

WORLD TRADE ORGANIZATION

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Committee on Subsidies and Countervailing Measures

INFORMAL GROUP OF EXPERTS ON CALCULATION ISSUES RELATED TO ANNEX IV OF THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

Report to the Committee on Subsidies and Countervailing Measures

Supplement

1. This supplemental report by the Informal Group of Experts is submitted in response to the SCM Committee's request at its April 1998 meeting that the Group resume meeting with a view to resolving issues that the Group's report (G/SCM/W/415/Rev.2) had identified as outstanding. In this connection, the Group held its eleventh meeting on 5-6 November 1998, and its twelfth meeting on 7 May 1999.
2. The Group members participating in this phase of the Group's work were: Mr. Robert Arnott (Australia), Mr. Stephen Gospage (EC), Mr. Takuya Igarashi (Japan), Mr. Wieslaw Karsz (Poland), Mr. Ju-Young Lim followed by Mr. Ki-Baek Park (Korea), Mr. Roy A. Malmrose (United States), Mr. Donald Orth (Canada), Ms. Ma Elena Reyna (Mexico), Ms. Vera Thorstensen (Brazil), and Ms. Clarisse Morgan (WTO Secretariat) as Secretary of the Group.
3. The issues that had been identified as outstanding in the Group's report were: accelerated depreciation, cost/risk of ad hoc loan or credit guarantees, sales denominator for export subsidies, upstream subsidies, equity infusions, and royalty-based financing. In addition, the Group noted that in the United States' comments to the Committee about the Group's report (included in document G/SCM/W/416/Suppl.2), the United States had asked the Group to consider the question of commercial risk, which the United States believed had been insufficiently addressed in the report. Similarly, the Group recalled that in response to one of Canada's comments on the report, the Group had indicated that it would consider the situation of high-value, low-volume products, and any particular calculation issues that might arise with respect to subsidies on such products.
4. The Group reached consensus on a recommendation regarding ad hoc loan guarantees. The Group did not reach a consensus on any of the other issues discussed. The Group considers that there are no further issues on which consensus is likely to be reached, and therefore considers that it has completed its mandate from the Committee.
5. The Group recalls that as it stated in its first report to the Committee (G/SCM/W/415/Rev.2), it does not view its recommendations as exhaustive of every potentially relevant issue under Article 6.1(a) and Annex IV. In this regard, the applicability and usefulness of any of the Group's recommendations to a particular situation should be assessed on a case-by-case basis.

Cost to government of ad hoc loan or credit guarantees (Recommendation 14-Rev., attached)

6. Regarding the cost to government of ad hoc loan or credit guarantees, the Group recalled that it had recommended in its first report (Recommendation 14, paragraph 6) that in the case of ad hoc guarantees, a cost to the government should be deemed to arise in the event of a default, in which case the cost would be the full amount of the default coverage provided, less any fee paid for the guarantee. The Group also recalled that some Members had argued that an ad hoc guarantee imposes a cost on the providing government even where there is no default, i.e., the expected cost of providing the guarantee, based on the probability of a default.

7. The Group concluded that the concept of default-related risk¹ was relevant in determining the cost to the government from ad hoc guarantees. In particular, the Group recommends that if the fee charged for an ad hoc guarantee is sufficient to cover the default-related risk at the time the guarantee is provided, there would be no cost to the government, either from the provision of the guarantee or from any subsequent default coverage. Conversely, if the fee is insufficient to cover the default-related risk at the time the guarantee is provided, there would be a cost to the government in the amount of the shortfall. The Group recommends that to be sufficient to cover the default-related risk, the fee would need at least to equal the total amount guaranteed (principal plus interest) times the default-related risk expressed as a percentage.

8. For example, if the principal plus interest amount guaranteed was \$100,000 and the default-related risk (i.e., the government's net probable cumulative monetary loss) at the time that the guarantee was provided was 10%, the government would incur no cost in providing the guarantee if the fee was at least \$10,000. Even if the beneficiary defaulted, and the government had to cover the default, there would be no cost to the government, because the fees were sufficient to cover the default-related risk as it existed at the time the guarantee was provided. Conversely, continuing the same example, if the fee was \$6,000, the cost to the government of providing the guarantee would be \$4,000. This cost would not be affected by whether or not the beneficiary defaulted. The Group recommends that any such cost be treated as a grant, and allocated over the life of the guaranteed loan or credit.

9. The Group recognised that quantifying a risk-based cost to the government would be difficult, due to the difficulty of establishing the probability that a default would occur, and the likely amount that would be recovered with respect to a particular guaranteed debt. The Group discussed at length the most fair and transparent manner for determining the actual risk of default associated with any given guarantee. It was noted that accurately measuring the true risk of any individual ad hoc guarantee would be difficult. In particular, it was pointed out that where a guarantee is provided pursuant to a programme (as opposed to ad hoc), such a programme will operate on the basis of risk pooling. That is, if a programme is operating on a commercially viable basis, guarantees will be made to more- and less-risky participants, in such a way as to allow the guarantee programme as a whole to cover its own costs. Assessments of risk can be made in such a context because comparators (the other participants in the guarantee programme) are available.

10. In the case of an individual ad hoc guarantee, the Group recognised that making an individual risk assessment would be difficult, and for this reason identified some surrogates or proxies that could

¹ Defined for purposes of this report as the government's net probable cumulative monetary loss on the guaranteed debt, that is, the probable amount (or percentage) of the combined principle and interest over the life of the debt that the government would have to pay on behalf of the beneficiary in the event of a default. This in turn would reflect both the probability of a default occurring (i.e., of a payment being missed) and the likely amount of the guaranteed debt that would eventually be recovered, including the realistic recovery value of any collateral formally held by the government (assuming that the government became responsible for the debt once a default occurred).

be used. In particular, as a general approach, risk could be assessed on the basis of a statistical analysis of commercial loans or credits made to borrowers with a similar credit rating or borrowing at similar interest rates to those paid by the borrower in question on non-guaranteed debt. Such an analysis would calculate the total amount defaulted and not recovered on all such loans and credits as a percentage of their combined principal and interest over their lifetimes. Thus, if the combined total principal and interest of the comparable commercial loans and credits amounted to \$1,000,000, and defaulted unrecovered principal and interest totalled \$100,000, the default-related risk for the guaranteed loan or credit would be estimated at 10 per cent. In this context, the Group noted that some bond rating companies (Moody's, for example), publish reports concerning default and loss/recovery rates, which might provide a basis for an analysis of this type.² In addition, depending on the availability of data, default and recovery information for government-operated loan/credit guarantee programmes in the country in question might be usable as a proxy, if the risk level of the ad hoc guarantee appears comparable to that of the guarantees provided under the programme. The interest rate paid by the borrower on non-guaranteed debt also might provide an indication of the default risk of the guaranteed debt. In conjunction with this, and in general, average industry-wide, or finally, country-wide default and loss/recovery information for debt of all kinds also might be usable.

11. The concern was expressed that the use of surrogates could be unpredictable and not fully transparent, and might be inappropriate in individual cases where the actual default-related risk was very small, thus raising questions of fairness. Thus, assessments of default-related risk would need to be made with great care, on the basis of the information (including any objective risk assessment conducted) that was available at the time the guarantees at issue were provided.

12. Regarding collateral held by the government in connection with an ad hoc guarantee, it was recognized that the realistic liquidation value of collateralized assets might be difficult to establish, as their book value might not correspond to their market value, and additional costs might be incurred in the liquidation process. This being said, however, it was noted that in practical terms the existence of significant collateral in favour of the government might in most instances fully cover the default-related risk, and thus eliminate any risk-based cost in providing the guarantee. By taking account of the recovery value of any collateral, the recommended methodology allows for this possibility.

13. The Group noted that this recommended methodology for ad hoc guarantees represents a modification of the approach in Recommendation 14, paragraph 6 of the Group's first report. Recommendation 14, paragraph 6 would in all cases treat the amount of default coverage (less any fees paid) under an ad hoc guarantee as a cost to the government, without taking into account the default risk and the sufficiency of fees and collateral to cover it. As indicated, under the new recommended approach, the occurrence or not of an eventual default would not affect the calculation of the cost to government of providing an ad hoc loan guarantee. The Group also emphasised that in

² For example, the Moody's report, "Historical Default Rates of Corporate Bond Issuers", which covers 1920 to the present, updated periodically, and is available on Moody's website (<http://www.moodys.com/cbi.htm>), provides historical rates of default (i.e., instances of missed payments) for senior unsecured debts of corporate bond issuers in all rating categories, over different time horizons. The report also provides information on loss and recovery rates, measured by selling prices per \$100 of par value on defaulted debt instruments of differing degrees of security (senior secured bank loans, equipment trusts, senior secured bonds, senior unsecured bonds, subordinated bonds, and junior unsecured bonds) as well as on preferred stock. (The recovery rates thus take into account recovery through liquidation of collateral.) To arrive at an estimate of the percentage probability of loss, the default rate for the appropriate rating category can be multiplied by the loss rate (one minus the recovery rate) for the relevant type of debt. The appropriate rating category would be chosen based on the credit rating of the borrower and the degree of security of the debt in question. For example, if the borrower in question has a Ba rating (which pertains in the Moody's report to senior unsecured debt), and the guaranteed loan or credit in question is senior secured, the appropriate default probability would be that for Baa, rather than Ba, to take into account the greater degree of security of the guaranteed debt than that of the senior unsecured debt used as the standardised basis for the Moody's data.

modifying Recommendation 14, it is not revisiting an issue which was already decided in its first report. Rather, the Group is taking account of its conclusions on an outstanding issue, the cost/risk of ad hoc loan or credit guarantees, in order to finalise the text of Recommendation 14.

14. The Group also noted that the recommended risk-based assessment of cost to the government from ad hoc guarantees is generally consistent with the Group's recommended methodology (Recommendation 14, paragraphs 2-5 of the Group's first report) for the provision of guarantees under a programme. In particular, that recommendation provides, regarding the provision of guarantees, first that the programme's long-term viability be assessed, on the basis of the sufficiency of premiums/fees collected to cover defaults and operating expenses. If the programme is viable, an individual event of default would not be deemed to impose a cost to the government³. If the programme is not viable, then whether or not there is a default by a particular beneficiary, a proportionate share of the shortfall of the programme's overall income to expenses would be allocated to the firm(s) subject to the Article 6.1(a) enquiry.

Accelerated depreciation

15. The Group recalled the limitations, discussed in its first report to the Committee, of the two approaches to accelerated depreciation that it had previously considered. First, treating any tax savings from accelerated depreciation in a given year as a grant could overstate the amount of the cost to government by failing to take account of the possibility that more taxes would be paid in later years. On the other hand the OECD approach, which would calculate the cost to government over the entire depreciation period, might understate that cost as higher taxes might not be paid in later years in practice, if the firm were unprofitable or assets were replaced at the end of the depreciation period. Furthermore, the true amount of the cost to the government could only be known (including by that government itself) after the end of the depreciation period, yet an Article 6.1(a) claim involving accelerated depreciation might be raised at some point during a depreciation period.

16. The Group considered a third possible approach to accelerated depreciation, which in general terms would treat any tax savings from accelerated depreciation as a tax deferral, and then, in accordance with the Group's recommendation on tax deferrals (Recommendation 12.B), would treat the deferred tax amount as an interest-free loan for the period of accelerated depreciation. In keeping with the Group's recommendation in its first report on timing and sales denominator issues in the case of tax-related subsidies (paragraph 52 and Recommendation 6.B), the approach discussed would assume that the "loan" was provided in the year following that to which the depreciation expense in question was attributed. A number of issues and problems were discussed concerning this approach, and no consensus was reached on any recommendation regarding accelerated depreciation.

Sales denominator for export sales

17. The Group recalled the difference of views over the appropriate sales denominator for export sales that is reflected in section VI.E, paragraph 67 of its first report. The Group concluded that views had not changed since those earlier discussions, and that therefore there would be no benefit to further discussing this issue.

³ The Group noted that guarantee programmes might sometimes involve some form of collateral. The Group noted that if this were the case, the effects thereof on a programme's viability normally would be reflected in its overall financial results as recorded in its financial statements.

Upstream subsidies

18. The Group considered whether any progress could be made regarding upstream subsidies. The Group concluded that this issue seemed to raise a number of questions that go beyond the mandate of the Group.

Equity infusions

19. The Group discussed whether it would be possible to make any further progress with respect to the cost to government of providing equity where there was no publicly-traded stock, and therefore no market price to use as a comparator. The Group reached no consensus on this issue.

Royalty-based financing

20. The Group discussed, but reached no consensus on, the cost to government of providing royalty-based financing.

Low-volume, high-value products

21. The Group discussed the problem, raised by Canada in document G/SCM/W/416, of the sales denominator for low-volume, high-value products. Two possible examples mentioned were ocean liners and offshore oil platforms. For such products, a "sale" might be considered to have taken place at the time the contract was signed between producer and purchaser, although the product might physically be delivered only several years thereafter. Assuming that subsidies were involved in any such sale, application of the rule on the sales denominator in paragraphs 2 and 3 of Annex IV might lead to anomalous results. That is, there might be no "sales" during the most recent 12-month period preceding the granting of the subsidies, depending on the timing of the subsidies in relation to the timing of the sale, depending on whether the subsidies were "tied" to the product or not, and depending on the scope of the recipient firm's operations. Thus, there might be situations in which no clear basis existed for the calculation of *ad valorem* subsidization, even where subsidies had been received.

22. The Group acknowledged that this was a potential problem that should be identified in its report, although in practice it might be difficult to clearly identify types of products and firms with respect to which this situation could arise. The Group further concluded that the language in paragraphs 2 and 3 of Annex IV might limit the Group's ability to make any sort of recommendation to address this situation.

Commercial risk

23. The Group considered the question of commercial risk. As an example of the issue, the relationship of commercial risk and the provision of government loans was discussed. In this connection, the Group recalled its recommendation (Recommendation 9) that the cost to government of loans should be determined on the basis of a government borrowing rate for debt with comparable maturity to that of the loan in question. An issue that was posed by the United States, generally reflected in document G/SCM/W/416/Suppl.2, was whether this was sufficient given that certain borrowers posed more of a risk, and thus arguably a higher cost to the government, than others.

24. It was pointed out that the Group's original recommendation with respect to the government's cost of providing a loan assumed that no other considerations, in particular provision for bad debts, came into play. Because of the extra risk of certain loans, however, some members of the Group argued that the government should increase the interest rate on those loans, to cover its commensurately higher cost. No consensus was reached on the question of commercial risk.

RECOMMENDATION 14-Rev.

Loan/Credit Guarantees

1. It is recognised that guarantees can be provided both to borrowers (as loan guarantees) and to lenders (as credit guarantees). It is also recognised that guarantees can be provided through a guarantee programme, or on an ad hoc basis.

B. GUARANTEE PROGRAMMES

2. A two-part procedure is recommended for determining the cost to the government of loan or credit guarantees provided through a programme. The first part consists of assessing the long-term viability of the guarantee programme as a whole. The second part consists, if the programme is not viable, of attributing to the firm involved in the Article 6.1(a) enquiry the appropriate portion of the government's cost under the programme.

3. To assess the long-term viability of a guarantee programme, it is recommended that the financial statements for the programme for a relatively long period, normally the most recent five years, be examined. If the total fees paid into the programme by participating firms during the period were at least equal to the total amount paid by the government under the programme to cover defaults, plus the costs of operating the programme, the programme would be viable. In this case, there would be no cost to the government, either from the provision of the guarantee or from any event of default coverage. If, however, the total fees paid into the programme by participating firms during the period were less than the total amount paid by the government under the programme to cover defaults, plus the costs of operating the programme, the programme would not be viable.

4. In the second part of the analysis (i.e., attributing the appropriate amount of government cost under the programme to the relevant firm), it is recommended to first calculate the cost to the government of the programme as a whole. This cost should be calculated as the difference between the total amount of fees actually paid into the programme by all participants (including those not involved in the enquiry) and the total amount of fees that would have been required for the programme to be viable during the relevant period.

5. The next step in the recommended methodology would be to attribute the appropriate portion of this cost to the particular firm involved in the enquiry. This should be calculated by applying to the total cost of the programme that firm's percentage share of total loan/credit amounts guaranteed under the programme during the relevant period. This subsidy would be deemed to have been provided on the date(s) the fees were paid by that firm.

C. AD HOC GUARANTEES

6. In the case of ad hoc guarantees (i.e., those that clearly are not linked to any guarantee programme), it is recommended that if the fee charged for an ad hoc guarantee is sufficient to cover the default-related risk⁴ at the time the guarantee is provided, there would be no cost to the government from the provision of the guarantee. Conversely, if the fee is insufficient to cover the default-related risk at the time the guarantee is provided, the cost to the government would be the

⁴ Defined as the government's net probable cumulative monetary loss on the guaranteed debt (that is, the probable amount or percentage of the combined principal and interest over the life of the debt that the government would have to pay on behalf of the beneficiary in the event of a default), taking into account both the risk of default and the probable amount of any recovery following a default, including the realistic recovery value of any collateral formally held by the government.

amount of the shortfall. The Group recommends that to be sufficient to cover the default-related risk, the fee would need at least to equal the total amount guaranteed times the default-related risk expressed as a percentage.

7. For example, if the amount guaranteed (principal plus interest) was \$100,000 and the default-related risk at the time the guarantee was provided was 10%, the government would incur no cost in providing the guarantee if the fee was at least \$10,000, because the fee would fully cover the default-related risk. Conversely, continuing the same example, if the fee was \$6,000, the cost to the government of providing the guarantee would be \$4,000. The Group recommends that any such cost be treated as a grant, and allocated over the life of the guaranteed loan or credit.

8. In the view of the Group, ideally the default-related risk used in the calculation should be the actual probable monetary loss in the event of a default on the particular guaranteed loan or credit in question at the time the guarantee was provided, taking into account the realistic recovery value of any assets formally held by the government as collateral. Where this is not possible, because the necessary information (i.e., an independent assessment of the probability of default and probable amount of loss/recovery) is not available, some sort of surrogate would be needed. In this regard, the Group notes that a statistical analysis of commercial loans or credits made to borrowers with a similar credit rating, or borrowing at similar interest rates to those paid by the borrower in question on non-guaranteed debt, could be used as a basis. Such an analysis would calculate the total amount defaulted and not recovered on such loans and credits as a percentage of the combined principal and interest over the lifetimes of the loans and credits. In this context, the Group noted that some bond rating companies publish information on historical default rates for different grades of bonds issued around the world, ranging from investment grade down to junk bonds, as well as historical loss/recovery rates for defaulted debt of different levels of security (from senior secured bank loans to junior subordinated bonds)⁵. If the guaranteed debt could be associated with these rating and debt categories, this information could be used as a proxy for the probable monetary loss on the guaranteed debt. In addition, default and recovery information for government-operated loan/credit guarantee programmes in the country in question might be usable, if the level of risk of the ad hoc guarantee appears comparable to that of the guarantees provided under the programme. The interest rate paid by the borrower on non-guaranteed debt also might provide an indication of the default risk of the guaranteed debt. In conjunction with this, or if none of the previously mentioned surrogates is available, average industry-wide, or finally, country-wide default and loss/recovery information for debt of all kinds might be another possibility.

9. In view of concerns that the use of surrogates could be unpredictable and not fully transparent, and might be inappropriate in individual cases where the actual default-related risk was very small, the Group notes that assessments of default-related risk in the case of ad hoc guarantees would need to be made with particular care, on the basis of the information (including any objective risk assessment conducted) that was available at the time the guarantees at issue were provided.

⁵ To the extent that such loss/recovery information is broken out for debt of differing levels of security, it would take into account the recovery value of collateralised assets. If any published information from a bond rating company were used, its specific definitions and parameters would need to be examined carefully to ensure that it was used appropriately.