EUROPEAN CENTRAL BANK

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Subject: **COMMENTS ON THE MACROECONOMIC STATISTICAL TREATMENT OF REPO-TYPE TRANSACTIONS AND SECURITIES LENDING**

Dear Carol,

In two letters addressed to Mr. Israël (Head of the Balance of Payments Statistics and External Reserves Division) and Mr. Sandars (Money and Banking Statistics Division) respectively, both dated 25 May 2000, you requested comments on two documents which focus on the statistical treatment of repo-type transactions and securities lending. I am writing to transmit the ECB's views on this issue, which also reflect the opinions of the Working Group on Balance of Payments Statistics and External Reserves Statistics and the Working Group on Money and Banking Statistics with the exception of the United Kingdom which reserves its position.

Those responsible for the different statistical areas within the ECB (i.e. balance of payments statistics, money and banking statistics and monetary union financial accounts) have adopted a common approach for the statistical treatment of repo-type operations. The general rule is that the criterion of transfer of economic ownership should be applied, instead of the criterion of transfer of legal ownership. Whenever there is a firm commitment to return securities to the original owner at the end of the operation, economic ownership of the securities is considered to remain with the original owner, in the sense that the original owner retains the risks and rewards associated with ownership (profits/losses due to value changes and the benefit of the coupon payment), while not necessarily retaining legal title. This recommendation leads to the recording of genuine repurchase agreements, sell/buy-back transactions and securities lending as collateralised loans without a change in the ownership of the underlying asset (i.e. Option II in the first document provided).The following comments, which were prepared by the ECB's Balance of Payments Statistics and External Reserves Division and the ECB's Money and Banking Statistics Division, present

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in more detail the methodological and conceptual reasons why the ECB's statistical decision-making bodies opted for the "collateralised loan" treatment.

Several arguments support option II. First, this treatment better reflects the economic rationale behind these financial operations. The commitment to repurchase the securities exchanged implies that the economic ownership of the underlying collateral remains with the original owner, who retains the risks and rewards associated with the possession of these assets. The exchange of securities in repo-type transactions or securities lending does not imply any recording in the balance sheets of the depository corporations (MFIs) or of the other economic sectors, nor under *BoP portfolio investment* or *Reserve assets/securitie*s, since the securities subject to repurchase agreements/securities lending still remain on the balance sheet of the securities lender. In addition, this treatment ensures broad consistency with accounting practices within the euro area, according to which only claims and liabilities derived from an associated exchange of cash are recorded, with no on-balance-sheet recording of any change in holdings of securities.

Apart from these general arguments, we would like to draw attention to the following remarks in the first document:

<u>Option I:</u> the document highlights the problems associated with the recording of these transactions as outright purchases/sales of securities or as derivative transactions. We fully subscribe to the difficulties embodied in such treatment.

<u>Option III:</u> we acknowledge that there may be many practical difficulties in the provision of supplementary information on the sector identity of the counterparties to these transactions or the kind of securities exchanged, to the extent that this information is not captured in the accounting statements of the economic agents involved. In addition, this option would not solve all of the problems derived from on-selling practices.

<u>Option IV:</u> in practical terms, the distinction between collateral securities that can be sold/lent on from those that do not have this feature is not technically feasible from our point of view, as the required information would never be available from current information sources. In addition, we agree with all other drawbacks expressed in the document, namely the subsequent artificial increase registered in gross figures, problems in applying market valuation to *accounts payable/receivable* or inconsistencies with accounting statements (which merely consider these commitments to return securities collateral as off-balance-sheet items).

<u>Option V:</u> the same drawbacks as those expressed in the preceding paragraph would apply to this solution, since the two options are similar except in the separation of "securities on reverse transactions".

Option II: We cannot subscribe to most of the arguments set out in paragraph 16:

With regard to the first bullet point, we see two elements in a repo transaction: the security itself, which only entails a relationship between the issuer and the original holder of the security; and a commitment in some of these transactions to repay an amount of cash, which exclusively concerns the lender and the borrower of the cash. Three parties are involved whose relationship would only change in the case of default on the cash loan and, hence, the picture would only be modified at that time. Until that moment, the situation would be fairly reflected by means of the "collateralised loan" approach. In no way is the measurement of inter-sector claims distorted.

With regard to the second bullet point, there is an apparent confusion between real transactions (in this case, a cash loan) and the provision of guarantees for such deals (exchange of securities without any change in ownership). As far as euro area statistics are concerned, the provision of guarantees does not imply any recording unless they are invoked (only in the new common template on international reserves and foreign currency liquidity is there provision for a figure measuring "contingent liabilities"). Regarding the exchange of collateral in these transactions, since no change in ownership occurs, there exists no claim or liability derived from the commitment to return the securities to the original owner. Therefore, the maturity of the repo should only be taken into account as far as the repayment of cash from the cash borrower to the cash lender is concerned (in euro area money and banking statistics there is no provision for a maturity breakdown of the repo liabilities of MFIs as they are all considered to be short-term). This view is consistent with the collateralised loan approach as well as with current accounting practices.

With regard to the argument mentioned under the third bullet point, it should be analysed within a wider scope. The consideration of any one country's external debt independently from the amount of claims held by that country on the assets side of its international investment position could undoubtedly be somewhat misleading. We favour assessing a country's stability on the basis of its net stock position (i.e. taking account of both assets and liabilities).

The argument under the last bullet point, that retaining the security in the portfolio of the security "provider" would run counter the fact that he no longer has the right to sell the security until the repo transaction comes to maturity, would imply that any claim that cannot be immediately transferred by the owner should not be considered on the assets side of external stock statistics (for instance, pledged assets, gold deposited or lent, etc.). We do not see any reason to change the criterion followed so far (i.e. that the rights associated with the ownership of this kind of assets remain with the original owner).

In our view, the most serious drawback of treatment as a "collateralised loan" expressed in the document is that given in the fourth bullet point (i.e. the difficulties in the application of the accruals principle to derive the interest receivable on the securities exchanged in the case of on-selling). Consideration of negative interest derived from the negative position arising seems to be the only reasonable solution, although it is not entirely satisfactory.

In general, we do not think that there are compelling arguments for a change to the agreed treatment, which has been discussed extensively in several fora. The main drawback of the treatment of these transactions as collateralised loans, as highlighted in the document, is the negative ("short") position that should be recorded in the event of the securities borrower selling the securities to a third party. A short sale should be treated statistically as a liability or a negative asset. In our view, a negative entry on the assets side (as is current practice) would better reflect the economic reality behind these practices, since the overall net balance would not doublecount the relevant securities.

I should comment on the following paragraph on page 4 of the second document attached to your letter: "*To avoid this overcounting of gross reserves, an alternative approach is for the cash receiving central bank, while retaining the repoed securities on its balance sheet, to remove the securities from its measure of reserves. This is the recommendation in the provisional Operational Guidelines of the Data Template for International Reserves and Foreign Currency Liquidity. In this manner, the collateralized loan approach is retained but reserves are not 'overstated'"*. The treatment described in this paragraph does not coincide with any of the practices recommended in the final version of the IMF Operational Guidelines, dated October 1999, and is not in line with the treatment currently applied within the euro area (which is described in the ECB document "The statistical treatment of the Eurosystem's international reserves"). Neither document recommends reclassification of the securities lent or repoed; hence the amount of securities in reserve assets does not change as a result of any of these transactions, when the "collateralised-loan" approach is applied. As stated in the earlier letter to Mr. Joisce, we fully support the non-reallocation of the securities concerned, and follow this treatment in our statistics.

Finally, the note is silent on the treatment of gold swaps and gold repos. As explained in our previous correspondence, the ECB considers that the statistical treatment of repo-type transactions and securities lending should also be applied to all reversible gold-related operations (also including gold deposits and gold loans). In view of this, I would suggest that the treatment of reversible gold-related operations should also be covered in the IMF note.

Should you have any further questions or need further clarification on any of the above points, please do not hesitate to contact us.

Best regards,

[signed]

Peter Bull

Encl.

Cc: Members of the Working Group on Balance of Payments and External Reserves Statistics;
Members of the Working Group on Money and Banking Statistics;
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