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Repurchase Agreements, Bond Lending and Other Related Instruments

Prepared by the Financial Flows and Stocks Task Force
European Central Bank

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Balance of Payments Statistics
Financial Flows and Stocks Task Force

REPURCHASE AGREEMENTS, BOND LENDING AND OTHER RELATED INSTRUMENTS
Full Report to the Working Group on Statistics

INTRODUCTION

1. The recording of repurchase agreements, bond lending and other related instruments in the balance of payments is an outstanding issue from the full reports on Portfolio Investment Flows and Other Investment Flows presented to the Working Group on Statistics (WGS) in October 1995.

2. For the recording of these instruments in the balance of payments, the key question is whether the underlying assets should be recorded as Portfolio Investment (like an outright sale or purchase of securities)or Other Investment (like a collateralised loan). The criteria which the Task Force have investigated as a means of answering this question are "change in ownership" and "accounting practices of banks", including the view of market participants.

3. This paper provides *firstly* a description of various instruments. *Secondly*, a harmonised method of recording for EMU balance of payments statistics is recommended. *Thirdly*, the reasons for these recommendations are outlined. The reasoning is based on discussions within the Task Force and on the written comments received from Member States. The current statistical treatment in Member States is indicated. This paper does not deal with valuation issues.

4. This full report incorporates preliminary comments from the Task Force on Money and Banking Statistics and Stage Two and Three Divisions of the Monetary Economic and Statistics Department of the EMI. However, they will need to give further consideration to those instruments (sell/buy back) where the recommendations included in this report do not lead to a common treatment at the EU level.

DESCRIPTION OF INSTRUMENTS

Repurchase agreements

5. Under a repurchase agreement (repo) the holder of a bond sells the bond for cash but agrees to repurchase the bond at a fixed price on a fixed date. There is a formal contract between the two parties, which sets out the legal standing of the transaction. In London and elsewhere, this is the PSA/ISMA Global Master Repurchase Agreement. The contract allows for margining, marking to market, collateral substitution and manufactured dividends.

6. If a coupon is paid during the life of the repo it is passed on to the original holder (lender) of the securities. Most of the coupon payments are made to the bearer at the coupon date. The back office settlements system will recognise the actual owner of the coupon payment. According to the ISMA contract the coupon is to be passed to the original owner on the day that it is received, by way of a manufactured dividend.

7. The Task Force agreed that, under a repo agreement, there is an *obligation* to return the securities. The Task Force labelled these instruments as "*genuine*" repurchase agreements. **This full report classifies only these "*genuine*" repos as repurchase agreements.**

8. The Task Force discovered that in some Member States instruments exist which appear to be similar to genuine repo agreements or have the same name, but under which an obligation to return the underlying securities does not apply; instead, there is an "option" to return them. These instruments are for example, "unechte Wertpapierpensionsgeschäfte" or "spurious" repurchase agreements" (Germany, Luxembourg, Austria and Italy), "Remeré" (France) and "outright sale with an option to buy back" (Denmark and Portugal). As the Task Force agreed that such transactions should be recorded under Portfolio Investment, the recommendations outlined below do not apply to them.

Sell/buy back transactions

9. Like repurchase agreements, sell/buy back transactions are often a way to raise or lend short term capital which is secured against securities sold or purchased. In contrast to repurchase agreements, the transaction is structured in two parts, a spot deal and a forward deal which are, however, executed simultaneously. The economic benefit of a coupon payment made during the duration of the transaction is the same as for repurchase agreements but the method of passing it is different. The main difference between repurchase agreements and sell/buy back transactions revolve around the settlement systems required for the two types of transactions. Repurchase agreements can be considered as a technical evolution of sell/buy back transactions.

10. The Task Force agreed that under a sell/buy back transaction, there is an obligation to return the securities.

Bond lending

11. Bond lending either involves the lending of securities (collateralised by cash or marketable paper) or the payment of the fee for the bonds lent with no capital transfer involved. The Task Force dealt with the first case only (most Members of the Task Force do not regard lending of securities without a collateral as a balance of payments transaction). Under lending of securities collateralised by cash or marketable paper, the borrower has the right to decide over these securities and may sell them to a third party. The borrower of the security can sell or hold these securities or deliver the

securities under a futures or options contract. The collateral, if cash, will most likely be invested and the borrower of the securities will be paid a rate of interest. Coupon payments on the bonds belong to the original owner.

12. Some Member States have a strong wish to make a distinction between bond lending against cash and bond lending against other assets. Bond lending against cash can be regarded as a "*reverse*" repurchase agreement. In fact, some Member States collect data only on bond lending against cash; bond lending against other assets is either difficult to capture statistically or is not regarded as a balance of payments transaction.

RECOMMENDED TREATMENT FOR EMU BALANCE OF PAYMENTS STATISTICS

13. **The Task Force recommends that the accounting practice of banks should be used as the guiding principle for the balance of payments treatment of repurchase agreements, sell/buy back transactions and bond lending rather than the change in ownership criterion. Where there is no accepted international accounting standard, the Task Force would encourage the adoption of a common practice which would suit statistical needs.**

14. **For repurchase agreements and bond lending, this recommendation leads to the recording of these instruments as collateralised loans.** All Member States, except Austria and Germany, follow this recommendation. Austria records at present repurchase agreements under Other Investment but will consider recording genuine repurchase agreements as collateralised loans following the treatment in the banking statistics. Concerning bond lending, data is available on bond lending without collateral and is included in the International Investment Position. Bond lending with collateral is not included in the balance of payments flow data. In Germany, bond lending (with and without collateral) is recorded as securities transactions in the balance of payments to reflect the change in the securities holdings shown in the banks' balance sheets.

15. **For sell/buy back transactions, reliance on banking accounting practices does not lead to a harmonised treatment at present.** Despite harmonisation efforts, national accounting practices diverge amongst Member States. In some Member States, banks regard these transactions as outright sales/purchases of securities, whereas in others these are considered as collateralised loans. The significance of these transactions in Member States varies. For those Member States where sell/buy back transactions are significant, it might be envisaged that, initially, data could be provided as supplementary information in the form of a memorandum item to the BOP statement. For some Member States this could only be provided in total (repos, bond lending and sell/buy backs), making no further distinction. **In the longer term, the Task Force would encourage the adoption of an international common accounting practice. The Task Force suggested that an appropriate forum for the discussion of these practices on repurschase agreements, bond lending and sell/buy back transaction would be the EMI Task Force on Money and Banking Statistics. It may be necessary to seek the support of other Sub-Committees and Working Groups.**

REASONING

16. The Task Force considered whether these transactions involve the outright sale/purchase of the underlying instruments or if these should be considered as collateralised loans. Two aspects were examined: (i) change in ownership and; (ii) accounting practice of banks including the view of market participants.

(i) Change in ownership

17. One of the criteria for the recording of the various instruments could be the change in ownership. If there is a change in ownership in the underlying assets, the transaction should be recorded under Portfolio Investment; if there is no change in ownership, the transaction should be recorded under Other Investment (i.e. as a collateralised loan). The Task Force considered it useful to make a distinction between *legal* ownership and *beneficial* ownership. Beneficial ownership means the right to the rewards of ownership (i.e. coupon payment or capital appreciation) or, negatively, the risks if the value of the asset deteriorates.

Repurchase agreements

18. With respect to repurchase agreements, the IMF Manual (5th edition) suggests no legal change in ownership of the underlying securities. It states that "securities often do not change hands and the buyer does not have the right to sell them. So, even in a legal sense, it is questionable whether or not a change of ownership occurs." (para 418). However, the Task Force found that, contrary to the statement in the IMF Manual, securities involved in the repurchase agreement often *do* change hands and the buyer *may* sell the securities during the life of the agreement.

19. The terms of the ISMA's Global Master Agreement (GMA) governing standard repo contracts were used for guidance in this respect. Paragraph 6(f) of the GMA suggests that the repo involves a legal change in ownership. It states that "the parties shall execute and deliver all necessary documents and take all necessary steps to procure that all right, title and interest in any Purchased Securities and any Equivalent Securities shall pass to the party to which the transfer is being made upon transfers of the same in accordance with this agreement free from all liens, claims, charges and encumbrances". However, other paragraphs (para 8 on "substitutability" and para 16 on "non-assignability") taken from the GMA seem to suggest that an effective change in ownership may not take place.

20. The Task Force agreed that where there is a change in legal ownership, it is only a *temporary* one and that the seller's retention of all rights to the coupon payments indicates no change in *beneficial* ownership.

Sell/buy back transactions

21. For sell/buy back transactions, an instrument which is not described in the IMF Manual, it is clear that there is an obligation to return the underlying securities. Legally, the seller gives up all rights of ownership to the bonds. However, the economic benefit (coupon payment) is passed to the seller (original stock holder) in the forward price. There are also some contracts known where the buyer has the right to the coupon interest on the securities bought during the life of the sell/buy back transaction.

Bond lending

22. Regarding bond lending, it has been suggested that these transactions should be regarded as transactions involving a change in ownership of the securities lent. This would imply that the transaction in collateral should be recorded under Portfolio Investment. However, a number of Member States do not agree with this view and argue that no change in ownership takes place.

It is difficult to determine whether a "change of ownership" takes place, legally or beneficially or both, under each of the above situations, so that a clear cut answer to the treatment cannot be achieved using this method. The Task Force concluded that the change in ownershipcriterion for the balance of payments treatment is not helpful in this respect.

(ii) Accounting practice of banks (market participants' view)

23. Accounting practices of banks provide a useful insight for the statistical treatment of instruments. If accounting practices treat a transaction as a collateralised loan this would indicate that the underlying financial instrument is *not* regarded as having been sold or purchased (article 12 (2) of the EC Directive 1986 no. 635) For balance of payments purposes, the financial transaction could, in such cases, be recorded under Other Investment.

Repurchase agreements

24. For repurchase agreements, the underlying assets of a repurchase agreement remain on the balance sheet of the original owner. This indicates that repos should be recorded under Other Investment (collateralised loans).

Sell/buy back transactions

25. Regarding sell/buy back transactions, the accounting practice of banks varies amongst Member States at present but generally follows an economic rationale consistent with the treatment of repurchase agreements. However, a harmonisation of the accounting practices could be assumed for the beginning of Stage Three and not only for statistical purposes.

Bond lending

26. As regards bond lending, in a majority of Member States, the bonds lent remain on the balance sheet of the original owner (as, for example, in the Netherlands, Ireland, and the United Kingdom). In Germany, the bonds lent are removed from the balance sheet.

The Task Force was in favour of following the accounting practices of banks in order to agree upon a treatment. This is mainly because banks are mostly involved in these types of transactions.

27. Some Member States mentioned that, for the statistical treatment of repurchase agreements, bond lending and sell/buy back transactions, it is useful to follow the economic nature of the transaction. It was stated by some Member States that market participants viewed the above instruments as being close substitutes for one another. The accounting practice of banks is seen as the best indication of economic nature/market perception of the nature of the transactions.

SUMMARY

28. For the recording of "genuine" repurchase agreements, sell/buy back transactions and bond lending in the balance of payments, the key question is whether the underlying assets should be recorded as Portfolio Investment or Other Investment. The criteria which the Task Force have investigated as a means of answering this question are "change in ownership" and "accounting practices of banks " including the view of market participants. Non-genuine repos are not addressed in this report.

29. The Task Force recommends that the accounting practices of banks should be used as the guiding principle for the balance of payments treatment of repurchase agreements, sell/buy back transactions and bond lending rather than the change in ownership criterion.

30. For repurchase agreements and bond lending, this recommendation leads to recording under Other Investment as collateralised loans in nearly all countries. For sell/buy back transactions, reliance on banking accounting practices does not lead to a harmonised treatment at present. Where there is no accepted international accounting standard, the Task Force would encourage the adoption of a common accounting practice. **The Task Force suggested that an appropriate forum for the address these practices of all instruments mentioned in this report would be the EMI Task Force on Money and Banking Statistics. It may be necessary to seek the support of other Sub-Committees and Working Groups.**