister concerned to make a statement to Parliament supplementing the information contained in the Minute. The department should also send copies of the Minute to both the PAC and the relevant departmental Select Committee.

39. Approval of the guarantee should not be given until 14 days⁽²⁾ after such a Minute has been laid before Parliament. Every effort should be made to ensure that the full waiting period falls while Parliament is in session. Where, in cases of special urgency, it is considered necessary to give a guarantee before 14 days have expired, the reasons for the urgency should be explained in the Minute.

40. If a Member of Parliament signifies an objection by letter, Parliamentary Question or Early Day Motion, the guarantee should normally not be proceeded with until the letter or Question has been answered or, in the case of an Early Day Motion, the Member or Members have been given an opportunity to make direct personal representations to the Minister. Where an objection, in whatever form, is signified, departments may wish to advise their Ministers to take the initiative by making contact with the Member or Members concerned. This may be particularly appropriate if it is proposed to issue the guarantee urgently or promptly on expiry of the waiting period. In all such cases the Treasury should be notified of the outcome of any representations made by Members.

(1) PAC Tenth Report, Session 1976-77, paragraphs 57-67

(2) Exclusive of Saturdays and Sundays.

41. The opening and closing paragraphs of the Minutes should follow a standard form as follows:

Opening paragraph -

"It is the normal practice, when a government department proposes to undertake a contingent liability in excess of £100,000 for which there is no specific statutory authority, for the department concerned to present to Parliament a Minute giving particulars of the liability created and explaining the circumstances; and to refrain from incurring the liability until 14 days (exclusive of Saturdays and Sundays) after the issue of the Minute, except in cases of special urgency."

Closing paragraph -

"The Treasury has approved the proposal in principle. If, during the period of 14 days (exclusive of Saturdays and Sundays) beginning on the date on which this Minute was laid before Parliament, a Member signifies an objection by giving notice of a Parliamentary Question or by otherwise raising the matter in Parliament, final approval to proceed with incurring the liability will be withheld pending an examination of the objection."

The wording of the closing paragraph will of course need to be adapted where, for reasons of urgency, it is proposed to issue the guarantee before the expiry of the normal 14 day period (39). It is also necessary to include in the Minute the following sentence:

"If the liability is called, provision for any payment will be sought through the normal Supply procedure."

42. Parliament should be kept informed of any change in the nature or increase in the size of the risk covered by the guarantee. Moreover, as long as a guarantee remains in force a note should be appended to the annual Supply Estimate of the relevant vote showing the size of the commitment outstanding at the latest convenient date.

Indemnities

43. An indemnity in its widest sense includes a guarantee, but is normally distinguished in law on the basis that a guarantee is ancillary to a contract between the recipient of the guarantee and the principal debtor, whereas in the case of an indemnity the promisor undertakes an original and independent obligation to make good some loss.

44. Examples of circumstances where a department may wish to consider the giving of an indemnity are as follows:

- (a) Where a department receives on loan an object of value from a non-Exchequer source and the owner, as a condition of loan, insists upon

the continuance of current insurance, the receiving department should make every effort to persuade the lender to accept an indemnity in place of insurance (104).

- (b) Indemnities are sometimes given in respect of services, as distinct from objects, provided to a government department. An example is the use by a department of premises and facilities belonging to an outside body. In such a case it may be necessary to give an indemnity to safeguard the body against damage to its buildings or equipment, or personal injuries to its staff, arising from the government use of the facilities. The department should, however, exclude from the scope of the indemnity any damage or injury attributable to negligence on the part of the indemnified body or of its contractors, agents or employees.

45. Indemnities may be of either a statutory or a non-statutory nature. The issue of most indemnities will be in the normal course of business (32(b)), but when they are not, the same Parliamentary procedures are applicable as to guarantees, unless the indemnity is authorised by a statute which specifies other procedures. Indemnities against loss or damage given to lenders or objects for exhibition by national museums and galleries are subject to separate reporting arrangements.

Letters of comfort

46. There is no simple or accepted definition of a letter of comfort. In the private sector the phrase typically refers to a letter issued by a parent company to a creditor of a subsidiary or associated company to give reassurance that the parent company is aware of financial obligations being assumed by the subsidiary or associate. In certain cases an indication may be given or implied as to the parent company's likely reaction should a subsidiary or associate subsequently fall into financial difficulties. But the essence of a letter of comfort is that it is intended to give some reassurance to the creditor without the parent company being legally bound, in all circumstances, to stand behind the subsidiary's obligations.

47. While a private sector body may be able to sustain a position in which it is bound morally but not legally, a public sector body, which is ultimately dependent on government credit, is unlikely to be able to issue a document of this kind without effectively committing government credit and having to meet the obligation if it should materialise. Moreover, although it has no automatic legal effect a letter of comfort could lead to a threat of legal action, which might have implications for government credit.

48. Departments should therefore approach any request for the issue of a letter of comfort with a strong pre-disposition to reject it. If, exceptionally, a Department believes there may be valid reasons for giving an assurance of this kind in a particular case the Treasury should be consulted in advance. If the Treasury agrees to the issue of a letter of comfort then the department should arrange for the matter to be laid before Parliament in a way analogous to that prescribed for guarantees in paragraphs 38-42. Legal advice should be sought on the terms and implications of any such letter and report to Parliament.

49. Departments should similarly beware of issuing letters which although not intended as comfort letters may, because of the fact that they are issued at all, be interpreted as implying a degree of comfort, for example, letters to financial institutions, banks, other lenders, or their agents which comment on, and thereby acknowledge, the financial arrangements proposed in particular cases. The presumption must in such cases be even stronger that such letters should not be issued. The Treasury should be consulted if, for any reason, this presumption is thought not to apply to a particular case.

General statements of support

50. Circumstances may arise in which a government department needs to make a general public statement of support for an outside body. For example, it may be desired to reassure creditors about the creditworthiness of a Companies Act company wholly or partly owned by the government, and that in the event of liquidation the government will ensure that the valid claims of the creditors are met. Such a statement involves the assumption by the government of a potential extra liability, albeit an unquantifiable one, and should be notified to Parliament at the earliest opportunity after clearance with the Treasury. The effect of such a statement is to bring the body concerned into the category discussed in paragraphs 50-54 below. Where such a statement is likely to be the prelude to successive borrowing operations by the body effectively on government credit, the department should ensure that it is equipped with appropriate statutory powers for the purpose in accordance with paragraph 32(c) above.

Non-Crown bodies dependent on government credit

51. Contingent liabilities of nationalised industries and other non-Crown bodies which are ultimately dependent on government credit are not normally under the direct control of departments; but since they may in certain circumstances incur a contingent liability which will have to be met, if it arises, from public funds, departments should be especially alert to their responsibilities under paragraph 32(c) above. (See also N119-123).

52. In general, such bodies are creatures of statute, either specific or general under the Companies Acts, or are established by Royal Charter, and have no legal powers to enter into commitments outside their defined powers. In the normal course of business they may be required to enter into commitments eg in the case of trading bodies for the supply and the receipt of goods and services, and may need to give assurances of various kinds incidental to these transactions. But departments should satisfy themselves that there are adequate arrangements in force to ensure that the acceptance of contingent liabilities in any other situation is consistent with the body's defined powers and that, in the event of the liability maturing, the body would have the ability to meet it, if necessary by borrowing within any borrowing limits. In the case of international organisations to which the United Kingdom belongs, it is particularly important that the relevant international agreement clearly sets out the financial responsibility of the members for discharging all its obligations including guarantees and contingent liabilities.

53. In particular, departments should ensure that the bodies concerned have adequate internal procedures with regard to the issue of assurances in the form of comfort letters and consult the department and the Treasury before issuing such letters. In addition, they should ask the bodies to be guided by the government's view that any assurance in the form of comfort letters in relation to borrowing should be treated in their accounts on the basis of an analogy with legally enforceable contingent liabilities. If, in cases where the relevant borrowing is counted against statutory borrowing limits, the liability arising out of a letter of comfort is excluded from the note to the accounts relating to contingent liabilities on the ground that it is covered by a separate note comparing borrowings against limits, this should be explained in the note relating to contingent liabilities.

54. As legislative opportunities present themselves, departments should take steps to ensure that the statutory financial limits of statutory bodies for which they are responsible include borrowings by subsidiary companies (in the Companies Act sense) and borrowings by any other party which have been guaranteed by the parent body or in relation to which the parent body may have issued any comfort letters or similar assurances.

55. Where such arrangements are not already in operation departments should arrange to be consulted by the bodies they sponsor before new or renewed guarantees or letters of comfort in relation to borrowing above a specified limit are issued. Unless otherwise agreed with the Treasury, this limit should not exceed £1 million or any borrowing limit applicable to the body in question, whichever is less.

ECGD : MONITORING AND CONTROL OF CONTINGENT LIABILITIES

ECGD's normal business as an insurer is to take on contingent liabilities for the repayment of trade credit and loans made in support of UK exports and in relation to UK owned overseas investment. The Department provides insurance within aggregate statutory limits on liabilities set under the Export Guarantees and Overseas Investment Act.

2. ECGD charges premia for the business it underwrites and the level and structure of these premia are intended to ensure that the Department operates at no net cost to public funds taking one year with another. This, and the fact that ECGD provides less than 100% cover, acts as a general check on the extent to which contingent liabilities are taken on.

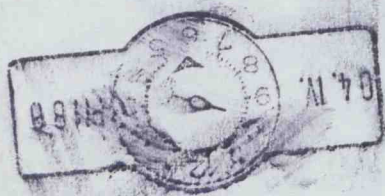
3. In controlling liabilities on individual cases the risks arising from both commercial factors and economic/political factors are considered. The management of commercial risk is undertaken by assessment of the financial strength of the buyer, limiting exposure to an appropriate figure in each case, and where necessary seeking additional security. The economic and political risk is assessed by country and the terms of cover in each market determined in the light of that assessment: for the majority of markets cover is only available within a ceiling. Since 1983, under guidelines approved by Ministers, ECGD has taken a more rigorous approach to the setting and observation of these limits with the aim of directing support to those countries best able to repay.

4. Once a guarantee has been given, ECGD are committed and often can do little to affect the outturn. However, where difficulties arise cases are monitored, and where possible action taken to avoid or minimise loss. Furthermore, as part of the implementation of the Management Review, the Department is exploring more sophisticated systems for managing and controlling contingent liabilities.

TIN

Although the assessment and reporting of contingent liabilities was significantly tightened up as a result of the Crown Agents episode in the early 1970s, the administrative changes made to the control and monitoring arrangements did not explicitly cover international economic agreements. This is remedied in the new issue of Government Accounting. Individual new commitments were of course examined ad hoc as they were undertaken. (But, as the recent tin case has shown, the extent of contingent liabilities depends critically on legal interpretation of international agreements.) There was no systematic analysis of different types of liability, or the steps needed to minimise exchequer exposure under such Agreements. As a consequence of the tin experience, guidance and a checklist of actions applying to all similar international economic commitments has already been prepared, to ensure that financial risks are identified for Ministers before decisions are taken on new or extended agreements. It will be put to Ministers shortly, together with the results of an interdepartmental review of commodity policy being undertaken by DTI.

TRADE : EGED : Jun 1980



04.11.80

COPIED TO

FILE

(54) EEL

TRADE: TYN PT2



bc BQ

10 DOWNING STREET

From the Private Secretary

10 March 1986

CONTINGENT LIABILITIES

You will have seen my separate letter of today to John Mogg about ECGD's finances.

Concern about ECGD finances has prompted the Prime Minister to enquire what steps are taken to control and monitor the contingent liabilities entered into by Government. I should be grateful to have a report on this.

The Prime Minister would also be grateful to know whether the monitoring arrangements identified the International Tin Agreement as a potential liability for Government.

(David Norgrove)

Richard Broadbent, Esq.,
H.M. Treasury.

✓