

## **Reserve Assets and Reserve Asset Transactions.**

This work purports to be a contribution to the analysis of some accounts comprising the caption of International Reserves and their most characteristic transactions to try to reach a consensus on future technical accounting recommendations on this subject.

Toward this end, the accounting caption will be presented, as well as the most typical transactions.

### **1. Gold.**

The purpose of metallic reserves generally created in Gold, in their traditional sense, is to carry out possible translations of bills issued by the Bank. Accordingly, this represents a fundamental indicator for credibility in the value of the currency.

This definition that some Central Banks divide the caption of "Monetary Gold" and "Nonmonetary Gold" was sustained at this point. "Monetary Gold" is earmarked to supporting the issue of currency and "Nonmonetary Gold" is used to trade or increase "Monetary Gold" if necessary. It is worth noting that both are components of international reserves.

Gold or platinum was also considered as a Bullion reserve, although they are currently not recognized as such. Notwithstanding the foregoing, those countries that mint those metals could incorporate them as a foreign currency holding as it conforms with the value reserve, in their opinion.

Moreover, some Central Banks tried to mint platinum which, in this case, deserves the same comment as silver.

### **Valuation of holdings.**

The international listing of the troy ounce less depreciation hedge against significant fluctuations observed in that listing is generally used to value Gold.

Notwithstanding the foregoing, it is recommendable to value at market prices and hedge against market price fluctuations, hence, option transactions can be used as a defensive measure.

In gold producing countries where Central Banks buy part of the gold production, valuation should be performed by using the acquisition costs plus costs incurred in the process of translating into "good delivery gold" or at market prices, whichever is lower.

The gain or loss on revaluation of gold should follow general recommendations already issued for the gains or loss on valuations of International Assets in other currencies.

### **Gold Trading.**

- **Repurchase agreements.**

#### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions.

This criterion does not include contracts entered into for account of third-parties.

#### **Definitions and Characteristics**

This is the transaction whereby the Central Bank sells Gold and it is bound to repurchase such gold in a determined time at a determined price.

When transacted, assets (reserves) are temporarily transformed, that is, gold reserves are reduced and foreign currency holdings are increased.

Upon maturity, gold is reincorporated or repurchased (with the stipulated interest due) and foreign currency holdings are decreased.

#### **Valuation and Recording Criteria**

When carried out, the decrease in this transaction will be recorded in the International Asset account which represents the Gold held by the Central Bank. Concurrently, the increase in foreign currency will be recorded in the international Asset account which represents the foreign currencies held by the banks, due to foreign currency income.

At maturity, that is, when repurchased, the transaction will be recorded in an opposite manner with a decrease in International Assets – Foreign currency and an increase in International Assets – Gold. The earnings on the transaction will be recorded in an income account.

These assets should be revaluated by future exchange rate fluctuations which represent gains or losses that will be recorded in an asset or liability clearing account, in order not to recognize them until the transaction has been concluded. The foregoing will avoid including them in the operating remainder. Once the

transaction has been concluded and cash has been realized, it may be transferred to an Income Account.

Depending on the regulatory laws of each country, this income may be accrued or recorded directly in gains and losses.

### **Rules of Presentation in financial Statements**

Assets generated by these transactions should be reflected in the Balance Sheet in the currency of the country. It is advisable to present them as recommended for presenting Gold and Foreign Currencies.

Since the transaction is a temporary change of status of International Assets plus the increased return on interest, gains or losses generated from the revaluation recorded in asset or liability accounts should be included in earnings and, therefore, in the Statement of Income.

- **Term deposits in Gold.**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

This is a placement of a certain amount of gold at a determined period of time that generates interest.

The particularity of this transaction is that interest is not calculated in Gold. Instead, it is calculated in a foreign currency (usually the US dollar). This phenomenon can cause confusion in reports with regard to applying the listing of the Troy Ounce to stockholders' equity (stock contable) is not necessarily representative of the reserves in ounces, since stockholders' equity is influenced by the accrued interest component.

### **Valuation and Recording Criteria**

Changes in books consist of changing assets, but within the caption of "Gold". In other words, the change is the decrease in Gold available and increase in Gold Placed or deposited when placed, and the decrease in Gold Placed and increase

in Gold available (for the original capital) and Foreign Currencies (for interest earned) at maturity.

The valuation is the same carried out for components of the caption of international Assets – Gold.

### **Rules of Presentation in Financial Statements**

Assets generated by these transactions should be reflected in the Balance Sheet in the currency of the country. It is advisable to present them as recommended for presenting Gold and Foreign Currencies.

Since the transaction is a temporary change of status of International Assets plus the increased return on interest, gains or losses generated from the revaluation recorded in asset or liability accounts should be included in earnings and, therefore, in the Statement of Income.

- **Options with Gold.**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

The purpose of these transactions is to protect the Bank from possible adverse fluctuations in the Gold quotations.

In this point, we will only briefly discuss a very interesting point relative to the criterion for valuation of reserves at market price.

Actually, the valuation at market price exposes the Bank to changes that are sometimes very marked in the income account, since the Gold market is a highly volatile market.

This is why some Banks do not adopt the market price criterion, hence, they choose to write it off or calculate an alternate price on a period considered representative, or create reserves for possible fluctuations.

In view of this scenario, the alternative of purchasing options by stipulating prices that, for example, are lower than market prices result in the Bank making “future

purchases". On the other hand, stipulating such prices in excess of market prices result in the Bank making "future sales". This can be a sufficiently useful tool to face unquestioned valuation at market price, since it allows for reducing possible losses incurred for these items.

It is worth noting that the figure of "future purchase" or "future sale" is strictly for reference. In practice, Central Banks do not dispose of their holdings of precious metals. Instead, stipulated prices and prices actually verified are offset at maturity.

Option Contracts.- An option contract is the right, but not an obligation, to purchase or sell a currency at a determined price in a defined term.

Option Premium.- This is the price charged or paid for having the right of whether or not to exercise the option at a determined date.

There are two types of options:

- A.- Call Option: - The right to purchase gold.
- B.- Put Option: - The right to sell gold.

Options are classified as:

- A.- European.- These are exercised or cancelled only at maturity.
- B.- American.- These are exercised or cancelled at any time up to the date of maturity

A premium is paid when purchasing an option and it is collected when selling it.

### **Valuation and Recording Criteria**

The premium charged or paid is recorded in an asset or liability clearing account in order to be considered as unrealized gains or losses until such time whether or not the option is exercised. The option will be restated to market value and the fluctuations derived will be recorded in the clearing account referred to above against a deferred charge or credit. Once the option has been exercised, the gain or loss may be applied to an Income Account.

On an independent basis, call and put option transactions may be recorded in Memorandum Accounts for the value of ounces subject to the transaction and such ounces may be revalued.

### **Rules of Presentation in Financial Statements**

The premium collected or paid and gains or losses on revaluing the option recorded in clearing accounts should be included in Other Assets in the Balance Sheet, since the option is in effect. Deferred charges or credits recorded in offsetting entry of the revaluation should be summarized in other assets or other liabilities, whichever applies. Once the transaction has been concluded, the foregoing should be transferred to the Bank's gains or losses, as well as in the Statement of Income.

## **2. Cash Resources Available in Foreign Currency**

These assets are representative of immediately available foreign currencies generally deposited in correspondent banks abroad or at Central Banks themselves.

Funds deposited abroad are used to properly meet the daily needs of the bank in transactions that will be described hereinbelow.

By the same token, bills kept at the Bank are purported to meet the possible demand for bill. They are usually allocated toward servicing interest on public securities denominated in foreign currencies or minor payments (per diems, etc.).

### **Valuation of Holdings.**

Valuation of holdings is stated in legal tender by applying the exchange rates in effect on the applicable representative markets to the balances stated in foreign currency of origin.

Should there be illegal markets that generate exchange rates known as "parallel" or "black" exchange rates, the quotations issued by official agencies should be considered. Otherwise, we would be validating a market that operates outside of institutions, even though we know that they do not necessarily represent economic reality.

For statistical or useful purposes (particularly when there are marked fluctuations in the exchange rate that make it difficult to compare amounts), their balances are usually stated in a representative currency, generally, the US dollar. Consequently, reports may even have up to three columns: one representative of the statement of the balance in foreign currency of the country of origin, another one in the local currency, and the other one in US dollars.

### **Transactions with Cash Resources Available in Foreign Currency**

- **Overnight Placement:**

## **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

## **Definitions and Characteristics**

As to be discussed at the proper time of describing the account (Cash resources in Foreign Currency) in theoretical terms, this account is not remunerated, that is, it does not accrue interest.

The balances of foreign currencies deposited in correspondent banks abroad are usually placed “overnight” at the end of daily operations.

A capital position is generated whereby zero balances are carried forward at the end of the day. Balances recorded in zero the day before plus the interest accrued overnight are deposited at the start of operations on the next day.

Interest generated by this type of investment is generally quite lower with regard to the representative market rate. However, they are obviously higher than the zero interest expected from an account of free availability such as the one being analyzed.

## **Valuation and Recording Criteria**

There are various alternatives to exposure, depending on the recording criteria adopted.

It is most advisable to journalize the deposit at the close of each balance sheet. This way, these accounts will always show a zero balance.

However, this method can require a volume of information and timeliness that are difficult to manage and control.

This is why the alternative is to keep exposed “overnight” deposit balances in the account representative of immediately available assets. Such deposit balances should be quantified after closing the balance sheet, or the placement and collection of capital plus interest should be recorded the following day, and disclosed in a note to the financial statements.

## **Rules of Presentation in Financial Statements**

Pursuant to the foregoing, there would be a possibility of presenting them in a representative account after closing the balance sheet every day. On the other hand, the placement and collection of capital, and related interest should be recorded in an income account.

Should the information be available in advance, it should be reflected when transacted.

### **Open Market Transactions:**

- **Buying/selling foreign currencies:**

#### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

#### **Definitions and Characteristics**

When conceptually describing the deposits of immediately available foreign currencies, we said that they were allocated to meet the daily needs of the bank. In this sense, buying/selling foreign currencies on the financial market depict a typical Central Bank transaction.

This transaction between the Central Bank and financial entities consists of exchanging national currency and foreign currency (generally US dollars for the currency that best represents the value reserve in our economies).

Market preference of taking a position in US dollars or national currency can usually be seen through this transaction.

In this sense, the Central Bank usually buys or sells foreign currencies on the local market. Through these purchases or sales, the Bank credits (delivers funds to) or debits (deducts funds from) from financial entities. Revenues or expenditures are verified through these transactions, whichever applies, in representative accounts of the deposits of immediately available cash funds made abroad.

#### **Valuation and Recording Criteria**

The exchange rate in effect on the market should be applied to record the revenue or disbursement relative to the foreign currencies at issue.

By the same token, the exchange rate used to calculate the payment (in case of a purchase) or collection (in case of a sale) should be calculated for the applicable change in the current accounts of financial entities.

Under this scheme, differences that can possibly be determined should be presented in income accounts that represent the difference verified derived from the negotiation.

If negative, differences are generated by selling foreign currencies at a lower price than book value whereas gains are generated by selling foreign currencies at a higher price than book value.

### **Rules of Presentation in Financial Statements**

Differences should be presented in the Financial Statements in Active Accounts of availability of foreign currency and in the Liability of Current Accounts of Financial Entities. Gains or losses on transactions should be presented in the respective profit or loss accounts.

- **Foreign Currency swap or Repurchase and/or Deferment Transactions:**

#### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

#### **Definitions and Characteristics**

This involves transactions carried out by the Central Bank on the local market for the express purpose, in this case, of regulating liquidity and possibly interest rates. The description of this scheme also applies to repurchase and/or deferment transactions or swap transactions to be carried out with other assets (for example, public securities).

The transactions discussed in the foregoing paragraph that purport to provide the system with liquidity are denominated “swaps receivable” or “repurchases/deferments receivable”. Such transactions consist of purchasing foreign currency with the obligation to resell at a predetermined price with a *financial cost charged by the Central Bank*.

By the same token, the transactions discussed above that purport to absorb liquidity are denominated “swaps payable” or “repurchases/deferments payable”. The impact on capital is exactly the contrary to the “receivables” referred to above, inasmuch as they involve sales of foreign currencies with the future obligation to repurchase and *the financial cost will be paid by the Central Bank in this case.*

This type of transactions can be carried out with Public Securities, instead of foreign currency.

### **Valuation and Recording Criteria**

#### **"Repurchases/deferments or swaps receivable"**

A debit is recorded in the representative account of immediately available foreign currencies or public securities holdings in accordance with the market exchange rate. In turn, a credit is recorded in the current account of the intervening bank equivalent to the amount of the foreign currencies or securities acquired, translated into legal tender (national currency) by applying the exchange rate stipulated when the transaction was carried out.

Accordingly, the obligation to resell at the stipulated price for maturity in representative asset and liability accounts of the respective funds receivable and reserves payable can be recorded as a contingency.

A debit is generated in the Bank's current account in the stipulated amount at maturity, simultaneously with the retirement of foreign currencies or securities at issue at market prices.

Accordingly, the possible difference generated should be reflected in income accounts representative of the gain generated if the market exchange rate is lower than the stipulated resale price, or the loss generated if the market exchange rate is higher than the stipulated resale price.

#### **"Repurchases/deferments or swaps payable"**

A credit is recorded in the representative account of immediately available foreign currencies or public securities holdings in accordance with the market exchange rate. In turn, a debit is recorded in the current account of the intervening bank equivalent to the amount of the foreign currencies or securities sold, translated into legal tender (national currency) by applying the exchange rate stipulated when the transaction was carried out.

Accordingly, the obligation to repurchase at the stipulated price for maturity in representative asset and liability accounts of the respective funds receivable and reserves payable can be recorded as a contingency.

A credit is generated in the Bank's current account in the stipulated amount at maturity, simultaneously with the retirement of foreign currencies or securities at issue at market prices.

Accordingly, the possible difference generated should be reflected in the representative income accounts of the gain generated or loss incurred.

### **Rules of Presentation in Financial Statements**

The transaction discussed above should be reflected in Active accounts in the Financial Statements relative to the foreign currencies or securities purchased or sold. This transaction should be reflected in the liability account of Deposits of Financial Entities in the Financial Statements as an offsetting entry.

An entry contrary to the original entry made is recorded when the transaction is concluded.

Gains or losses on the transaction will be recorded in the respective Profit or Loss accounts.

### **3. Investments of Foreign Currency:**

These accounts are representative of the funds comprising the reserves invested in international financial centers.

The practice of investing reserves generates for banks which converts the external assets of Central Banks not only in quality indicators supporting the currency, but also in a significant source of tax revenues.

The Charters of Central Banks often refer to the features that should be characterized by this type of placements. The limitations and recommendations always revolve around the proper solvency of banks receiving the funds, adequate liquidity that should characterize transactions carried out, and the good risk rating of securities invested in by Central Banks.

### **Valuation of Holdings.**

Stating these balances in foreign currency is generated by applying the exchange rates in effect on the applicable representative markets to the balances stated in foreign currency of origin.

The particularities offered by this subject concerning how it is applied to securities holdings will be addressed in the point relative thereto.

## **Traditional investment alternatives of immediately available foreign currency.**

- **Fixed Term Deposits:**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

This generally used investment is made by depositing foreign currencies in an international institution for a preestablished term during which funds may not be drawn. Effective henceforth, the receiving bank pays the stipulated interest at maturity.

### **Valuation and Recording Criteria**

When the deposit is made, international assets are translated thereby recording the decrease in available funds, as well as the deposit at issue.

Effective henceforth, accrued interest is recorded and an offsetting entry is recorded in the applicable income accounts.

Preferably, the entry recorded should concur with the balance sheet closings operating up to the maturity date. Should the maturity date fail to concur with the balance sheet closing, a supplementary entry will be recorded for the unaccrued period.

### **Rules of Presentation in Financial Statements**

Assets generated by these transactions should be reflected in the Balance Sheet in the currency of the country. It is advisable to present them as recommend for presenting Gold and Foreign Currencies.

Since the transaction is a temporary change of status of International Assets plus the increased return on interest, gains or losses generated from the revaluation recorded in asset or liability accounts should be included in earnings and, therefore, in the Statement of Income.

- **Foreign Securities:**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

This investment consists of purchasing securities of governments of other countries.

These securities purchased from governments of other countries often comprise a notable part of the international reserves of central banks. The significant difference compared to the investment in term deposits is that debtors are not banks. Instead, they are the Treasuries of various countries seeking financing for their budgets, by placing these instruments.

### **Valuation and Recording Criteria**

Applying related market prices should be considered as a criterion for recording. Such market prices should be restated to the related balance sheet closing. However, an alternative perspective should be observed concerning this point.

Listing these securities is quite volatile. Applying the market valuation criterion may lead to possible significant fluctuations at an international reserve level.

This fact together with the low turnover of these instruments in the investment portfolio of banks (they generally remain in their assets until maturity) support alternative valuation opinions such as, for example, maintaining balances at cost price and generating gains or losses at maturity or their possible (often remote) realization.

When previously referring to the valuation of securities, it is worth noting that we are defining how the valuation of securities is quoted in its currency of origin, hence, this valuation is not translated from the currency of origin into national currency. Foreign currency translation can generate valuation differences (gains or losses) that decrease or increase in those applicable to the variances in the prices of securities.

Let us take a detailed look at the securities issued by the US Treasury, given their extensive use on international markets. However, we also note that there are

other securities issued by other countries such as Germany and Japan, for example.

Actually, securities issued by the US Treasury are supported by the US government which obviously minimizes the risk.

Its ongoing issues and operator preference for this instrument make this market one of the most liquid in the world. Its rates are considered as an obligatory reference on international markets.

This instrument, based on its characteristics, can be divided into two groups: Treasury bills and Treasury Notes/Bonds.

Securities known as Treasury Bills generate a flow of funds that fully recover nominal value at maturity. It is usually denominated for a term of less than one year.

Accordingly, they are valued by applying market prices to registered nominal value.

By the same token, Treasury notes are for longer terms between two and ten years. On the other hand, Treasury Bonds are for terms exceeding ten years. They pay interest every six months and the total capital at maturity.

They are accordingly valued differently, depending on whether capital or interest is involved. The market price is applied to the portion relative to capital valuation while its interest is accrued in the representative account of interest earned on that Note.

- **Securities Substitution Mechanism**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

This mechanism consists of exchanging US treasury bonds held by the Central Bank (CB), the Federal Reserve (the Fed), and another International institution (ICI).

The CB advises the Fed to deliver a certain amount of securities to the ICI referred to as Original Securities. As an offsetting entry, the ICI delivers the securities that the CB has selected as substitutes (collateral securities) of the original securities to the Fed to be deposited on behalf of the CB.

Although the nominal values fail to concur, since different types are involved, the amounts concur when restated to market prices.

The market value of collateral securities is usually requested to exceed the value of the original securities by a percentage (usually 2%), thereby covering possible drops in prices that can unbalance the transaction.

This agreement generates an income that could be aggregated to the interest of leased securities which are collected in foreign currency at its maturity.

At maturity, the ICI returns the original securities to the Fed to be returned to the CB which in turn advises the Fed that the transaction has been concluded.

It is also worth noting that during the transaction, the CB does not waive the return that would be generated by simply holding the original securities.

In this sense, various alternatives may arise during the duration of the agreement:

1) An interest note of a substitute security matures and the CB charges it. Accordingly, the CB “replaces” the amount originally stipulated in securities and delivers the interest collected.

2) An interest note of an original security matures and the ICI collects it. Accordingly, the ICI “replaces” the amount originally stipulated in securities and it also pays the CB the interest at issue. The CB records them with an offsetting entry in earnings at that time.

- **Reserves managed by private institutions:**

### **Objective and Scope**

The objective and scope should establish the particular criteria relative to valuation, recording, and presentation of these instruments in the financial statements maintained by Central Banks in their positions

This criterion does not include contracts entered into for account of third-parties.

### **Definitions and Characteristics**

The complexity encompassing international reserve management occasionally results in banks deciding to invest part of their international reserves in specialized institutions.

The transaction is carried out by signing Investment Management Agreements between Central Banks and the institution at issue.

The agreement consists of a cash deposit made by the Bank which the Bank referred to as an “underwriter” will receive to manage and invest for an established period of time.

It is worth noting that there is a method whereby a third bank referred to as “custodian” receives the original deposit and makes placements according to the instructions of the “underwriter”.

The transactions determined by the Central Bank tend to enhance low risk benefits and clear guidelines related to diversifying the portfolio (they normally refer to the average duration of the required portfolio, the credit rating of currencies in which transactions are carried out, and the instruments that can be invested).

Effective henceforth, the custodian periodically reports the make up of the Bank’s portfolio (market value, cost value, and accrued interest) which is immediately compared to the report sent immediately before the income/expense derived for that transaction in that period is generated.

### **Valuation and Recording Criteria**

Given that the Central Bank does not “make duplicate entries” in its accounting of each one of the transactions carried out by the custodian. Normally, the Bank chooses to periodically adjust its portfolio and record this adjustment in income accounts as an extraordinary item. The foregoing avoids identifying items such as interest, valuation adjustments, etc., even though all of them have comprised the items recorded income.