BOPCOM-05/26

Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005

Fee on Securities Lending and Reversible Gold Transactions

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

OUTCOME PAPER (BOPTEG) # 21

DECEMBER 2004

(1) Topic: **Income on Securities Lending and Reversible Gold Transactions**

(2) Issues – see BOPTEG Issues Paper # 21.

(3) Recommendations:

(i) A majority of BOPTEG members was of the view that the amount received by the owner of a security for making it available to another unit under a securities lending arrangement is property income. Among the reasons given were consistency with the definition of investment income as the return for provision of a financial asset, that the payment relates to the value and length of the agreement, that business accounts were built on the perception that it was an income, and a concern that there would be an extension of the production boundary if any owner (financial or nonfinancial enterprise or a household) of a security could potentially become a financial service provider.

(ii) A minority of members considered that the payment should be a service. Among the reasons were that the amount does not fit with existing definitions of dividends or interest, the payment could not be added to the value of the asset, and the payment is not associated with a liability.

(iii) It was recognized that amounts payable to a custodian for arranging a securities lending should be classified as a service. It was noted that in some cases, the payment may be made to the custodian, who charges the security owner less in return for the right to lend out the security.

(iv) Discussion on gold lending fees was not taken up, pending a discussion under issue # 27 on whether gold was a financial asset or not.

(4) Rejected Alternatives:

No members wished to classify the fees as a service if provided by a financial intermediary, but as income if provided by another entity.

An alternative approach was given in the ABS paper, based on the starting point that reversible transactions should be treated as outright sales with an associated derivative. As the treatment of reverse transactions differed from international standards and it involved an extension of the definition of derivatives, it was not taken up.

(5) Questions for the Committee:

(i) *Does the Committee consider that amounts payable to a security owner for provision of a security as investment income or a service? See above 3(i) and (ii).*

(ii) *Consequent to that decision, does Committee members have views on the particular type of income or service to which they should be classified? See above 3(i) and (ii).*

(iii) *Does the Committee have any views on the classification of gold lending fees? See above 3(iv).*

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUE PAPER 21

INCOME ON SECURITIES LENDING AND REVERSIBLE GOLD TRANSACTIONS

Prepared by Carlos Sánchez Muñoz[1]

European Central Bank

October 2004

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[1] The views expressed in this Paper are those of the author and do not necessarily represent those of the European Central Bank.

1. **Securities lending (borrowing)** consists of the delivery of securities for a given time period. Usually the borrowers (e.g. brokers) subsequently on-sell the securities outright to other clients. The ability of the borrower to on-sell the securities reflects that legal ownership is transferred to the borrower, while the economic risks and benefits of ownership remain with the original owner. In return, the "lender" receives a fee from the "borrower" for the use of the security.

2. **Gold loans** consist of the delivery of gold for a given time period. As in the previous case, legal ownership of the gold is transferred (the temporary borrower may on-sell the gold to a third party), but the risks and benefits of changes in the gold price remain with the lender. Gold borrowers (usually market dealers/brokers) often use these transactions to cover their sales to third parties in periods of (temporary) gold shortage. A comparable fee is paid to the original owner for the use of the gold.

3. In both types of transactions, the fee is justified by the transfer of the use of the financial instrument/gold from the original owner to the borrower. No exchange of cash takes place. Occasionally, some provision of collateral to the lender may guarantee that, when the transaction matures, the borrower will return the financial instrument to its original owner plus a fee previously agreed.[2] The amount of the fee is determined by the value of the underlying asset and the duration of the reversible transaction.

4. The difficulties associated with the treatment of the fee resulting from securities lending and reversible gold transactions were tackled in the framework of investigations concerning the treatment of repo-type transactions by a Technical Group on Reverse Transactions (TG-RT) mandated by the IMF BOP Committee. No clear-cut recommendation could be submitted by the TG-RT on this specific issue.

I. Current international standards for the statistical treatment of the issue

5. Neither the *Balance of Payments Manual, fifth edition (BPM5)* nor the *1993 System of National Accounts (1993 SNA)* explicitly tackle the issue nor provide any applicable recommendation.

II. Concerns/shortcomings of the current treatment

6. As stated before, international statistical standards do not provide any guidance for the statistical treatment of this issue. The lack of guidance may pave the way for heterogeneous treatments across countries/reporting economies.

III. Possible alternative treatments

7. The TG-TR considered two alternative treatments for the fee associated with securities lending and gold loans/deposits, namely as property (investment) income or as (financial) services.

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[2] Should cash be provided as collateral, both securities lending and gold loans are normally treated as repo-type operations in statistics.

Treatment as investment income

8. According to paragraph 272 of the BPM5, *"Investment income (property income in the SNA) covers income derived from a resident entity's ownership of foreign financial assets. (…) Interest is payable in accordance with a binding agreement between the creditor and the debtor".* [3]

9. The TG-TR considered that *property (investment) income* represents a return from the issuer/ borrower to the holder/lender for the right to use a non-produced (financial) asset; in *securities lending/borrowing* a non-produced asset (the security) is made available to the borrower, which pays the fee in return for the right to *use* the financial asset. These arguments were interpreted by the TG-RT as supportive to the treatment as property (investment) income.

10. However, the TG-TR also recognised that, should the treatment as income be the preferred one, determining the type of income would not be straight forward. Actually such "income" would have little to be with the underlying financial instrument. For example, in the event of equity securities lending, the fee associated with the transaction can hardly be treated as a dividend (only applicable to the original *issuer* of the equity). Even for debt securities, the treatment as income would be hazardous, since it cannot be classified together with the income accrued by the original holder (and payable by the issuer).

11. Accordingly, the TG-TR concluded that, should the treatment as income be selected, it would require the creation of a new income category, in the "(primary) income account". However, the annotated outline on the revision to the fifth edition of *BPM5* is proposing to structure the primary income account so that income items are explicitly linked to their associated asset on which the income is receivable/payable. "Other income" may be inappropriate as that would normally be expected to be linked to "other investment". If a separate income category for income to cover securities lending were to be created for the fee receivable/payable on securities lending, a different asset item may also be necessary.

12. Paragraph 4.41 of the European System of Accounts (ESA95) reads: "*Property income (D.4) is the income receivable by the owner of a* ***financial asset*** *or a tangible non-produced asset* ***in return for providing funds to****, or putting the tangible non-produced asset at the disposal of, another institutional unit."*

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[3] Further extracts from BPM5 paragraph 272: "*(…) The most common types of investment income are income on equity (dividends) and income on debt (interest). Dividends, including stock dividends, are the distributed earnings allocated to shares and other forms of participation in the equity of incorporated private enterprises, cooperatives, and public corporations. Dividends represent income that is payable without a binding agreement between the creditor and the debtor. Among other types of income on equity are (i) earnings of branches and other unincorporated direct investment enterprises and (ii) direct investors' shares of earnings of incorporated direct investment enterprises. (The latter type of earnings, which are not formally distributed, are earnings other than dividends.) Shares of reinvested earnings attributed to direct investors are proportionate to the participation of the direct investors in the equity of the enterprise. Also, in principle, income is imputed to households from net equity in life insurance reserves and pension funds and included indistinguishably under other investment. Interest, including discounts in lieu of interest, comprises income on loans and debt securities (i.e., bank deposits, bills, bonds, notes, and trade advances). Net interest flows arising from interest rate swaps also are included. (See paragraph 406.)*"

13. Following this guidance, the treatment as interest (property income) seems to require the provision of funds from the lender to the borrower. However, such provision of funds do not take place in the case of either securities lending or gold loans/deposits. Actually no transaction is recorded in the financial account, nor any outstanding position is recorded in the international investment position.

14. One additional difficulty of the treatment as property income would be the need to recognise an independent financial entry in the financial account. Income does not accrue on the financial instrument exchanged (i.e. on any newly created obligation of the issuer vis-à-vis the temporary holder of the security), but rather on the use of the instrument. Should such a fee be added to the value of the underlying instrument (i.e. either securities or gold) while applying the accruals principle, the final result would exceed the true (market) value of the instrument.

15. For all these reasons, the implementation of this solution (treatment as investment income) would require the previous recording of a transaction in the financial account. This requirement would not conform to current practices in statistics.

16. For gold loans, the TF-RT discussed whether gold can be considered as a financial asset, a commodity, or a service. Gold is unique in the *1993 SNA* and *BPM5*, in that it can be either a financial asset (monetary gold is included in *reserve assets*) or a commodity (all other uses), depending on which institutional unit holds it and the use to which it is being put. If a gold loan is undertaken so that the ultimate user (for whom the financial intermediary borrows it, in the first place) takes delivery of it as commodity gold, treating the fee payable/receivable as property income is inappropriate as the commodity is a produced asset and produced assets do not earn property (investment) income.

Treatment as financial service

17. Paragraph 258 of the BPM5 defines financial services in the following manner: *"Financial services covers financial intermediary and auxiliary services (except those of insurance enterprises and pension funds) conducted between residents and non-residents.(…)"*[4]

18. The TG-TR considered that, for the fee to be eligible for consideration as a financial service, some elements of securities lending should qualify to be considered as productive. Following this line of reasoning, the TG-TR intended to find out which productive activity could be assimilated to securities lending. The closest productive activity it found was *intermediation*, though the TG-TR finally recognised securities lending (i.e. the temporary cession of ownership on securities) did not belong in this productive activity.

[4] Further extracts from BPM5 paragraph 258: *"(…) Included are intermediary service fees, such as those associated with letters of credit, bankers' acceptances, lines of credit, financial leasing, and foreign exchange transactions. (For the latter, the spread between the midpoint rate and the buying or selling rate is the service charge.) Also included are commissions and other fees related to transactions in securities—brokerage, placements of issues, underwritings, redemptions, and arrangements of swaps, options, and other hedging instruments; commissions of commodity futures traders; and services related to asset management, financial market operational and regulatory services, security custody services, etc*

19. However, the TG-TR also recognised that the non-existence of an adequate description of a productive activity in which securities lending could be encompassed does not necessarily preclude it from being treated as a service. The report of the TG-TR to the BOPCOM suggested some parallel justifications which could be used to justify the treatment as financial services. For example, securities lending could be assimilated to market making (offers the borrower a facility different from the alternative of purchasing the security).

20. In the case of gold loans/deposits, the use of a produced asset in the *1993 SNA* is treated as a service. However, although the underlying nature of a gold loan is the same as securities lending, and both were deemed to be productive, the production from gold lending would be different from that from securities lending: it would be a service for the use of a produced asset, not the provision of liquidity to a financial market.

21. The TG-RT considered also a third blended possibility whereby the fee would be treated as a financial service if the "lender" happened to be a financial intermediary, and as property (investment) income in all other cases. No clear solution to the problems outlined for the treatment as investment income was envisaged. In the end, the TG-RT could not come up with any satisfactory recommendation.

22. All in all, it seems the TGRT had good arguments to reject the treatment of these fees as investment income. It is not as clear why the treatment as financial services was rejected, since no fundamental problem seems to derive from the text addressed to BOPCOM.

IV. Points for discussion

(1) What are the views of BOPTEG members concerning the three alternatives considered by the TG-RT for the treatment of the fees associated to securities lending, namely:

(i) Treatment as investment (property) income;

(ii) Treatment as financial service;

(iii) Blended approach whereby it would be treated as financial services if the "lender" were a financial intermediary, and as investment (property) income in all other cases.

(2) If securities lending fees are treated as investment (property) income, should they be classified as:

(i) interest or dividends, depending on the nature of the instrument provided by the fee recipient?

(ii) interest in all cases, regardless of the nature of the instrument provided by the fee recipient?

(iii) securities lending fees as a new income category?

(iv) some other treatment?

Note: Amounts payable on gold loans will be dealt with under the nonmonetary gold heading.

References

ECB, *The Statistical Treatment of Income Accruing on Securities Lending and Reversible Gold Transactions*, (document accompanying an official consultation letter addressed to the IMF Statistical Department in September 2000)

Technical Group on Reverse Transactions: Progress report to the 2003 meeting of the IMF Bop Committee (BOPCOM 2003/12) (http://www.imf.org/external/pubs/ft/bop/2003/03-12.pdf)

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

BOPTEG ISSUES PAPER # 21A

THE NATURE OF LEASE PAYMENTS ON GOLD LOANS

Prepared by International and Financial Accounts Branch
Australian Bureau of Statistics
November 2004

The Nature of Lease Payments on Gold Loans

Gold Loans

Gold loans or deposits are undertaken by monetary authorities to obtain a non-holding gain return on gold. The physical stock of gold is "lent to" or "deposited with" a financial institution (such as a bullion bank) or another party in the gold market (such as an intermediary for a gold dealer or gold miner with a temporary shortage of gold). In return, the borrower may provide the monetary authority with high quality collateral, but no cash, and will make a series of payments, known as lease payments.

The party who borrows the gold from a monetary authority may in turn "lend" the gold to a dealer or miner. This ability to on-lend indicates that, while the package of transactions which makes up a gold loan is clearly very different from an outright sale of the gold, the rights and privileges associated with ownership of the gold have changed from the monetary authority to the borrower. The loan or deposit may be placed on demand or for a fixed period. The amount of gold to be returned is based on the *volume* initially lent, regardless of any changes in the gold price.

The security and liquidity aspects of the monetary authority's gold loan claims on the depository corporations are regarded as a substitute for physical gold, such that the loan values are retained within the monetary authority's monetary gold reserves, leaving monetary gold stocks unchanged. If the loan is for a fixed period, it is usually available on short notice, to help meet the criteria for inclusion in reserve assets.

Gold loans or deposits share many of the characteristics of securities repurchase agreements (repos) and securities lending, the statistical treatment of which has proved intractable.

Gold Swaps

In order to analyse gold loans, it is useful to first understand gold swaps.

A gold swap involves an exchange of gold for foreign exchange deposits, with an agreement that the transaction be unwound at an agreed future date, at an agreed price. Gold swaps are usually undertaken between monetary authorities, although gold swaps sometimes involve transactions when one of the parties is not a monetary authority. In this case, the other party is usually a depository corporation.

Gold swaps are undertaken when the cash-taking monetary authority has need of foreign exchange but does not wish to sell outright its gold holdings. The monetary authority acquiring the foreign exchange pays an agreed rate, known as the gold forward rate. At maturity, the *volume* of gold returned is the same as that swapped, while the *value* of the foreign exchange - as determined at the time of initiation of the swap - is returned.

While, because of the limited number of players, gold swaps are unlikely to be tradable, they have all of the other characteristics of a financial derivative. The gold forward rate, which determines the payments associated with a gold swap, is set taking into account current and expected interest rates and gold prices. If gold swaps are considered financial derivatives, in

statistical terms the payments associated with a gold swap are transactions in a financial derivative. Otherwise, the payments may be considered margin payments on a forward contract.

Components of a Gold Loan

A gold loan can be seen as a gold swap where the borrower of the gold provides no foreign exchange in exchange for the transfer of the gold. That is, a gold loan is a gold swap with an extra leg, whereby the gold lender lends the money received back to the gold borrower.

In order to gain an understanding of a gold loan, it is useful to separate it into three parts:

1. Change of Ownership of Gold - the monetary authority transfers the physical stock of gold to the borrower. The borrower can (and usually does) sell the gold to a third party.

2. Loan - as the borrower has ownership of the gold but has not paid for it, the monetary authority is deemed to have issued a loan to the borrower equal to the value of the gold. The borrower has a loan liability to the monetary authority.

3. Forward Contract - the borrower enters into a forward contract to deliver the original quantity of gold borrowed, to the monetary authority when the gold loan matures. At the maturity date, the monetary authority extinguishes the loan claim on the borrower in exchange for the receipt of the borrowed gold.

Analysing these components helps to understand the multiple positions and flows which are combined to make up a gold loan, and hence to understand the nature of the loan and the lease payments.

Lease Rates

In the case of a gold swap, the gold lender (cash taker) makes payments at an agreed rate, the gold forward rate, to the gold borrower.

If the above view of gold loans is correct, one component of the lease payments is the same payments as in a swap, but these are more than offset by interest on the loan going in the other direction, resulting in a net payment by the gold borrower to the gold lender (the opposite direction of the payment under a swap).

These payments are called gold lease payments and, according to the above view of gold loans, are made up of:

- interest on the loan, and
- transactions in a financial derivative or margin payments on a forward contract.

To test the validity of this view, it is useful to look at how gold lease rates are determined in the market:

Gold lease rate = LIBOR - GOFO rate

LIBOR is the London Inter-Bank Offered Rate, a widely used international risk-free interest rate.

The GOFO rate is the Gold Forward Offered rate, which is the rate at which contributors (the market making members of the London Bullion Market Association) are prepared to swap gold against US dollars.

The charts below show the daily gold price and the daily one year LIBOR, GOFO, and gold lease rates over the past seven years.

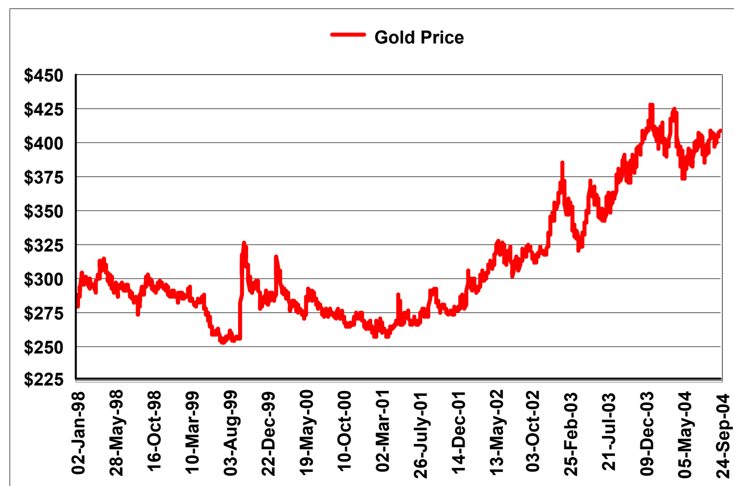

Chart 1: Daily Gold Price from 02/01/98 to 24/09/04
Source: www.lbma.org.uk

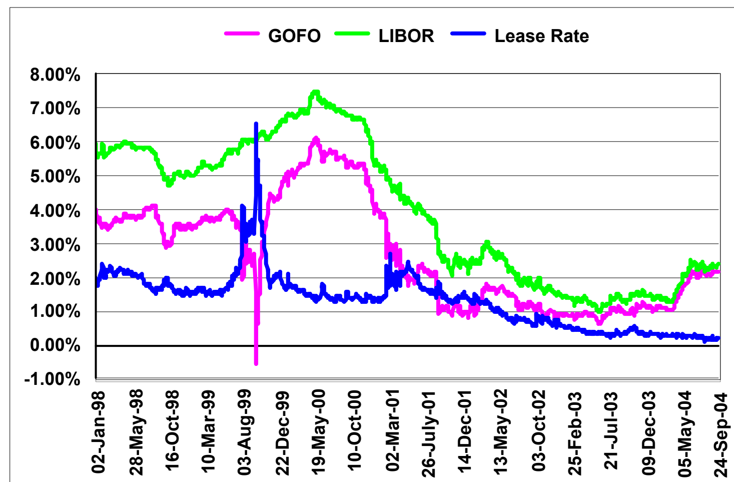

Chart 2: Daily One Year GOFO, LIBOR, and Gold Lease Rates
from 02/01/98 to 24/09/04
Source: www.lbma.org.uk

The relationship of LIBOR and the GOFO rate to the lease rate is shown in Chart 2.

Comparing Chart 1 and Chart 2 shows that the gap between GOFO and LIBOR is significant in times of falling gold prices, and GOFO approaches LIBOR in times of rising gold prices.

The composition of the lease rate supports the view of the components of a gold loan outlined above. The payment of interest indicates the existence of a loan and the use of the GOFO rate indicates the existence of a gold swap.

Conclusion

The topic of this paper is the treatment of the lease payments on gold loans. The analysis of the positions and the flows has been done together as it is not possible to draw conclusions on the nature of the flows without looking at the positions to which they relate.

The description of components of a gold loan in this paper is likely to be controversial given the state of the overall debate on reverse transactions, but it is hopefully a useful contribution to that debate. The empirical support lent by the derivation of the lease rate, that is that the loan is seen by those setting the rate as a loan and a swap, may prove useful in that debate.

The conclusion on the nature of the lease payments is that they are the net of two flows, interest on a loan and transactions in a financial derivative or margin payments on a forward contract. These should be recorded separately.

Points for Discussion

1. Do BOPTEG members agree that, in interpreting reverse transactions, both positions and flows need to be taken into account?

2. Do BOPTEG members agree with the interpretation of gold loans and the associated income flows outlined in this paper?

References

BOPCOM 01-16: The Macroeconomic Statistical Treatment of Reverse Transactions, IMF, 2001.

London Bullion Market Association, www.lbma.org.uk