

Background document for the CMFB on UK's "Special Liquidity Scheme"

Executive summary

The UK introduced a temporary scheme – the Special Liquidity Scheme - in April 2008, in response to difficulties experienced by banks in providing acceptable collateral for their borrowing. This scheme has just closed to new applications and was very sizeable.

In short, the scheme works as follows. The government loans securities to the Central Bank. The government does not receive cash or securities in return, but only a service fee. The Central Bank swaps the government securities against AAA-rated collateral held by commercial banks, charging a service fee. The commercial banks can use these government securities as collateral in their money market borrowing or sell the government securities. The government securities (or similar ones) have to be returned to the Central Bank at the maturity of the exchange. There is an indemnity given by the government, which covers any loss on the overall scheme, but not losses on individual participating banks. The Central Bank also takes precautions against losses by setting the required collateral above the value of the government securities.

There are two main steps identified in this consultation to be analysed in statistical recording – the provision of government securities by the government to the Central Bank, and the subsequent exchange of government securities against AAA-rated securities with commercial banks. For both steps the main issue to determine is whether or not the existing statistical guidance (in the ESA95 Manual on Government Deficit and Debt, and in other statistical standards) is applicable to the Special Liquidity Scheme. In this framework, it is important to recall a principle of ESA95 that economic substance should be emphasised over legal form, leading to similar statistical recording for similar operations.

The existing guidance for securities lending without a flow in cash is that the securities should remain on the balance sheet of the lender, based on the rationale that there is a firm commitment concerning the reverse transactions and therefore there is no definitive change of economic ownership. Should this guidance be applied to both steps, then UK consolidated gross general government debt would not be affected.

However there are some specific features of the Special Liquidity Scheme which may call into question the direct application of the statistical guidance mentioned above, notably that in this case the government lends its own securities (not the securities of third parties), that the scheme is designed to operate over a significantly longer period of time than is usually the case in securities lending operations, and that there is a government indemnity (guarantee) for any net loss under the scheme. There is also a general question whether the issue of a large amount of new government securities (13% of GDP), and their subsequent appearance in the financial markets when banks sell them or use them as collateral, should give rise to statistical recording which does not include the securities in government consolidated gross debt.

If the above arguments lead to the government securities being recorded on the Central Bank's national accounts balance sheet, the implication would be a substantial rise in UK consolidated gross general government debt during the application period for the scheme, followed by a fall in debt when the government securities are returned to government.

The two questions arising from this scheme, to be answered by CMFB members, are set out below:

Question 1: How should the provision of securities by the UK government to the Central Bank under the Special Liquidity Scheme be recorded (stage 1)?

(See Background document, paragraph 5.1-5.16, and 6.29)

	Only one option (X)
a) Option 1 nothing, stock-lending with no cash, with no increase of government debt.	
b) Option 2 impute an issue of government securities, and their subsequent purchase by the central bank, thereby increasing government debt.	
c) Another option (please specify in comments)	
d) No opinion	

Question 2: How should the exchange of assets between the UK Central Bank and banks participating in the Special Liquidity Scheme (stage 2) be recorded?

(See Background document paragraph 6.1-6.30)

	Only one option (X)
a) Option 1 - as back-to-back repos	
b) Option 2 - record nothing, as stock-lending with no cash	
c) Another option (please specify in comments)	
d) No opinion	

Please note that there is a link between the two questions, as described in paragraph 6.29 of this document.

1. Background

- 1.1 One major feature to emerge in the United Kingdom (as elsewhere) during the ongoing financial turmoil was that uncertainties about the valuation of assets in bank balance sheets led to uncertainty about their financial positions. As a result they were reluctant to lend to each other on the inter-bank market, and this had started to affect their willingness to lend money to individuals and businesses. By April 2008 it was clear that there was no immediate prospect that markets in mortgage-backed securities would operate normally. The Bank of England judged that the situation would improve only by dealing with the problem of illiquid assets on banks' balance sheets.
- 1.2 Following a series of rumours about the solvency of major banks, the Governor of the Bank of England decided to act¹. On 21 April 2008 the Bank of England announced the "Special Liquidity Scheme" (SLS) whereby banks and building societies could "swap"² illiquid assets for UK government securities. The scheme is limited to assets existing on banks' balance sheets before end-December 2007, or securities formed from them. The banks could then use the government bills as security to borrow against. The scheme started immediately, had a six-month period for applications (this so-called "Drawdown Period" was subsequently extended by three months), and then runs for three years afterwards. The scheme has just closed to new applications and during the period some UKL 185 billion (around 13% of GDP) of government bills were provided.
- 1.3 One reason for the design of the scheme as a "collateral exchange" was that it was designed to avoid statutory disclosure requirements. The avoidance of disclosure is designed to protect the stability of the financial system - if banks need to approach the Bank of England they want to do so in privacy, because they are concerned about being identified as potentially in trouble.
- 1.4 The Special Liquidity Scheme was designed as a temporary scheme. It is nevertheless assumed that a decision on the statistical classification of the SLS would be applicable to any permanent schemes with similar characteristics.

2. Problem statement - Overview of the SLS

- 2.1 The scheme can be divided into three main stages³:

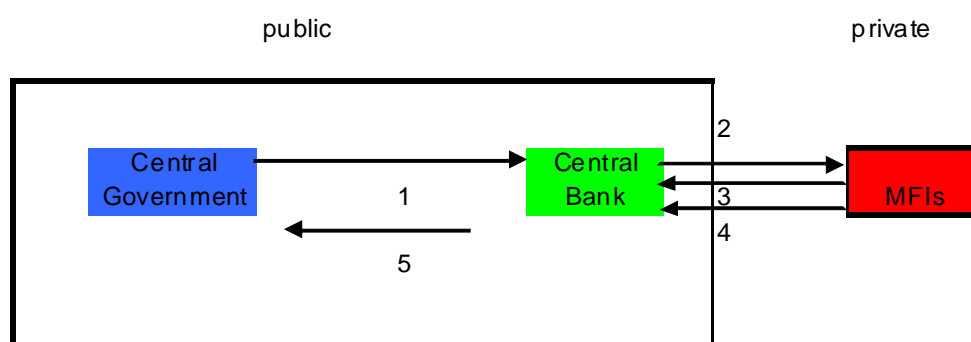
¹ Newspaper reports have indicated that the Governor initiated the design of the scheme, and thus it was a Bank of England initiative. The possible option of re-arranging the transactions concerned, should transactions be recorded in the accounts, is therefore not considered further in this document.

² "swap" is written in inverted commas to differentiate the terminology from that used in the National Accounts definition of a financial derivative swap. The term exchange is generally used instead of swap in this document for that reason. However, media coverage has generally used the term swap.

³ The first two stages of the operation could in theory have been undertaken in a single stage, directly between government and the commercial banks, however this is not the case in the SLS. Some EU governments have addressed similar liquidity difficulties by purchasing illiquid bank assets – see the other CMFB consultation document for further information. It could be argued that all these types of operation should be recorded in the same way in national accounts, however this issue is not further analysed in this paper.

- Stage 1: government "issues" securities to the central bank.
- Stage 2: the central bank exchanges these assets with participating banks' assets, charging a fee for doing so.
- Stage 3: the banks now legally own sufficient quality assets to use as collateral to borrow against in the markets, allowing these markets to return to action.

2.2 It is just stages 1 and 2 that are analysed here. One important consideration is that the central bank's role at stage 2 is indemnified by government. The recording of stage 2 of the transaction is influenced by the recording of stage 1, therefore the recording of both these steps needs to be decided (see the paragraph at the end of this document).



- 1 Government issues securities, 'acquire'd by central bank.
- 2 MFIs 'acquire' government securities from central bank
- 3 Central bank 'acquires' assets from MFIs
- 4 MFIs pay fees to central bank
- 5 Central bank pays fees to government

3. Detailed description of each stage

Stage 1: Government issuance of securities

3.1.1 The National Loans Fund (NLF, part of central government) issues nine-month maturity UK Treasury Bills. The Debt Management Office (also part of central government) buys the bills from the National Loans Fund⁴ and supplies the central bank with the necessary government securities for the scheme.

3.1.2 The Treasury Bills will not be issued directly to the market, although the issuance will be at market rates. The Debt Management Office loans them to the central bank in a stock-lending arrangement, and no cash is paid for them.

⁴ The Debt Management Office borrows from the National Loans Fund on an ongoing basis for a variety of reasons, and uses the cash from this borrowing to finance the purchase of the Treasury Bills for this scheme. These are all internal transactions within the UK Central Government.

- 3.1.3 Stock-lending is the temporary transfer of securities with agreement for their return at a pre-agreed time. Here that time is just prior to their 9-month conventional redemption time.
- 3.1.4 The Treasury Bills will be fungible (exchangeable or substitutable) with 6-month, 3-month and 1-month Treasury Bills, issued through the Debt Management Office's regular sales of Treasury Bills, at the appropriate time of remaining maturity.
- 3.1.5 Although legal ownership of the bills passes to the central bank under the stock-lending transaction, there are no cash transactions (apart from the fee) and hence the Debt Management Office retains the cash 'interest' that would usually accrue to the holder on redemption.
- 3.1.6 Once a participating bank has subsequently entered into an asset exchange with the central bank, it is free to use the borrowed government securities as collateral in a repo (repurchase agreement) at stage 3 or to sell them outright on secondary markets. If it does sell them outright, it is still obliged to return securities to the central bank, so will need to buy an equivalent amount of securities from the market (or issuer) before the 'swap' is reversed with the central bank, and before the time when the central bank has to reverse the stock-lending with government.

Stage 2: The collateral asset exchange

- 3.2.1 The government securities will be exchanged for participating banks' eligible assets⁵. Legal ownership of the securities and assets will transfer. Economic ownership remains with the original asset holders.

Timing and maturity

- 3.2.2 Participating banks were able to enter into new asset exchanges at any point during a period starting from 21 April 2008 until 30 January 2009. The scheme operates for three years after the end of this initial period.
- 3.2.3 These exchanges will be for a term of one year or the maturity of the collateralised asset, whichever is shorter. Participating banks will be able, at the discretion of the central bank, to renew the exchange each year while the scheme is still in operation. After that, the scheme will close. So, should the markets recover and the scheme be no longer necessary, the central bank can effectively stop the scheme at the next annual roll-over point.

Valuation

- 3.2.4 The market value of both government and collateralised securities will be valued by the central bank, using observed market prices.

⁵ There is a detailed list of eligible assets, however this is not strictly relevant for statistical recording purposes.

- 3.2.5 If an independent market price is unavailable the central bank will use its own calculated price. In practice an observable market price will exist for securities in the scheme. The one exception is where a bank takes its own assets on balance sheet (such as mortgage or credit card assets), securitises them through its usual securitisation SPV(s) and then buys the resulting bonds so they can be used in the scheme. As this issue of bonds is exclusively for use in creating collateral for the scheme, it won't have a market value.
- 3.2.6 The value of the underlying assets will be marked to market on a daily basis and differences will be corrected for via a margin account. This is intended to ensure that the discounted expected value of the exchange will always be zero. These margin payments are not in cash. They involve the participating banks adding more collateral if required, known as 'margin securities'. If the market moves so that participating banks have too much collateral they may withdraw margin securities but not the original collateral. Similarly, if the market moves in this way, the central bank does not provide additional government securities.
- 3.2.7 The central bank may call a default if the participating bank fails to supply margin securities on the day they are requested.

Service Fee

- 3.2.8 Participating banks will pay a fee to the central bank for the financial services provided. This fee should not be confused with the "haircut". The central bank pays a fee to the government (the Debt Management Office) – this fee, which is fixed (and at present significantly less than the service fees paid by participating banks), is based on standard terms for borrowing government securities.

Haircut

- 3.2.9 The "haircut" is the percentage discount applied to the values of the banks' assets being 'swapped' under the scheme vis-à-vis the Treasury Bills received – the SLS sets out clearly the appropriate formula. This means that participating banks need to provide the central bank with assets of greater value than the government securities they receive, with more assets to be provided, or government securities returned, if the value of the assets were to fall.
- 3.2.10 There are no cash payments for the haircut.
- 3.2.11 The haircut is designed to ensure that in the event of a default by a participating bank, the realisable value of the collateral should be sufficient to cover the amount due from them.

Conditions

- 3.2.12 Participating banks will initially provide the central bank with assets of significantly greater value than the government securities they have received. If the credit ratings on banks' assets pledged as securities are downgraded, the banks would need to replace them with alternative highly-rated assets, or return some of the government securities.
- 3.2.13 One scenario here is what would happen if a participating bank could not provide alternative assets and has already repo'd or sold its government securities and could not get the originals or replacements? In this case the participating bank would be in default to the central bank. The central bank would keep the collateralised assets, and purchase new government securities to replace those it needs to return.

Interest

- 3.2.14 Under the terms of the asset exchange, the cash interest earned on the collateral will be received by the central bank as its legal owner. The central bank will pass it through to the participating banks immediately. Similarly, the scheme details state that any interest on the government securities will be receivable by the participating banks, which would pass it through to the central bank. However, the interest on Treasury Bills is rolled up into the redemption payment and they are always returned before the redemption date, so no cash will flow from central government and hence there is not interest to be returned.

4. Government indemnity

- 4.1 The participating banks retain responsibility for any losses on their collateralised assets, and the haircut is set at a level so the central bank should not lose. However, given its scale in relation to the central bank's balance sheet, the scheme is indemnified by UK Government (the Treasury). No fee is charged for the indemnity.
- 4.2 The scheme is designed to avoid the public sector taking on the risk of potential losses. The scheme is only exposed to potential loss if a participating bank defaulted and the realizable value of its collateral became less than the value of the government securities it had been loaned.
- 4.3 The indemnity covers loss on the overall scheme, not losses on individual participating banks.

5. National accounts recording for Government issuance of securities

- 5.1 A conventional issue of short-term (up to 1 year) maturity government securities would be recorded in the financial account in the F.331 transaction category; as a government liability and an asset of the holder. The accounts would be balanced by a transaction in cash (F.2).

- 5.2 The classification question here is whether (and if so, how) to record any transaction between central government and central bank.
- 5.3 ESA95 paragraph 5.64a states that AF.332 long-term securities “lent or subject to repurchase does not change balance sheet and remains classified in AF.332.” This is included in the description of the AF.332 category because these are the types of securities usually associated with such an exchange but as other types of assets can be used the guidance could probably be extended to also cover AF.331 short-term securities.
- 5.4 While the classification category of the government securities will indisputably remain as AF.331 if recognised, the guidance suggests that under normal circumstances the asset holding of the securities does not change to the central bank sub-sector’s balance sheet. There are however arguments, explored later, that consider the situation to be different from a conventional stock-lending or repo transaction.
- 5.5 Eurostat's *Manual on Government Deficit and Debt (MGDD)*, Part V Section 3 states:

Securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of “loan in materials” that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan “...when creditors lend funds to debtors”. No transaction should affect the financial accounts (stocks and flows).

Generally, in the accounting system of the contracting parties there is no effect on the balance sheet but possibly an entry in the “off-balance sheet” in order to record the forward reverse transaction. But in some countries, portfolios reflect directly the transaction. Two cases should be distinguished.

Where the distinction between securities lending with cash and without cash is available, it would be better classifying the latter transaction under “other accounts receivable/payable” and not under deposits or loans.

- 5.6 This recommended treatment is consistent with the guidance in statistical manuals outside of national accounts - the IMF Balance of Payments Manual (6 Edition) paragraphs 7.58 to 7.61 and the “Statistical Treatment of the Eurosystem’s international Reserves” (ECB, October 2000):

In 7.58 it is stated that in reverse transactions in securities “no transaction in the security is recorded and the ownership of the assets as shown in the IIP is unchanged.

Par.7.59 specifies that only if the reverse transaction in security is accompanied by the supply of cash, then a loan or deposit has to be

recorded. Securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of “loan in materials” that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan “...when creditors lend funds to debtors” No transaction should affect the financial accounts (stocks and flows).

Finally, par. 7.61 states that “if a party that receives securities under a reverse transaction on-sells the securities to a third party, then it has a short position”. Par 7.28 explains that “the party with the short position records a negative value for the holding of the asset. The short position is shown as a negative asset, rather than a liability”.

- 5.7 Finally it may be noted that the same recording and rationale are used to record securities lending without cash collateral in monetary statistics, as contained in the relevant amended ECB BSI Regulation:

In page 18 it is stated that in the case of “Lending of securities without cash collateral or against securities collateral (exchange of assets), neither the lending/borrowing of the securities nor the possible posting of securities collateral gives rise to entry for any of the counterparties. When the borrower of the securities sells them during the lending period (shorts the securities), it records a negative position in the securities portfolio for the shorted securities.

- 5.8 So, the guidance in the MGDD could be interpreted as recording no transactions between central government and central bank for the stock-lending of the government securities in this case. *[option 1]*
- 5.9 However, 'very short maturity' is not defined - the convention for short is less than one year, so it is probably reasonable and appropriate for very short to be interpreted as less than one month or even less. In stock-lending transactions such as repurchase agreements (repos) the maturity can often be as short as overnight or the following day, whereas the maturity here is 9 months (and in addition the operation can be rolled over with new securities). It is possible that the situation described in the manual was only referring to the overnight or following day type of transaction at the time in which the manual was drafted. Conversely, the generality does not rule out longer periods of maturity.
- 5.10 Similarly, another major difference from the conventional situation is that stock-lending usually takes place using assets issued by another entity, since an entity's securities cannot be used as collateral for its own borrowing. While from an institutional unit viewpoint this does occur here, from a National Accounts sectoral viewpoint it is not the case: the transaction within government is consolidated and hence the securities do not appear in the accounts. This leads to central government lending its own “assets”, created specifically for this purpose, which are not recorded in its consolidated balance sheet. So, while the manual does not explicitly rule out such a situation, it is open to interpretation whether this type of stock-lending is the

one envisaged by the manual or not. Conversely, the stock-lending of own assets could still be viewed as “lending of materials”.

- 5.11 A further issue to be analysed is the existence of a government guarantee on the central bank's SLS operation (more precisely, on all its residual risks) and the fees paid to government by the central bank. It may be questioned if it is reasonable that calls on the guarantee and such fees are recorded when the underlying assets covered by the scheme are not themselves recorded in the system.
- 5.12 Finally, it is questionable whether the statistical treatment of the operation as securities lending reflects the economic reality when considering the whole scheme. The economic reality seems to be some very large underlying flows designed (for policy reasons) to have the effect of enabling further market activity, and most likely some or all of the securities created may circulate in the financial markets. It may be argued that the national accounts rules on stock-lending were created to be applied to market-based transactions, not to large-scale interventions for public policy purposes. Is it credible to record nothing in this situation?
- 5.13 As an alternative to recording nothing, therefore, an issue of the government security and a purchase of it by the central bank could be imputed. *[option 2]*
- 5.14 Thus the key question to be answered here is if the first stage can be interpreted statistically as stock-lending with no cash, where the existing statistical guidance is clear (the economic ownership of the securities does not change), or if the nature of the specific operation leads to the view that the economic ownership of the government securities does change (i.e. the Bank of England owns the securities).
- 5.15 For EDP purposes there would be an increase in government debt from option 2 but not option 1. This is because under option 1 the securities remain government-owned and are therefore consolidated out of the measure of debt. Under option 2, at the maturity of the scheme the return of the government securities to government would lead to a consequent fall in government debt.
- 5.16 For the counterpart transaction in the national accounts of the option 2 imputation there are a number of sub-options. It is however recommended that the most appropriate would be an imputed F.512 injection of equity into the central bank (with a withdrawal of equity when the government security is returned), since this reflects that instead of the SLS, government could have made a capital injection to the Central Bank to allow it to purchase the government securities.

Question 1: How should the provision of securities by the UK government to the Central Bank under the Special Liquidity Scheme be recorded (stage 1)?

(See paragraphs 5.1-5.16, and 6.29)

	Only one option (X)
a) Option 1 nothing, stock-lending with no cash, with no increase of government debt.	
b) Option 2 impute an issue of government securities, and their subsequent purchase by the central bank, thereby increasing government debt.	
c) Another option (please specify in comments)	
d) No opinion	

6. National accounts recording of the collateral asset exchange between central bank and participating banks

6.1 ESA95 paragraphs 5.02-5.04 provide general information on financial transactions.

5.02. Considering the definition of a transaction (see paragraph 1.33), a financial transaction is an interaction between institutional units ... by mutual agreement, involving a simultaneous creation or liquidation of a financial asset and the counterpart liability, or a change in ownership of a financial asset, or an assumption of a liability.

5.03. Financial assets are economic assets, comprising means of payment, financial claims and economic assets which are close to financial claims in nature.

5.04. Means of payment consist of monetary gold, special drawing rights, currency and transferable deposits.

Financial claims entitle their owners, the creditors, to receive a payment or series of payments without any counter-performance from other institutional units, the debtors, who have incurred the counterpart liabilities.

Examples of economic assets which are close to financial claims in nature are shares and other equity and partly contingent assets. The institutional unit issuing such a financial asset is considered to have incurred a counterpart liability.

6.2 As noted in paragraph 5.7 above, the statistical recording in the ECB's BSI regulation applicable to securities lending against securities collateral (exchange of assets) is identical to the treatment of securities lending without cash collateral, namely that no entries are recorded in securities for any of the counterparties.

6.3 Although there is a legal transfer of ownership of the underlying assets, for a sale of assets to be recorded in National Accounts there needs to be an exchange of economic ownership.

6.4 The participating banks are still responsible for any losses on their securities used in the scheme. Additionally, the interest earned on the collateralised assets will be received by the central bank, which will pass it through to the participating banks immediately.

6.5 Both of these factors indicate that it is not really an exchange of assets as recognised in National Accounts. As the economic reality is not one of transfer of economic ownership, there should not be a recording of two simultaneous financial transactions exchanging the assets. Accordingly, the government securities involved in the asset exchange between the central

bank and the participating banks would not be recorded in either of their balance sheets.

- 6.6 There are two remaining recording possibilities: recording as back-to-back repos [option 1], or not recording anything [option 2].

Recording as a back-to-back repos [option 1]

- 6.7 Repurchase agreements (repos) are financial arrangements whereby a seller "sells" securities (typically government bills and bonds, or corporate bonds or shares) that it owns to another (the buyer, usually a bank). The 'sale' is made under a commitment to 'repurchase' the same (or similar) securities at a fixed price on a specified future date, or a date subject to the discretion of the buyer. Repos are usually very short-term, such as overnight or one day maturity.
- 6.8 The difference between the sum at which the asset is 'sold' and 'repurchased' is called the repo rate. It is effectively an interest rate. In a repo of reasonable maturity the cash interest is usually paid at the end, although it can be paid throughout. In National Accounts interest is accrued.
- 6.9 A repo differs marginally from a collateralised loan. In a collateralised loan the borrower places the collateral assets under a lien (right to take a property if an obligation is not fulfilled) to the lender. Physical possession of the collateral assets is with the lender during the period of the loan. When it is fully settled, the borrower gets ownership of the collateral assets back. If the borrower fails to clear the loan, the lender can dispose of the collateral assets to recover what they are due. If the disposal provides amounts that are insufficient to meet what was due, the lender has the legal right to recover the balance from the borrower.
- 6.10 For a repo, if the borrower defaults on repurchasing the securities, then the lender (also known as the repo buyer) can liquidate these assets. If the value of the securities has impaired, they stand to make a loss and can't recover this from the borrower. If there is a default and the market value of the assets has risen, they will make a profit. Thus, a repo carries more risk for the bank than a collateral loan does. Normally, repos are over-collateralised to reduce the amount of risk involved.
- 6.11 In most repos the securities do not actually change legal ownership and the buyer does not have the right to sell them onto a third party.
- 6.12 Each leg of the Special Liquidity Scheme could be viewed as involving two separate financial transactions: the sale and repurchase of the underlying asset. Its economic nature has similarities to both a collateralised loan and repo in that the 'lender' party appears to provide advances, secured on assets as collateral, and agrees a fixed price return at the time of the repurchase. The advances and return are not observed because they are offset by a similar transaction going in the opposite direction. In the Special Liquidity Scheme the securities do change legal ownership and the participating banks do have

the right to sell them onto a third party, as long as they return similar securities at the time of redemption. In assessing the risk if there is a default the scheme is more like a repo than a collateralised loan.

- 6.13 In National Accounts the underlying asset in a repo is deemed not to have been sold, and the economic reality recorded is that of an F.4 loan in the financial account (unless it is a short-term repo where an MFI is the seller, in which case it is recorded as an F.29 deposit). The value of the loan can be seen to be the 'adjusted market value' of the securities, where the adjustment represents the risk factor present in the repo rate.
- 6.14 One factor to consider here is the distinction between economic and legal ownership. A repo, or collateralised loan, involves the transfer of underlying assets that are legally owned. A question to be asked is if National Accounts recognise a repo or loan of assets where the seller does not economically own the assets and hence they are not part of the entity's National Accounts balance sheet (or in this case not actually recorded in the National Accounts at all)? This links back to the first question, as although the central bank is the legal owner of the government securities, the first question is trying to determine whether they should be considered the economic owners. ECB guidance, reproduced later in this section, states “[securities lent out under securities lending operations should remain on the original owners balance sheet](#)”, whereas it is the case here that if an economic sale is not imputed they would not be on the balance sheet in the first place, and hence can not remain there.
- 6.15 If the ‘record nothing’ option is chosen, there is a further issue. Banks have created certain types of securities to exchange in the scheme that are not recognised as assets in National Accounts. For these securities the ESA95 paragraph 5.64a point about whether the stock-lending rules allow this situation is relevant, because it says that the stock lent does not change balance sheet but remains classified in AF.332 (i.e. it should be recorded in national accounts).
- 6.16 If the classification as a repo is appropriate and assuming the transactions are not re-routed via other sectors, two repos could be recorded. Both parties to the repo are MFIs (one central bank, S.121, and one 'other', S.122) and both repo loans are short-term. Hence, both would be recorded in F.29.

<u>Loan's underlying asset</u>	<u>S.121</u>	<u>S.122</u>
Government security	asset	liab
Asset Backed Security	liab	asset

- 6.17 The key extracts of the Manual on Government Deficit and Debt Part V Section 3 on this point are:

2) [The difference between the selling price and the repurchasing price should be recorded as interest, on an accrual basis, and included in property income.](#)

- 4) The treatment specified in ESA95 for repos is applicable only in the case the original seller of the asset has an unquestionable commitment to repurchase it under conditions agreed at inception.
- 6) In the case an economic agent resells an asset "acquired" under a repo arrangement, a negative entry is recorded in his balance sheet.
- 7) Only securities lending with cash may be treated in a similar way to repos.

Where there is an effective flow of cash, it is clear, from an economic point of view, that the case is very similar to a repurchase agreement transaction. There is no definitive change of ownership and there is a firm commitment concerning the reverse transaction on securities. Thus, the transaction should be recorded in loans or deposits, according to the general rules mentioned above.

On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of "loan in materials" that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan "...when creditors lend funds to debtors". No transaction should affect the financial accounts (stocks and flows).

Where the distinction [between securities lending with cash and without cash] is not available, the treatment would depend on the estimated share (through specific information) of each kind of transaction within the global figures. It may be assumed that only a minority of these transactions is cash-free. Thus, in absence of reliable data, a "repo-like" treatment could be applied for the whole.

- 6.18 Similarly, the ECB guidance notes to the regulation ECB/2001/13 on the MFI balance sheet statistics states (paragraph 110-112)

Securities lending without cash collateral

110. Securities lending without cash collateral involves one party lending securities to another party with a firm commitment to the return of the same (or similar) securities on a specified future date. Contrary to repo-like operations ... there is no exchange of cash collateral - either the collateral takes the form of other assets or there is no collateral at all.

111. For the purposes of euro area money and banking statistics, securities lending operations without cash collateral should not give rise to any entries on the balance sheet (i.e. should be treated as off balance sheet operations). To maintain consistency with the treatment of repo-type operations, securities lent out under securities lending operations should remain on the original owners balance sheet (and are not to be transferred to the balance sheet of the temporary acquirer) where there is a firm commitment to reverse the operation

Furthermore, as cash (representing repayable collateral) has not been passed from the temporary acquirer to the original owner, no entries are to be made under 'deposits' or 'loans'.

112. If the temporary acquirer sells the securities outright, this sale should be recorded as a transaction in securities and entered in the portfolio of the temporary acquirer as a negative position in securities.

- 6.19 Although repos are usually very short-term, such as overnight or one day maturity, there is no requirement that they should be, and there are many examples of repos with maturity longer than a calendar quarter. ESA95 recognises the existence of repos with longer maturity than those of the exchanges proposed in this scheme.
- 6.20 Whilst these are transactions where both legs can be viewed as 'securities lending without cash collateral', this is only because the collateral used is 'swapped'. It could also be viewed as imputed securities lending with cash collateral, since the net cash position is zero.
- 6.21 To illustrate this key aspect further consider the following table, where entity A exchanges with entity B the financial instrument described in each row for the financial instrument described in the column.

A \ B	Cash	Security	Nothing
Cash	F.2	F.4 repo	F.4 loan
Security	F.4 repo	****	Nothing (stock-lending)
Nothing	F.4 loan	Nothing (stock-lending)	N/A

- 6.22 The blue-shaded entry needs to be determined. This can be viewed as either the sum of the two pink-shaded entries (security lending with cash) or the sum of the two yellow-shaded entries (security lending without cash). The net cash position is identical in both these scenarios, but the gross asset/liability position will be very different from the net asset/liability position.
- 6.23 The conventional interpretation here is as the sum of the yellow entries, but this case possibly exposes that this interpretation may be wrong and should be challenged.
- 6.24 It might be argued that in a straightforward exchange of items no transactions would be recorded. However, ESA95 paragraphs 1.36 (non-monetary transactions) and 3.139a (cross-border barter) indicate that transactions should be recorded and estimated. SNA93 paragraphs 3.34-3.37 are also relevant.

Recording nothing [Option 2]

- 6.25 The alternative to repo-type recording is to record no transactions (apart from the arrangement fees, which are part of gross operating surplus in the Generation of Income account). This option uses the interpretation that this is stock-lending with no cash collateral. The *Manual on Government Deficit and Debt* states *“On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement”*. This is consistent with the guidance provided by other statistical manuals quoted above (balance of payments and money and banking statistics).
- 6.26 While neither of the general conditions - being without collateral or for a very short maturity – apply here, there is nothing to suggest situations different from the general case should be included or excluded.
- 6.27 Indeed, the requirement of the SLS that participating banks must maintain their securities at a value greater than the value of the government securities, which may lead to the participating banks providing further assets or returning some government securities, could lead to a complicated sequence of imputed transactions were recording as back-to-back repo operations to be used,
- 6.28 Question 2, set out below, which deals with these two options, is focused on the financial accounts treatment of the operation between the central bank and the banks taking part in the SLS. It is primarily a financial accounts recording question and by itself has no impact on government deficit and debt.
- 6.29 Nevertheless it is important to note that the two questions posed in this document are linked, and this is why question 2 is presented to the CMFB. Should option 1 be adopted in response to question 2, then the response to question 1 must be option 2 (i.e. stage 2 can only be recorded as back-to-back repos if the securities themselves are recorded as in the possession of the Bank of England, since repo operations are undertaken with assets existing in the balance sheet).
- 6.30 It is finally worth noting that it is fundamental that the sector accounts should be appropriately balanced, with matching assets and liabilities in the financial instruments concerned in this operation. If the financial institutions participating in the SLS sell the government securities, then other market participants will hold these securities as assets. There would be no corresponding liability recorded in the financial accounts, but in aggregate across the accounts there would be no 'excess assets' because a negative asset ("short position") would be recorded by the relevant financial institutions participating in the SLS.

Question 2: How should the exchange of assets between the UK Central Bank and banks participating in the Special Liquidity Scheme (stage 2) be recorded?
(See paragraphs 6.1-6.30)

	Only one option (X)
a) Option 1 - as back-to-back repos	
b) Option 2 - record nothing, as stock-lending with no cash	
c) Another option (please specify in comments)	
d) No opinion	