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Information Paper

The production of financial corporations and price/volume split of financial services and non-life insurance services

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The OECD Task Force on Financial Services ('The Task Force') has examined issues related to the definition of the financial corporations sector, the measurement of output and the allocation of production of financial services and price and volume measurement for financial and non-life insurance services. This resulted in a set of detailed recommendations which will be submitted for decision to the AEG meeting of January 2006. The task force met for the last time between 10-12 May 2005, in Paris. The final report is being finalized.

The present paper is only intended to inform the AEG on the broad lines of the recommendations.

1. The definition of financial corporations

The SNA 93 definition of financial corporations puts particular emphasis on financial intermediation, i.e. on an activity, and does not specify particular services provided by financial corporations. Two elements characterise the description of the activity put forward in the SNA 93, namely "risk-taking" and "repackaging". However, the rapid development, in recent years, of various financial markets has significantly changed the way in which financial corporations operate. In this respect, the Task Force agreed that the terms "financial risk management" and "liquidity transformation" better describe the activities of financial corporations. In addition, the Task Force paid particular attention to units lending and financing themselves exclusively via own funds and units that produce financial services for only one unit or a group of units.

In the light of the changing nature of financial activities and units and the work carried out to define specialised units, the Task Force agreed on recommendations that:

- Define financial corporations by the nature of their output (financial services including insurance and pension funding services) instead of their main activity (intermediation) while still preserving the term "financial intermediation" to reflect their main activity.

- Treat 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, they do not exclude a financial a financial corporations' own funds as a source of financing.

- Make specific reference to services included in the concept of financial services (e.g. liquidity provision services and risk assumption services).

- Imply that units that provide financial services exclusively with own funds would be considered financial corporations if they, provides loans to a range of clients and incurs the financial risk of the debtor defaulting

- Imply that units that produce financial services for only one unit or a group of units are considered as financial corporations if it keeps a complete set of accounts and is capable of acquiring assets and incurring liabilities on its own account.

2. Measurement of output and allocation of FISIM

The total value of output of financial corporations consists of two components: (i) commissions and fees (directly measured) and (ii) revenues from financial intermediation services indirectly measured (FISIM).

An important question in the context of the calculation of FISIM is whether (in addition to loans and deposits) securities (shares owned and issued, bonds owned and issued) are carriers of financial services and whether returns from all these securities should be included in an estimate of the total value of financial services.

The Task Force agreed that FISIM should be systematically allocated and that primarily deposits and loans attract implicit charges and these instruments are included in the calculations of FISIM. Other instruments (such as bonds) that may attract FISM should not be included unless allocation to user sectors can be made. Thus, in practice, FISIM may be limited by convention to loans and deposits. The task force will recommend a calculation of FISIM based on the use of reference rates.

Holding gains and losses

In the SNA 93 holding gains and losses are neither the result of production nor income and are to be recorded independently of whether they are realised or not. Nevertheless, with respect to securities, it may be argued that expected (not actual) holding gains are part of the price at which some financial services are exchanged. In principle, holding gains could therefore be considered when approximating the value of financial services indirectly.

Because of the conceptual and practical difficulties in estimating expected holding gains and losses, the Task Force agreed to presently not recommend the inclusion of expected holding gains and losses in the measurement of financial services output. Still it is recommended that further investigation of the role of expected holding gains and losses throughout the system be made.

The choice of reference interest rate

The choice of the reference rate for the calculation of FISIM is important for the overall level of measured output but even more so for its allocation across institutional sectors. The SNA 93 defines the reference rate as ‘the pure cost of borrowing funds’, that is a rate from which the risk premium has been eliminated to the greatest extent possible and which does not include any intermediation services.

The Task Force agreed to recommend that the reference rate used in the compilation of FISIM should be a risk-free rate that has no service element in it and that reflects the maturity structure of the financial assets and liabilities to which FISIM applies. In addition, it is recommended that a single reference rate be used for transactions in the local currency, but different reference rates may be used for transactions in other currencies.

3. Market making services

Several financial corporations carry out foreign exchange operations and buy and sell securities both on their own account as well as on behalf of clients. Buying and selling on behalf of clients may be on demand, that is in immediate response to an instruction from the client to buy or sell a specific security. Market making activities relate to buying and selling of securities in order to meet future demands. In these transactions two prices are quoted for transactions in securities: a bid price and an ask price. The difference between the ask price and the mid price is a margin paid by the buyer to the financial corporation, and the difference between mid price and the bid price is a margin paid by the seller.

The Task Force agreed to recommend that the measurement of the margins on foreign exchange and buying and selling of all securities by all financial corporations be made regardless of the purpose for which the securities and other instruments are being bought or sold. It is also recommended that when there is a delay between the purchase and sale of a security, in order to avoid including holding gains and losses, different margins are calculated on the basis of the prices prevailing at the time each of the purchase and sale take place.

4. Price and volume measurement for financial services

There is no directly observable price or quantity that is truly representative of the output of FISIM. This causes major conceptual and practical problems regarding volume measurement and deflation of FISIM. In the absence of direct deflators of the output at current prices, the Task Force agreed to recommend one of the following two approaches:

- The rate of change of the volume indicator can be derived using the rate of change of stocks of loans and deposits deflated by a general price index (e.g. the GDP deflator)

- Direct output indicator method. Break down the different characteristics linked to financial services (e.g. numbers and value of loans and deposits, savings, money transfers etc.). For each of the characteristics an appropriate volume indicator is to be derived. The volume indicators are then weighted together.

5. Price and volume measurement for financial and non-life insurance services

The measurement of the output of non-life insurance services at current prices is obtained using a formula based on the difference between premiums (plus adjusted premium supplements) and adjusted claims. In practice it is difficult to construct a price index that truly reflects the output of non-life insurance services to be used for deflating the current price output. In the absence of this ideal deflator, the Task Force agreed to recommend the compilation of a direct volume indicator by using one of the methods proposed below, and obtain the price index as the ratio between the current price series and the volume series:

- Obtain a direct volume measure of the output (and by extension, the consumption) of non-life insurance services by extrapolating the current price measure of the base year by the rate of change of a volume index, which is obtained by deflating gross premiums earned by a premium price index (PPI or CPI, depending of the context). When the premium price index covers premium supplements, it is advisable to use the rate of change of a volume index compiled as gross premiums plus adjusted premium supplements deflated by this extended premium price index.

- In the absence of adequate premium price indices, a volume indicator can be compiled using quantity indicators such as the number of policies, by line of product (house-owner insurance, motor vehicle insurance, third party liability, etc.) appropriately weighted preferably by net premiums or, when not possible, by gross premiums.

A paper for decision, explaining the detailed recommendations, will be submitted to the January 2006 meeting of the AEG.