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Issue 44
Financial assets classification

NON-MONETARY GOLD

by Chris Wright and Stuart Brown
with accompanying information from Robert Dippelsman

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AEG Paper – Nonmonetary Gold

A. Executive Summary

1. It is proposed that a clarification should be made to the *1993 SNA* to state that unallocated metal accounts should be classified as a financial asset/liability, specifically, a deposit. At present, this case is not discussed and these accounts may sometimes be classified as outright ownership of the physical asset. It is proposed to state that allocated metal accounts, held outside the central bank (S.121), will continue to be regarded as ownership of the metal as a nonfinancial asset.

2. This issue was initially raised for gold, but, as shown below, investigations have shown that the same arrangements are also used for silver and certain other precious metals and could in principle be applied for other commodities.

B. Background, including *1993 SNA* position and main reasons for change

3. This topic was covered in BOPTEG issues papers dealt with at two meetings and in electronic discussion:

Nonmonetary Gold, http://www.imf.org/External/NP/sta/bop/pdf/bopteg27.pdf (BOPTEG Issues Paper 27)

The Treatment of Non-Monetary Gold in the Macro Economic Accounts, http://www.imf.org/External/NP/sta/bop/pdf/bopteg27a.pdf (BOPTEG Issues Paper 27A)

Non-Monetary Gold: A Possible Way Forward, http://www.imf.org/External/NP/sta/bop/pdf/bopteg27b.pdf (BOPTEG Issues Paper 27B)

The first two issues papers discussed a possible change to the *SNA* to reclassify gold held by financial corporations from a nonfinancial to a financial asset. The third paper proposed an alternative that would clarify the *SNA* to state that unallocated metal accounts, which represent a claim against a third party rather than outright title, should be classified as a financial asset, but that allocated metal accounts should be nonfinancial assets. The proposal in the third paper was adopted by the IMF Committee on Balance of Payments Statistics.

4. Allocated and unallocated metal accounts as well as other background information are explained in BOPTEG Issues Paper 27B, prepared by Stuart Brown (ONS) and Chris Wright (Bank of England), extracted here (with some editorial changes):

Non-Monetary Gold: A Possible Way Forward
by Chris Wright (Bank of England) and Stuart Brown (U.K. Office for National Statistics)

The Issue

5. The underlying concern in this debate has been to address the perceived distortion of physical trade statistics due to the inclusion of all bullion market transactions undertaken
between resident and non resident counterparties. In the words of Issues Paper 27A, "Inclusion of all gold transactions between residents and non-residents as imports and exports of goods would seriously distort the economic accounts of those countries with large international markets in gold" such as Japan and the United Kingdom.[1]

6. As a solution to that problem, there was a proposal for the creation of a new financial instrument classification – Financial Gold – similar in nature to the current SNA concept of Monetary Gold but broader in its scope. Physical gold would then be classified as:

- Commodity Gold if it were held for industrial use or as a valuable;
- Non Monetary Financial Gold, if held by financial institutions and/or bullion traders for market making purposes; and
- Monetary Gold (a subset of Financial Gold) if held by Central Banks as a reserve asset.

Such a delineation would then regard interdealer trading as transactions in financial assets – not purchases and sales of goods – such that bilateral trading positions could then be netted, and resident/non resident business recorded as net financial transactions, that is as financing entries, rather than as trade in goods within the balance of payments.

7. Implementing such a proposal is not straightforward. Specifically, it requires that gold transactions which result in a change of classification – between commodity and financial or between monetary and non monetary financial – should be separately identified, and a reclassification entry logged. This in turn requires that the boundary between commodity and financial gold is well defined.

8. Objections to the proposal are nevertheless principally conceptual. A shared characteristic of financial instruments within the SNA framework is that they are issued by an institutional unit and so represent a liability to that unit as well as an asset to the holder. Gold is an asset which has no corresponding liability so, in an SNA framework, has the hallmarks of a valuable rather than a financial instrument. Nevertheless, the global market in which gold is traded is highly sophisticated, exhibiting all of the characteristics of a financial market.

[1] According to Issues Paper 27A, the UK figures could be as high as three-quarters of the existing trade flows. In Japan, recorded trade in non-monetary gold in 2003 was 14% of imports and 19% of exports.

The Proposal

9. In seeking to define a possible boundary between financial and commodity gold, Issues Paper 27A presents various alternative proposals. That contained in Paragraph 11 has attracted particular interest. This definition, which emerged from discussions with gold traders, views financial gold as “gold traded between counterparties through electronic metal accounts”.

10. The IP is attracted to this definition both because of its precision and practicality. But the description of trading through dematerialised electronic accounts has raised the additional possibility that inter dealer turnover may not in fact give rise to the rapid changes in ownership of commodity gold which were thought likely to dominate conventional measures of trade in goods. The point at issue is whether traders exchange title to physical gold or whether the regular process of trading takes place in a genuine financial asset – a deposit – which happens to be denominated in units equivalent to physical gold, but for which the credit positions of one institutional unit are matched by a liability position for another unit.

So What Are Metal Accounts?

11. Metal accounts are any form of account facility provided by a third party, which give the holder the market risks and benefits of holding physical metal without the need to provide secure storage. They record the holder’s outstanding balance, expressed as a quantity (weight) of metal – gold or other precious metal.

12. But such accounts occur in at least two distinct forms:

- As a record of title to specified allocated gold; and
- As a claim against a third party to deliver unallocated gold.

13. In the former guise, metal accounts serve the needs of both the retail investment market and of Monetary Authorities and market professionals requiring safe custody of physical inventories. The account provider typically offers a one stop service to investors – purchasing, storing and selling investment grade bars and coin to order. Accounts of this type constitute “full outright ownership of the metal” and, as such are advertised as 100% backed by physical stocks. By contrast, accounts denominated in unallocated gold are targeted at the professional gold market. Account providers hold title to a reserve base of physical (allocated) gold and issue claims to account holders denominated in unallocated gold. The account holder does not hold title to physical gold but instead holds an unsecured claim against the account provider, in effect a deposit with the account provider.

14. The two forms of account can operate in tandem. For example, a gold refiner in Australia might deposit and hold allocated gold in an Australian metal account but then be called upon to deliver gold in London. Instead of physically transporting bullion, the refiner can use a facility known as a Location Swap through which his allocated holding in Australia is exchanged for an unallocated claim against a London account provider. This claim can then be converted into an allocated holding allowing delivery

of physical gold to the customer. The process described here involves an exchange of title to physical gold between the refiner and the Australian account provider; a counterpart exchange of claims against the London account provider between the Australian account provider and the refiner; and an exchange of title to allocated gold between the London account provider and the refiner; matched by a counterpart reduction in the refiner's claim against the London account provider. Transactions in physical gold are here seen to be settled through transactions in claims for unallocated gold.

15. The systems used for over-the-counter gold trading are equivalent to those described above. Physical gold may enter or leave the gold market through a transaction between an account holder and a metal account provider, who will normally be a market maker. The first round effect is to raise the stock of allocated gold held by the account provider and to raise equivalently market claims for unallocated gold against the provider. Thereafter, inter dealer trading of metal account claims take place and will either be settled for cash or through the further transfer of title to physical gold. Accordingly, bullion market turnover overwhelmingly constitutes transfers of claims against metal account providers - transfers of title to allocated gold following clearing and settlement, are small by comparison.

16. These account types are fully reflected in the London Market. The London Bullion Market Association (LBMA) is the representative body for gold and silver trading in London. It lists nine market making members of which five offer clearing services. Trading is conducted through balances held by its fifty or so ordinary members with the market making members – trading balances taking the form of unsecured claims on unallocated gold. Allocated gold accounts, where holders own title to specified bars also exist but are used either to settle claims or as safe custody, rather than for trading purposes. For example, the Bank of England provides an electronic book entry service for the transfer of title to allocated gold used by LBMA members and other central banks. Daily turnover in these allocated gold accounts has averaged around 3% of unallocated gold turnover in London over the past year.

The Statistical Treatment of Allocated and Unallocated Gold

17. The distinction between allocated and unallocated metal accounts would seem to be a fundamental one. The former are equivalent to a custody record of title while the latter are an unsecured claim against a third party to deliver a specified quantity of metal of defined purity. As such, transactions in these latter credit balances cannot be classified as transactions in gold, since no change in title to physical gold occurs.

18. Unallocated gold credit balances can be viewed as equivalent to a foreign currency deposit. They represent the unsecured claim of the holder to receive from the account provider a stated quantity of gold. But they are not title to gold. For its part, the account provider views credit balances in unallocated gold as a liability to be recorded on its balance sheet. Physical gold held by the account provider against these liabilities are held in its own name and will appear as assets (valuables) on its balance

sheet. There is no requirement for such holdings to match outstanding liabilities to account holders.

19. Such patterns are observable in the currency analysis of UK banking data. For the LBMA market makers who contribute to these data, deposit liabilities denominated in gold can be identified and typically substantially exceed gold assets. Gold liabilities reported by these market makers are in many cases held by non residents.

20. Classifying unallocated gold accounts in this way brings an immediate resolution of the potential problems highlighted by Issues Paper 27A without the need for a new and controversial financial instrument class. It delivers the same results for the trade in goods statistics as the proposed Paragraph 11 definition of Financial Gold in Issues Paper 27A. However it does not include the requirement to record reclassifications under OCVA whenever the change in ownership of gold causes it to move from being a financial asset to commodity gold or vice versa.

21. Moreover, classifying metal accounts in this way should facilitate statistical collection. The boundary between allocated and unallocated gold is a precise one which is already recognised in the balance sheets of account providers. In addition, if transactions in unallocated gold deposits are to be regarded as financial, then such transactions need only be collected or estimated net. There is no requirement to record the gross flows needed when gold transactions are regarded as trade in goods.

C. Evidence of consensus about need for change and recommendations

22. This issue was considered at two BOPTEG meetings in 2004 and concluded at the 2005 BOP Committee meeting.

23. There was a general consensus that unallocated metal accounts should be classified as financial assets/liabilities, while allocated metal accounts represent ownership of the metal, a nonfinancial asset. The Committee also agreed that the treatment of unallocated metal accounts could be extended to other unallocated metal accounts. As to the classification of allocated metal accounts to a particular instrument category, subsequent discussion confirmed the view that they were within the existing definition of deposits, and within that were analogous to foreign currency denominated deposits.

D. Example worked through the accounts

24. The following example covers the case of a gold owner who deposits gold bullion, of value 100, with a dealer, either as: A) an unallocated account; or B) an allocated account.

A. Unallocated Gold Account

	Assets		Liabilities	
Dealer:	Nonfinancial asset - gold	100	Financial liability – unallocated gold deposit	100
Depositor:	Financial asset – unallocated gold deposit	100		-

B. Allocated Gold Account

	Assets		Liabilities	
Dealer:		-		-
Depositor:	Nonfinancial asset - gold	100		-

E. Impact on GDP and other major variables

25. The impact will be largely on balance sheets and financial account transactions, and will be important mainly in the limited number of countries that have specialized markets. However, there will be some effects: (i) transactions in allocated gold between market practitioners, e.g., end of day switching between unallocated and allocated positions to reduce overnight credit risk exposure to a clearing member (financial risk management) still has the potential to register as an export/import of goods depending upon the residency of the counterparties; (ii) unallocated metal accounts will generate FISIM in the same way as foreign currency deposits; and (iii) the customer's decision on whether to hold allocated or unallocated gold will affect the balance sheet of the bullion bank with the choice of unallocated causing both sides of the latter's balance sheet to rise.

26. As shown in the example above, the net worth of each entity is unaffected, but the recognition of unallocated metal accounts as a form of financial intermediation means that both assets and liabilities are increased equally for dealers.

F. Consideration of consistency with other manuals and classifications

27. The *Monetary and Financial Statistics Manual* paras. 156-7 discusses gold deposits in a context that would be called allocated gold in the terminology used in this paper.

G. Consideration of business accounting standards

28. There is no explicit guidance in accounting standards. The consultation with UK and Japanese bullion dealers cited in the issues papers supports the proposal.

H. Evaluation of practical feasibility of the recommendations

29. The proposal will improve data collection by providing clearer guidance to data reporters about how to classify dealings in gold and other commodities. The classification as a financial asset means that values will be recorded net in the financial account, avoiding large gross value in goods trade or a misleading inclusion of net transactions as services as some countries currently do.

I. Single conceptual solution

30. It is proposed that a clarification should be made to the *1993 SNA* to state that unallocated gold accounts should be classified as a financial asset/liability, specifically deposits. The principles also appear applicable to unallocated accounts for other precious metals and any other commodities for which such accounts may exist[2]. The treatment of such arrangements would be as discussed for index-linked instruments, as dealt with at the July 2005 AEG meeting. Deposits are currently classified as either national currency or foreign currency. Unallocated accounts could be included in foreign currency deposits, which could be renamed as “foreign currency and other deposits” or, for countries where these cases are of analytical interest, a supplementary extra category could be added for “deposits linked to values other than a currency.” Offering these accounts would be treated as financial intermediation.

31. The treatment for allocated gold and other metal accounts would be unchanged, but should be specified, i.e., that they would be regarded as amounting to ownership of gold or other metal as a nonfinancial asset. Offering these accounts would be treated as a nonfinancial activity. (This is a pragmatic solution, in that some, although not all, of the gold held will be monetary gold, so that arguably the function is similar to that of a custodian, i.e., financial auxiliary.)

32. It is not proposed that a new financial instrument class be added to cover financial gold.

33. In regard to the related issue of the classification of amounts payable for the supply of gold, the July 2005 AEG meeting decided that they should be treated as interest in all cases. It was recognized that, in cases where the gold or other metal was a nonfinancial asset, this was a simplifying convention.

[2] The authors are not aware of the existence of unallocated commodity accounts other than those denominated in gold and certain other precious metals.

J. Questions for AEG discussion

AEG members are asked to consider:

- Whether unallocated gold accounts should be classified as financial assets/liabilities?

- Whether other unallocated metal accounts should also be classified as financial assets/liabilities?

- Whether other forms of unallocated electronic commodity accounts, if such exist, should also be classified as financial assets/liabilities?

- If any accounts are classified as financial assets/liabilities, whether they should be classified as deposits?
    - If they are deposits, whether they can be classified as foreign currency deposits, or whether a specific deposit class needs to be assigned?

If included in foreign currency deposits, whether the classification should be changed to "foreign currency and other"?