PROPERTY INCOME AND HOLDING GAINS IN THE SNA

Introduction

1 In the current update of the SNA, concern has been raised that conventions regarding what can be recorded as property income and what should be omitted from property income are not fully consistent. The purpose of this paper is to explore this issue, particularly in regard to decisions affecting property income that have been taken as part of the update process, but also considering the issue more broadly in terms of the guidance provided in the 1993 SNA.

2 This paper forms the basis for an electronic consultation on the topic. To facilitate this discussion, a number of questions have been included. Persons with an interest in the topic are invited to provide their comments by no later than 31 August 2006. Comments can be provided to peter.harper@abs.gov.au. The comments will then be summarised and submitted to the ISWGNA for consideration.

Holding gains and income

3 A basic tenant of the SNA is that holding gains are not considered to form part of income. The income accounts in the SNA are *transaction* accounts. A *transaction* is an economic flow that is an interaction between institutional units by mutual agreement or an action within an institutional unit that it is analytically useful to treat like a transaction, often because the unit is operating in two different capacities[1]. Holding gains and losses, which are due to changes in the level and structure of prices, are not transactions, because there is no interaction between institutional units[2]. The particular relationship between income and holding gains is discussed in the 1993 SNA paragraph 8.15, which explicitly states that holding gains and losses accruing during the accounting period do not form part of (disposable) income.

4 While the exclusion of holding gains from income is occasionally raised as an issue, it is not an issue that has actively canvassed as part of the current update process. Reconsideration of the treatment of holding gains in the system was not on the list of issues agreed to by the Statistical Commission and as such is out of scope of the current update.

Property income

5 Property income is shown in the SNA within the allocation of primary income account, which forms part of the primary distribution of income account. Property income is the income receivable by the owner of a financial asset or a tangible non-produced asset in return for providing funds to or putting the tangible non-produced asset at the disposal of, another institutional unit[3]. In the 1993 SNA property income consists of interest, the distributed income of corporations (i.e. dividends and withdrawals from income of quasi-corporations), reinvested earnings on direct foreign investment, property income attributed to insurance policyholders, and rent[4]. As part of the SNA update process, an additional form of property income – retained earnings in investment (mutual) funds – has been proposed.

[1] 1993 SNA para 3.12
[2] 1993 SNA para 3.57
[3] 1993 SNA para 7.88
[4] 1993 SNA para 7.89

6 Because property income is shown in the SNA in the allocation of primary income account, there may be an impression that it is an allocation of the primary incomes generated by production activities in the current period or a reallocation of other property income flows in the same period. However, notwithstanding the impression that may be created, the 1993 SNA does not make any such stipulation and, as will be argued, such a position would be inconsistent with the nature of much of the property income that is actually recorded in the national accounts.

Interest

7 Interest is property income receivable by owners of certain kinds of financial assets, namely deposits, securities other than shares, loans and other accounts receivable. It is defined in the SNA as the amount that a debtor becomes liable to pay to a creditor over a given period of time without reducing the amount of principal outstanding, under the terms of the financial instrument agreed between them[5].

8 A key feature of interest is that the amount is fixed by agreement – either a particular amount is specified or the method by which the amount is to be determined is specified[6]. Importantly, the amount payable is not related to the economic performance of the debtor – although presumably the debtor will consider his economic prospects in determining how much interest he will be prepared to pay. As such, the calculation of interest, and therefore its recording in the system, is not dependent on the source of funds available to the debtor to pay the interest. The debtor is certainly not restricted to paying interest only out of primary incomes and/or property incomes receivable.

9 A few examples help demonstrate this point. Governments often pay large amounts of interest on bonds etc that they have issued. In many cases, the primary incomes available to government are far less than the interest payments. Taxation – a secondary income – is of course generally used to finance the interest payments.

10 In another example, it is quite possible that banks may use holding gains from dealing in instruments other than loans and deposits as a source of funds for paying interest on their borrowings. In a further example, in Australia at least many households borrow from banks to invest in housing for rental purposes. The income received is generally less than the amount of interest payable[7]. This is because there is an expectation that the holding gains on the property will more than offset this gap. In this regard, some of the interest is being funded by the expected holding gain[8]. In neither case does the use of holding gains as a potential source of funds to meet interest commitments affect what is recorded as interest.

11 It is the view of the author of this paper, that because of the nature of interest, it cannot be said that interest <u>includes</u> holding gains, even though holding gains may be a source of funds that the debtor uses to meet the interest commitment. Rather, it is considered that the debtor's holding gains are irrelevant for the recording of interest, which should be recorded in the system without regard for the source of funds that may be used by the debtor to meet the interest commitment.

[5] 1993 SNA para 7.93
[6] For example, bonds that are indexed to a price index such as the CPI.
[7] Because of the tendency for such investments to be in a negative income situation, they are known as 'negative gearing'.
[8] Of course, if the holding gain does not materialise, the debtor will need to meet the interest obligations from another source of funds.

Question #1 Is it reasonable for interest to be recorded in the system without regard to the source of funds that are used by the debtor to meet the interest commitment?

Distributed income of corporations

12 In the SNA, this income can take two forms – dividends and withdrawals from income of quasi-corporations.

13 Dividends are a form of property income to which shareholders become entitled as a result of placing funds (in the form of equity capital) at the disposal of corporations. Unlike in the case of interest, the holders of shares are not entitled to a fixed or predetermined income[9]. Rather, the income that is receivable in the form of dividends is directly linked to the economic performance of the corporation in which the shares are held. As such, dividends can be considered to be related to the income that is available to the corporation for distributing to shareholders.

14 The 1993 SNA does not provide any restrictions on what might constitute dividend income. However, both the fifth edition of the IMF's *Balance of Payments Manual* (BPM5) and the IMF's 2001 *Government Finance Statistics Manual* (GFSM 2001) elaborate on what should and should not be recorded as dividend income.

15 In BPM5 there is a discussion on stock dividends, bonus shares and liquidating dividends. Stock dividends are treated as income, bonus shares as an exchange of one form of capital for another, and liquidating dividends as withdrawal of capital[10].

Question #2 Does the BPM5 treatment of stock dividends, bonus shares and liquidating dividends pertain to dividends recorded in the national accounts? If so, should the SNA be clarified along these lines?

16 GFSM 2001 states that "dividends are payments a corporation makes out of its current income, which is derived from its ongoing productive activities. A corporation may, however, smooth the dividends its pays from one period to the next so that in some periods it pays more in dividends than it earns from its productive activities. Such payments are still dividends. Distributions by corporations to shareholders of proceeds from privatization receipts and other sales of assets and large and exceptional one-off payments based on accumulated reserves or holding gains are withdrawals of equity rather than dividends"[11]. In discussing the issue of the treatment of dividends from public corporations, the AEG took a position similar to the GFSM; it considered that in the updated SNA exceptionally large payments should be treated as a withdrawal of equity and not as dividend income.

17 A similar position to the GFSM 2001 treatment is taken in the SNA in its discussion of withdrawals from income of quasi-corporations. The 1993 SNA states that such withdrawals of income do not include withdrawals of funds realized by the sale or disposal of assets, or funds withdrawn by

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[9] 1993 SNA para 7.113
[10] BPM5 para 290.
[11] GFSM 2001 para 5.87

liquidating large amounts of accumulated retained savings or other reserves of the quasi-corporation. Presumably, "other reserves" would include reserves attributable to holding gains.

18 Because of its discussion of withdrawals from income of quasi corporations, it could be argued that the authors of the 1993 SNA considered that the recording of dividends should be restricted in a similar fashion to the recording of withdrawals of income from quasi-corporations, although this is not explicitly stated. If the proposed clarification regarding dividends from public corporations were to be extended to cover dividends from all types of corporations, this would achieve a consistency in the recording of dividends and the recording of withdrawals of income from quasi-corporations, and a consistency in the recording of dividends regardless of the institutional sector of the corporation paying the dividends.

Question #3 Should the proposed clarification regarding dividends from public corporations, where exceptionally large payments are treated as withdrawals of equity, be extended to cover all types of corporations?

Reinvested earnings on direct foreign investment

19 1993 SNA defines the retained earnings of direct foreign investment enterprises to be (a) the operating surplus of the enterprise plus (b) any property incomes or current transfers receivable minus (c) any property incomes or current transfers payable, including dividends[12]. Clearly, therefore, it is only income that is available to the direct investment enterprise – and not any holding gains that may have accrued to that enterprise – that can be recorded as reinvested earnings on direct foreign investment.

20 The recording of reinvested earnings on direct foreign investment will be unchanged in the updated SNA.

Retained earnings in investment funds

21 The AEG agreed on the principle of recording retained earnings in investment (mutual) funds in a similar way to income attributed to insurance policyholders. However, the AEG was undecided on the specifics of the proposal, including whether holding gains would be included in the retained earnings and whether a new component called 'property income attributed to holders of investment funds' is required.

22 As mentioned above, in the case of reinvested earnings on direct foreign investment, holding gains are specifically excluded from the calculation of the retained earnings. The other form of 'retained' earnings recorded in the SNA relates to income attributed to insurance policyholders, which again is generally recorded excluding holding gains. (However, as will be seen, this paper proposes a different treatment for pension schemes and life insurance where benefits are 'defined'.) Under ESA95, which has already adopted the recording of retained earnings in investment funds, only property income received by investment funds that is not distributed is recorded as being reinvested[13]. As such, holding gains received by investment funds are not recorded as being attributed to holders of investment funds and then reinvested. Accordingly, given the current SNA treatment of reinvested earnings on direct foreign investment and insurance, and the ESA treatment of retained earnings in investment funds, there appears

[12] 1993 SNA para 7.122
[13] ESA para 5.141

to be a case for recording retained earnings in investment funds in the updated SNA excluding holding gains. However, an alternative would be to include holding gains accruing to the investment fund as part of income, or at least the real component of the holding gains, as these holding gains form part of the 'return' to the holders of equity in investment funds.

Question #4 Should the retained earning in investment funds be recorded excluding holding gains received by the investment funds? Or should the holding gains accruing to the investment funds, or at least the real component of the holding gains be considered as part of income?

Property income attributed to insurance policyholders – non-life insurance

23 The 1993 SNA is quite explicit on how property income attributed to be non-life insurance policyholders should be treated, stating "as the technical reserves are assets of the insurance policyholders, the investment income receivable by insurance enterprises must be shown in the accounts as being paid by the insurance enterprises to the policyholders. The income payable by insurance enterprises to policyholders in this way is described as property income attributed to insurance policyholders."[14]

24 As part of the SNA update process, the AEG has extensively discussed non-life insurance. At one stage, a proposal was made to attribute investment income of insurance enterprises' own-funds to policyholders, but this was rejected by the AEG. In the end, the AEG did not make any recommendation to change the SNA treatment of property income attributed to be non-life insurance policyholders. However, it could be considered that holding gains, or at least real holding gains, accruing to the non-life insurance enterprise should be treated as part of income attributable to non-life insurance policyholders, notwithstanding that such holding gains are not treated as part of the income receivable by the non-life insurance enterprise.

Question #5 Is there a case for seeking to change the SNA 1993 treatment of property income attributed to non-life insurance policyholders to include holding gains accruing to the non-life insurance enterprise?

25 As an aside, the treatment of holding gains by non-life insurance enterprises requires further elaboration, not in terms of its treatment of income but the way in which these holding gains are ultimately acquired by the enterprises. Any holding gains by non-life insurance enterprises on their technical reserves should be recorded as a non-transaction increase in the policyholders' claims on the enterprises. However, ultimately, these gains, like interest and dividends received on the technical reserves are acquired by the enterprises. In the case of interest and dividends on technical reserves, this is achieved by attributing the income to the policyholders, and then the policyholders handing over the income by way of premium supplements. However, as the holding gains are currently not part of income they cannot be rerouted back to the insurance enterprise in this way. Three possible alternatives exist: (1) change the treatment of income attributed to policyholders to include holding gains, (2) show the holding gain as a withdrawal of investment by policyholders in the insurance technical reserves, offset by additional premium supplements or (3) undertake the rerouting via the other changes in volume account.

26 The AEG agreed to conceptually recognise that expected holding gains could form part of 'adjusted' premium supplements. If the treatment of income attributed to policyholders is not changed,

[14] 1993 SNA para 7.124

the this would suggest that the ‘expected’ part of the actual holding gain could be treated as a withdrawal of investment offset by the additional premium supplement, with the remainder of the actual holding gain rerouted via the other changes in volume account.

Question #6 Should holding gains and losses on non-life insurance technical reserves be ‘rerouted’ back to the non-life insurance enterprise by showing the expected holding gain as a withdrawal of investment by policyholders in the insurance technical reserves, offset by additional premium supplements, with the remainder of the actual holding gain rerouted via the other changes in volume account?

Property income attributed to insurance policyholders – defined benefit pension schemes

27 AEG and supplementary discussion on the treatment of defined benefit funds has suggested that the correct amount of property income attributable to beneficiaries during a year should be calculated by applying an appropriate interest rate to the current value of claims. This is in fact the increase in the liability during the period because the pension date has become one year closer – the so-called ‘unwinding of the discount’. While this is the income payable during the period, no actual payment of income occurs until the beneficiary becomes eligible for a pension.

28 In calculating property income on defined benefit pension funds in this way, no regard is given to the source of funds that may be available to the pension scheme to pay this income when it becomes due. In other words, the treatment of this income is very similar to that of interest.

Question #7 Is it reasonable for property income on defined benefit pension funds to be recorded in the system without regard to the source of funds that are used by the pension scheme to meet the commitment when due?

Property income attributed to insurance policyholders – defined contribution pension schemes

29 In defined contribution pension schemes, the benefit that is attributable to the beneficiary increases by the ‘return’ that the pension scheme earns on the beneficiaries’ contributions (plus of course any additional contributions). This ‘return’ can take the form of interest, dividends or holding gains. As such, the ‘return’ to beneficiaries is uncertain or ‘at risk’, compared with defined benefit schemes where the return to beneficiaries is certain.

30 There would appear to be two ways in which this ‘return’ could be recorded:

(1) It could be all recorded as property income payable by the pension scheme to the beneficiaries – in other words, holding gains would be recorded as part of the income of beneficiaries [15]

(2) Only the amounts relating to the interest and dividend components could be shown as property income, with the holding gain component representing a non-transaction increase in the beneficiaries’ claims on the pension scheme

[15] An alternative would be to record only the real component of holding gains as income.

31 The first way, which would include as part of property income amounts sourced from holding gains, would be consistent with the treatment of defined benefit schemes, where no regard is given to the source of funds underlying the income. However, it would be inconsistent with property income on other forms of 'uncertain' investment, such as investment in equities. It would also be inconsistent with the treatment of property income on non-life insurance, which is discussed above.

32 The 1993 SNA states that "the investment income receivable by the pension funds is … recorded as being payable by the pension funds to the entitled households in the primary income accounts of the pension funds and the households under the heading property income attributed to insurance policyholders"[16], which is consistent with the second alternative mentioned above.

33 There has been no discussion within the AEG to suggest that this method of recording property income on defined contribution schemes be changed in the updated SNA.

Question #8 Should the SNA 1993 treatment of property income on defined contribution pension schemes be retained, or should holding gains (or at least real holding gains) form part of this income?

Property income attributed to insurance policyholders – life insurance

34 Economically, life insurance is very similar to pension schemes, and it is essentially treated in the SNA in the same manner. Therefore, it would seem reasonable to have a consistency of treatment between property income attributed to pension scheme beneficiaries and property income attributed to life insurance policyholders. As in the case of pension funds, life insurance benefits may be 'defined benefit' or 'defined contribution'. Accordingly, it is suggested that if the benefit under the life insurance policy is 'defined' then the property income payable to the policyholder would be equal to the underlying interest rate applied to the outstanding value of claims. If the benefit is 'at risk' then the property income payable to the beneficiary would be equal to the property income earned by the life insurer on the investments made on behalf of the beneficiary.

Question #9 Is it reasonable for property income attributed to life insurance policyholders to be treated in the same manner as property income recorded on analogous pension schemes?

Rent

35 Rent is a form of property income that accrues to owners of non-produced tangible assets that put the assets at the disposal of other units[17]. Rent, like interest, is typically determined on the basis of an agreement that either fixes the amount or determines the method by which the amount is to be calculated. Therefore, as rents are essentially predetermined and are not dependent on the economic performance of the entity making the rent payments, it is considered that they should be recorded without regard to the source of funding.

[16] 1993 SNA para 7.127
[17] 1993 SNA 7.87

36 In the update of the 1993 SNA there has been much discussion on issues associated with non-produced tangible assets. However, none of these discussions has lead to a reconsideration of the nature of rent itself.

Question #10 Is it reasonable for rent, like interest, to be recorded in the system without regard to the source of funds that are used by the renter to meet the rent commitment?

Conclusion

37 This paper has examined the various components of property income, both from the perspective of the 1993 SNA and also taking account of various AEG discussions relating to property income. It is the view of the author that there are two types of property income, as shown in the table below:

Type of property income	Nature of income	Treatment
Category 1 Interest Rent Property income on defined benefit pension schemes Property income on defined benefit life insurance schemes	Predefined, not dependent on the economic performance of the payer	Record without regard to the source of funds used for making payment
Category 2 Dividends Withdrawals of income from quasi corporations Reinvested earnings on direct foreign investment Retained earnings in investment funds Property income on defined contribution pension funds Property income on defined contribution life insurance Property income on non-life insurance	Dependent on the economic performance of the payer	Exclude payments that are sourced from holding gains accruing to the payer, as the payments represent actual distributions of income

38 It is considered that, for Category 1 property incomes, the issue is not whether holding gains are 'included' or 'excluded' from the amounts recorded as income. Rather, the view is that holding gains on behalf of the debtor are irrelevant for how these incomes are measured, because of their nature. This is because the incomes are predefined. As such, it is considered that they are not 'distributions' of income as such, even though we record them in the primary distribution of income account.

39 The property incomes in Category 2 are, however, considered to be genuine distributions of income. As such, it is the author's view that only income that is actually received – either by way of primary income or property income – can be distributed. As holding gains do not form part income

received, they should not form part of income distributed. Likewise, payments that are sourced from sales of assets cannot be shown as the distribution of income.

40 Therefore, it is not considered that holding gains are included in some cases, and excluded in others. Rather, holding gains are only relevant to the second category, and under the existing SNA convention of excluding holding gains from transaction accounts such as the income account, they should to be excluded from the incomes in that category.

41 The author of this paper is of the view that there is no inconsistency in the current SNA treatment of holding gains and property income, and that the decisions taken by the AEG relating to property income have not caused an inconsistency to emerge. However, an alternative point of view is that an inconsistency does exist. It is argued that because the payments for incomes in category 1 may be sourced from holding gains, then the income payments in category 2 should also be recorded including, rather than excluding, holding gains, and that the SNA should be changed accordingly. A variant of the alternative would be to only record the real component of holding gains as income.

Question #11 Is there an inconsistency in the SNA with regard to the treatment of property income and holding gains that needs to be resolved as part of the update process?

Question #12 If it is considered that there is an inconsistency in the SNA, how might this inconsistency might be resolved?

42 If there are any questions about the issues canvassed in this paper, or any points of clarification required, the author would be happy to oblige.

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Appendix

Consolidated set of questions

Question #1 Is it reasonable for interest to be recorded in the system without regard to the source of funds that are used by the debtor to meet the interest commitment?

Question #2 Does the BPM5 treatment of stock dividends, bonus shares and liquidating dividends pertain to dividends recorded in the national accounts? If so, should the SNA be clarified along these lines?

Question #3 Should the proposed clarification regarding dividends from public corporations, where exceptionally large payments are treated as withdrawals of equity, be extended to cover all types of corporations?

Question #4 Should the retained earning in investment funds be recorded excluding holding gains received by the investment funds? Or should the holding gains accruing to the investment funds, or at least the real component of the holding gains be considered as part of income?

Question #5 Is there a case for seeking to change the SNA 1993 treatment of property income attributed to non-life insurance policyholders to include holding gains accruing to the non-life insurance enterprise?

Question #6 **Question #6** Should holding gains and losses on non-life insurance technical reserves be 'rerouted' back to the non-life insurance enterprise by showing the expected holding gain as a withdrawal of investment by policyholders in the insurance technical reserves, offset by additional premium supplements, with the remainder of the actual holding gain rerouted via the other changes in volume account?

Question #7 Is it reasonable for property income on defined benefit pension funds to be recorded in the system without regard to the source of funds that are used by the pension scheme to meet the commitment when due?

Question #8 Should the SNA 1993 treatment of property income on defined contribution pension schemes be retained, or should holding gains (or at least real holding gains) form part of this income?

Question #9 Is it reasonable for property income attributed to life insurance policyholders to be treated in the same manner as property income recorded on analogous pension schemes?

Question #10 Is it reasonable for rent to be recorded in the system without regard to the source of funds that are used by the renter to meet the rent commitment?

Question #11 Is there an inconsistency in the SNA with regard to the treatment of property income and holding gains that needs to be resolved as part of the update process?

Question #12 If it is considered that there is an inconsistency in the SNA, how might this inconsistency might be resolved?