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SNA REVISION PROCESS: PROVISIONAL RECOMMENDATIONS ON THE MEASUREMENT OF THE PRODUCTION OF (NON-INSURANCE) FINANCIAL CORPORATIONS

Paul Schreyer (OECD) and Philippe Stauffer (SFSO, Switzerland)

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1. Executive summary

Recent developments on financial markets have significantly changed the way in which financial corporations operate. The question was therefore raised whether current SNA prescriptions are still adequate to account for the services provided by financial corporations. An OECD Task Force examined these questions and submitted a report to the OECD National Accounts Experts in October 2003 who recommended submitting provisional recommendations to the SNA Revision process.

At this point, the recommendations concern:

- A definition of financial corporation with emphasis on the nature of their output (financial services) instead of their activity (intermediation). "Risk Management" and "Liquidity transformation" activities replace "Intermediation" activities to better capture the nature of the business of today's financial corporations.

- All sources of funds are treated symmetrically in the proposed definition, in recognition of the fact that financial services are produced by taking and investing funds, independently of their origin. In particular, there is no reason to exclude the financial services produced by the investment of financial corporations' own funds. Thus the Task Force recommends that the present SNA rule concerning the exclusion of own funds in the computation of FISIM should be abandoned.

- The definition also implies that money lenders that provide financial services exclusively with own funds would be considered financial entities. This implies changes to the present SNA which does not recognise such money lenders as financial enterprises.

- The reference rate approach towards measuring indirectly-priced financial services has recently gained significant ground in OECD countries' statistical practice. This convergence in approaches should be reflected in the SNA, with explicit recommendation of the reference rate approach.

- The work of the Task Force and the present report also discusses whether implicitly-priced financial services are attached to assets and liabilities other than deposits and loans. While economic reasoning would favour the consideration of all assets and liabilities, such considerations tend to be at odds with present rules in the SNA when it comes to securities whose expected return comprises holding gains and losses. No recommendations are put forward at this point.

2. Background and reasons for change

Recent developments on financial markets have significantly changed the way in which financial corporations operate. The question was therefore raised whether current SNA prescriptions are still adequate to account for the services provided by financial corporations. For example, new financing patterns have reduced the importance of interest incomes, which traditionally constituted a major feature of financial corporations' business. Innovation has produced new financial instruments, often remunerated indirectly, that did not exist when the SNA was debated. New specialised units have been created, delivering for example treasury services to non-financial corporations. In this context, current national accounts practices may not be well suited to register all these changes and value added of financial corporations may well be underestimated. A background paper elaborated by an OECD Task Force (Schreyer and Stauffer 2003) describes in greater detail the changing nature of financial activities (see Box) that motivated such concerns.

The changing nature of financial activities

Risk management has always been at the heart of the activities of financial corporations. Changes on financial markets have, however, modified this activity with possible implications for its measurement. Traditionally financial corporations collected money mainly by accepting deposits and provided funds mainly by granting credit. Balance sheets reflected the activities of financial corporations as providers of services and their composition did not change drastically over time. Financial innovation changed this in a radical way. Today, risk management uses complex financial instruments to bundle and unbundle the different components of risk. Off-balance sheet instruments are often involved in providing services and the characteristics of the various instruments are far more complex. Risks are ***traded*** so that more risk-averse agents bear less risk than those who are risk-friendly. This kind of risk trading is therefore achieved through exchanges of risk among individuals at a given point in time. Risk-sharing and risk-shifting are the main features of the new risk management, and they impact on the forms of remuneration.

Liquidity transformation is another activity that characterises modern financial enterprises. It shares common features with risk management and in practice it is often difficult to distinguish between the two. Delivery of liquidity has also changed over time so that a separate description appears worthwhile. Investors, on the one hand, have always been concerned with liquidity because they are uncertain about the time at which they may want to increase or reduce their holdings of a financial asset. Borrowers, on the other hand, are concerned with liquidity because they are uncertain about their ability to raise added funding in the future. A "new" liquidity transformation has risen in importance with financial liberalisation and capital markets integration. Arbitrage activities, counterpart activities and underwriting facilities have a common feature: they provide liquidity. By creating new assets and liabilities with different liquidity profiles financial corporations provide services on both sides of their balance sheets. Here again the remuneration of this "new" liquidity is different: while commissions remunerate some of these actions, others –like arbitrage- are remunerated through ***expected holding gains***. Further, this new liquidity transformation is initiated by the financial corporation itself and is not as much demand-driven as before. Using their substantial portfolio assets financial corporations take advantage of opportunities arising on sub-markets, thereby contributing to a smooth functioning of the overall structure.

The SNA uses the concept of FISIM – financial intermediation services indirectly measured - to put a value on financial services that are not explicitly priced. In practice, measurement is often narrowly defined around the traditional deposit/loan business, thereby leaving out other financial instruments that may be carriers of financial services with implicit prices.

In this context, a central question is therefore whether the notion of indirectly measured output can be extended from the deposit/loan case so as to obtain as complete as possible a measure of the services provided by financial corporations.

3. Recommended changes

During the 2003 October meeting of the OECD National Accounts Experts, delegates strongly supported the changes put forward by the Task Force on the identification of financial corporations.

3.1. Identifying financial corporations: current treatment and consequences

The SNA 93 chooses an approach based on the analysis of institutional units and emphasises the aspect of economic activity. Financial corporations are defined as "…all resident corporations or quasi-corporations principally engaged in financial intermediation or in auxiliary financial activities which are closely related to financial intermediation" (Paragraph 4.77).

Financial intermediation itself is defined as "…a productive activity in which an institutional unit incurs liabilities on its own account for the purpose of acquiring financial assets by engaging in financial transactions in the market. The role of financial intermediaries is to channel funds from lenders to borrowers by intermediating between them. They collect funds from lenders and transform, or repackage, them in ways that suit the requirement of borrowers. They obtain funds by incurring liabilities on their own account, not only by taking deposits but also by issuing bills, bonds or other securities. They use these funds to acquire financial assets, principally by making advances or loans to others but also by purchasing bills, bonds, or other securities. A financial intermediary does not simply act as an agent for other institutional units but places itself at risk by incurring liabilities on its own account." (Paragraph 4.78).

Several points are noteworthy:

First, the definition of financial corporations puts particular emphasis on financial intermediation, that is, on an *activity*. The SNA does not specify particular *services* provided by financial corporations. Two elements characterise the description of the activity put forward in the SNA, namely "risk-taking" and "repackaging".

Second, the definition in paragraph 4.78 is quite general in that it does not prescribe any particular composition of assets or liabilities in the identification of financial corporations. For example, a unit that exclusively collects funds for investment by issuing interest-bearing securities would clearly qualify as a financial corporation. Involvement in the loan-deposit business is not a necessary condition for identification as a financial corporation.

Third, there is some ambiguity about the role of 'own funds' as a source for the provision of financial services. Paragraph 4.78 allows for funds to be obtained by issuing all kinds of securities, and by implication this includes shares and therefore part of equity which can reasonably be equated with 'own funds'. However, a different paragraph (6.125) of the SNA explicitly excludes own funds as a source for intermediation activity and the associated services. Furthermore, the SNA indicates that the exclusive use of a unit's own funds as a source of lending and investment does not give rise to financial intermediation.

These and other considerations led the Task Force to revisit the definition of financial corporations. In doing so, account was taken of the changing nature of financial activities.

3.2. *A proposed definition*

In light of the above points, the Task Force proposes a broader definition of non-insurance financial corporations:

Financial corporations are all resident corporations or quasi-corporations principally engaged in providing financial services to other institutional units. The production of non-insurance financial services is the result of risk management, liquidity transformation and/or auxiliary financial activities.

Risk management and liquidity transformation are productive activities in which an institutional unit incurs financial liabilities for the purpose of acquiring mainly financial assets. Corporations engaged in these activities obtain funds, not only by taking deposits but also by issuing bills, bonds or other securities. They use these as well as own funds to acquire mainly financial assets by making advances or loans to others but also by purchasing bills, bonds, or other securities.

Auxiliary financial activities facilitate risk management and liquidity transformation activities. Financial auxiliaries – the units that are primarily engaged in auxiliary financial activities – typically act on behalf of other units and do not put themselves at risk by incurring financial liabilities or by acquiring financial assets.

This definition:

- Defines financial corporation foremost via the nature of their output (financial services) instead of their activity (intermediation). Thereby, it extends the logic of the production indirectly measured to incorporate elements of the balance sheet of financial corporations other than deposits and loans.

- Emphasises "Risk Management" and "Liquidity transformation" activities rather than "Intermediation" activities. This semantic change seems to better capture the nature of the business of today's financial corporations.

- Treats all sources of funds symmetrically, in recognition of the fact that financial services are produced by taking and investing funds, independently of their origin. In particular, there is no reason to exclude the financial services produced by the investment of financial corporations' own funds. Thus the Task Force recommends that the present SNA rule concerning the exclusion of own funds in the computation of FISIM should be abandoned.

- Allows for investment in non-financial assets. Parts of the non-financial assets that financial corporations own are simply one alternative form of investment. It may occupy a small share of (non-insurance) financial corporations' assets, but should not be excluded on an a-priori basis.

- Implies that a unit that produces financial services *exclusively* on "own account" is not considered a financial corporation, as there is no delivery of services to third parties. For example, households managing their own portfolio cannot be financial corporations.

- Implies that a unit that, as a primary activity, produces financial services for *several* other units is considered a financial corporation.

- Leaves open a borderline case when a unit produces financial services for only one other unit. There is yet no consensus on whether such a unit should be considered a financial corporation. On the one hand, it can be argued that services delivered to a single client resemble activity on own account in particular when the single client is also the only shareholder as in the case of specialised units that supply treasury services to a single mother company. On the other hand, it is hard to see that the number of units to which financial

services are delivered should be the decisive criterion for the existence of a financial corporation.

– Implies that money lenders that provide financial services exclusively with own funds would be considered financial entities.

In such a context terminology is important. The above definition puts forward the provision of financial services as the determining characteristic for a financial institution. The Task force felt that a distinction had to be made between financial *services* and financial *instruments:*

- *Financial services* constitute the typical output of financial corporations. It is the services that users value and that are provided – implicitly or explicitly – on the market. What makes them somewhat different from non-financial services is that they are often provided implicitly. The Task Force proposed a list of such services (see Schreyer and Stauffer 2003). While this list does not claim to be exhaustive, it was widely supported by practitioners.

- *Financial instruments* are the tools by which financial corporations produce bundles of financial services. They constitute the observable form of the transaction in which financial corporations and their clients engage. For example, liquidity provision is a financial service, as is record keeping. Both services are produced by banks but sold as a bundle to customers who purchase the financial product 'current account'. Of course, there may be financial instruments that provide only one type of financial service in which case 'financial service' and 'financial product' coincide.

One notes that some financial instruments function as 'inputs' into the production process of financial services. These are not 'inputs' in the SNA sense of being intermediate consumption to the production process. But these are inputs in the sense that they are needed to generate financial services: for example, deposits may be necessary to provide the funds for loans – the instrument by which liquidity services are delivered to borrowers. Nor are instruments 'output' in the sense that they constitute the production of financial corporations. Thus, financial instruments cannot be easily classified into categories of inputs or outputs. However, there is no specific need to do so, as long as it is clear that financial services constitute the output of financial corporations.

Given that financial instruments are only a tangible form by which some financial services are provided and considering that financial services can only be provided by institutions classified as financial corporations, it follows that loans or deposits are not *as such* production. There may be no production at all (e.g., if a loan agreement is made between two households). A service and production in a national accounts sense only exists because there is an institution called "financial corporation" that collects funds and transforms them into financial instruments that suit the preferences of customers, be they the providers or the users of funds.

➔ ***For DECISION by the February 2004 AEG meeting***

1. The above definition for non-insurance financial corporations should be adopted provisionally. It should be further developed to become a single definition for all financial corporations, including those providing insurance services.

2. Own funds should not be excluded as a source of funds for the provision of financial services.

3. Money lenders that provide financial services exclusively with own funds should be considered financial entities.

Implications for the SNA:

- *In particular, paragraphs 4.77-4.80 concerning the definition of financial corporations and their activity;*

- *Paragraphs 6.133 and 6.134 concerning money lenders; and*

- *Paragraphs that require exclusion of own funds from 'intermediation' activity, in particular 6.125.*

4. Measuring financial services

4.1. Securities as carriers of financial services

An important question is whether all securities (shares owned and issued, bonds owned and issued, and derivatives) are potential carriers of financial services and whether returns from all these securities should be included in an estimate of the total value of financial services. There was wide agreement that ***securities other than shares*** are carriers of financial services. Services provided are implicitly remunerated with interest rate differentials.

Particular attention was paid to ***shares***. Equity can be seen as one particular way of providing liquidity and risk assumption services to non-financial units. It is more difficult to make this case for equity held by financial institutions with a view to achieving short-term trading gains. However, even in this case, there may be a portfolio management service rendered, for example to holders of securities issued by the financial corporation. In the event, this may also be a service for the financial corporation's own shareholders who bought equity of the financial corporation in expectation of returns following successful portfolio management services.

Several members of the OECD Task Force were of the opinion that all securities, including shares, should be considered potential carriers of financial services, reflecting the fact that sources and uses of financial assets are highly substitutable. This view has not been shared by others who were of the opinion that i) a financial corporation's operation with equities cannot be distinguished from those of non-financial units and that this situation leads to a case where every investment in equity would give rise to production if some financial services are associated with shares; or ii) there are simply no financial services associated with shares, and consequently they should not figure among those service-generating assets and liabilities that enter the measure of financial services. An argument in the consideration against the inclusion of shares is the fact that an important part of the returns to shares consists of ***holding gains or losses*** that receive special treatment in the system of national accounts.

4.2. Holding gains/losses

The SNA 93 draws a distinction between property income and holding gains and losses. The latter are changes in value of an asset due to changes in its price that constitute neither transactions nor income. Holding gains or losses are recorded by the SNA independently of whether they are realised or not through subsequent financial transactions. In the eyes of the SNA, holding gains are not the result of production and so can never be compensation for a service. It would thus appear that holding gains or losses cannot enter the valuation of financial services.

Such a categorical exclusion sits, however, uneasily with economic theory and with the perception of practitioners in the financial services industry. If one admits that all assets and liabilities on the balance sheet contribute to and are potential carriers of implicitly-priced financial services and if there is a

presumption that the value of these services during a period is somehow related to the financial return on assets and liabilities during the same period, then it seems difficult to exclude all price changes from measures of financial return, and to limit the latter to interest and dividend payments, i.e. to property income as conventionally defined in the SNA. The difficulty of excluding price changes from measures of financial return lies in the simple fact that economic actors look at *all* components of remuneration of financial assets and (expected) price changes are an important component. For certain instruments, in particular shares, they are *the* most important element and their exclusion would render measures of financial return void of content. From an economic perspective it can also be argued that (expected) holding gains are part of the price at which some financial services are exchanged. For example, the value of risk assumption services could be measured by a risk premium, itself the difference between the expected return (including price changes) on a risky asset over the expected return on a risk-free asset.

One notes that there are cases where holding gains already enter the value of production under current practice in the national accounts. For example management of portfolios on behalf of clients may involve service fees that are linked to holding gains of securities. Then, the portfolio managers' commissions reflect part of the overall holding gains. But commissions are unambiguously income and will therefore enter the production measure in national accounts.

➔ ***For INFORMATION of the February 2004 AEG meeting***

Implicitly-priced financial services are attached to assets and liabilities other than deposits and loans. In particular, interest-bearing securities are such carriers of financial services and should therefore be considered in the measurement of output. There is no agreement whether other securities, in particular shares, should also be considered carriers of financial services. The consideration of other securities is at odds with present rules in the SNA although it is hard to disregard them on economic grounds and from a perspective of the financial services industry.

It is stressed that the recognition of bonds in the computation of the value of implicitly-priced financial services does not mean that the difference between interests received from and interests paid for bonds is in itself a meaningful measure of the value of financial services provided by bonds. Thus, different elements of production should not be associated with each different type of financial instrument and matching of the same type of asset and liabilities is inappropriate. Rather, property income inflows and outflows from all relevant assets and liabilities have to be considered jointly in the computation of output. Financial corporations would thus be treated as a margin industry. Like the measure of their production reflects margins (positive or negative) on a wide variety of "products", i.e. financial instruments.

Holding gains or losses should not as such and in their entirety enter measures of indirectly-priced financial services. If holding gains were at all considered, ex-ante (expected), not ex-post (actual) holding gains/losses would be the appropriate variable. In this case, expected holding gains for all instruments should enter the computation of indirectly-priced financial services. This issue will receive further review in 2004. It also impacts on the decision relative to treatment of holding gains or losses from technical reserves held by insurance corporations.

Implications for the SNA:

- *None at this moment – to be revisited end-2004*

4.3. Reference rate approach

The reference rate approach towards measuring and allocating indirectly-priced financial services has recently gained significant ground in OECD countries' statistical practice. This convergence in approaches should be reflected in the SNA, although differences remain with regard to specificities of implementation such as the empirical choice of the reference rate. When the reference rate method is used both to

determine the level and the allocation of indirectly-priced financial services it has consequences for the existing SNA prescriptions about the computation of the overall level of FISIM in paragraph 6.125.

➔ ***For DECISION by the February 2004 AEG meeting***

4. The reference rate approach should be the recommended tool for measuring production of indirectly-priced financial services. A single reference rate should be used, preferably reflecting the maturity structure of risk-free assets.

Implications for the SNA:

- *Review in particular of paragraphs 6.124-6.131 and 7.108 as well as Annex III regarding the measurement of FISIM, and the use of the reference rate method.*

4.4. Outstanding items

Several additional points have been identified as important by national accounts experts and will be treated by the OECD Task Force in the course of 2004. These points concern:

- Price/volume split of the value production of financial corporations, whether directly or indirectly-priced;
- Allocation of the value of indirectly-priced production to other institutional units;
- Treatment of specialised financial corporations such as treasury units or mutual funds.

REFERENCE

Schreyer, Paul and Philippe Stauffer (2003); *Measuring the Production of Financial Corporations: Background Report of OECD Task Force on Financial Services (Banking Services) in National Accounts;* Report presented to the OECD National Accounts Experts Meeting 7-10 October 2003, Paris [STD/NAES(2003)9].