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SUBJECT:	ACCOUNTING AND FINANCIAL REPORTING FOR SECURITIES LENDING TRANSACTIONS.			

TO: Board of Investments
Board of Housing
Commissioner of Higher Education
Public Employees' Retirement Division
Teachers' Retirement Division
State Compensation Insurance Fund
Health Facility Authority
Montana State Lottery

FROM: Accounting Bureau - Department of Administration

INTRODUCTION

This management memo establishes State accounting policy for the accounting and financial reporting of securities lending transactions as promulgated in the Governmental Accounting Standards Board (GASB) Statement No. 28. **Accounting and Financial Reporting for Securities Lending Transactions.**

GENERAL INFORMATION

GASB Statement No. 28 establishes standards for securities lending transaction accounting and financial reporting. These types of transactions occur when governmental entities transfer their securities to broker-dealers and other entities for collateral and agree to return that collateral for the same securities in the future. The purpose of these transactions is to enhance the return on the governmental entity's portfolio by receiving some type of payment for the use of its securities by the broker-dealer.

GASB Statement No. 28 establishes requirements for reporting underlying securities and collateral received in security lending transactions, related income and expenditures and disclosing the activity in participating entity's financial statements. The accounting and reporting for the collateral and underlying securities depends on the type of collateral received and the ability of the governmental unit to pledge or sell collateral securities during the term of the transaction. The investment income and expenses the governmental unit records from these transactions depends on the type of collateral received. In the case of cash collateral, the governmental unit invests the cash to obtain a return which is shared with the borrower. With securities or letters of credit, the governmental unit receives a loan premium or fee from the borrower.

TERMINOLOGY

agent fees - amounts paid to security lending agents for managing securities lending transactions.

borrower(s) - an individual or entity that transfers collateral to a governmental entity in a security lending transaction.

borrower rebate - amounts paid to the borrower for the use of cash collateral provided to the lender by the borrower.

collateral - cash, securities, or letters of credit received from the borrower as protection against the underlying securities of a security lending transaction not being returned by the borrower. Lenders usually receive collateral in the amount of 102 and 105 percent of the market value of domestic and foreign underlying securities, respectively. The majority of security lending transactions result in the receipt of cash as collateral.

collateral investment pool - a pool managed by an agent that commingles cash collateral received on securities lending transactions of more than one lender for investment purposes.

credit risk - the aggregate risk of a lender's exposures to the borrowers of its securities. Credit risk exists when the amount the borrower owes the lender exceeds the amount the lender owes the borrower for security lending transactions.

income distributions - interest, dividends, and other distributions made by an issuer of securities. Income distributions on underlying securities and collateral securities are payable to the respective parties of the security lending transaction (e.g. income on underlying securities is payable from the borrower to the lender).

lender(s) - a governmental entity that transfers securities to borrowers in a securities lending transaction.

loan premium or fee - amounts received by the lender from the borrower for the use of the underlying securities in a security lending transaction that provides securities or letters of credit as collateral.

loss indemnification - an agent's guarantee of protection from certain losses for the lender.

securities lending agent - an entity that arranges security lending terms and conditions, monitors market values for underlying securities and collateral, and arranges the investment of cash collateral in security lending transactions. Agents may be financial institutions that handle the custody of the lender's portfolio or independent financial institutions.

securities lending transaction - transactions whereby governmental entities transfer securities to borrowers for collateral and agree to return the collateral for the same securities at some point in the future.

underlying securities - securities transferred from the lender to the borrower in a securities lending transaction. The types of securities that governments lend include: U.S. government/agency securities, domestic and foreign corporate equity and fixed income securities, and foreign government fixed income securities.

NOTE: For the purposes of this GASB statement and management memo, the statement of changes in plan net assets and statement of plan net assets required by GASB 25 for Defined Benefit Pension Plans are considered an operating statement and balance sheet, respectively.

ACCOUNTING PROCEDURES

State agencies participating in **securities lending transactions** are required to report the **underlying securities** of the transactions as assets even though the securities are transferred to the **borrower**. Additional transactions depend on the type of **collateral** the **lender** receives and whether the securities lending transaction is made through an investment pool. **The Board of Investments will record securities lending transactions at year-end for each fund based on its year-end portfolio balance.** Following are the accounting requirements for each type of collateral received:

CASH COLLATERAL - Cash received as collateral for securities lending transactions and investments made with that cash should be recorded as assets (C/A 1643) by the lender with a corresponding liability being recognized (C/A 2543). The underlying securities should continue to be shown as an asset for the entity. In transactions involving cash collateral, the lender uses the cash to earn investment income by investing the cash through a financial institution, purchasing

securities or by investing through a securities lending agent in a collateral investment pool. These earnings are used to pay the borrower an agreed upon amount of interest (borrower rebate) on the amount of cash transferred to the lender with the residual earnings resulting in income for the lender. The lender continues to receive the investment income on the underlying securities as well. **NOTE:** If cash collateral from a borrower is restricted to being deposited only, the transaction should be treated as involving securities collateral as discussed below.

Cash Collateral Example:

Assume an entity holds U.S. government securities with a coupon rate of 9%, book value of \$497,000 and market value of \$500,000 which are recorded in C/A 1644 - Long Term Securities on Loan. These securities are loaned to a borrower for \$510,000 cash, with the requirement that the securities be returned to the lender at the end of thirty days. The following entry would be necessary to record the balance sheet transaction:

DR	1643 Cash Collateral - SL	510,000
CR	2543 Liability under Securities Lending	510,000

The book value of the underlying securities would remain as an asset on the entity's records in C/A 1644.

SECURITIES AS COLLATERAL - Securities received as collateral for securities lending transactions should be recorded as assets (C/A 1699 or 6399) by the lender with a corresponding liability being recognized (C/A 2599 or 7199) if the securities lending contract *specifically* allows the lender to pledge or sell the collateral securities without borrower default. The lender may sell or pledge the collateral securities if the contract specifically allows the activity, but at the end of the securities lending transaction, must return similar securities to the borrower. The borrower pays the lender a loan premium or fee for the use of the underlying securities in this type of transaction. In securities lending transactions involving securities as collateral, borrowers and lenders have certain ownership rights over the securities they hold. Each party has income distribution rights whereby interest, dividends or other income distributions are the right of the original holder of the securities. Income distributions on the underlying securities of a transaction are payable to the lender from the borrower, while income distributions on the collateral securities are payable to the borrower from the lender. In the event that collateral securities are sold/pledged at one price and the price rises before the lender purchases similar securities to return to the borrower, the lender will have an economic loss on the securities lending transaction.

NOTE: Securities lending transactions collateralized by securities that the lender does not have the ability to pledge or sell or letters of credit should **not** be recorded as assets/liabilities by the lender. The only transaction recorded with these types of collateral is the revenue and related expenses as discussed below in the **INVESTMENT REVENUE AND EXPENDITURE RECOGNITION** section.

Securities Collateral Example:

Assume an entity holds U.S. government securities with a book value of \$997,000 and market value of \$1,000,000 which are recorded in C/A 1644 - Long Term Securities on Loan. These securities are loaned to a borrower who receives corporate securities that have a market value of \$1,020,000 as collateral, with the requirement that the underlying securities be returned to the lender at the end of thirty days. The following entry would be necessary to record the balance sheet transaction:

DR	1699 Corporate Securities - Collateral	1,020,000
CR	2599 Liability under Securities Lending	1,020,000

The book value of the underlying securities would remain as an asset on the entity's records in C/A 1644.

INVESTMENT REVENUE AND EXPENDITURE RECOGNITION:

In addition to reporting the assets and/or liabilities for securities lending transactions, the related income and transaction costs must be recorded in accordance with the requirements of GASB Statement No. 28. Costs of securities lending

transactions including agent fees and borrower rebates should not be netted against related income including loan premiums or fees received as part of the transaction.

NOTE: Securities lending transaction costs will be recorded as negative revenue in a separate object of revenue as a reduction of securities lending income. The Board of Investments has statutory authority (17-6-201 (7), MCA) to deduct the cost of administering and accounting for investing activities from investment income for each fund. The Board of Investments will continue to record investment income from securities lending transactions as a net amount during the fiscal year; at year-end an adjusting entry will be made to record securities lending expenses and related additional revenue. The expenses and additional revenue will be based on cumulative information provided by the State's securities lending agent.

Revenue and Expense/Expenditure Example:

Assume the same details as the Cash Collateral Example above and that the collateral is invested through an agent for the state in a cash pool with the agent. The gross earnings on the collateral investment for the thirty days are \$50,000. The rebate paid to the borrower (broker X) is 98% (\$49,000) with net earnings to the lender of \$1,000, of which 30% (\$300) is paid to the agent. In addition, the earnings for the underlying securities in the amount of \$45,000 is received by the lender. The following entries would be necessary to record the operating statement transactions:

1.	DR	1104 Cash in Treasury	45,000	
	CR	5101 Budgeted Revenues	45,000	O/R 0008 (Rev. Class 13XX)

To record investment earnings for underlying securities.

2.	DR	1104 Cash in Treasury	50,000	
	CR	5101 Budgeted Revenues	50,000	O/R 1644 (Rev. Class 13XX)

To record investment earnings from securities lending transaction collateral.

3.	DR	5101 Budgeted Revenue	49,000	O/R 1626 (negative)
	CR	1104 Cash in Treasury	49,000	

To record payment of borrower rebate from securities lending transaction.

4.	DR	5101 Budgeted Revenue	300	O/R 1626 (negative)
	CR	1104 Cash in Treasury	300	

To record payment of agent fees from securities lending transaction.

Transactions 2,3 and 4 above would not be performed on a transaction basis, but would be recorded as a net amount in the month of the transaction and adjusted at year-end by Board of Investments:

Month A:	DR	1104 Cash in Treasury	700	
	CR	5101 Budgeted Revenues	700	O/R 1644 (Rev. Class 13XX)

To record net investment earnings from securities lending transaction collateral.

Year-End	DR	5101 Budgeted Revenue	49,300	O/R 1626 (negative)
	CR	5101 Budgeted Revenue	49,300	O/R 1644 (Rev. Class 13XX)

To record payment of borrower rebate and agent fees from securities lending transaction.

In the case of securities lending transactions involving collateral in the form of securities or letters of credit, loan premiums or fees should be recorded as investment income with any agent fee being shown separately as an investment expense. Income distributions received from the borrower on the underlying securities would be recorded as regular investment income (revenue class 13XX).

INVESTMENT POOLS - Some governmental entities pool money from several funds for investment purposes and the pool (STIP, MTCOMP, RFBP, etc.), rather than the individual funds, may participate in securities lending transactions. Assets and liabilities resulting from the receipt of collateral in the form of cash or securities that can be pledged or sold must be recorded by the pool (similar to the transactions above for individual funds). The investment pool must then allocate the assets and liabilities that arise from the securities lending transactions to the individual participating funds based on each fund's equity in the pool. Additionally, revenue and costs associated with the securities lending transactions should be recorded for the pool as discussed above in the **INVESTMENT REVENUE AND EXPENDITURE RECOGNITION** section and then allocated to the individual participating funds based on their pro rata share of income distributed from the pool. Allocations are usually made on a pro rata basis based on each fund's equity in the pool. The Board of Investments will continue to record investment income from securities lending transactions as a net amount during the fiscal year; at year-end an adjusting entry will be made to record security lending expenses and related additional revenue based on participants' pro rata share of distributed income. **The Board of Investments will record collateral assets and liabilities related to securities lending transactions at year-end for each fund based on its pro rata share of the pool's year-end portfolio balance.**

NOTE: If securities lending income/expenses related to pooled securities that represent equity owned by one fund becomes the assets of another fund because of contractual or legal provisions, the allocation of income/expense to each fund should be determined by the specific language of the provision. If securities lending income/expenses related to pooled securities become the assets of the other fund based on provisions other than legal or contractual (management decision), the income/expenses should be recorded by the fund that reports the equity in the pooled investment and then moved to the recipient fund as an operating transfer.

Investment Pool Example:

Assume an investment pool (STIP) holds U.S. government securities with a coupon rate of 8%, book value of \$497,000 and market value of \$500,000 that are recorded in C/A 1644 - Long Term Securities on Loan in the pool agency fund (A/E 07041). Each participating fund has their equity in the pool recorded in C/A 1613 - Participants STIP Investment. The pool's securities are loaned to a borrower for \$510,000 cash, with the requirement that the securities be returned to the lender at the end of thirty days. Assume the collateral is invested through an agent for the pool in a cash pool with the agent. The gross earnings on the collateral investment for the thirty days are \$50,000. The rebate paid to the borrower (broker X) is 98% (\$49,000) with net earnings to the lender of \$1,000, of which 30% (\$300) is paid to the agent. In addition, the earnings for the underlying securities in the amount of \$40,000 is received by the lender. Assume Pool participant A (A/E 02999) has 1,000 shares of 100,000 outstanding shares (1%) and the asset, liability, income and expense will be allocated on that percentage. The following entries would be necessary to record the securities lending transaction for the pool and participant:

1. A/E 07041	DR	1643 Cash Collateral - SL	510,000
	CR	2543 Liability under Securities Lending	510,000

To record the securities lending collateral of the pool. (The book value of the underlying securities would remain as an asset on the pool's records.)

2. A/E 02999	DR	1643 Cash Collateral - SL	5,100
	CR	2543 Liability under Securities Lending	5,100

To record Participant A's pro rata share of equity in the pool's securities lending collateral transaction.

3. A/E 07041	DR	1104 Cash in Treasury	40,000	
	CR	2114 Income Due Participants	40,000	SDL 1201

To record investment earnings received for the underlying securities by the pool.

4. A/E 07041	DR	2114 Income Due Participants	400	SDL 0025
	CR	1104 Cash in Treasury	400	

5. A/E 02999	DR	1104 Cash in treasury	400	
	CR	5101 Budgeted Revenue	400	O/R 0025

To record the allocation of investment earnings on the underlying securities to Participant A.

6. A/E 07041	DR	1104 Cash in Treasury	50,000	
	CR	2114 Income Due Participants	50,000	SDL 1644

7. A/E 07041	DR	2114 Income Due Participants	49,300	SDL 1626
	CR	1104 Cash in Treasury	49,300	

To record gross investment earnings and related transaction costs for collateral securities investment by the pool.

8. A/E 07041	DR	2114 Income Due Participants	7	SDL 0025
	CR	1104 Cash in Treasury	7	

9. A/E 02999	DR	1104 Cash in Treasury	500	
	CR	5101 Budgeted Revenue	500	O/R 1644

10. A/E 02999	DR	5101 Budgeted Revenue	493	O/R 1626 (negative)
	CR	1104 Cash in Treasury	493	

To record the allocation of investment earnings and transaction costs for collateral securities to Participant A.

Transactions 6 through 10 above would not be performed on a transaction basis, but would be recorded at the net amount in the month of the transaction then adjusted at year-end by Board of Investments:

Month A:	A/E 07041	DR	1104 Cash in Treasury	700	
		CR	2114 Income Due Participants	700	SDL 1644
	A/E 07041	DR	2114 Income Due Participants	7	SDL 0025
		CR	1104 Cash in Treasury	7	
	A/E 02999	DR	1104 Cash in Treasury	7	
		CR	5101 Budgeted Revenue	7	O/R 0025

To record net investment income for security lending collateral transactions.

Year-End	A/E 02999	DR	5101 Budgeted Revenue	493	O/R 1626(negative)
		CR	5101 Budgeted Revenue	493	O/R 1644
	A/E 02999	DR	5101 Budgeted Revenue	7	O/R 0025
		CR	5101 Budgeted Revenue	7	O/R 1644

A/E 07041	DR	2114 Income Due Participants	49,300	SDL 1626
	CR	2114 Income Due Participants	49,300	SDL 1644

To record gross investment earnings and related transaction costs for security lending collateral transactions.

DISCLOSURES

The following disclosures are required to be made for securities lending transactions:

- ▶ Source of legal or contractual authorization for entering securities lending transactions.
- ▶ Any significant violations of legal or contractual authorization.
- ▶ General descriptions of securities lending transactions including:
 - Types of securities loaned
 - Types of collateral received
 - Whether the lender has the right to sell/pledge securities received as collateral
 - Amount by which value of collateral securities exceeds the value of the underlying securities
 - Restrictions on the amount of securities that can be loaned
 - Carrying and Market values of the underlying securities as of the balance sheet date
- ▶ Description of loss indemnification.
- ▶ Statement of whether the maturity dates of investments made with cash collateral received from borrower's match the maturity dates of the related loaned securities. This statement can be a general statement rather than a detailed list of maturity dates.
- ▶ Amount of losses related to securities lending transactions from borrower or agent default.
- ▶ Amount of losses recovered from defaults of prior periods.
- ▶ Amount of credit risk as of the balance sheet date (if no risk exists, a statement to that affect should be made).

In addition to the above disclosures, cash collateral deposits, collateral securities and underlying securities reported on the lender's balance sheet must satisfy GASB Statement No. 3 classification disclosures, (see MM 2-87-6).

Carrying and market values of collateral securities and underlying securities (except investments in collateral investment pools) included in the lender's balance sheet should be disclosed by type of investment. The collateral securities should be classified by custodial risk categories. **IF** collateral securities are recorded in the lender's balance sheet and are already classified by custodial risk, underlying securities should not be classified by custodial risk, but should be disclosed as uncategorized. **IF** collateral securities are **not** recorded in the lender's balance sheet (letters of credit or securities with no rights to sell/pledge), underlying securities should be classified by custodial risk categories. Investments in collateral investment pools should be disclosed as uncategorized.

CLOSING

The provisions of GASB Statement No. 28 are effective beginning in fiscal year 1997. Entities presenting comparative financial statements need to consider restatements of prior year amounts presented in financial reports issued for the year of implementation. Questions regarding this management memo should be directed to the Department of Administration, Accounting Principles and Financial Reporting Section (APFRS), at 444-3092.