Australian Government
Australian Accounting Standards Board

Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

Staff Paper

Project:	**Insurance Activities in the Public Sector**	**Meeting:**	AASB August 2022 (M189) NZASB August 2022 (M102)
Topic:	Bank depositor compensation schemes	**Agenda item:**	AASB 4.6 NZASB 8.6
Contacts:	Angus Thomson athomson@aasb.gov.au	**Date:**	18 July 2022
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Objectives of this paper

1. The objectives of this paper are for the AASB and the NZASB to:

   (a) NOTE the submission letter from the Reserve Bank of New Zealand on ED 2022-3 *Insurance Contracts in the Public Sector* regarding bank depositor compensation schemes; and

   (b) DECIDE whether any action is needed.

Background

2. In its response to ED 2022-3, the Reserve Bank of New Zealand commented that it is preparing to establish a Depositor Compensation Scheme for New Zealand, subject to the passage of draft legislation.[1] This raises the issue of accounting for bank deposit guarantees and similar arrangements.

3. This paper explains why staff propose that the Boards do not address the issue of bank depositor compensation schemes provided by public sector entities in this project.

Structure of this paper

4. This paper outlines:

   (a) the scope of:

      (i) AASB 9/NZ IFRS 9 *Financial Instruments*, AASB 7/NZ IFRS 7 *Financial Instruments: Disclosures* and AASB 132/NZ IAS 32 *Financial Instruments: Presentation*

      (i) AASB 17/PBE IFRS 17 *Insurance Contracts*

      in the context of 'financial guarantees';

   (b) the nature of contingent liabilities; and

   (c) the nature of provisions.

1 Deposit Takers Bill – Exposure Draft: Explanatory Notes (rbnz.govt.nz) – see chapter 2.2 and Appendix A

Financial guarantees

5. A bank depositor compensation scheme could be regarded as a type of 'financial guarantee contract' as defined in AASB 9/PBE IPSAS 41:

> 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.

6. If accounted for under AASB 9/PBE IPSAS 41, financial guarantee contracts are recognised as liabilities:
   (a) initially measured at fair value [AASB 9/PBE IPSAS 41.5.1.1]; and
   (b) subsequently measured at the higher of [AASB 9/PBE IPSAS 41.4.2.1(e)]:
      (i) the amount of the loss allowance determined in accordance with AASB 9/PBE IPSAS 41.5.5 (expected credit losses); and
      (ii) the amount initially recognised under AASB 9/PBE IPSAS 41.5.1.1 less, when appropriate, any income recognised in accordance with the principles of AASB 15/PBE IFRS 15.

7. AASB 17/PBE IFRS 17.7(e) says:

> An entity shall not apply PBE IFRS 17 to: …[2]
>
> (e) financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. The issuer shall choose to apply either PBE IFRS 17 or PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 30 *Financial Instruments: Disclosures* and PBE IPSAS 41 *Financial Instruments* to such financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.

8. In the event that an entity had previously accounted for a financial guarantee as an insurance contract, it can choose to continue to do so under AASB 17/PBE IFRS 17.7(e). Staff note that:
   - we are not aware of any public sector entities with financial guarantees accounted for as insurance contracts; and
   - any new financial guarantees are not eligible for the accounting policy choice in AASB 17/PBE IFRS 17.7(e).

Contingent liabilities

9. 'Contingent liability' is defined in AASB 137.10/PBE IPSAS 19.18 *Provisions, Contingent Liabilities and Contingent Assets* as:

> A contingent liability is:
>
> (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
>
> (b) a present obligation that arises from past events but is not recognised because:

2 This quote uses the New Zealand references for convenience.

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

(ii) the amount of the obligation cannot be measured with sufficient reliability.

10. Contingent liabilities are the subject of disclosure – they are not recognised on balance sheet [AASB 137.27/PBE IPSAS 19.35].

Provisions

11. 'Provision' is defined in paragraph 10 of AASB 137.10/PBE IPSAS 19.18 as:

a liability of uncertain timing or amount.

12. A provision is recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation [AASB 137.14/PBE IPSAS 19.22].

13. The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period [AASB 137.36/PBE IPSAS 19.44].

Staff analysis and discussion

14. A bank depositor compensation scheme such as that proposed for New Zealand:

(a) would not qualify for recognition under AASB 17/PBE IFRS 17 in the event that it is regarded as being a financial guarantee because there is no track record of applying insurance accounting;

(b) seems unlikely to be a provision, at least until a relevant credit event occurs that would lead to a probable outflow of resources; and

(c) might be regarded as a contingent liability, and the subject of disclosure.

15. The Australian government has a similar scheme to that proposed for New Zealand – the *Financial Claims Scheme – Deposits,* authorised under the *Banking Act 1959* that guarantees deposits up to AUD250,000 at eligible authorised deposit-taking institutions. In the Consolidated Financial Statements of the Australian Government, disclosures are presented about the scheme among the Government's 'significant but remote indemnities, guarantees and warranties', including disclosure of the latest estimate of deposits eligible for coverage [AUD1.1 trillion as at 31 December 2020]. [page 135, 2021]

16. The New Zealand and Australian governments each have a range of schemes that could fall into a broadly similar category as a depositor guarantee, including the following.

New Zealand	Australia
Business Finance Guarantee Scheme: Established in March 2020 to support small and medium businesses to access credit related to, responding to, or recovering from, COVID-19. Loans are indemnified for 80% of their value . The indemnities are initially reported at fair value as a financial guarantee	***Small and Medium Enterprise Guarantee Scheme:*** Government guarantees to eligible lenders to enhance lenders' willingness and ability to provide credit, to support small and medium enterprises (SMEs) to access additional funding to continue operating through the COVID-19 outbreak.

New Zealand	Australia
contract and included as part of other provisions (note 22), representing the indemnity fee foregone by providing the indemnity without charge. The scheme closed on 30 June 2021 with lending facilities totalling $2.86 billion. [page 63 & 113, 2021 – Note 22 Provisions]	Guaranteed loans up to $250,000. The Scheme is capped at $20 billion. Disclosed as an 'unquantifiable indemnity, guarantee or warranty'. [page 135, 2021]
National Provident Fund guarantee: A provision has been recognised for the guarantee of superannuation schemes managed by the National Provident Fund (NPF). Included in the provision is the NPF's defined benefit plan annuitants scheme unfunded liability position of $762 million (2021), represented by a gross estimated pension obligation of $801 million (2021) with net investment assets valued at $39 million (2021). [page 113, 2021– Note 22 Provisions]	***Terrorism reinsurance scheme:*** The Australian Reinsurance Pool Corporation administers a terrorism reinsurance scheme for commercial property and associated business interruption losses arising from a Declared Terrorism Incident. The Australian Government guarantees payment above the private sector retrocession balance up to a maximum of $10 billion. The Australian Government also operates the Australian Victims of Terrorism Overseas Payment Scheme to provide financial assistance to Australians who are victims of a declared overseas terrorist act. Disclosed as an 'unquantifiable indemnity, guarantee or warranty'. [page 134, 2021]
New Zealand Export Credit Office guarantees: The Office provides a range of guarantee products to assist exporters to manage risk and capitalise on trade opportunities. The obligations to third parties are guaranteed by the Crown and are intended to extend the capacity of facilities in the private sector. [page 121, 2021 – Note 26 Contingent Liabilities]	***Medical indemnities****:* The Australian Government indemnifies potential liabilities under the *Medical Indemnity Act 2002* and the *Midwife Professional Indemnity (Commonwealth Contribution) Scheme Act 2010.* The Australian Government also indemnifies certain health-care organisations for adverse events arising from the provision of agreed services or health-care products (including blood products and vaccines). Disclosed as an 'unquantifiable indemnity, guarantee or warranty'. [page 134, 2021]
	Financial Claims Scheme – Insurance: A Policyholder Compensation Facility established under the *Insurance Act 1973* provides a mechanism for making payments to eligible beneficiaries with a valid claim against a failed general insurer. Disclosed as a 'significant but remote indemnity, guarantee or warranty'. [page 135, 2021]

Staff comments

17. Staff note that addressing financial guarantees and any similar arrangements in the public sector are outside the scope of the current insurance project on the basis that:

- depositor compensation schemes such as that proposed for New Zealand would not be eligible to apply AASB 17/PBE IFRS 17;
- the similar scheme in Australia is currently treated among the Commonwealth's 'significant but remote indemnities, guarantees and warranties', subject to disclosure and not recognition and measurement; and

- there is a potentially wide range of issues associated with accounting for government guarantees that are well beyond the current project.

Question for Board members

Q1: Do Board members agree with staff that the issue of bank depositor compensation schemes is outside the scope of the current project on insurance activities in the public sector?