Report of the

Expert Group Meeting on Financial Flows and Balances

Washington, D.C. - September 6-15, 1988

Bureau of Statistics

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Executive Summary

An Inter-Secretariat Working Group, consisting of the United Nations, the European Communities, the Organization for Economic Cooperation and Development, the World Bank, and the Fund, was organized in 1983 to oversee the revision of the United Nations' A System of National Accounts (SNA), which had last been revised in 1968. The principal vehicle of the revision process was the organization of a series of expert group meetings on specialized statistical topics. Each expert group has consisted of representatives of the Inter-Secretariat Working Group, six national accounts specialists (the "core group") who attended all the meetings, and six experts in the particular statistical topic of the meeting. The Fund, as part of its contribution to the revision process, hosted expert group meetings in its three primary areas of statistical responsibility--balance of payments, public finance statistics, and financial statistics. The principal goal of these meetings was to integrate, to the greatest extent possible, the Fund's specialized statistical systems with the global national accounts system. Reports on the balance of payments and public sector statistics meetings have already been submitted to the Executive Board. 1/

This report contains a detailed review of the discussions and recommendations of the final meeting hosted by the Fund, the Expert Group Meeting on Financial Flows and Balances, which was held at Fund Headquarters from September 6 through 15, 1988. The meeting agenda dealt with four main issues in the field of financial statistics:

1. Conceptual and data links between the SNA and other statistical systems of financial flows and balances
2. Financial transactors
3. Financial assets and liabilities
4. National and sectoral balance sheets and reconciliation accounts.

The first item dealt with an examination of the analytical objectives of specialized systems of financial statistics, principally the Fund's money and banking statistics (MBS), in relation to the global national accounts system which covers both financial and nonfinancial transactions. The focus of the discussions was on establishing the appropriate role for the analysis of financial transactions in the SNA in relation to MBS and other systems such as flow of funds analysis, and on harmonizing these systems, wherever possible. It was recognized that specialized systems for financial analysis were necessary and that the SNA framework could not be expected to encompass all such specialized systems. The recommendation of the Expert Group was that flow of funds analysis should become a more central element of the SNA framework through the

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1/ Expert Group Meeting on External Sector Transactions for the Revision of the System of National Accounts (SNA) (EBD/87/216, August 17, 1987), and Report of the Expert Group Meeting on Public Sector Accounts (SM/88/202, September 2, 1988).

inclusion of a matrix that would permit the three-dimensional analysis of transactions between creditors and debtors according to type of instrument.

The second and third items of the agenda were mainly concerned with the impact on the framework of the SNA of the substantial innovations that have occurred in recent years in financial markets, institutions and instruments. Under the second item, Financial Transactors, which dealt with the coverage and definition of the financial institutions sector and its appropriate subdivision, the financial institutions sector in the present SNA includes only financial intermediaries, i.e., those enterprises that both incur financial liabilities and acquire financial assets in the market. Since the issuance of the present version of the SNA in 1968, however, there has been a very substantial growth of financial services that facilitate financial intermediation, such as those provided by financial guarantors, brokers, mortgage advisors, financial advisors, etc. The Expert Group recommended that the financial institutions sector be expanded to encompass a broad range of financial services and that these activities be designated financial auxiliaries and, in addition to financial intermediaries, they form a separate subsector of the financial institutions sector. The Expert Group also recommended a change in the subsectoring of financial intermediaries. In the current SNA, subsectoring depends largely on the identification of institutions which have liabilities in the form of demand deposits, thereby focusing on a narrow money definition. The Expert Group, recognizing that there are few countries that currently place primary emphasis on narrow money, recommended that all institutions that accept deposits or mobilize funds through issuing deposit substitutes be grouped within a single subsector, entitled "other depository institutions." The financial institutions sector would, therefore, be subsectored as follows:

1. Central bank
2. Other depository institutions
   - 2.1 Deposit money institutions
   - 2.2 Other
3. Other financial intermediaries except insurance companies and pension funds
4. Financial auxiliaries
5. Insurance companies and pension funds

The Expert Group also clarified a number of issues concerning the boundaries between the financial sector and other domestic sectors.

Agenda item 3 dealt with the classification scheme for financial instruments in the present SNA, which is based primarily on the liquidity and maturity characteristics of instruments. The Expert Group recognized that there has been a great deal of innovation in the form of new financial instruments that has blurred these characteristics. It, therefore, examined a range of other characteristics such as marketability, negotiability, and alternative uses of instruments. The

conclusion reached was that the present classification scheme was basically suitable, but that it should be simplified, with less emphasis placed on distinctions between short- and long-term maturities. The recommended classification scheme is presented below:

1. **Gold and SDRs**

2. **Currency and deposits**
   a. **Currency**
   b. **Transferable deposits**
   c. **Other deposits**

3. **Securities other than shares**
   a. **Short-term**
   b. **Long-term**

4. **Loans**
   a. **Short-term**
   b. **Long-term**

5. **Shares and other equity**

6. **Insurance technical reserves**
   6.1 **Net equity of households on life insurance reserves and on pension funds**
   6.2 **Prepayments of premiums and reserves against unsettled claims for casualty insurance**

7. **Other accounts receivable and payable**
   7.1 **Trade credit and advances**
   7.2 **Other**

Memorandum item:

Direct investment
- **Equity**
- **Loans**
- **Other**

Attention was also given to classification problems raised by the large number of new financial instruments created in recent years and by problems such as payments arrears and the impact of high rates of inflation on the nature of instruments. The general conclusion reached was that most new instruments are variants of or combinations of existing instruments and that the classification schemes and principles for recording transactions can deal with the majority of new instruments. The revised SNA will attempt to provide guidance on analyzing the characteristics of new instruments in order to facilitate proper classification.

The fourth agenda item **covered** national and **sectoral** balance sheets and **reconciliation** accounts and was **primarily** concerned with how they could be **more** fully **embodied** in the **revised** aNA. The present SNA includes in the capital accounts all capital formation in tangible reproducible assets, as well as changes in the accumulation of tangible nonreproducible assets if the latter changes are a consequence of a purchase or sale of those assets. Also included are the creation, elimination, purchases, and sales of financial assets and intangible nonfinancial assets. Not included in the capital flow accounts, but rather in the reconciliation accounts of the SNA, are all other changes in the stocks of financial, intangible nonfinancial, and tangible assets. It was agreed that the reconciliation accounts in the current SNA need to be further integrated with the present sector accounts of the SN& and that a new concept, entitled **"Changes** in Net Worth," should **be introduced** into the SNA. The need **to separately** identify **revaluation** items was **seen** to be necessary to enable alternative income measures to be constructed.

The Expert Group's discussion of the links between financial flows and balances covered the valuation of financial instruments as assets and liabilities and the treatment of foreign **currency-denominated** items. As a **general principle** of **valuation**, the **Expert Group recommended** retention of **the symmetric treatment** of **assets and liabilities at market prices**. For those financial instruments denominated in foreign currencies, valuation changes can result from exchange rate changes as well as from changes in market prices. While the Expert Group **agreed** that under unitary exchange rate systems the **valuation** of **foreign currency-denominated** stock positions was straightforward, it concluded that several techniques, which are elaborated in the report, might have to be used under multiple exchange rate systems, depending on individual countries' systems and data limitations.

The **recommendations** of the **Expert Group** are **likely** to **have** important implications for financial analysis at the national and international levels, as the revised SNA will serve as the basic framework for macroeconomic statistics for a broad range of countries. Within the Fund, the recommendations will be reflected in revisions of the statistical **methodologies** for balance of **payments, government** finance, and money and banking statistics; several of the recommendations will serve as guidance for eliminating inconsistencies which exist within these methodologies. Numerous proposals which clarify treatment ofnfinancial instruments and institutions will facilitate analysis and operations within the Fund. With respect to analysis at the national level, the primary influence is likely to relate to the increased prominence of financial transactions within the **national** accounts framework which should improve links between the financial and real sectors of the economy.

Introduction

The meeting was opened by Mr. Dannemann, Director of the IMF Bureau of Statistics, who stressed that the meeting was important not only because it dealt with the financial accounts of national economies but also because of the nature of the accounts as they overlap other fields of statistics. Mrs. Carson of the Bureau of Economic Analysis, U.S. Department of Commerce, was selected by the Group to chair the meeting, the agenda of which covered not only issues related to financial flows and national and sectoral balance sheets but also a number of items included in the discussions of earlier meetings and referred to this meeting for the views of the financial experts. In view of this, the need to reach decisions on the large number of items to be discussed was stressed, and it was also noted that the detailed report of the meeting should be completed in a timely manner in order to expedite the drafting of the revised United Nations' A System of National Accounts, (SNA).

It was agreed that, in its discussions, the Group would be primarily concerned with the elaboration of a system based on conceptual considerations, and that this should not be unduly constrained by considerations of present-day data limitations; it was also agreed that statistical handbooks dealing with practical problems of data compilation would be developed for each major subject area.

It was agreed, as well, that the author of the revised SNA would guide the discussions where necessary to ensure coverage of specific problems (and their overall implications for the system) that would need to be decided upon to allow drafting to proceed. It was noted that the revised SNA would be more forward-looking than the present SNA and would contain greater discussion of the reasons for the treatment described therein.

I. Conceptual and Data Links Between the SNA and Other Statistical Systems of Financial Flows and Balances

A. Analytical objectives and structural relationships

This topic of the agenda was aimed at establishing the appropriate role for the analysis of financial transactions in the SNA in relation to other statistical systems, such as the IMF's Money and Banking Statistics (MBS) or flow of funds analysis, that are specifically directed at financial analysis. The present SNA provides insufficient detail in the capital finance accounts to permit detailed analysis of the ways in which sectoral savings/investment gaps are financed. A major issue that needed to be addressed was whether the SNA should be expanded to provide the basis for such detailed analysis or whether such concerns should remain with other statistical systems. In either case, the objectives of and the links between the SNA and these other systems needed to be examined.

It was recognized that SNA and specialized financial statistics such as MBS have different analytical objectives. The SNA provides a comprehensive framework for measuring and analyzing the determinants of income (production, and distribution and redistribution of income and wealth) and attempts to examine the extent to which each sector of the economy is involved in each of those determinants of income. As transactions involving production and distribution of income and wealth are classified in the same manner for all sectors, the analysis is also able to determine the effect of the actions of one sector on the income of other sectors as well as the limitations imposed by other sectors' actions on the income of the sector under study.

The purpose of the data on financial assets and liabilities included in the capital finance accounts of the SNA is to enable the analyst to assess the effects of production and income distribution on the asset and liability portfolio of each sector and, of equal importance, to assess how this portfolio impinges on the sector in the execution of its production plans and in its possibilities of income generation. The incorporation of accounts of financial institutions enables the SNA to analyze the intermediary role of financial institutions in this process.

The Group recognized that MBS focuses on a narrower analytical objective--that is, on relating a concept of money to the domestic and external positions of banking institutions. In contrast with the SNA, MBS is designed to provide a standard set of analytic financial aggregates that facilitates the integration of money, credit, and balance of payments analyses. Monetary statistics are compiled by countries because of the demonstrated relationship between money growth and real output, prices, and the balance of payments and their relevance for the formulation of financial policy. There is no universally applicable approach to monetary analysis or policy and thus there is no single analytical framework which can encompass the needs of all users. MBS is, however, sufficiently generalized to permit assessment of the linkages among the banking sector, the balance of payments, and the other domestic sectors of the economy, with special emphasis accorded to the government or public sector. These constitute key elements of a financial program, focusing on the principal financial targets, that is generally applicable.

Approaches to monetary analysis have been undergoing significant change in many countries, in part because of the substantial innovation that has affected financial markets, financial institutions, and financial instruments. The concept of money itself has undergone considerable revision since the 1968 SNA; many countries now tend to focus on monetary measures considerably broader than that of currency plus transferable (or demand) deposits, which previously was regarded as having a generally stable relationship to income. The quality of this relationship has declined, owing to changes in the structure of financial institutions and instruments that have increased the substitutability of other assets for narrow money, while higher rates of inflation have made it increasingly costly to maintain non-income-earning balances. Countries have therefore tended to focus on a variety of money measures, which include nontransferable deposits (time, fixed, and savings accounts) and often short-term securities issued by the banking system, in an effort to identify the particular mix of instruments that bears a stable relationship to target macroeconomic variables. In addition to these measures comprising only bank liabilities, many countries have developed even broader liquidity concepts, which include financial liabilities of other sectors that, from the point of view of the holder, can be easily substituted for banking sector liabilities (treasury bills, commercial paper, etc.).

In the discussion, the Group concluded that both the SNA and MBS provide a picture of the economy, including information useful for decision making. The SRA is a broad system, encompassing both financial and nonfinancial transactions as well as balance sheets. MBS focuses on financial activities and related stocks.1/ The SNA and MBS have different objectives, and the SNA should not be expected to embrace all of the MBS objectives but only those relevant to national accounts analysis. In this connection, one participant noted the difficulty of having one presentation that would meet all possible analytical uses. The consensus of the Group was that the SNA should not define a monetary concept, as this would soon become outmoded. There was support, however, for the inclusion of an explanation of monetary concepts and the range of monetary aggregates in a handbook so long as these explanations were updated periodically. It was suggested that, in any event, the SNA classification of financial instruments should be structured in such a way that a variety of monetary aggregates could be derived.

1/ Text shown in boldface is excerpted from the Summary of Conclusions and Recommendations, as prepared by the Expert Group at the closing of the meeting (see Appendix V).

One participant, noting that in the present SNA the various accounts for the financial system are identical to those for other sectors, raised the possibility of adopting a three-dimensional approach for the financial sector (that is, by instrument as well as by creditor/debtor sectors), similar to that in the present SNA Table 24, "Financial transactions of the detailed sub-sectors." There was some support among the Group for this proposal. An additional question that would need to be addressed in the discussion of subsequent agenda items was whether such an approach should be followed in the SNA accounts or in a supplementary table.

Several speakers questioned the stated S need for international comparability insofar as this could detract from the usefulness of the data for national policymakers if carried too far.

It was noted that the SNA accounting presentation might not be the best framework for presenting monetary data, and that differences in the frequency and currentness of SNA and Maa data were an additional factor that could cause these two presentations to differ. Notwithstanding this, the links between the SNA and MBS are important, and the Group concluded that consistency in definitions of transactors and transactions at higher levels of aggregation is critical to the complementary use of both systems. Consistency at other levels is generally desirable, but should not conflict with the preparation of statistics for particular analytical objectives.

The Group also noted the Expert Group on Public Sector Accounts' conclusion that there was a lack of feedback in the SNA among the production, income and outlay, capital formation, and capital finance accounts, and that the SNA needed to be an integrated system. One participant questioned whether MBS served to facilitate integration with the IMF's government finance and balance of payments statistics, since the former system is based on stock data whereas the latter two are based on flows.

B. Flow of funds accounts

The present SNA includes information on assets and liabilities in balance sheets, reconciliation accounts, and capital flow accounts for all sectors; each of these accounts includes the same sector breakdown for assets and liabilities by type. In the sector balance sheets and accounts of the SNA, no three-dimensional information is available on the links among the types of financial instruments, the sector which holds a financial asset, and the sector for which this instrument constitutes a liability. Outside the sector accounts, however, the SNA includes one table (Table 24) which presents changes in the holdings of financial assets by debtor and creditor sectors; the institutional and instrument classifications used in the table are consistent with those included in the rest of the system. Table 34 of Provisional International Guidelines on the National and Sectoral Balance Sheet and Reconciliation Accounts of the System of National Accounts (M60) includes the stocks of assets and liabilities by debtor and creditor sectors.

Apart from questions of linking the SNA to specific statistical systems for financial analysis such as MBS, which are discussed in Section I.0 of this report (Links between the SNA and MBS), a more basic question concerns the extent to which detailed data on financial flows should be integrated into the revised SNA. Flow of funds systems have been developed in a number of countries as extensions of the national accounts to deal with the specific issue of inter-sectoral financing. Flow of funds accounts in their simplest form are records of the financial transactions of a sector with the other sectors of the economy and with the rest of the world. They are a natural extension of the capital finance accounts of the SNA which identify aggregate savings/investment gaps for each sector and provide further information on the financial instruments through which the sector obtains funds from or provides funds to other sectors.

The Group recognized, however, that extending the present an& capital finance accounts to a three-dimensional classification identifying creditor and debtor sectors would amplify those accounts to a greater extent than the income and outlay and capital accumulation accounts of the system, where such detailed inter-sectoral linkages are not included. On the other hand, flow of funds accounts facilitate the detailed analysis of how surplus sectors finance deficit sectors and, in particular, permit an analysis of the key role played in the economy by financial institutions even though their impact on the production, income and outlay, and capital accumulation accounts is quite small. Flow of funds matrices which include detailed information on financial instruments and sectors also assist the investigation of the impact of interest rates and exchange rates on financing decisions.

The Group recognized that the capital finance accounts of the present SNA were a form of flow of funds accounts but noted that, to date, only a few countries had developed capital finance accounts. Several reasons were cited, namely: data limitations; the complex requirements of the SN; lack of staff; the fact that many countries are still following earlier versions of the SNA; lack of coordination between central banks and statistical offices; poor results in modeling, possibly due to data limitations; and the long lag inherent in the compilation of data, resulting in the use by analysts of more current indicators.

The Group decided that, paralleling the present the SNA capital finance accounts, the SNA will continue to record, for each sector, changes in assets and liabilities broken down by type of instrument. In addition, the central framework should contain a three-dimensional matrix classified by instrument, creditor sector, and debtor sector in the general form of flow Table 24 of the SNA and stock Table 34 of M60. While this expanded presentation would form part of the central framework, it would be given a lower priority than that accorded the capital finance accounts. **The instrument and sector classification schemes should be identical** for the stock **and** flow matrices. In order to encourage the wider **development** of flow of funds accounts in the context of differences in the stages of statistical **development** among countries, it was agreed that a variety of options for their **development**, that would be less demanding in terms of both resource and data requirements, should be articulated. However, since the SNA should propose a conceptually ideal system, such **options** should **be elaborated** in a **handbook.** The importance of providing a variety of options was emphasized, since "developing countries" were in no sense a homogeneous group.

On the general question of the complementary role of handbooks in the **implementation** of the revised SNA, it was noted that unless these were issued simultaneously with the SNA, countries would lack practical guidance on how to implement the SNA's recommendations.

Several participants felt that the background paper prepared for this agenda item ("The Flow of Funds Accounts,. the UN's System of National Accounts, and the **Developing** Countries") would **provide useful input for the proposed handbook. Several participants acknowledged the analytical usefulness of the financial instrument and sectoral groupings proposed in** the paper but noted that they departed in some respects from the existing sector and instrument classification schemes in the present SNA, as well as from modifications in those schemes which were proposed under items II and III of the Agenda.

'C. Links between the SNA and MBS

The decision made by the Group to include in the SNA detailed stock data, articulated by debtor and creditor sectors, means that there will be little difficulty, in principle, in reconciling these data with disaggregated MBS data. This would permit the integration of monetary analysis with the other SNA analyses indicated above.

The remaining question under this agenda item, therefore, was whether the links between the SNA and MBS should be further **improved** by expanding the present MBS to include financial flow data. On this question, most participants agreed that such an expansion would be desirable since monetary analysis is facilitated by flow data and since flow data are more readily reconciled with SNA transactions and more usefully integrated with flow of funds analysis. It was recognized that a flow analysis based on changes in levels would often be unsatisfactory, as it could be distorted by such factors as valuation changes, changes in accounting practices, and discontinuities in data resulting from changes in coverage or in the reporting population. The presentation of stock and flow data for MBS would have to be accompanied by a fairly detailed reconciliation account.

Although the Group considered an expansion of MBS to encompass flow data to be desirable, both for monetary analysis and for facilitating links with the SNA, it was felt that the development of a fully articulated and consistent set of flow data in MBS would be very difficult, owing to a variety of practical problems. These included the following:

1. While some of the adjustments necessary to move from stock data to flow data were in principle straightforward, others were more complex and problematic in nature; these would include the treatment of provisions and write-offs and the valuation of securities and foreign currency liabilities and assets.

2. The compilation of flow data by the IMF would require a much greater disaggregation of reported data than at present and would increase significantly the resources required to prepare and compile such data in both member countries and the IMF.

3. Collecting flow data directly or estimating detailed flows from stocks would be impractical for an international organization such as the IMF. This could be done only by countries themselves, since they have access to the required detailed data, but 'this would be a major problem in countries facing resource constraints. It was further recognized that preparation of flow data might involve substantially expanded data collection within countries.

4'. Since the analytical usefulness of flow data would be diminished considerably if such data were not compiled on a. monthly (or.. perhaps quarterly) basis as are stock data, this requirement would add further to the reporting burden of countries.

In view of these practical problems, some participants suggested that MBS should perhaps take a pragmatic approach, namely: (1) MBS should have flow data for those countries that regularly produce such data; (2) in cases where valuation and other non-transactions-related factors are not important, only stock data would be presented; and (3) in other cases, a middle ground could be sought by compiling "adjusted" stock data, rather than "fully fledged" flow data, whereby only the major non-transactions-related adjustments are made.

In summary, the participants agreed that it would be desirable to have flow data consistent with MBS stock data, since flows better reflect underlying financial activity in a form consistent with the SNA. However, participants recognized that it would not be feasible in most cases for the IMF to derive flow data from the stocks due to technical difficulties with respect to provisioning, write-offs, valuation, and other reconciliation account items.

II. Financial Transactors

A. Definition of financial institutions

The current SNA and MBS define financial institutions as those enterprises primarily engaged in financial transactions in the market consisting of both incurring financial liabilities and acquiring financial assets. The Group discussed the following two situations in which the application of this definition may not be appropriate.

1. A growing number of establishments presently classified in the enterprise sector deal in financial instruments and/or provide financial services. These services, which in some cases may be similar to those undertaken by banks, include those provided by securities brokers, dealers, flotation companies, commodity brokers, and loan brokers. Also included are agencies whose principal function is to guarantee, by endorsement, bills or similar instruments. intended for discounting or refinancing by financial institutions and institutions engaging solely in hedging instruments, such as swaps, options, and futures, which have resulted from recent financial innovation. Although these establishments provide services which are very similar to those provided by financial institutions proper, they are not considered to be financial institutions under the present SNA definition since they are not "at risk," that is, they do not incur liabilities on their own behalf nor do they acquire financial assets.

2. In many countries, institutions deal in financial transactions as agents for individuals and private companies by holding funds in trust and investing on behalf of beneficiaries but do not incur liabilities and acquire assets on their own account. Trust and custody activities of banks and nominee companies fall into this category.

Most of the participants recommended that the financial institutions sector in the SNA be expanded to include (in addition to enterprises which are primarily engaged in financial transactions in the market consisting of both incurring financial liabilities and acquiring financial assets) auxiliary enterprises that facilitate financial intermediation. These auxiliary enterprises would include financial guarantors, brokers, mortgage advisors, financial advisors, etc.. Several reasons were given for this broadening of the present SNA sectoral boundary, namely:

1. Financial institutions are increasingly engaging in the provision of financial services as well as financial intermediation per se. The financial services they provide do not differ from those of institutions engaged solely in providing financial services. The present SNA classifies the latter as nonfinancial institutions, implying, paradoxically, that the services they provide are nonfinancial ones.

2. This broadening would be consistent with the recommendation of the Expert Group Meeting on Production Accounts and Input-Output Tables that the revised SNA should give more attention to the "production" of financial institutions.

3. A continued focus on the present narrowly defined financial institutions sector would mean that the nonfinancial private corporate sector would increasingly become a residual category for financial service institutions.

4. It is becoming increasingly difficult to draw the line between true intermediation and auxiliary financial activities, particularly those involving contingent assets and liabilities. Therefore, institutions performing these intermediation and auxiliary activities should be grouped together for a complete picture of financial activities.

5. The rapid changes in financial arrangements and behavior as a result of continuing innovation would mean that continued adherence to a narrow definition would result in individual institutions continuously moving in and out of a sector defined in terms of primary activity as an intermediary. A broader definition that would include financial service institutions would reduce such occurrences and would minimize the amount of secondary production.

The Group agreed that, in defining the broad-based financial institutions sector, the guiding principle should be the primary type of transaction or activity, although some participants cautioned that there may be borderline questions, particularly in subsectoring within the financial institutions sector. There was general agreement that the definition of the financial institutions sector should be consistent with, or identical to, other major international classification schemes. The Group agreed that the financial sector will consist of corporate and quasi-corporate enterprises whose primary activities fall in divisions 65, 66, and 67 of the current draft version of the International Standard Industrial Classification, Rev. 3 (ISIC). The Group's feeling was that the use of ISIC would lead to a definition that would be close to the SNA's activity classification underlying the production accounts, and that the adoption of a different classification would obscure the analysis of production and financial intermediation. The use of ISIC would also minimize the amount of secondary production by financial enterprises and the amount of financial activity by production units. In addition, if the ISIC definition of "financial intermediation services" were not adopted, there would be a danger of losing information on financial services since once these were allocated to the nonfinancial corporate sector it would be difficult to separate them.

Several participants favored retaining the present narrow SNA definition of the financial sector. In their view, the financial/ nonfinancial breakdown was a relatively minor one, affecting only the supplementary tables in SNA balance sheets, and any attempt to amend the present definition to reflect the effects of financial innovation would have a profound effect on the SNA. The question was also raised as to whether it was financial service enterprises that had become more important or whether the main impact of innovations was in the growth of off-balance sheet items of financial intermediaries as well as of direct financing in the nonfinancial corporate sector.

The present definition of financial institutions covers both incorporated and unincorporated enterprises. In view of the problems involved in collecting data for unincorporated enterprises, the question arises as to whether it might be more practical and appropriate to include them in the household sector. The Group concluded that, in contrast to the present SNA, unincorporated enterprises mainly engaged in financial activities falling in divisions 65, 66, and 67 of ISIC, Rev. 3, should be treated in the same way as unincorporated enterprises engaged in nonfinancial activities. This means that they will be treated as quasi-corporate enterprises and classified with financial institutions only if they have a complete set of accounts including information on withdrawals. Otherwise, they will be classified with the household sector.

B. Subsectors of the financial institutions sector

The Group recommended that the financial sector, as defined in section II.A., should be subsectored as follows:

1. Central bank
2. Other depository institutions
   2.1. Deposit money institutions
   2.2. Other
3. Other financial intermediaries except insurance companies and pension funds
4. Financial auxiliaries
5. Insurance companies and pension funds.

The Group agreed that this enlarged financial sector should be referred to as the financial corporate sector.

The Group agreed on the definitions presented in Table 1, below, for the financial corporate sector and the appropriate subsectors. Primary identification of subsectors would be at the one-digit level. In the case of category 2, Other depository institutions, it is suggested that, when national authorities find it analytically useful, this category should be divided between 2.1, Deposit money institutions, and 2.2, Other.

Table 1. 'Definition of the Financial Corporate Sector and Subsectors

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Financial corporations]/

Incorporated and quasi-corporate enterprises which are (i) primarily involved in financial intermediation in the market, that is, engaged in financial transactions consisting of both incurring liabilities and acquiring assets which are primarily financial; or (ii) engaged in auxiliary activities, that is, those closely related to financial intermediation but not in themselves involving financial intermediation. Holding companies whose primary activity is the management and control of financial enterprises are to be considered financial enterprises and classified in the subsector which includes the preponderance of their subsidiaries' activities, irrespective of their own specific activities. All subsectors of the financial sector should be divided between public, national private, and foreign-controlled corporations.

Subsectors

1. The central bank

The public financial institution which is a monetary authority, that is, which issues currency and sometimes coins, and may hold all or part of the international reserves of the country. The central bank also has liabilities in the form of demand or reserve deposits of other depository institutions and often government deposits.

2. Other depository institutions,

All financial enterprises, except the central bank, which have liabilities in the form of deposits or financial instruments such as short-term certificates which are close substitutes for deposits in mobilizing financial resources and which are included in measures of money broadly defined.

At a secondary level of subsectoring, other depository institutions may be divided into:

2.1. Deposit money institutions

All depository institutions which have liabilities in the form of deposits payable on demand and transferable by check or otherwise usable in making payments.

Table 1 (concluded). Definition of the Financial Corporate Sector and Subsectors

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2.2. Other

All other depository institutions which have liabilities in the form of deposits other than transferable deposits or in the form of financial instruments such as short-term certificates which are close substitutes for deposits and which are included in measures of money broadly defined.

3. Other financial intermediaries except insurance companies and pension funds

All financial enterprises (except those included above and except insurance companies and pension funds) which are primarily engaged in financial transactions in the market, consisting of acquiring financial assets and incurring liabilities.

4. Financial auxiliaries

All enterprises engaged primarily in activities closely related to financial intermediation but which do not themselves perform an intermediation role. This would include enterprises which provide guarantees, stock brokers, mortgage brokers, insurance brokers, insurance agents, actuaries, financial advisors, etc. Also included are entities which manage the operation of financial markets.

5. Insurance companies and pension funds

(No change in coverage from present SNA.)

J Bodies which regulate or supervise financial corporate enterprises should be included in the general government sector or central bank subsector as appropriate.

With respect to the central bank subsector, the Group agreed that this would include the accounts of the central bank and would not include central bank or monetary authority functions carried out by the government unless separate full accounts were maintained for these operations. The central bank subsector in the revised INN will therefore be identical to that in the 2NA.

The Group noted that the subsectoring of financial institutions in the present 2N6 is based on a narrow concept of money defined as the sum of currency outside banks and deposits payable on demand and transferable by check or otherwise usable in making payments (hereinafter referred to as "transferable deposits"). The Group recognized that, because of financial innovation, banks are able to offer "money substitutes" which in most respects differ little from "transferable deposits." As a result, the generally close historical relationship between narrow money and income has weakened in many countries. For purposes of monetary analysis, countries, as well as MBS, have begun to emphasize broader measures of money which encompass all money substitutes that are liabilities of banking institutions. The above developments also call into question the usefulness of separately identifying the existing SNA subsector termed "other financial institutions," since such a separate identification results in a large and growing group of other banking institutions that operate in a similar way to narrow money-issuing institutions being included in a residual sector in SETA.

While the Group was of the view that the above developments necessitated a restructuring of the subsectoring in the SNA, they were not in favor of basing the subsectoring on any one measure of money. Nevertheless, several participants favored the introduction of a "banking" subsector that would parallel the MBS Banking Survey level of consolidation, since this would be consistent with the trend toward analysis of broad money measures. Two participants noted that if broad money aggregates were to be a guiding principle the term "banks" was perhaps not the most appropriate since in many countries this term has a strict legal meaning and there might be institutions that, while not defined as "banks," issue money substitutes. The Group therefore agreed to use the term "other depository institutions." It was also agreed that the issuance of narrow money and broad money could be a useful guiding principle, although this would take a subsidiary role to the one-digit level of classification and would have to be based on each country's particular definitions of monetary aggregates. This breakdown of other depository institutions, which would be an optional one, was seen by some participants as useful in providing continuity with the present SNA and in enabling the continued identification of narrow money. It would also be a useful breakdown for countries to maintain as they established procedures for the collection of data on "other" other depository institutions.

While several participants felt that only those depository institutions with "appreciable" transferable deposits should be classified as deposit **money** institutions, the majority of the Group felt that this would be inconsistent with the need to reduce the focus on narrow money and would not provide for historical continuity.

A number of participants expressed the view that defining subsectors in terms of a national definition of money, whether broad or narrow, could lead to **a** lack of comparability across countries. The Group recognized this as a potential difficulty but concluded that for the time being the other depository institutions subsector should be based on a broad money concept that would, to a certain extent, be left up to individual countries to specify. This was considered an issue that could be reviewed in later meetings. In this context the Group agreed that, while the text of the SNA would not specify a particular definition of money, the various broad measures that do exist would be described.

With respect to the other subsectors of the financial corporate sector, the Group recognized that "other financial intermediaries except insurance **companies** and pension funds" **would include** many important institutions whose **primary** function is **carrying** out financial transactions in the **market** but which do not incur broad money liabilities. It was agreed that the definition of the subsector would not be exhaustive but that the text of the SNA would include illustrative examples.

The decision taken by the Group to expand the coverage of the financial institutions sector to include entities engaged primarily in the provision of financial services but not themselves intermediaries required the addition of a new subsector of "Financial auxiliaries." The types of activities to be included in this subsector have been discussed in the previous section of this report.

The definition of the subsector for "insurance companies and pension funds" in the present SNA was left unchanged by the Group because the coverage of <u>institutions</u> was thought to be appropriate. The treatment of insurance <u>transactions</u> in the new <u>SNA</u> was seen to be in need of substantial revision, particularly with regard to casualty insurance. Preliminary discussions of this topic were held under item V of the **agenda,** but it was recognized that the topic would require further discussion at subsequent meetings.

C. <u>The borderline of financial institutions</u>

1. <u>Nonfinancial enterprises</u>

The Group recognized that one aspect of financial innovation in recent years has been the substantial growth of activity formerly carried out by or through financial institutions but now engaged in directly by nonfinancial enterprises. Two examples that were noted were the increase in consumer credit directly provided by producers and retailers of goods, and the tendency of enterprises in some countries to meet their financing needs by selling their own obligations directly on the money and capital markets. In some cases, the obligations incurred by the nonfinancial enterprises were similar in form to obligations of depository institutions that were included in measures of broad money. The Group was asked to address the question of whether these developments should be reflected in any way in the financial institutions sector.

The Group recognized that the increase in financial activity on the part of nonfinancial enterprises was an important economic development that reflected changes in the roles of financial and nonfinancial enterprises, but this was not seen to have any implications for the sectoring of the transactors. The Group agreed that the sector in which a transactor was to be classified would be determined only by its primary activity and that no attempt should be made to differentiate activities beyond the level of the statistical unit that maintained full accounts. Thus, the provision of credit by a large retail enterprise would not influence the sectorization of that unit unless it became the primary activity, or unless the credit were provided by a subsidiary that maintained its own full set of accounts, in which case the subsidiary would be classified in the financial corporate sector. Similarly, the mode of financing of an enterprise would not determine its sectorization.

The Group then addressed the complex issue of holding companies. An extensive discussion took place on the definition and sectorization of such companies, which centered on two alternative criteria to be used in classifying holding companies: according to the character of its subsidiaries or according to the function of the holding company itself. It was recognized that mere ownership of other companies would not be sufficient to classify an enterprise as a holding company. A large retail company that owned producing subsidiaries would be classified according to its own primary activity, as would each of the subsidiaries which maintained full accounts.

Holding companies were therefore **defined as companies** set **up mainly to own and control other companies; they normally would not have any direct activity** of their own. **Some participants expressed** the view that **holding companies should always be classified as financial institutions,** irrespective of the nature of their subsidiaries' activities, since the essence of a holding company is not production but rather the financing and control of its subsidiaries; this is evident from the preponderance of financial assets on its balance sheet representing claims on subsidiaries. Most participants felt, however, that the European System of Accounts (ESA) practice of classifying holding companies according to the sector in which the majority of the subsidiaries are classified was appropriate. Several participants felt that to always classify holding companies as financial institutions would distort the analysis of the flow of funds in the economy, since, if the subsidiaries were predominantly nonfinancial, large cross-sectoral transactions would be generated between the holding company and its subsidiaries.

The discussion then turned to precisely how a holding company and its subsidiaries should be classified. Several speakers favored following the ISIC classification, although it was recognized that ISIC is not clear in this area. It was suggested that holding companies that received funds from outside and channeled these to their subsidiaries should be classified to ISIC Division 65 (that is, 6599: Other financial intermediation n.e.c.), while those that engaged in nonfinancial activities should be classified to ISIC Division 74 (that is, 7414: Business and management consultancy activities). Several participants said that ISIC should be used to classify holding companies but suggested a rewording to the affect that "in all cases where a holding company has a majority of financial subsidiaries, it should be considered a financial institution"; this approach was generally in line with **ESA**.

The Group reached the tentative conclusion that holding companies should be classified to the institutional sector in which the activity of the group is concentrated. The Group expressed the hope that this recommendation would be reviewed in the near future by other Expert Groups, and noted that the recommendation might not be consistent with the latest draft of ISIC. It was agreed **by** the **Group** that steps should be taken to ensure that ISIC be amended as necessary to be consistent with the Group's recommendations concerning the classification of holding companies.

With regard to the subsectoral classification of holding companies, it was agreed that holding companies should be classified to the category of "other financial intermediaries except insurance companies and pension funds" unless most of the subsidiaries they controlled belonged to one of the other financial subsectors. Thus, a bank holding company whose subsidiaries were primarily depository institutions would be classified under subsector 2, Other depository institutions, and a holding company whose subsidiaries were primarily in insurance would be classified under subsector 5, Insurance companies and pension funds.

With respect to financial subsidiaries of retailers or manufacturers whose primary function is to provide credit to customers who purchase their goods, **the Group recommended classification in the financial** sector if **there are separate legal** entities with **complete accounts.**

With regard to internal financing arms--that is, subsidiaries whose role is to incur liabilities and provide funds to the other members of the group--some participants felt that these should always be classified according to the enterprise's main activity. One participant suggested that if the financing subsidiary were not a separate legal unit, any attempt to classify it as a financial institution without regard to the nature of the activities of the group as a whole would be a fiction. Another participant noted that if the subsidiary's sole role was to finance the activities of the group, it should not be considered a financial institution; if, however, it also channeled funds outside (except for cash management operations), it should be classified in the financial sector. A further suggestion was that these subsidiaries should be classified in the financial sector only if they obtained funds from the market: if their funds were derived solely from the parent they would not be classified in this way. The Group's reaction to these suggestions was mixed. They were seen by some as a departure from the "legal principle" of classification, as inconsistent with the earlier decision made on holding companies (since the financing objective could be met either by the holding company or the financing subsidiary), and noted that if the financing subsidiary did not have autonomy of decision making it should not be considered **a financial** institution. Others, **however**, expressed the opinion that, since the Group had agreed to extend the **coverage** of financial institutions to include auxiliary services, it would be illogical not to include financing subsidiaries in the financial sector. **The majority of the Group recommended that subsidiary enterprises whose primary role is to raise funds on the market to finance the parent organization should be classified in the financial sector if the subsidiaries are separate legal entities with complete accounts. The Group noted that some participants argued that it would often be more useful for analytic purposes to combine these subsidiaries with their parent organization.**

The Group was in favor of disaggregated reporting, in keeping with **the decision made by the Expert Group Meeting on Production Accounts and Input-Output** Tables, in **March** 1988, which **decided to retain** the "legal unit" rather than the "family of enterprises" concept. One participant suggested that the family of enterprises concept could be shown in supplementary tables. Another was in favor of aggregated reporting on the grounds that it would be difficult to sectorize large and diversified enterprises. It was also pointed out that disaggregated reporting might be difficult in practice, since only consolidated accounts might be available.

2. Government

a. Monetary authorities

The Expert Group Meeting on Public Sector Accounts, which took place in January 1988, had concluded that, where government agencies carrying out monetary authority type functions are not separate institutional units, they must remain part of the government sector. To meet the needs of both fiscal and monetary policy, and to provide links to the IMF's Government Finance Statistics (GFS) and MBS, the Meeting had decided that it would be necessary to introduce appropriate subdivisions of the main SNA transactions classification and a complementary presentation, and had referred the question of how this should be done to the Expert Group Meeting on Financial Flows and Balances.

MBS identifies the following monetary authority type functions that may be undertaken by government and that are consolidated with the accounts of the central banks to obtain the monetary authorities' accounts:

i. maintenance of international reserves;
ii. issuance of currency;
iii. transactions with the IMF; and
iv. operation of exchange stabilization funds.

Where these operations are undertaken within government, MBS reroutes them into a monetary authorities account, which consolidates these transactions with the accounts of the central bank.

The SSA recognizes that these central banking functions may be performed outside of the central bank in some cases, but it adopts a different approach to displaying the relationships involved. Because it is concerned with all the activities of the economic agents whose accounts it presents and not with just one particular aspect (such as their role in financial intermediation), the SSA considers it important that the institutional identity of the decision making transactor units be maintained in the basic accounts. It does recognize, however, that the data with which MSS is concerned may be important to many analysts, and it provides for a supplementary table (Table 25, "Financial transactions of the monetary system," in the SNA) on central banking functions performed by entities other than the central bank and gives a consolidation of the central bank and other monetary institutions to form the equivalent of the MSS Monetary Survey.

In ESA, the subsector for central banking authorities includes, in addition to the central bank, "central monetary agencies of essentially public origin (e.g., agencies managing foreign exchange, agencies whose function is to influence the bond market or money supply), which keep a complete set of accounts and enjoy autonomy of decision in relation to the central government"; however, ESA concludes that "most of the general government agencies engaged in monetary activities are not institutional units." The issue of currency by the state, its transactions with the Fund, and its management of portfolio investments designed to influence the money supply are therefore assigned in most cases to the central government subsector in ESA.

In SNA the subsector of financial institutions termed "other monetary institutions" is defined to include all banks except the central bank that have liabilities in the form of transferable deposits. MBS defines an analogous subsector termed "deposit money banks," which differs slightly from the SSA grouping of "other monetary institutions" because of reroutings made in MBS for deposits accepted by governmental institutions such as postal giro systems and the treasury. These deposits are consolidated with the deposit money banks' accounts in MBS. In addition, central banks sometimes engage in commercial banking activities and play a major role in the creation of deposit money. Where separate accounts relating to such commercial banking activities are maintained, al consolidates them with the accounts of the deposit money banks.

Table 25 of the NA consolidates the accounts of the central bank and other monetary institutions (defined in terms of narrow money) with the monetary functions of the treasury to obtain a consolidated account for the monetary system. The questions posed to the Group were:

1. Is this consolidated statement sufficient for the respective analyses of fiscal and monetary policy, or is there a need to identify separately a consolidated monetary authority which brings together monetary authority type functions that are carried out by the central bank and by the government?

2. How should the revised SNA treat deposit-taking activities of government institutions? Should they be included in a construct similar to Table 25 in the present SNA?

Three participants expressed the view that SNA should not have a monetary concept and logically, therefore, it should not have a monetary authorities concept. Many felt, however, that even if it were not useful for the SNA proper, it would be important to have a monetary authorities concept in the SNA in order to show the relationship between the SNA and MSS. The Group supported the recommendation of the Expert Group Meeting on Public Sector Accounts with regard to the treatment of government agencies carrying out monetary authority and deposit-taking functions: (1) these agencies must remain part of the government sector where they are not separate institutional units, and (2) it will be necessary to introduce appropriate subdivisions of the main SNA transactions and balance sheet classification in order to meet the needs of both fiscal and monetary analysis and to provide links to GFS and MSS.

On the question of presentation, the Group concluded that a complementary presentation along the lines of SNA Table 25 should be included in a handbook rather than in the SNA proper. One participant suggested that the table should show each of the subsectors and individual reroutings in the columns and instruments in the rows, since this would effectively provide a bridge between the SNA and 1BS. It was agreed that the IMF would provide the author of the revised SNA with a proposed precise formulation of the table; this would reflect possible changes now being considered in the manner in which contra-entries for reroutings are made in the MSS presentation.

b. Lending operations of government

Government lending operations may be carried out in a wide variety of ways. The government may lend directly to the final user of funds through a development budget or a special lending fund; the government may borrow directly from abroad and on-lend the funds to a domestic user; or the government may lend funds to a financial institution which then on-lends to the final user. In these cases the government directly acquires a financial asset. The government may also facilitate lending **operations** by guaranteeing the borrowing of other institutions or enterprises.

The above discussion raises the question as to whether lending operations undertaken by the government solely for public policy purposes should be attributed to the government or to the financial institutions sector.

The current SNA includes in the **government** sector "(v) public saving and lending **bodies** which are **financially integrated** with a government or which lack the authority to acquire financial assets or incur liabilities, **respectively, in the capital market" (NA, Table 5.1, "The definition of institutional sectors and subsectors," p. 79). The guideline for financial institutions is parallel, stating: "Where the public** institutions include lending institutions, the liabilities of which are in fact to the public authorities only, though they have the legal authority to incur liabilities to the **public or** to **other financial** institutions, the data in respect of these entities should be given separately." This suggestion **presumably** was made to permit an **alternative supplementary** consolidation of such institutions in the government sector.

The Group was asked to address the question of the **appropriate** treatment of government lending operations, particularly in the following areas:

1. Should the present legalistic distinction as to when lending institutions should be included in the government sector be maintained in the revised SNA?

2. Should financial institutions whose lending operations are directly controlled by government be classified in the government sector, or should they continue to be separately identified as public financial institutions?

3. Should a financial institution that is incorporated be placed in the financial institutions sector regardless of its source of funds? This would parallel the treatment accorded to **enterprises.**

The Group concluded that the present SNA criteria for deciding whether a government lending body should be classified to the government sector or to the financial sector should be maintained. The criteria include in the government sector those bodies that "are financially integrated with government" or "lack the authority . . . to incur liabilities in the capital market."

3. Related issues

a. Regional central banks

When there is a common central bank for a group of countries, many financial statistics take on different meanings from those for countries with their own central banks. The Annotated Agenda raised a number of issues with respect to the statistical treatment of the operations of regional central banks (RCBs) and the use of a common currency, including: the residency of the headquarters of the common central bank; the allocation of the total assets and liabilities of the headquarters to the balance sheets of the national offices; and the measurement of foreign assets and currency in circulation in each member country.

Discussion of this specialized topic was limited. Several participants said that if an RCB is not considered to be an international organization, all of its assets and liabilities should be apportioned among the member countries, although they were uncertain as to how this might be done: a technical paper setting out options would be needed. One participant did not see the problems set out in the Annotated Agenda as insuperable: the assets and liabilities of the headquarters of RCBs should be prorated among member countries, as should the balance comprising net worth. In his view, problems arising in measuring currency in circulation were not necessarily more severe than for countries whose currency circulates freely in other countries; this had not precluded countries in the latter situation from compiling money measures. Overall, the participants felt that the SNA depiction of the central bank would have to recognize that prorating would have to be done for regional central banks.

On the basis of the above discussion, the Group agreed that all financial assets and liabilities of RCBs should be allocated among the participating countries. The statistical problems raised by RCBs should be dealt with in the sections of the revised SNA where residency and central banks are discussed.

b. Classification of the financial and nonfinancial corporate sectors

Discussion of this agenda item centered on the paper prepared by the IMF, at the request of the Expert Group on External Sector Transactions, on "The Classification of Corporate Enterprises."

The specific issue before the Group was whether resident corporate enterprises should be differentiated between direct investment enterprises and nondirect investment enterprises rather than in terms of foreign-owned (that is, majority ownership of equity) and domestically owned enterprises (that is, majority ownership of equity). Direct investment enterprises were defined in accordance with the OECD "Detailed Benchmark Definition of

Foreign Direct Investment" to encompass those enterprises in which a single foreign investor or a group of related entities had 10 percent of equity **participation. These enterprises, therefore, encompassed branches, subsidiaries (where the ownership of the foreign investor or related investors was more than 50 percent), and associate companies (where the ownership of the foreign investor or group of related investors was** 50 **percent or less).**

The Group agreed that the financial and nonfinancial corporate sectors should be divided into three subsectors on the basis of control: i.e., public, national private, and foreign-controlled. The same rules should be used to determine publicly controlled enterprises as those adopted to define foreign-controlled enterprises. In the absence of other evidence of control, it was agreed that the degree of ownership of equity should be used as a proxy for control because it was a more measurable criterion. As a "rule of thumb," the level of ownership by a foreign investor or group of related investors should be in excess of 50 percent of total equity. The group also agreed that the foreign-controlled subsector would include branches and subsidiaries as specified in the OECD "Detailed Benchmark Definition of Foreign Direct Investment." The decision on whether to include associates where the ownership is 50 percent or less would be left to individual countries on the basis of their qualitative assessment of the degree of control effectively exercised.

III. Financial Assets and Liabilities

Financial innovations have affected not only the structure and character of financial institutions, as discussed in Section II of the Annotated Agenda, but also the number and the types of instruments available to financial markets and transactors. Financial deregulation has spurred the development of new instruments to provide the mix of liquidity, risk, and yield demanded by customers. For the most part, these new instruments may only combine features of existing instruments, but they do so in ways that frequently make their classification in the present SEA framework quite difficult. In addition, financial markets have developed new techniques or have sharply increased the use of existing techniques in ways that may effectively change the nature of the instruments involved. Examples of this phenomenon include: the expanded use of bankers' acceptances and repurchase agreements; the facilitating of financing through contingent liabilities such as note issuance facilities (NIFs) and revolving underwriting facilities (RUFs); and the development of hedging techniques, including interest rate swaps, options, and forward rate agreements.

In view of these phenomena, the primary question before the Group was whether there was a need for basic changes in existing instrument classification schemes to provide additional guidance to compilers to enable them to deal with continuing innovation and to give sufficient information to users of these statistics.

A. Current classification schemes

Financial innovations provide for new arrangements among debtors and creditors and also result in the expansion in the use of existing instruments and the flexibility and speed with which a group of instruments can be replaced by another group of instruments in reaction to changes in risk/yield preferences among the issuers and holders of financial assets. The Group was asked to consider the impact of these two aspects of innovation as far as the adequacy of the existing SNA classification scheme was concerned.

The Group examined various schemes for classifying financial instruments. In particular, it considered the possibility of identifying other characteristics of financial instruments--such as negotiability, transferability, marketability, and convertibility--that might supplement or replace liquidity and maturity, which are the primary classification criteria in existing schemes. While this approach had some appeal to the participants, it was thought that it would be difficult to make such fine distinctions in practice and that, in any event, the characteristics, or the mix of characteristics, of a particular instrument could change very quickly. The Group therefore agreed that **the classification in the present SNA was a good point of departure. In addition, the classification scheme as presented in the revised SNA would have to be accompanied by general principles to classify instruments that may be**

specific to particular countries and may be developed in the years to come.

Most participants thought that, to be useful to all countries, the **categories** in the classification should be broad ones (although there could be explanatory listings within each category), since the list of instruments might vary among countries.

The Group recommended the classification scheme presented in Table 2, below, for financial assets and liabilities. There was a consensus that many of the categories, but particularly category 2, **Currency and deposits, should be subdivided according to positions denominated in domestic currency and those denominated in foreign** currency. **Category** 6, **Insurance technical reserves**, should be subdivided between 6.1, Net equity of households on life insurance reserves and on pension funds, and 6.2, **Prepayments** of premiums and reserves against unsettled claims for casualty insurance. Category 7, Other accounts **receivable and payable, should** be **subdivided between** 7.1, Trade credit and advances, and 7.2, Other. Disaggregation of other categories (noted by letters in **Table** 2) was considered of **secondary** importance. Specifically, **a maturity distinction of securities and loans would be optional**, according to the **recommendation** made under Item III.0 of the Annotated Agenda. Most of the Group agreed that direct investment, which is included in categories 4, 5, and 7, should be recorded as a memorandum item rather than appearing in the classification.

B. Classification of specific financial instruments or groupings of instruments

The Group attached considerable importance and devoted substantial time to the discussion of the classification of a number of key financial instruments.

1. Gold

Most members of the Expert Group on External Sector Transactions agreed that the Balance of Payments Manual's (BPM) distinction between monetary gold and commodity gold should be the basis for the harmonized treatment of gold: "Monetary gold is gold owned by the authorities (or others subject to their effective control . . .) that is held as a financial asset. Other gold (nonmonetary gold) owned by any entity, including the authorities that also own monetary gold, is treated . . . like any other **commodity.**" Recognizing that the Group on Financial Flows and Balances might also have a view about the application of this distinction, the Expert Group on External Sector Transactions suggested that in the SNA the entry offsetting the entry for the change in holdings of gold as a financial asset be made in the reconciliation accounts.

The discussion of this item centered initially on the question of whether goldheld by financial institutions other than the monetary

Table 2. Classification of Financial Instruments

1. Gold and SDRs

2. Currency and deposits
   a. Currency
   b. Transferable deposits
   c. Other deposits

3. Securities other than shares
   a. Short-term
   b. Long-term

4. Loans
   a. Short-term
   b. Long-term

5. Shares and other equity

6. Insurance technical reserves
   6.1 Net equity of households on life insurance reserves and on pension funds
   6.2 Prepayments of premiums and reserves against unsettled claims for pasualty insurance

7. Other accounts receivable and payable
   7.1 Trade credit and advances
   7.2 Other

Memorandum item:

Direct investment
  Equity
  Loans
  Other

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authorities should be treated as a financial asset or as a commodity. A few participants thought that such holdings should be considered financial assets: deposit money banks do not normally hold commodities and their gold holdings would be for hedging or investment purposes; such holdings would not be used for production and were not finished goods; and commodity gold would be used only to produce other goods. It was also pointed out that, at a meeting of the European Economic Community, following the Expert Group Meeting on External Sector Transactions (March 23-April 2, 1987), it was agreed that a new category of "financial gold" (comprising gold other than monetary and commodity gold) should be recognized and classified as a foreign asset. One participant noted more generally that gold was increasingly becoming a problem for national accountants and felt that items such as gold certificates and gold-denominated accounts should be recognized in the system as financial assets/liabilities.

The Group, however, **endorsed the recommendations of** the External Sector Meeting **that** only **two categories** of **gold be** recognized--namely **monetary gold and commodity gold. Monetary gold is gold owned by the authorities that is held as a financial asset and as a component of foreign reserves. Other gold owned by any entity, including the authorities,** is **treated like any other commodity.** The Group noted that a minority **of the participants saw** merit **in including in the** accounts **a** third **category called financial gold, which would be classified as a** financial **asset.** There was also some support for an even wider approach that would include, with nonmonetary/noncommodity gold, other tangibles such as platinum, silver, paintings, jewels, houses, etc.; this category of "financial investment goods" would fall between the categories of financial assets and intangible assets, since it would comprise reserves of value for which there is no liability. While many participants saw merit in this proposal, it was felt that its implementation would be impractical because there would be borderline problems and it would not be possible for statisticians to gauge the "motivation" of buyers of such commodities.

2. Financial leasing

It is generally recognized that some types of leases effectively convey the full rights and risks related to a physical asset from the lessor to the lessee. These leases are categorized as financial (or finance) leases as opposed to operating leases in which the lessor retains the rights of ownership and is providing a service by leasing the asset. When a financial lease arrangement exists, it is suggested that the physical asset should be attributed to the accounts of the lessee with a counterpart financial liability, while the lessor has a financial claim on the lessee. The present SNA does not recognize financial leases as financial instruments nor does it recognize the different flows that would have to be attributed to financial leases as opposed to operating leases. The Group held the view that most international statistical **systems as well as national accounting practices recognize financial** leases as financial instruments.

The Group agreed that financial leases should be recognized as financial instruments and that **financial leasing should be distinguished and treated differently from operating leasing in the SNA.**

The Group then discussed the question of how financial leasing should be distinguished from operating leasing. The present BPM states that "a lease arrangement expected to cover at least three fourths of the cost of the goods, together with the carrying charges, is to be taken as presumptive evidence that a change of ownership is intended." The present OECD practice is to require 100 percent coverage of cost. The International Accounting Standards 1/ differentiate financial leases from operating leases in qualitative terms without specifying a proportion of the original cost, apparently because of the practical difficulties of measurement. The Expert Group on External Sector Transactions appeared to favor a position somewhere between the BPM and a full-cost criterion. The Group on Financial Flows and Balances concluded that financial leasing contracts should be defined essentially by the intention to transfer all the risks and rewards incident to ownership to the user of the asset. This definition was preferred to alternative definitions that are based on a specific percentage of the total cost covered by the lease payments. One participant noted that the adoption of a specific cut-off might result in countries not reporting if the actual percentage of cost covered by the lease was not readily discernable.

On the question of the classification of transactions with respect to financial leasing, the Group concluded that where goods are obtained through financial leasing contracts, such goods should be recorded as if purchased by the lessee, with an imputed loan from the lessor. The payments in respect of the financial leasing contract should be divided into two parts: repayment of the loan in the capital finance account, and payments of interest in the income and outlay account. Payments for use of goods obtained under operating leasing should continue to be treated as purchases of services. One participant, while in favor of treating a financial lease as an imputed loan, was troubled by the re-attribution of ownership from one sector to another. For example, if a bank were to buy a factory and lease it to a producer, on the bank's books the bank is taking depreciation, obtaining a stream of payments, and in fact has the building. This would show producers investing less and banks engaging in more of the activities that they do not normally engage in. Re-attribution would cause major accounting problems, as a change of legal ownership would not actually have occurred. In response to this example, it was pointed out that in many countries, under generally accepted accounting principles with regard to leasing arrangements of this kind, the producer would be required to carry the physical assets on its books, while the bank would record a financial claim.

The Group recommended that in the transaction accounts and balance sheets, financial leases should be classified in the same category as loans. Contracts that meet the definition of financial leasing, irrespective of the type of goods acquired and irrespective of whether they are acquired by producers or consumers, would be included. The Group noted that financial leasing is most usually offered by independent legal units which are to be classified in the financial corporate sector. Their

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1/ International Accounting Standards Committee, Accounting for Leases, International Accounting Standards No. 17, London, 1982.

output is then imputed like other financial services. The valuation and treatment of output where financial leasing facilities are offered by a nonfinancial enterprise will be discussed in a future Expert Group Meeting in connection with the overall question of imputed bank output.

3. <u>Reinvested earnings</u>

The Expert Group on External Sector Transactions had reached the following conclusion on reinvested earnings on direct investment: "Most members of the group agreed that both the external and the domestic sectors of the national accounts, like the balance of payments, should include international flows of reinvested earnings attributable to direct investors." The Group, furthermore, strongly recommended that a full accounting should be prepared for consideration by the Meeting on Financial Flows and Balances and that, in the accounting, particular attention should be drawn to the implications for saving and national disposable income.

The paper, "Proposed Treatment of Reinvested Earnings on Direct Investment in the Revised SNA," which was prepared in response to the recommendations of the Expert Group on External Sector Transactions, presents a review of the current treatment of international flows of reinvested earnings in the BPM and spells out the methodology for the inclusion and presentation of data on such flows in the revised SNA detailing how these transactions would affect the consolidated accounts of the nation and discussing practical issues of compiling the necessary data.

The Group reviewed the conclusion of the External Sector Meeting to include international flows of reinvested earnings attributable to direct investors in the accounts of the SNA in line with the treatment adopted for the BNM. Most participants supported the conclusion.

Some participants were also in favor of extending this treatment to reinvested earnings on direct investment between domestic sectors. The majority, however, felt that sufficient information was not available on the full implications of such treatment. As a result, it was agreed to postpone a final decision in this regard to a future Expert Group, for which a paper should be prepared.

Two participants expressed the view, however, that a number of countries did not see the usefulness of the proposed treatment (namely, imputing reinvested earnings in the SNA) and that attempting to extend this approach to reinvestment of earnings between domestic sectors would compound the problem.

4. Transformed instruments

a. Bankers' acceptances

There are a number of cases in which a given financial instrument may be transformed into another instrument while the underlying instrument is still in existence. A clear example of this is a banker's acceptance, which creates a new instrument by replacing a direct trade credit claim between the supplier and the purchaser of goods or services with an instrument of substantially different characteristics from the original credit. A banker's acceptance is freely negotiable and trades in financial markets in the same way as a negotiable certificate of deposit or commercial paper. The question before the Group was whether the SNA should treat a banker's acceptance as the creation of a new instrument.

Two specific issues were addressed, namely, should an acceptance be recognized as an actual liability of the bank, and, if it should, how should the bank's claims on the customer be treated. Two participants expressed the view that an acceptance was a contingent liability of the accepting bank until such time as it began to circulate on the market; if the creditor had no intention of discounting the bill it should be considered as a guarantee. Another participant countered that an acceptance did not imply any conditions such as those attached to a guarantee--the bank has agreed that it will pay, unconditionally, the specific amount on the bill on a specified future date and, in this sense, an acceptance was no less an actual. liability than a negotiable certificate of deposit. Another participant pointed out that there is no consistency across countries in the accounting treatment of acceptances: some countries view them as contingent or off-balance sheet entries while others require that they be recorded as actual liabilities (and the claims on the customer as assets) on the balance sheet at the time of acceptance.

A majority of the Group favored treating bankers' acceptances as actual liabilities of banks at the time of acceptance, with the asset counterpart being claims on the banks' customers. Other participants, while seeing merit in this approach, felt that it was contrary to accounting practices in some countries and would be difficult to implement. It was noted that, in sectorizing the liabilities arising from an acceptance, there would-be problems in distinguishing between foreign and domestically held acceptances, but that this was a general problem applying to all negotiable liabilities issued by banks.

b. Repurchase agreements

A repurchase agreement involves the acquisition of funds through the sale of a financial instrument with the a reement to repurchase the instrument at a later date. While the al fo of the transaction usually is a sale, the nature of the trans ion is more like a collateralized loan. The bulk of these transactions are very short term and the securities often do not change hands. In addition, as the purchaser often cannot dispose of the securities, it has been argued that no sale has taken place because the purchaser does not acquire a basic right of ownership. Reflecting this attribute, MBS treats repurchase agreements as the creation of a new instrument.

The discussion made it clear that there was no consistent treatment of repurchase agreements. In some countries the repurchase agreement itself was viewed as a contingent account, while the books of the buyer 'and seller recorded an actual movement of the underlying securities from seller to buyer. In others, the agreement was treated as the creation of a new instrument on the balance sheet--an asset for the seller and a liability for the purchaser--and the underlying securities remained on the balance sheet of the seller.

Most participants recommended that repurchase agreements should be treated as the creation of a new instrument having the nature of a collateralized loan. Others noted that in some countries this treatment would represent a deviation from the legal basis of repurchase agreements. The latter group of participants felt that the rules should be phrased in such a way that each country should be able to interpret them in the manner that is appropriate given that country's legal and economic features. If the underlying legal basis of the repurchase agreement was not as a loan against collateral, the repurchase agreement should be considered as the sale and purchase of an asset, and the reversal should be considered as a contingent item. Others felt it important that the treatment in the SNA of repurchase agreements should reflect the economic rather than the legal nature of the transaction and that, while some flexibility was desirable, harmonization could only be achieved by a clear recommendation based on the economic nature of the transaction.

5. Suppliers' credits

The Expert Group on External Sector Transactions had suggested that the revised SNA should provide a definition (which is currently lacking) of trade and other suppliers' credits, and that in the formulation of such a definition, account should be taken of national practices.

The Group agreed that suppliers' credits should not be separately distinguished from trade credit, which also includes advances from purchasers. It was agreed that the revised SNA would employ terminology that would subsume suppliers' credits under trade credit and would de-emphasize the use of the term "trade."

6. International reserves

In the present SNA, international reserves are included only in Table 25, where it is noted that "the definitions of international reserves and offsets to these reserves are those of the International Monetary Fund and the collection internationally of these data is the responsibility of the Fund." The concept of reserves is critical to balance of payments statistics and is also an integral part of monetary statistics. The BEM defines reserves as "the monetary gold, special drawing rights (SDRs) in the Fund, reserve position in the Fund, use of Fund credit, and existing claims on nonresidents that are available to the central authorities either to finance payments imbalances directly or to manage the size of such imbalances by intervening to influence the exchange rate for the national currency" (BPM, p. 147). In defining which assets qualify as reserves, it is necessary to assess the assets' availability for use and the degree of effective control that the central authorities have over them. Within the IMF there is some variation in the definition of reserves; the BPM includes assets under the control of the **central authorities (for example those held by deposit money banks), while** MBS **usually includes** only assets **actually** held **by** the central **bank** and the government. In practice the differences are small. In recent years it has been noted that the major changes that have occurred in international capital markets and in the international monetary system have made it very difficult to define international liquidity simply in terms of official foreign reserves holdings. In order to assess a country's external liquidity in terms of available resources, it may be necessary to identify assets held by private residents that are close substitutes for official reserves, external resources that are readily available from international organizations and national authorities, and external resources that are readily available from private sources. Such a notion of liquidity can be far broader than reserves in that it includes private sector holdings and contingent assets, such as lines of credit, which can be mobilized by incurring a liability. The IMF is currently reviewing its definition of reserves.

In view of these developments the Group was asked to discuss whether SNA should have a concept of reserves and, if so, how such a measure **should be defined.**

The Group agreed that international reserves should be included in a supplementary presentation such as Table 25 in the current SNA. Although the Group felt that a measure of international reserves was not an essential analytical component of a broad system such as SNA, it was agreed that it did deserve a place in a supplementary presentation since it was a major financial indicator; it was necessary for harmonization with balance of payments; and its omission would place the SNA financial flows at risk of not being considered useful by analysts. It was concluded that it **would be useful to identify the components of international reserves in the SNA instrument classification. The Group agreed that the definition of international reserves would continue to be the responsibility of the IMF.** It was recognized that since the IMF's review of the definition might not be finalized until after the revised SPA is issued, and since adaptation to conditions in the future could lead to further redefinition, the SNA would have to be updated periodically to remain current with changes in the IMF's definition.

7. Monetary aggregates

No specific money measure is defined in the SNA although a narrow money concept is reflected in the definition of the "other monetary institutions" subsector and in Table 25. The importance attached to monetary measures arises from the use of such aggregates for financial analysis and policy formulation. In practice, money is an aggregate concept encompassing a range of instruments. Having an explicit definition of money in the SNA raises questions concerning the objective of the present SNA framework and the usefulness and feasibility of constructing a standard statistical measure across countries. However, because of money's critical role in economic analysis in many countries, the issue of its specific definition in the SNA appears to be an important and timely one.

The monetary concept implicit in the present SNA is a narrow one consisting of currency and transferable deposits issued by the central bank and the other monetary institutions. This narrow view of money has traditionally been related to the "transactions motive" for holding money. However, developments in financial markets since the last revision 'of the SNA, particularly financial innovation, inflation, deregulation in financial markets, and technological progress, have combined to produce many instruments with some "moneyness" or partial medium-of-exchange properties. These same factors have largely been responsible for the decline in the previously observed close relationship between narrow money and the level of economic activity.

The Group was unanimous in the view that the SNA should not have an explicit concept of money, since there is no single monetary aggregate that can be used across all countries and, even if there were, continuing innovation would make the elaboration of a harmonized monetary aggregate difficult and not useful. Some participants felt that it would be useful for MBS and the SNA to provide sufficient detail on broad money components to enable analysts to aggregate these as they saw fit.

It was agreed that the revised SNA would explain that there is no single definition of money. It would also explain that there is a range of aggregates, narrow and broad, the definitions of which differ among countries, and, moreover, that monetary definitions are continually changing. Illustration of the components used to derive alternative measures would be set out in a supplementary table.

8. New financial instruments

One of the major results of financial innovation in recent years has been the development of a broad range of new financial instruments. While the Group noted that the new financial instruments are for the most part variants of traditional instruments and can be accommodated in the SNA instrument classification, it went on to discuss some classes of instruments that represent major shifts in the way transactors conduct business and that may have a major impact on the usefulness of conventional balance sheet data for interpreting the performance of these transactors.

a. Note issuance facilities

Note issuance facilities (NIFs), **revolving** underwriting facilities (RUFs), and similar facilities are a rapidly growing means through which banks facilitate financing without necessarily providing credit. In a typical NIF, a bank or group of banks guarantees, generally for a period of five to seven years, that a borrower will be able to issue his own short-term securities up to the amount of the facility, and that the banks will purchase (or provide credit equivalent to) the securities not taken up by the market. The facility offers the borrower the guarantee of long-term financing with the flexibility of issuing short-term commercial paper or Euronotes. The banks receive a fee for the amount of the facility that is not drawn, irrespective of whether they have provided direct financing. The basic transactions involved in the NIF appear quite straightforward: for the banks the fees received are income, as is any interest received for credit actually provided under the NIF, and the credit and repayment would be recorded in the capital finance accounts; the borrowing sector's accounts would record the counterpart entries. The NIF itself represents a contingent asset/liability of the banks similar to a line of credit; only the credit actually provided will enter the bank's balance sheet, which will therefore not reflect the bank's full exposure, This feature of the NIF causes the greatest difficulty among analysts and bank **supervisors**: the banks may earn substantial income that is not generated by their on-balance sheet assets but rather by off-balance sheet contingent accounts.

Under current rules, the SNA records the securities issued under the NIF in the capital finance accounts and in the balance sheets for the relevant sectors, but the facility itself would not appear in flow, stock, or reconciliation accounts. As these facilities may be important for explaining the income received by the banking sector, the question before the Group was whether supplementary data on them should be collected for the SNA.

The Group felt that NIFs, RUFs, and similar facilities did not raise major issues for the SNA, as current accounting rules appeared to cover all the actual transactions involved, as noted above. The question was raised as to whether the fee earned by banks for NIFs and RUFs should be treated as interest, similar to a commitment fee for a loan, or as service income. **The Group agreed that, in the case of *NIFs*, RUFs, and similar arrangements, the fee paid for the contingent position assumed by the credit *institution* should be treated as a fee for a service. This was** consistent with normal business accounting practices and with the conclusion of the Expert Group on External Sector Transactions that factor incomes and service charges be separated. The Group said that **interest and credit are only recorded when notes are issued.**

The contingent aspect of NIFs and their potential impact on the accounts was noted by two participants. One was not sure whether NIFs were contingent assets or contingent liabilities or both and felt that they were therefore not as easy to classify as a contingent item that is either one or the other; his view was that NIFs probably did not fit into the SNA framework. Another participant saw the contingent aspect of NIFs as part of a wider question that is also relevant for hedging. Hedging activity has taken on new dimensions, and SNA and flow of funds analysis give only a partial picture of what is happening in the real world. He noted that if traders are **hedging** prices in foreign currency, the present SNA approach may lead to distortions.

b. Swaps. options. and forward rate agreements

Interest rate and currency swaps, foreign currency and interest rate options, and forward rate agreements (which are described in the IMF document "New Financial Instruments and the Balance of Payments") have grown rapidly in recent years, owing, at least in part, to a desire to hedge interest rate or currency exposure. The Group had before it the following **proposals** for the recording of these transactions in the Ste:

Swaps. The original borrowing by the parties engaged in the swap would be recorded in the capital finance accounts as increases in liabilities. Streams of interest payments would be recorded in the income and outlay accounts and streams of principal payments would be recorded in the capital finance accounts. Payments between the parties engaged in a swap arrangement do not represent interest payments, as there is no financial asset/liability arrangement between the parties; rather, they should be treated as an exchange of capital items and, to the extent that the flows are not equal, as a payment for a service.

Options. There are three possible transactions which can arise from an option agreement. First, a premium is paid at the signing of the option contract, and this should be recorded as a payment for services. Second, if the option is exercised, the transaction in the underlying instrument would be recorded in the capital finance accounts. Options are often marketable but, as the seller of the option incurs only a contingent liability and not an actual financial liability, the transaction of trading an option should be recorded as a transaction in intangible nonfinancial assets.

Forward rate agreements. A forward rate agreement is a contract in which two parties agree on the interest to be paid on a notional deposit of specified maturity at a specific future time. Principal amounts are agreed but never paid so that only payments due to the interest rate differential are exchanged. The flow transactions involved in a forward rate agreement therefore do not involve the payment of principal as such. "New Financial Instruments and the Balance of Payments" suggests that the flow due to the difference between the agreed rate of interest of the agreement and the prevailing rate should be classified not as an interest flow but rather as a payment for a service akin to an insurance premium. Others have suggested, however, that the nature of the transaction is different from insurance and that the flow should be viewed as a kind of capital transfer.

The Group recognized that the arrangements under discussion were very complex and that the simplified examples before the Group might not be representative of all the transaction flows that could be generated by these instruments. The recommendations, therefore, had to be provisional, indicating the desired way in which these operations should affect the SNA.

In the case of swaps, some participants argued that the purpose of interest rate swaps is to change interest rates paid and that the proposal before the Group assumed that no swap had occurred and the balancing item between the two parties would be treated as a service charge; it would be preferable to treat the net amount (the cost to each party to the swap) as interest, since this is what the parties have to pay. **The Group agreed that the treatment in the SNA of swap transactions should reflect the economic nature of the transactions. In the case of simple interest rate swaps, interest payments should be recorded net of payments between parties. Neither of the parties of the swap should be regarded as providing a service to the other. The Group noted that, where swaps are arranged through specialized brokers, one or both parties will usually pay a fee for the service provided by the broker.**

It was pointed out that under the Group's proposed approach an actual transaction would not be accounted for. If a cross-border transaction were involved, the implication for the BPM was that final payments to nonresidents should be recorded net of payments between the parties. The aEM could accommodate the Group's proposal, although in practice it might be difficult to collect the required data, since the BPM did allow for netting in certain cases. One participant favored treating each of the party's interest on a gross basis; there could be two borrowers from different countries lending from units in a third country, and net recording would not allow for sectorization. He felt that recording should be gross but that the presentation could be on a net basis.

The Group agreed that the same treatment that it had agreed on for swaps would, in principle, be applied to transactions under forward rate agreements. The Group recognized that adaptations might have to be made in the case of more complex swap and forward rate agreement transactions.

On the question of options, the predominant view of the Group was that these should be treated as contingent, rather than actual, assets and liabilities. This is the normal business accounting treatment. As long as the option is in the market, the seller is at risk because the option would be exercised as soon as the situation became, favorable to the buyer; until such a time, nothing would have transpired. One participant was, on balance, in favor of treating options as actual assets insofar as there are markets in which they can be sold. The initial seller would also have a liability since he would have a commitment. The present value of the commitment would be the value of the option in the market.

It was pointed out that a foreign currency option would change the value of the balance sheet, so that in a sense it would affect the value of an existing asset, although it would be extremely difficult to measure.

9. Contingent assets and liabilities

The Group recognized that contingent positions maintained by financial institutions were becoming increasingly important in explaining their activities. The questions posed to the Group were whether there was a need to include contingent assets and liabilities in the main SETA accounts, or perhaps in supplementary tables, and how would it be possible to distinguish between real and contingent assets and liabilities. As was noted above in the discussion of note issuance facilities, financial institutions are increasingly conducting business through contingent accounts or off-balance sheet items. Some of these transactions are effectively replacing former banking business by partly shifting the risks to third parties. As a result, the present definitions of financial aggregates have become less comprehensive than originally intended. Measurement of these contingencies has become critical for financial analysis and supervision, and data have become increasingly available.

The Group concluded that information about contingent assets and liabilities may be useful for certain types of economic analysis. The Group did not, however, see any reason for the SRA to deviate in this regard from its basic rule for recording transactions and stocks, and so concluded that contingent assets and liabilities should not be recorded in the main SA accounts and tables. Information on contingent assets and liabilities, preferably broken down by type and sector, could be shown as memorandum items. It was suggested that it would be useful to disaggregate contingent items by type, since there are many different types, and a detailed sectoral breakdown of counterparties would be necessary to make the information analytically useful. It was pointed out that it would be difficult to collect data on contingencies from banks and even more so in the case of nonfinancial private enterprises. Actual assets and liabilities would be distinguished from contingent ones on the basis of the conditionality of the relationship between the transactors. Where an unconditional relationship exists on the part of both transactors, it would be an actual financial asset or liability. On this basis, bankers' acceptances would be actual liabilities whereas NIFs, RUFs, and lines of credit would be off-balance sheet. A letter of credit would be conditional and therefore off-balance sheet, because a variety of formalities have to be completed before it is activated.

One participant was concerned about the precise definition of "conditionality," since various steps could be involved; if someone sells an option, the buyer is free to choose whether to exercise the option or not yet the seller is unconditionally engaged and in that sense is in the same position as a bank making available a line of credit. It was agreed that the revised Sit would give examples of contingent items. It would also delineate the boundary between actual and contingent assets and liabilities.

It was noted that the Bank for International Settlements (BIS) had developed a rigorous framework for commitments and contingencies for use in bank supervision, although this might not cover all of the activities of nonbanks. The suggestion was made that the secretariat of the Cooke Committee be consulted concerning the definitions of contingencies, since these would have to be ratified by other Expert Groups before the revised SNA was published.

C. Other issues

1. Maturity-based classifications

The Expert Group on External Sector Transactions had raised questions about the desirability of maintaining a distinction in the balance of payments capital account between long- and short-term transactions, but referred to the Expert Group on Financial Flows and Balances the question of whether such distinctions were still important from the view of financial analysis.

The view that innovation had made the maturity distinction more tenuous and therefore less useful was widely shared in the Group. Three distinct types of maturities were noted: (1) those with a definite short-term maturity; (2) those with a definite long-term maturity; and (3) those where both parties agree to adapt maturities according to their respective economic needs. This last group had become more prominent through, for example, the increasing prevalence of rollovers, active trading in securities, and floating rate notes. In the case of adjustable mortgage loans, it was argued that each time the rate is adjusted a new instrument is effectively created; in this sense, such a loan could be viewed as a series of short-term loans rather than as a single long-term loan. Also noted was the possibility that the maturity of an instrument could be viewed differently by the creditor and the debtor. A debtor could view a NIF, for example, as access to medium-term financing, executed through short-term instruments, while the creditor's commitment would be medium-term but actual claims acquired, if any, would be short-term.

In spite of the above developments, the Group did not wish to abandon the maturity distinction and agreed to maintain the basic distinction between long-term and short-term instruments in the revised SNA, but as a secondary criterion.

On the question of the definition of short-term, the Group agreed that short-term securities and loans should be defined as those which have an original maturity usually of one year or less, but with a maximum of two years to accommodate variations in practice between countries.

There was little support for the suggestion that maturity profiles be specified in terms of a number of time ranges. It was felt that there would be practical problems in having an international definition of maturity ranges, since some instruments, such as Euro-commercial paper, can be of any maturity and the dividing lines both within and among countries are different.

Concerning residual versus original maturity, the Group recognized that analyses on the basis of residual maturity may be appropriate for certain purposes--for example, analysis of banks' liquidity positions--but that these data should be developed outside the SNA in specialized systems. For transactions data,. residual maturity would not be feasible and original maturity would be more suitable.

The maturity distinction in SA should be based on original maturity rather than on residual maturity to promote consistency between the flow and balance-sheet accounts.

2. Zero-coupon and deep-discounted bonds and index-linked <u>securities</u>

The Expert Group on External Sector Transactions had addressed the question of the proper treatment in the <u>SNA</u> of the return on zero-coupon and deep-discounted bonds and indexed securities. That Group recommended that the return on zero-coupon bonds should be treated as interest and accrued over the life of the instrument. As the issue involves domestic as well as cross-border transactions, the Expert Group on External Sector Transactions had referred discussions to the Expert Group on Financial Flows and Balances.

Deep-discounted or zero-coupon bonds refer to a group of medium- or long-term financial instruments for which there is no or little interest paid during the life of the instrument. They are therefore similar in form to short-term discounted securities. However, in the case of long-term instruments the difference between the issue price and the redemption price can be very large. The principal issues that the Group was asked to address were the nature of the return to the lender on these instruments and when the return should be recorded.

With respect to the return on deep-discounted bonds, the issue would be whether it should be treated as interest and recorded in the income account or as a capital gain and recorded in the reconciliation account. As regards the time of recording the return, the options would include recording at the time of issue, at redemption, or distributed over the life of the instrument. In previous discussions of this issue, there had been little support for recording the return at the time of issue but there had been strong support for recording at redemption (following the normal rule of recording transactions on a due-for-payments basis) and over the life of the asset (adopting an accrual method of recording which matches the cost of capital with the provision of the capital). An intermediate approach would record the return in the income account at maturity but would record in the capital finance accounts increasing claims for the holder and liabilities for the issuer over the life of the instrument.

Similarly, the issue for indexed bonds would be whether to treat the indexed amounts as interest or as capital gains.

When this agenda item was introduced, it was pointed out that a number of studies made by the IMF on indexation had found some cases where the recipient of an index-linked payment had viewed this payment as interest income, and other cases where the payment had been considered as maintenance of value. This appeared to suggest that there is no single answer and that the best approach might be to collect separate data to enable the analyst to decide how these would best be used. It was also pointed out that there had not been a clear majority decision on the treatment of such securities at the EUROSTAT Joint Meeting of Working Parties on National Income Accounts and Money and Banking Statistics (Luxembourg, June 1988).

A majority of the Group recommended that the difference between the issue price and the value at maturity of both zero-coupon and other deep-discounted bonds should be treated as interest.

A variety of views were expressed as to when interest should be recorded. Some participants held the view that interest should be recorded when it was due; if due at the end of five years, it should not be accrued over the intervening period; it was not desirable to have imputations if they were not really necessary and if they did not reflect what was happening in the market; there was not an entitlement that was progressively earned. Other participants felt that when the interest was actually paid was irrelevant and that, under normal business accounting practices, the interest would be considered to be earned over the life of the instrument. A majority of the Group concluded that the interest on zero-coupon and deep-discounted bonds should be converted into a series of annual or quarterly payments over the full lifetime of the instruments.

It was noted that, in principle, such an adjustment should be made for any security that did not pay a market rate of interest and for which the issue price differs from the redemption price.

The Group then turned to a discussion of index-linked securities. These were seen as instruments in which the contract states that the holder would receive an agreed amount of interest and adjustments in value during or at the end of the contract based on movements in an agreed index such as the consumer price index. The index-linked value could be viewed in two ways: (1) as pure revaluation, and therefore as part of the revaluation accounts; or (2) as part of the original contract, and therefore to be recorded as actual interest.

The majority of the Group recommended that, in the case of index-linked securities, the full return should be treated as interest, since any contractual agreement should not be considered as revaluation and therefore part of the revaluation account. Several participants felt, however, that the indexed increment or monetary correction should be treated as a price adjustment and therefore belonged in the revaluation account. Another noted that, in the case of a country with 300 percent inflation, if the indexed part were treated as interest, this would lead to the unsatisfactory implication that at the end of the period the capital amount had dropped to one third of its opening value. Against this view, it was pointed out that this result did not differ from what would happen under conditions of monetary instability to a non-indexed security when very high nominal interest rates prevailed.

The Group also recommended that, in the case of index-linked securities, when the indexed return is paid only at maturity, that return should be converted into a series of annual or quarterly payments over the full lifetime of the instrument (as for zero-coupon or deep-discounted bonds).

3: Payments arrears

In the introduction of this item it was pointed out that, while the present aNA makes no specific reference to the recording of payments arrears, its accounting principles allow for the correct treatment of such arrears. The accounting treatment was seen to be straightforward. If the "due for payment principle" were adhered to, interest and amortization would be recorded when due, and when these were not paid a contra-entry would be made in the capital finance accounts which would be equivalent to the new liability. The presentation for transactions would be to record interest when due in the current account, and to record in the capital account a new liability representing overdue interest and principal.

The Group agreed that the appropriate treatment of payments arrears is that already provided for in the SNA. When the payments of interest and amortization fall due, debits are recorded in the current and capital account, respectively, of the debtor, and a contra-entry is shown in the capital account in respect of the credit which has been involuntarily provided to the debtor.

The Group saw two possibilities for the presentation of a new liability representing overdue interest: it could be shown as a new item or as a memorandum item, with accounts payable broken down. Some neatness was seen in taking the memorandum item approach rather than expanding the list of assets and liabilities, and the Group therefore agreed that it

would be useful to identify these amounts as memorandum items where they are important.

4. <u>Provisions and write-offs</u>

Creditors can adjust their balance sheets in a number of ways that are **not considered transactions** in the SN. These adjustments can lead to substantial problems in estimating flows from stock data and can also lead to large asymmetries between creditor and debtor reporting. The most **important** of such adjustments relate **to provisions**, write-downs, and write-offs and these adjustments can be made against both domestic and external debtors. They usually involve a creditor reducing the balance **sheet value of his claims on particular debtors (specific provisioning)** or the whole of his asset portfolio (general provisioning). In the case of specific **provisioning**, all (write-off) or part (write-down) of a given claim may be removed from the balance sheet. These actions may be taken for prudential reasons or as required by supervisory authorities.

Provisions and **write-offs do not affect the** existence or **value of** the claim of **the creditor on the debtor;** the **legal** claim still exists but the balance sheet is adjusted to reflect the probable worth of the asset and also net worth. Since no real change has taken place in the **debtor/creditor** relationship through **provisioning**, these unilateral balance sheet changes on the part of the creditor should not be interpreted as transactions but rather as analogous to valuation changes. In calculating flows from balance sheets in which provisions have been made, it is necessary to adjust the assets so that the reduction in reported claims is not interpreted as a decline in credit (repayment of loans).

As neither the SNA nor M60 provides clear guidance on provisioning and write-offs, the question for the Group was whether these adjustments should be treated in the same way as valuation changes and should therefore be recorded in the reconciliation accounts of the <u>SNA.</u>

The Group saw a clear distinction between arrangements in which the claim of the creditor on the debtor was extinguished, and therefore in which a transaction had taken place, and arrangements in which the claim was not extinguished and there was no transaction. Within the first group, there was a need to distinguish between contractually' agreed write-offs and those in which a creditor writes-off an item because he thinks the debtor will not pay. In the latter case there will be an imbalance in the **balance** sheets of the creditor and the debtor, because the debtor will not acknowledge the write-off in his balance sheet. This unilateral case would not lead to a transaction until and unless the liability were to be extinguished by the debtor; until such time, there would be only a valuation question with regard to the debtor's balance sheet. One participant noted that there was a need to distinguish between voluntary and involuntary forgiveness and that the symmetry of the system needed to be preserved, since involuntary forgiveness would represent a reconciliation entry rather than a capital transfer (as in the case of a voluntary forgiveness) and in the counterpart entry the asset would disappear (as it would in the reconciliation accounts).

The general view that emerged from the Group's discussions was that, for SNA balance sheet purposes, the creditor's balance sheet would be reconstituted (by adding back in any amounts the creditor had written down) unless there was incontrovertible evidence from both sides that the claim had been extinguished or unless the creditor removed the total claim from his balance sheet. It was admitted that a possible problem with this **"reconstitution" approach for write-downs,** which resulted in no entry in the reconciliation accounts, was that write-downs may in some cases be **economically** equivalent to changes in **market valuation** which are reflected in the reconciliation accounts.

In summary, the Group identified three categories within the broad **range of provisions, write-offs, and debt forgiveness operations:**

1. With respect to a bilateral agreement between the creditor and debtor that a financial claim no longer existed, the SNA would record a capital transfer from the creditor to the debtor.

2. With regard to a full write-off of a claim from the creditor's balance sheet, this would be taken as prima facie evidence that the creditor no longer had a financial claim, and the reduction in the creditors's balance sheet would be accounted for by an entry in the reconciliation account.

3. All other adjustments to creditors' own balance sheets with regard to provisioning and write-downs of financial assets would be excluded from SNA; that is, these adjustments would be reversed for the purpose of SNA balance sheets and would therefore lead to entries in neither the transaction accounts nor reconciliation accounts.

5. <u>Debt/equity swaps</u>

Debt/equity swaps or other forms of debt conversion have been used increasingly by heavily indebted countries to reduce their debt burden in the short and medium term. A secondary market for existing debt of developing countries emerged in 1982. This market **played** a major role in shifting international banks' debt exposure toward nonbank investors who purchased the debt instruments at discount from the banks. Increasingly, in the last **several years,** these claims **have** been **exchanged** for equity investments in the debtor countries. These arrangements vary between countries and may take many complex forms, but the end result is usually the extinction of a foreign **currency-denominated fixed payment** liability, such as a security or a loan, and the substitution of a domestic currency **equity-type** liability to a nonresident. This may **occur directly,** when the liability of an enterprise is exchanged for equity in the same enterprise, or **indirectly,** when the central bank redeems **outstanding debt (normally** at a discount) but the proceeds of the redemption must be reinvested in approved equity within the country. In the first case, debt is extinguished and replaced by an equity-type liability, while in the second case the debt still exists but is now a liability to a resident (the central bank). Both cases result in a nonresident's holding an equity-type claim in the debt-swapping country. In the second case the transactions are explicit--the central bank buys a financial asset from a nonresident for local currency and the nonresident uses the local currency to purchase equity--and should cause no difficulty for recording in the te. In the first case (the direct swap), the transaction may have to be imputed and there may be problems of valuing the transaction. An additional issue is also raised by the fact that the transaction by which the liability is extinguished may take place at a price substantially different from the value at which the liability is booked, thus requiring an entry in the reconciliation accounts.

In the ensuing discussion on the appropriate treatment of debt/equity swaps in the SNA, some participants saw the difference between the face value of the instrument and the amount actually received as more properly belonging to the reconciliation accounts, while others saw it as a transaction involving a capital transfer. Those favoring the treatment of the difference as a capital transfer did so both because it would reduce the government deficit and because the difference was agreed upon. Others felt that while the difference could be construed as a capital transfer, this might not be the best reflection of what is actually happening : This would be true particularly if a third party were involved; in this case it would not be clear whether the capital transfer was being provided by the original creditor or by the third party. In concluding its discussion of this agenda item, the **Group agreed** that **the present SNA accounting principles could deal adequately with transactions involved in debt/equity swaps. The Group recognized that debt/equity swaps usually involve a difference between the full value of the debt instrument and the value of the equity obtained. The Group further agreed that this difference should be accounted for in the reconciliation account, not** as a **capital** transfer.

6. __Discounting/Rediscounting__

The appropriate treatment in the SNA of discounting financial instruments, where the intent of the transaction is to achieve an objective other than that of financing the original issuer of the instrument, was discussed by the Group. It was agreed that, both for balance sheets and for transaction flows, no special recognition of the intent of discounting would be recognized. It was pointed out that while MBS does not recognize discounted instruments in balance sheets, MBS recommends that, in the presentation of flow data, the intent of discounting should be recognized (for example when the central bank discounts government paper to increase the liquidity of banks).

IV. National and Sectoral Balance Sheets and Reconciliation Accounts

In concept at least, balance sheets were an integral part of the 1968 SNA, though the structure and definitions and the classifications and tables were not presented. Practical **recommendations** appeared in 1977 in M60, which **developed recommendations** for **balance** sheets compatible with the **1968 SNA and** in so **doing revealed** some **problems** in linking stock and flow data in terms of **valuation, coverage,and changes** in stocks not accounted for by current flows.

The SNA Expert **Group** Meeting on the SNA Structure (held during June 23-27, **1986) had recommended** that the new **SNA embody more** fully the **balance** sheets **and reconciliation** accounts to **produce a** complete set of accounts, from opening stocks through transactions and revaluations to closing stocks. This implies some constraints on the form, the valuations used, and the **classifications** of assets and sectors used in the balance sheets, but at the same time the **interlinked** system strengthens both the **concepts and the data of national accounts.**

As an analytical tool, balance sheets represent a useful step forward. In practice, to date only a few countries have developed balance-sheet-type data; in consequence, not much national experience is available on the problems of developing balance sheets along the lines of those proposed in M60. Such experience as is available suggests that, at this stage at least, the main problems relate to data availability and valuation rather than to definitions or concepts of balance sheets.

A. Scope and coverage and
B. Nonfinancial assets

The present SNA includes as assets: all financial assets; intangible assets such as copyrights, patents, etc.; and, with regard to tangible assets, all reproducible assets that are created as a result of a production process. Also included are certain tangible nonreproducible assets, such as land and natural resources, that are used as fixed assets in production. Some intermediate forms of assets that are included are improvements of **nonreproducible** assets such as improvements to land, costs that make mineral deposits operational for mining, costs spent on developing timber tracts, orchards, etc., which are assumed to reflect the increase in the **value** of the **nonreproducible tangible** assets, and, finally, growth of livestock. Excluded from assets covered in the SNA are **tangible nonreproducible assets that are not used in production, such as forests, seas, and air, which could be called environmental assets; also excluded are human capital and the product of research and development.**

The Group agreed that human capital would not be included in the SNA balance sheets. It also deferred a discussion of the possible inclusion of environmental assets to a later meeting.

Research and development expenditures

The main topic under discussion for this item of the agenda was the treatment of research and development expenditures; this was an area in which an immediate decision was needed, as it had system-wide implications. The Expert Group Meeting on Production Accounts and Input-Output Tables had questioned the SNA treatment and had felt that such expenditures should not be considered as intermediate consumption, although it would also not be appropriate to treat them as final expenditures. Such expenditures were clearly a kind of capital expenditure that differed from fixed capital expenditure, although the intent (to enhance future productive capacity) was the same.

The Group endorsed the recommendations of the Expert Group on Production Accounts that expenditures on mineral exploration and some types of expenditures undertaken by producers on research and development should be removed from intermediate consumption and treated as capital formation.

Two main arguments were made in favor of the proposed treatment. First, research and development expenditures should not be classified as intermediate consumption since their inclusion as such would not lead to a true measure of cost of production and could in fact lead to negative value added. Second, these expenditures would normally be expected to generate future income and, if they were classified as final expenditures, there would be double counting because there' would be a future income return. On this latter point some participants, while generally in favor of the treatment of such expenditures as capital formation, noted that these expenditures would not always lead-to income-producing capital. There could be development expenditures on new technologies that were not recouped, or exploration that did not yield commercial results. For these reasons some participants favored the establishment of a separate category for research and development expenditures (including exploration costs), which could perhaps be termed "investment expenditures." Most of the Group, however, preferred not to have a separate category and concluded that all such expenditures should be included in capital formation.

The Group agreed that there were problems in capitalizing the items under discussion on the balance sheet and in ascribing a service life to them. Although most participants thought they should be amortized, it was not clear how this should be done and over what period. In this connection it was noted that a group of consultants to the OECD would shortly be finalizing a report that covered the sorts of questions for which the Group was seeking answers. The Group concluded, therefore, that questions concerning the types of expenditures to be treated in this way, the depreciation of such expenditures, and their treatment in balance sheets would be discussed in a later meeting on the basis of reports being prepared on research and development expenditures, and on mineral exploration.

Consumer durables

With respect to the treatment of consumer durables, it was noted that assets (and liabilities) are not only important as factors of production but should also be viewed as elements of wealth. It would therefore be useful to have balance sheets for households that would reflect their **positions** from the **viewpoint** of consumers rather than **producers.** Suggestions were made to identify two categories of consumer durables--those that represent a store of value and those that meet households' needs; and the former **category** could be included in the balance sheets of households. **Alternatively,** consumer durables could be treated as memorandum items, although **there could be** a **case** for including items with a high resale value in the main wealth accounts.

Intangible nonfinancial assets

There was a limited discussion of agenda item IV.B.4., relating to intangible nonfinancial assets. Very few countries identify the present SNA categories representing purchases and sales of intangible assets. Any payments made are generally included with property income or by some countries as payments for services. This practice implicitly assumes that no such assets are identified. In view of this, it might be advisable to eliminate this category wholly or partly from the SMA. If partly eliminated, this category may only include those intangible assets that are of lasting value, because the authors, artists, or inventors who produced these assets (copyrights), have since died and the assets can no longer be reproduced; they have become assets similar to historical monuments.

The Group concluded that it would be useful to clarify the coverage of what is referred to in the present SNA as nonfinancial intangible assets. It was agreed that the defining characteristic of the assets covered here is that they confer "rights" on their owners without any corresponding liabilities elsewhere in the system. The list of assets presently included in this category may need to be enlarged.

Reconciliation accounts

The Group then turned to a discussion of the role **and** form of the reconciliation accounts, **particularly** with **regard** to their **distinction** from the capital accounts.

The present SNA includes in the capital accounts all capital formation in tangible reproducible assets, as well as changes in the accumulation of tangible nonreproducible assets if the latter changes are a consequence of a purchase or sale of those assets. Also included are the creation, elimination, purchases, and sales of financial assets and intangible nonfinancial assets. Not included in the capital flow accounts, but rather in the reconciliation accounts of the SNA, **are** all other changes in the stocks of financial, intangible nonfinancial, and tangible assets. While the reconciliation accounts were originally conceived as including only valuation changes, M60 broadened their coverage to include: (1) nonreproducible assets used in production that were not part of the capital finance accounts (such as discovered subsoil assets and such items as livestock, growth of timber tracts, etc.); (2) adjustments for unforeseen events; and (3) adjustments for changes in structure and classification.

In past discussions there have been two arguments brought forward to expand the present coverage of the capital accounts to include more changes in the stocks of tangible and intangible assets, to the extreme that all changes would be shown in the capital flow accounts, and the reconciliation accounts would include, exclusively, revaluations of assets. It was suggested, first, that such a treatment would result in reconciliation accounts that would be more meaningful analytically, and second, that the capital flow accounts of the SNA would cover all changes in assets that affect the relation among production, income generation, and investments (fixed and financial). Expansion of the capital flow accounts does not necessarily mean that production and GDP would be affected. Such an effect could be avoided by incorporating in the capital flow accounts counter-items to those increases or decreases of assets that are not the result of production; such counter-items (which would not represent changes in either assets or liabilities) to be added to gross saving would avoid affecting the measure of GDP and net lending.

Three proposals emerged from the ensuing discussion, namely:

1. Retain the present SNA treatment, which includes only actual transactions in the capital accounts with a separate set of reconciliation accounts (which include both revaluation and reconciliation items).

2. Adopt the proposal made in the Annotated Agenda, which would move most nonrevaluation items from the reconciliation accounts to the capital accounts, and extend the proposal by subdividing the reconciliation accounts into two parts, comprising revaluation items and reconciliation items, respectively. Reconciliation items relating to changes in reproducible and nonreproducible tangible assets would be moved to the capital accumulation accounts, while the remainder would stay in the revaluation subcategory of the reconciliation accounts.

3. Adopt the approach described in the background paper on "How to deal with non produced assets and exceptional events in the national accounts? Considerations on the variations of wealth account." Under this proposal, the reconciliation accounts would be integrated with the main SNA tables to provide a measure of net worth. A "Change in Wealth Account" would be introduced. This would have three parts: (1) one corresponding to the capital accumulation accounts; (2) the net acquisition of assets and incurrence of liabilities (that is, financial accounts); and (3) reconciliation accounts, albeit with a different name.

This proposal would not change balance sheet values but would simply be a reformulation of Table 7.1 in M60.

Most of the Group felt that the SA needed to change, and therefore they did not support the first proposal noted above. Neither did they support the proposal made in the Annotated Agenda, modified as noted above, since the majority of the Group did not wish to extend the coverage of the capital finance account of the SNA. Such a broadening would introduce an inconsistency between the income accounts and the capital accounts. The Group agreed, however, that the capital *finance* account should be divided into two separate accounts.

The Group was in broad agreement with the proposal made in the background paper, and it was agreed that the present reconciliation accounts developed in M60 needed to be further integrated with the present sector accounts of the SNA and that a new concept, called "Changes in Net Worth," should be introduced into the SNA. In doing this, the Group supported the recommendation made by the Expert Group on the SNA Structure to divide the present reconciliation accounts into two separate accounts (or subaccounts), one covering revaluation items and the other containing the remaining items from the present reconciliation accounts. The need to separately identify revaluation items was seen to be necessary to enable alternative income measures to be constructed. The second subaccount would comprise structural and coverage changes and unexplained differences. Two participants thought that a sectoral breakdown for each item in the two new subaccounts would be needed.

Agreement was reached on assigning the name *financial* account to the second section of the present capital finance account, and the term revaluation account to cover the revaluation items of the present reconciliation accounts. It was suggested that further details regarding the order, *balancing* items, and names of the remaining two accounts should be elaborated as part of the design of an accounting framework for the SNA, which is planned to be discussed in a future Expert Group Meeting.

On the question of presentation, it was noted that the form of reconciliation account suggested in M60 is perhaps not the clearest or most useful. Several participants saw the need for a presentation that would show how to move from opening to closing balances and said that the presentation adopted needed to be an integral part of the conceptual tables in the SNA. Although the Group did not reach a formal conclusion on this point, the view that emerged was that, in order to integrate the reconciliation accounts with the SNA, the first panel of the capital accumulation accounts would show capital transactions, the second panel would show the reconciliation accounts with the breakdown agreed by the Group, and the final panel would show the financial accounts. Within the reconciliation accounts there would be, for each type of asset and liability, a column for opening values and columns for each of the factors leading to the closing values, which would be shown in the final column. There would also be totals at the bottom of each subaccount.

The **Group agreed** that **the revaluation** account must **be so arranged that holding gains and losses can be clearly identified, distinguishing changes due to relative price movements from changes due to general price movements.** This would be necessary to enable the derivation of measures of real capital gains and real net worth. In its discussion of the choice of an indicator of general price movements, the Group noted that there was a long-standing debate on how to measure general inflation, and that there was no ideal measure. Nonetheless, it was considered important that the Group reach a **decision** on the indicator to be used. The Group concluded that **the index measuring general price movements, that is, the variation in the internal purchasing power of the currency, should be as broad as possible in its coverage. An acceptable approximation is the price index of Gross National Expenditure (GNE), which covers final consumption and capital formation.** It was noted that the price index of GNE would not be available for all countries and, in addition, that it would not be sufficient to have an index that was available only on an annual basis, since it **would be** necessary to capture price **variations** within the year. **Monthly or quarterly indexes** that could be used to **interpolate** the annual **index were therefore needed. For these reasons the Group concluded that alternative broad measures will also be suggested in the revised SNA when the GNE index is not available.**

<u>Holding gains and losses</u>

The discussion then turned to the definition of "holding gains and losses" and how these would be differentiated from other income. Within the general framework discussed above, the specific question was whether these would be viewed only in the context of variations in general prices, or in terms of relative prices. Although a wide range of views was **expressed, most of the Group preferred the term "holding" gains and losses to the proposed alternative "capital" gains and losses. These gains and losses include both realized and unrealized gains and losses. Several** participants were not certain as to how the results should be interpreted when the sum of relative changes in individual items was a large negative or positive figure. Presumably, if the result were positive, it would mean that relative prices of tangibles had increased at a faster rate than general inflation. The question was raised as to whether there was room conceptually for net gains or losses, and it was pointed out that the results would be open to interpretation if net gains or losses occurred because a less than ideal index had been used. One participant expressed the view that more thought and discussion should be given to the question of whether the index chosen should be **one** that exactly cancels out holding gains and losses.

C. Links between financial flows and balances

1. General principles

In the matter of the valuation of financial instruments, M60 suggested three factors to be considered in deciding the most appropriate mode of valuing the items in national and sectoral balance sheet accounts. The mode of valuation should:

1. **result in the most useful data for purposes of studying resources and wealth and economic and financial behavior;**

2. **be practicable to use--the values chosen** must **be** measurable and **collectible**; and

3. **be used** for all kinds of assets **and liabilities** to contribute to the **comprehensiveness** and simplicity of the relationships **between these** items in the **balance** sheet accounts.

It is considered axiomatic that entries must be valued identically for all transactors to facilitate comparison and consolidation of accounts. M60 reviews in detail the principles governing valuation of assets and liabilities and concludes in general that financial instruments are to be valued in a symmetrical manner regardless of their status as assets or liabilities. For those financial instruments with long-term maturity structures, the SA recommends that as assets they should be valued at market values on the basis that the financial decisions of investors will be influenced by their sales value in the market. The same valuation principle applies to these instruments as the liabilities of debtors; they are to be valued at market prices on the grounds that issuers of debt such as long-term bonds may chose to refinance their liabilities depending on interest rate developments subsequent to the contraction of the original financial obligation. In comparison, short-term instruments (for example, treasury bills) are valued in the SNA at nominal face value, since as assets and as liabilities they can be traded at or near their full nominal face value. For financial instruments denominated in foreign currencies, the SNA recommends that they should be converted to the national currency using the exchange rate prevailing on the balance sheet date.

The IMF Guide agrees with the **SNA on** the **valuation of** short-term assets **and** liabilities but **recommends an asymmetrical treatment of** long-term instruments, with assets **being valued at market value while** financial liabilities are **to be** valued **at** nominal **face value,** as this represents the ultimate cost to the debtor of discharging his **obligations.** It should be noted, however, that data on financial liabilities and assets compiled for MBS reflect accounting conventions in various countries that may differ from this recommendation.

The following questions were before the Group:

1. Should the SNA continue to recommend symmetry in the valuation of financial instruments as assets and liabilities?

2. Is there justification for valuing financial liabilities at nominal face value regardless of maturity structure in light of the active liability management currently being carried out by financial institutions?

As a general principle of valuation, the Group recommended retention of the symmetric treatment of assets and liabilities at market prices. There was interest, however, in developing information supplementary to the main tables that would show alternative valuation measures for corporate equity and long-term bonds. One participant noted that there might be problems in using market values in MBS since banks could probably provide only book values on the required monthly basis. He added that, while the M60 guidelines on valuation were useful ones, there were some problems: the suggestion that the value of unlisted securities be based on, for example, price/earnings ratios could not always be followed because the required data are not always available; the M60 proposal that data from companies' balance sheets be used for direct investment in subsidiaries could not always be followed because SNA valuation principles differ from normal business depreciation practices; M60 suggests that equity in life insurance and pension funds be shown in nominal values. Perhaps their value should be derived as a residual.

In order to assist the Group to reach a conclusion on the valuation of bonds issued at a discount, it was agreed that the IMF would extend the paper it had prepared for the External Sector Meeting to cover stocks.

2. <u>Foreign currency-denominated items</u>

For those financial instruments denominated in foreign currencies, valuation changes can result from exchange rate changes as well as from changes in market prices. The associated gains and losses will therefore depend on the frequency with which balance sheet entries are revalued. As in the case of domestic financial instruments, the counterpart of the valuation changes in the balance sheet is recorded in the SNA in the reconciliation accounts.

When compiling balance sheet data in terms of the national currency, a question arises as to the appropriate exchange rate to be used in converting the value of financial instruments denominated in foreign currencies or units of account: In a fluctuating exchange rate regime involving a unitary rate, it would appear reasonable to use the prevailing end-of-period exchange rate. However, the appropriate exchange rate to be used in situations involving multiple exchange rates, or where there are official and parallel, or "black," markets for foreign exchange, is less clear.

When dealing with transactions, both the Expert Group on External Sector Transactions and the Expert Group on Production Accounts and Input-Output Tables recognized that a multiple exchange rate regime implicitly incorporates elements of taxes and subsidies that are essentially of domestic origin. They recommended that the implicit taxes and subsidies be imputed as the difference between the exchange rate specific to a given transaction and a notional unitary rate approximated as a weighted average of the multiple rates applicable to the different classes of transactions.

In the context of valuing outstanding amounts of assets and liabilities denominated in foreign currencies, the question arises as to which of the several end-of-period multiple rates could be said to be applicable, since the multiple rates are designed to affect the volume of certain classes of transactions (for example, exports, imports, capital flows, etc.), while their impact on the levels of foreign assets and liabilities is often not considered. In the circumstances, since it is difficult to conceptualize any kind of weighted average, consideration could be given to using the end-of-period principal rate or the rate at which most of the transactions are deemed to be occurring.

The prevalence of an illegal or "black" market for foreign exchange in addition to the official market poses yet another problem for choosing an appropriate exchange rate for valuing holdings of foreign assets and liabilities in terms of the domestic currency. In these circumstances, too, it would appear reasonable to recommend the use of the end-of-period - principal rate prevailing in the official market for foreign exchange.

The Group agreed that under unitary exchange rate systems the valuation of foreign currency-denominated stock positions was straightforward, using the end-of-period unitary exchange rate. The Group concluded that under multiple exchange rate systems several techniques might have to be used to value foreign currency-denominated items in the balance sheet depending on individual countries' systems and data limitations. If there is a clear separation of markets, the preferred technique would be to apply the actual exchange rate used for transactions for a particular sector, asset, or liability. It was noted, however, that this might be difficult in practice because of data limitations. If the above clear separation does not exist, the conversion should be based on a rate obtained as a weighted average of actual rates. It was pointed out that, if weighted averages were used, the weights could be extremely volatile, and in practice the weights used might not accord with reality. If such an average could not be compiled, the rate used should be a "primary" or "principal" rate, or the rate at which the majority of transactions take place. It was suggested that the text of the SNA should acknowledge the possible problems and implications of using such rates. Whichever technique was selected, the rate would be an end-of-period one for the valuation of stocks. It was agreed that the IMF staff would guide the author of the revised 06 on exchange rate terminology used in the IMF.

3. **Estimation of flows from balance sheet data**

The Group concluded that a methodology for calculating financial flows from balance sheet data is more appropriate for a handbook than for the revised SNA.

V. Other Topics

A. Treatment of casualty insurance transactions

Discussion of this item focused on the background paper on "A Further Look at the Treatment of Insurance in the SNA." This paper noted that the SNA records insurance premiums when they are due to be paid, while ESA records them when they are earned. According to the SSA, insured sectors have no claims against insurance companies since claims are recorded only when paid; according to Fes, insurance companies have liabilities to the different sectors comprising prepayment of premiums. The paper proposed that the SNA follow the ESA treatment because it is more consistent with the analysis of insurance transactions and with the way insurance companies view their positions; if it were decided to change the SSA, then a new subcategory should be created under "insurance technical reserves."

It was pointed out that the above-mentioned treatments in ESA and the SSA also apply to insurance claims. There is no implication for the existence of liabilities of insurance companies but just a difference in the amount of claims. However, the part of claims that is not yet paid is classified by the SNA under "other accounts receivable/payable," while in ESA it is treated under a subheading termed "insurance technical reserves." The paper proposed that the SSA adopt the ESA treatment and that, within the classification of financial instruments, it would be necessary to create a broad category termed "insurance technical reserves."

The Group was in favor of. the proposals made in the background paper and recommended that for casualty insurance, premiums should be recorded when earned 1/ (not when due) and claims should be recorded when the event occurs (not when payments are agreed). This treatment requires the recognition of prepayments of premiums and reserves against unsettled claims. In the instrument classification, these items would be part of a new category, insurance technical reserves, covering casualty as well as life insurance. (See Item 6 of Table 2.)

The Group discussed the question of terminology in the area of casualty insurance and concluded that, since a satisfactory term could not be found, the term "casualty" would be retained. It was agreed that the revised SSA would provide a clear and comprehensive description of the coverage of the "casualty insurance" item.

The Group agreed that **a thorough review of all aspects of insurance would be undertaken at the next Expert Group Meeting.**

1/ Earned in this context means premiums earned are that part of the premiums paid intended to cover the risks during the relevant period.

B. Hyperinflation

The Group recognized the need for further work, of a conceptual and practical nature, on the effects of hyperinflation, in particular with regard to transactions in the income and outlay, capital, and reconciliation accounts, and balance sheets.

Participants urged the Inter-Secretariat Working Group to try to arrange for a paper to be prepared on this subject. The paper might draw on work already done by the IMF and on the discussions that will take place at the meting of ECLAC, the Centro de Estudios Monetarios Latino Americano (CEMLA), and the Central Bank of Argentina in November 1988 in Buenos Aires.

C. Other

It was agreed that participants who wished to comment on agenda items that were not fully discussed should forward these to Mr. van Tongeren or to other members of the Inter-Secretariat Working Group.