Conselho das Finanças Públicas

# CONTINGENT LIABILITIES

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*This is an automatic translation that has not yet been reviewed. Only the Portuguese version is authentic.*

*The purpose of the "Notes" series is to present short texts on matters related to the specific mission of the Portuguese Public Finance Council, which help interested observers to better understand and assess the issues involved in the Council's areas of activity. This is a non-regular series, which does not require specialised knowledge to consult, consisting of texts that, as a rule, will not exceed ten pages in length.*

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# General index

# 1 Introduction

Contingent liabilities are a key element in the analysis of the sustainability of public finances. Due to their conditional nature, these liabilities pose significant challenges to fiscal management, particularly with regard to their quantification and impact. This document analyses the types and implications of contingent liabilities, highlighting their importance for economic governance and fiscal transparency.

# 2 Definition and framework

Contingent liabilities are potential obligations that only materialise if certain events occur. Unlike non-contingent liabilities, which are unconditional and generally easier to quantify, contingent liabilities depend on the fulfilment of conditions or the occurrence of specific events to become effective. For this reason, contingent liabilities are recognised as potential liabilities and not as actual liabilities that make up public debt. Although they do not generally constitute debt, a high level of contingent liabilities may indicate a significant fiscal risk. Assessing their impact on the sustainability of public finances is complex, as it is difficult to estimate both the probability and the extent of their materialisation, as well as to predict when they might occur. It should also be noted that, under European legislation, contingent liabilities are subject to mandatory disclosure and are reported regularly to Eurostat in the context of fiscal surveillance.[1]

Contingent liabilities can be explicit or implicit in nature. In the case of explicit contingent liabilities, their occurrence is defined by law or contract, with responsibility assigned to the competent public entity, which is part of the General Government (GG) sector for statistical purposes. They consist of legal or contractual financial agreements that establish conditional requirements for making payments of economic value. These requirements only become effective if one or more of the stipulated conditions are met. Explicit contingent liabilities can take various forms, although guarantees are the most common. The explicit liabilities associated with these liabilities are those resulting from:

(i) GA guarantees granted to public companies or private entities, or GA guarantees issued on debts or other obligations with subnational governments;
(ii) GA insurance schemes (deposit insurance, crop insurance, war risk insurance);
(iii) Guarantees provided by the PA under European instruments and mechanisms (SURE, Pan-European Fund, InvestEU, etc.);
(iv) Potential obligations arising from pending legal proceedings;
(v) Indemnities, which reflect commitments to accept the risk of loss or damage that another party may incur; and
(vi) Unpaid share capital and other liabilities associated with the public business sector, including the obligation to provide additional capital, cover unsecured debt and the need to restructure or clean up liabilities.

[1] Data on contingent liabilities are collected by Eurostat as part of the strengthening of EU economic governance, in particular under Council Directive 2011/85/EU of 8 November on requirements for fiscal frameworks of the Member States
, as amended by Council Directive 2024/1265/EU.

(vii) Contractual obligations associated with Public-Private Partnerships (PPPs), including future payments, compensation and other commitments provided for in contracts that may give rise to contingent liabilities for PAs.

In turn, implicit contingent liabilities arise when the PA's obligation is not formally provided for in law or contract. This type of liability may derive from a moral obligation on the part of the PA, from legitimate expectations created by past practices, or from political and social pressures. Among the most common examples of this type of liability are:

(i) the bailout of public entities (including regional and local government) as well as private entities;
(ii) guaranteeing the solvency of the banking sector;
(iii) the failure of unguaranteed pension funds (including protection for small investors);
(iv) environmental reconstruction and natural disaster relief.

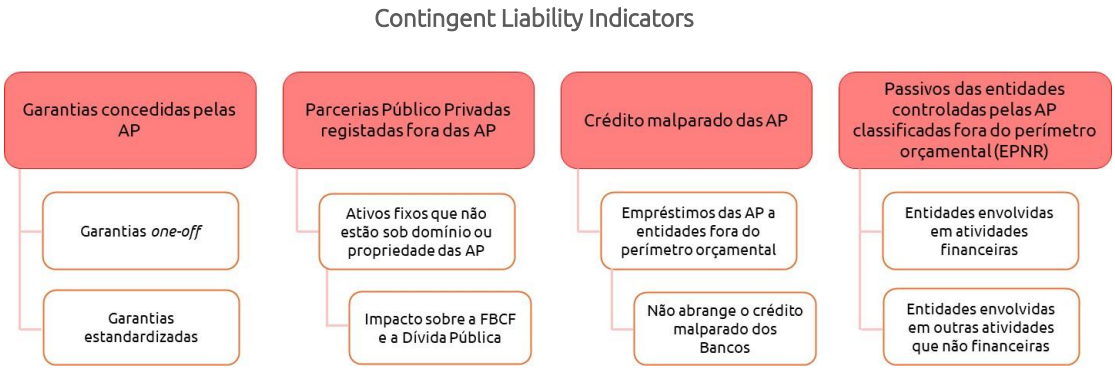
Explicit contingent liabilities are generally easier to quantify than implicit contingent liabilities. As a rule, PAs do not keep a systematic record of implicit risks, which makes it difficult to monitor them and can result in unexpected costs if it is necessary to cover expenses related to events that were not previously recognised as potential liabilities.

Despite these difficulties, the analysis and reporting of contingent liabilities have received greater attention, with an increase in the quantity and quality of information disclosed. The existence of data on PA contingent liabilities has allowed for better quantification of explicit liabilities, while implicit contingent liabilities continue to present significant measurement challenges. In this context, international organisations such as the OECD recommend that, whenever possible, implicit contingent liabilities be converted into explicit liabilities, unless the PA can reliably commit not to intervene in the face of the risks associated with these liabilities. This approach allows the PA to reduce unexpected costs and contribute to the sustainability of public finances in the face of the materialisation of potential obligations.

As they constitute a risk to the sustainability of public finances in all circumstances, contingent liabilities are particularly relevant in the context of the economic governance of the European Union (EU). Their systematic reporting aims to enhance fiscal transparency and enable a more comprehensive assessment of the risks that may affect the balance of public accounts. Under the Stability and Growth Pact (SGP), these liabilities are considered in both the corrective and preventive arms. In the corrective arm, they can be assessed in the context of compliance with the adjustment paths or plans presented by the Member State and may also justify requests for additional information on financial risks with a potentially significant impact. In the preventive arm, contingent liabilities are treated as risks that may compromise the defined fiscal objectives, justifying the need for continuous monitoring.

Statistical information on contingent liabilities of general government in the context of EU fiscal surveillance is collected and disseminated on the basis of a harmonised methodology defined by Eurostat. The main objective of this exercise is to enhance the transparency of public finances, ensure comparability between Member States and provide a more complete picture of the potential risks associated with the public sector's financial position. The methodology established by Eurostat includes a set of

standardised indicators that seek to capture different dimensions of fiscal risk exposure. The following figure presents the main indicators considered in this approach:




Source: Eurostat.

The indicators used are heterogeneous in nature and seek to capture different dimensions of the potential impact of contingent liabilities on public finances. Each of them provides an approximation of the maximum exposure of general government to risks associated with conditional liabilities. However, as they are constructed independently, there may be overlap. This means that the same fiscal risk may be reflected in more than one indicator, which increases the possibility of overestimating the overall impact. An illustrative example occurs when the debt of a public company outside the scope of the PA, but under State control, is accounted for simultaneously as a guarantee granted by the State and as a liability of a public company not integrated into the PA sector.

The impact of the pandemic crisis on the exposure of public guarantees

During the economic, social and health crisis triggered by COVID-19, the government adopted extraordinary measures to support the economy. In addition to measures with a direct fiscal impact, measures were implemented to support the liquidity of households and companies. Among these, standardised public guarantees granted to credit lines created under the COVID-19 measures stood out. This support led to an increase in contingent liabilities, representing a potential risk to medium and long-term financial sustainability.

The Temporary Framework for State Aid, approved by the European Commission at the beginning of the pandemic, authorised the granting of public guarantees to support COVID-19 credit lines. These guarantees ensured that financial institutions would finance credit lines to companies, with coverage from the National Mutual Guarantee System (SNGM) and the Mutual Counter-Guarantee Fund (FCGM), a mechanism endowed with public funds integrated into the PA sector. According to Eurostat statistical rules[2] , the estimated losses on these guarantees had an impact on public accounts at the time they were granted, namely in 2020 and 2021. The execution of the guarantees in subsequent years corresponds to the materialisation of already recognised liabilities and does not constitute a new fiscal impact up to the limit of the losses already recorded.

In addition to the guarantees for which the FCGM was responsible for execution, the State acted as the ultimate guarantor of these liabilities, issuing guarantees in favour of the FCGM to ensure the solvency of the SNGM. The State also assumed contingent liabilities related to Portugal's participation in European instruments in the context of the pandemic and reinforced credit insurance lines, including export insurance. Although some of these lines were not created specifically because of COVID-19, they were adapted and reinforced during the pandemic.

# 3 Categories of Contingent Liabilities – Eurostat Definition

This chapter describes the main categories of contingent liabilities reported in the European fiscal surveillance framework: guarantees granted by the general government, PPPs registered outside the general government, bad debt and liabilities of entities controlled by the general government classified outside the fiscal perimeter.

## 3.1 Guarantees granted by GAs

Guarantees issued by the GP are the most common form of contingent liabilities. The risk to public finances arises when these are granted to entities classified outside the GP perimeter, since, in these cases, their possible execution may result in new public expenditure with an impact on the balance and debt. Guarantees granted to PA entities, on the other hand, are subject to consolidation. In the latter situation, regardless of whether the guarantee is enforced, the impact on public accounts is already reflected in public expenditure (through the expenditure financed) and in debt, through the financing that benefited from that guarantee.[3]

[2] Manual on government deficit and debt – Application of ESA 2010 – 2022 edition.

[3] These guarantees are intended to ensure the implementation of public expenditure through the use of a financing instrument that supports it.

Guarantees can take two main forms:

- One-off guarantees: generally associated with debt instruments, such as loans or bonds. Their main function is to reduce the financing risk premium of the beneficiary entities, allowing them to obtain credit on more favourable terms. However, the risk of activation depends on the financial situation of the guaranteed entity: it can be difficult to estimate when there are no clear signs of default, but it becomes high when the company has significant weaknesses.

- Standardised (or normalised) guarantees: these cover similar types of credit risk, are issued in large numbers and according to identical rules. Although the probability of default for each individual transaction is uncertain, the large sample size allows for more reliable estimates of the number of guarantees that may be called upon.

## 3.2 Public-private partnerships (PPPs) registered outside the PA

PPPs are a form of contractual cooperation between the public and private sectors for the purpose of making investments or providing services. From an accounting point of view, they are only recorded outside the general government sector when, according to the criteria of the European System of Accounts (ESA 2010), the private partner assumes the greater share of the economic risks and rewards associated with the asset or the operation or management of the activity.[4] In these cases, the investment is recorded in the private partner's accounts. If it is found that the PPP should be classified in the GP sector, Gross Fixed Capital Formation (GFCF) (or other initial expenditure) should be recorded in the GP account.

The reporting of contingent liabilities related to PPPs outside the GP sector aims to quantify the total amount of potential liabilities associated with these contracts. The current value of the assets involved provides an approximation of the expenditure that would have to be recognised as public investment, as well as the impact on public debt if the GP were to acquire the assets during the contract period.[5]

In addition to the risk of a possible accounting reclassification, which would imply the integration of assets and liabilities within the scope of the PA, there are additional

[4] The three main categories of risk considered are: (i) construction risk (risk related to the construction process and its costs); (ii) availability risk (risk related to the availability of the asset for use after the construction phase); and (iii) demand risk (risk related to the demand for the services provided by the asset). In general, the assets involved in PPPs will be recorded in the private partner's accounts if the following conditions are met: the private partner bears the construction risk and at least one of the availability or demand risks, as provided for in the contract, with the public authorities only assuming one of the risks, and never the construction risk. In a situation where the construction risk is borne by the public authorities, or if the private partner bears only the construction risk and no other risk, the assets must then be recorded in the public authorities' accounts.

[5] Even when the asset is initially recorded by the private partner, if the risk materialises or the PPP is reclassified within the PA sector, the asset is recorded as Gross Fixed Capital Formation (GFCF) of the PA, at its market value on the date of reclassification. At the same time, the outstanding debt, equivalent to the market value of the asset, is recorded. If it exceeds the value of the asset, the difference is recorded as a capital transfer. After this reclassification, future financial charges associated with the debt are also recorded in the AP accounts.

liabilities arising from the contractual clauses between the PA and the private partner. These include the obligation to ensure the financial balance of the partnership in situations of economic and financial imbalance, which may result in future costs for the PAs and, consequently, contingent liabilities, often reflected in court decisions.

### 3.3 Bad debt of the PA

This category of contingent liabilities mainly includes loans granted by the PA to other institutional sectors of the economy.[6] Default on these loans (*non-performing loans* – NPLs) can lead to total or partial irrecoverability of the debt, resulting in losses for the PA sector. These losses may arise, for example, from a debt cancellation agreement in favour of the debtor, which is reflected as a capital transfer with a negative impact on the PA balance. Alternatively, the loss may result from the cancellation of debts after the liquidation of the debtor unit. In the latter case, there is no direct impact on the balance, but there is an indirect increase in the level of public debt, as the creditor faces increased financing needs due to the lack of repayment of the principal and interest on the loan granted.

### 3.4 Liabilities of entities controlled by the general government classified outside the fiscal perimeter

This category includes non-reclassified public entities (EPNR), i.e. entities controlled by the PA that have liabilities above a minimum threshold and which, according to ESA 2010, are classified outside the fiscal perimeter. As they are commercial entities outside the fiscal perimeter of the PA, these entities are included in sectors such as: (i) non-financial corporations; (ii) financial corporations; and (iii) the rest of the world. The risk associated with these liabilities stems from the possible inability of these entities to fully honour their commitments, as well as the possibility that they may not transfer the expected income to the general government sector, namely through the distribution of dividends. It should be noted that the figures reported by Eurostat in this area should be interpreted as the maximum theoretically possible loss, and not as an estimate of likely scenarios.

### 3.5 Public Enterprise Sector

The Public Business Sector (SPE) comprises three main areas: (i) the State-Owned Enterprises (SOE), which includes public companies and companies in which the State has a stake; (ii) the Regional-Owned Enterprises (RE), consisting of regional public companies in the Azores and Madeira; and (iii) the Local Business Sector (LBS), which includes local public companies and other entities subject to the legal regime governing local business activity. All of these sectors include entities that are part of the PA fiscal universe, in accordance with the sectoral classification defined by the ESA 2010 . To distinguish them from the above, the remaining entities that are not part of the PA sector are referred to as EPNR.

[6] Bad debts resulting from the typical lending activity of the banking sector with these sectors are not considered in this context.

Public companies that are commercial entities differ from the other entities included in the P universe, which includes non-commercial entities[7] , financed mainly by the PA. In the first case, we are dealing with companies that, operating in a free and competitive market, are subject, among other things, to business risk,[8] management risk[9] and risk of access to the financing necessary for their economic activity. In the second case, these are companies that are part of the PA fiscal perimeter, whose revenues and expenditures directly affect the fiscal balance and public debt, with their financing needs being met mainly by their respective budgets (State; autonomous regions or local authorities). Their indebtedness is controlled by the public entity that oversees them. In this case, fiscal risks are subject to scrutiny by the general government sector, unlike public companies that are not included in the universe.

In public companies outside the PA, fiscal risks lie mainly in the size of their liabilities and their inability to meet their responsibilities. For this reason, the debt generated by these entities is a critical indicator for assessing liabilities, as these represent potential responsibilities for the PA.

On another level, as the sector responsible for management control or the main shareholder of a given public company, there are also risks that may generate liabilities for the PA. A typical example of this situation is that which results from the need for the PA to intervene in entities experiencing difficulties due to staff bankruptcy (whose equity is negative), economic deficit (persistent accumulated losses) or inefficient management. Some of these risks are foreseeable and are reflected in fiscal documents, while others only materialise when specific events occur, which reinforces their contingent nature for the PA.

# 4 Contingent liabilities of the PA in the financial sector

With regard to financial companies, their weight and relevance justify a separate analysis, given the potential impact of these entities on financial stability. The risk associated with the financial sector is particularly important in contexts of economic or financial crisis, when the PA may be called upon to intervene to prevent systemic problems. This framework is intended only to illustrate the type of contingent liabilities that may arise in these situations.
Public financial support can take different forms:

[7] For the definitions of "market unit" and "non-market unit", please refer to the glossary available on the CFP website.

[8] The main business risks relate to: (i) changes in the prices of production factors (human resources, electricity, oil, among others); (ii) unforeseen changes in the operational activity of companies, as recently happened with the COVID-19 pandemic, which had a double impact on companies, with a reduction in revenues and an increase in expenses.

[9] The main management risks of the Portuguese SPE are associated with: (i) full compliance with the Legal Regime for the Public Business Sector (Decree-Law No. 133/2013 of 3 October); (ii) the transparency, timeliness and effectiveness of the State's exercise of its shareholder function; (iii) the autonomy, accountability and responsibility of public managers; (iv) levels of quality, efficiency and productivity.

- Direct interventions: transfers of resources to financial institutions, such as capital injections, recapitalisations or other support that directly affects public expenditure. These operations increase fiscal deficits and the level of public debt.

- Indirect interventions: these include the granting of guarantees or other instruments that create contingent liabilities, i.e. commitments that may become actual obligations if certain events occur, such as defaults by the beneficiary institutions. These liabilities constitute a potential risk to the sustainability of public finances, as they influence the fiscal space and the cost of financing for general government.

For reasons of transparency and monitoring of the impacts on general government accounts, Eurostat requires EU Member States to provide detailed information on: (i) transactions with a real impact on public accounts, (ii) *stocks* of financial assets and liabilities included in public debt, and (iii) instruments involving contingent liabilities, such as guarantees that may affect future general government liabilities.

In addition to explicit liabilities, there are implicit contingent liabilities arising from factors such as bad debt or financial weaknesses of institutions, which can compromise the stability of the banking system. These risks reduce the ability of institutions to meet the capital ratios required by the banking authority and may generate the need for state intervention, with a potential impact on the balance and public debt.

# 5 Conclusion

Although not formally accounted for as debt, contingent liabilities pose significant potential risks to fiscal stability and sustainability, as their materialisation may generate financing needs, affect the deficit and debt *stock*, and constrain fiscal trajectories. Effective management requires attention to quantification, monitoring and disclosure of detailed information in order to mitigate unexpected fiscal impacts. Fiscal surveillance, including European economic governance mechanisms, contributes to promoting more robust control and transparency practices. Nevertheless, challenges remain in relation to the transparency, predictability and management of these risks, highlighting the importance of continuing to improve methodologies and reporting procedures in the context of public finances.