

# **A Proposal to Better Elucidate the Income and Condition of Financial Institutions in National Accounts**

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## Paper Abstract:

The financial crisis was a reminder of the need for a truly informative picture of the income and net worth of financial corporations. To this end, our paper proposes some improvements in the treatment of holding gains and risk. The guiding principle of our improvements comes from Hicks' definition of income as a concept that includes expected gains and losses.

## Holding gains and losses:

Holding gains are a core part of operating results in many financial services industries, yet they are excluded from the definition of income in national accounts. Although including unexpected holding gains and losses in income would upset the important conceptual identity between income-based and expenditures-based measures of GDP, we argue that expected holding gains can often be included in income in ways that do not upset this fundamental identity of national income accounting. First, in cases of activities that generate holding gains on a consistent, low risk basis, provided that a user of the services can be identified, the role of holding gains as implicit payments for services can be recognized. Opportunities to enjoy predictable holding gains would be arbitrated away if there were no costs involved, so under this circumstance we can presume that costs are present and we can expect that these costs will represent costs of production.

Second, we investigate the feasibility of broadening the application of the treatment that is already given to holding gains that come from retained earnings on foreign direct investment to cover resident investors. Foreign investors in equity are treated as receiving income and then reinvesting it when their equity undergoes a revaluation through the mechanism of "reinvested earnings".

Recognizing the expected holding gains that implicitly serve as payments for services and the holding gains that can be treated as reinvested dividends does not entirely solve the problem of lack of visibility of a key component of what businesses themselves regard as their income. To fill in the remaining information gap, we introduce a broad concept of "income and gains and losses" (IGL). Reporting this concept as a supplementary item will enable users of the accounts to better understand the situation of households and businesses, particularly businesses that rely on holding gains to defray some or all of their expenses.

## Risk:

The treatment of risk in measuring FISIM has been the topic of much debate, and we will point out some practical difficulties in measuring risk for purposes of excluding risk-bearing

from FISIM. However our main focus is on how measures of the assets and income of financial institutions can better reflect risk.

The current practices are to measure debt instrument assets at book value and not to deduct a provision for bad debt expense (“credit losses”) in measuring the income of the creditor. These practices are necessary to avoid distorting the picture of the debtor’s net worth and saving, and they are extended to the case of the creditor so that the same measure of a transaction or position is used everywhere. Yet credit losses are such a fundamental part of the lending business that a realistic picture of the net worth, leverage and income of many types of financial institutions cannot ignore them.

To allow us to apply the measurement concepts that are most suitable for depicting the creditor’s situation when looking at the creditor, we introduce adjustment items for differences between the debtor and creditor perspective valuations. These valuation adjustment items are: a provision for credit losses that is deducted as part of the calculation of income and gains and losses, and an allowance for credit losses that is deducted from the comprehensive value of assets. The principle of the need for valuation adjustment items to allow for separate valuations of a transaction that are most suitable for each of the parties is already accepted in the SNA in the case of producers and users of intermediate inputs that are subject to taxes on products.

We illustrate our measures for the financial corporations in France and the United States.

We also show how our approach to recording credit losses can improve the depiction of the cost to governments (via their depositor insurer subsidiaries) of protecting insured depositors—and sometimes other creditors—when banks fail. (In the case of the US national accounts, to avoid overstating the net lending of the depositors, the current and capital transfers to depositors are not recorded, but this seems to result in an overstatement of government net lending.) When a bank fails, the government (or its deposit insurer subsidiary) buys the asset of each insured depositor at book value in a purely financial transaction. The government (deposit insurer) then suffers bad debt losses on the claims on the failing bank that it has acquired at book value. Provisions for bad debt losses of a large and infrequent nature are non-routine capital losses, so we show these costs as part of a concept labeled “income, capital transfers, and gains and losses”. We also report the government’s comprehensive net lending as “change in net worth from net lending and gains and losses.”