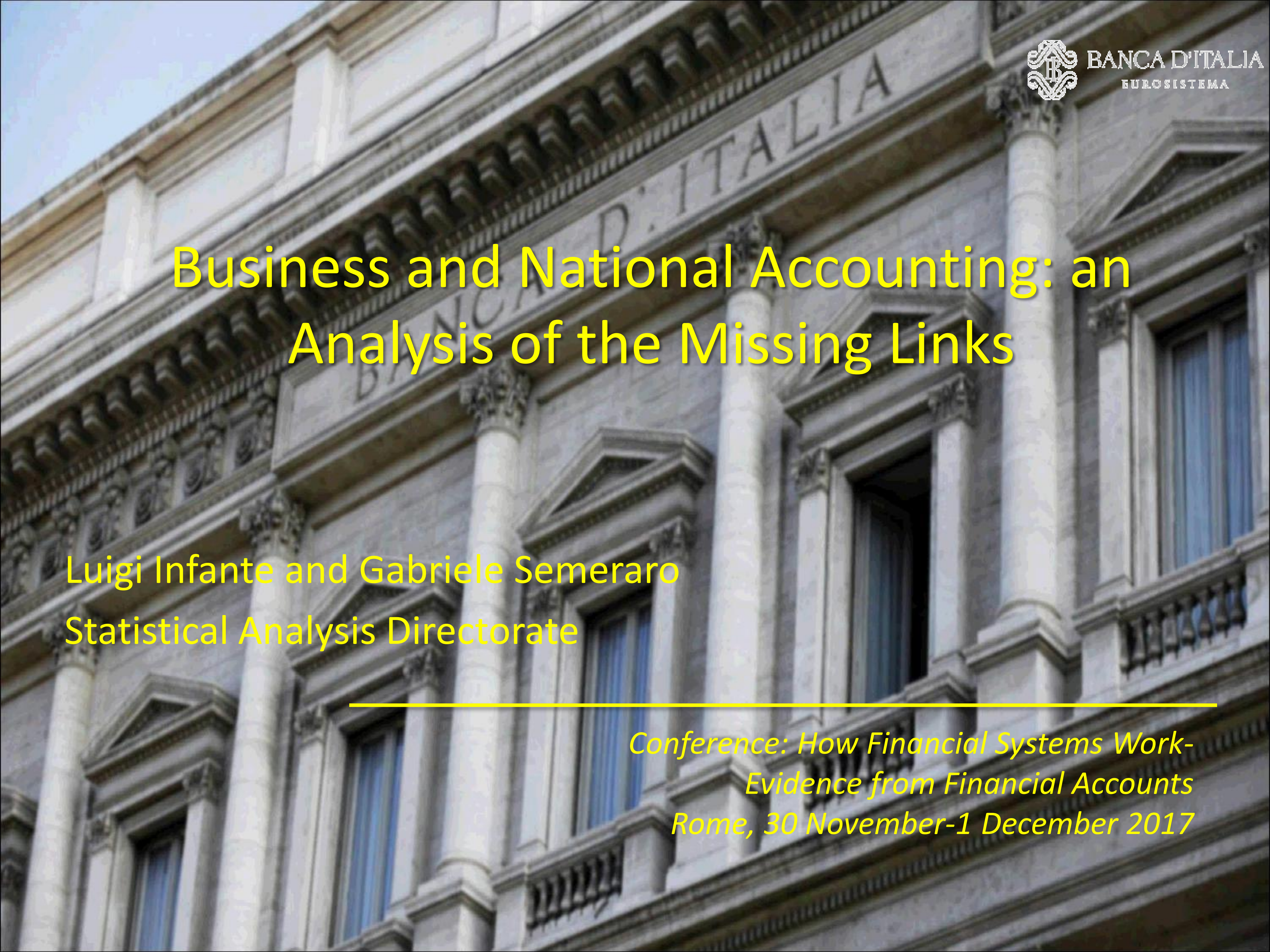

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Business and National Accounting: an Analysis of the Missing Links

Luigi Infante and Gabriele Semeraro
Statistical Analysis Directorate

Conference: How Financial Systems Work-
Evidence from Financial Accounts
Rome, 30 November-1 December 2017

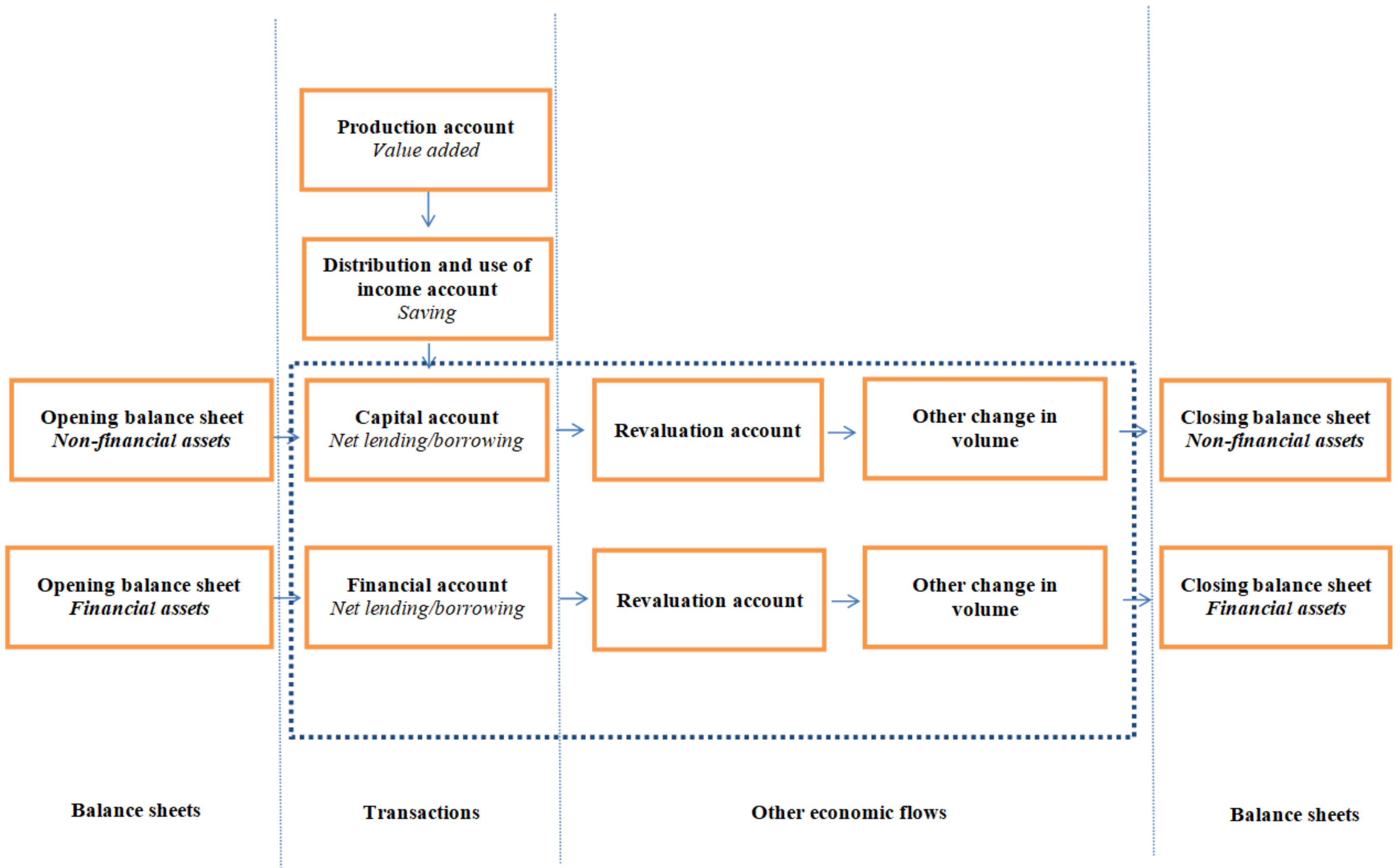
Outline

- Why National and Business accounts need to differ?

- Traditional corrections for bad debt and other provisions in N.A. are still valid?

- The role of holding gains in the measurement of net lending and financial production: possible improvements?

System of national accounts: sequence



Main purposes of National Accounts vs Business Accounts

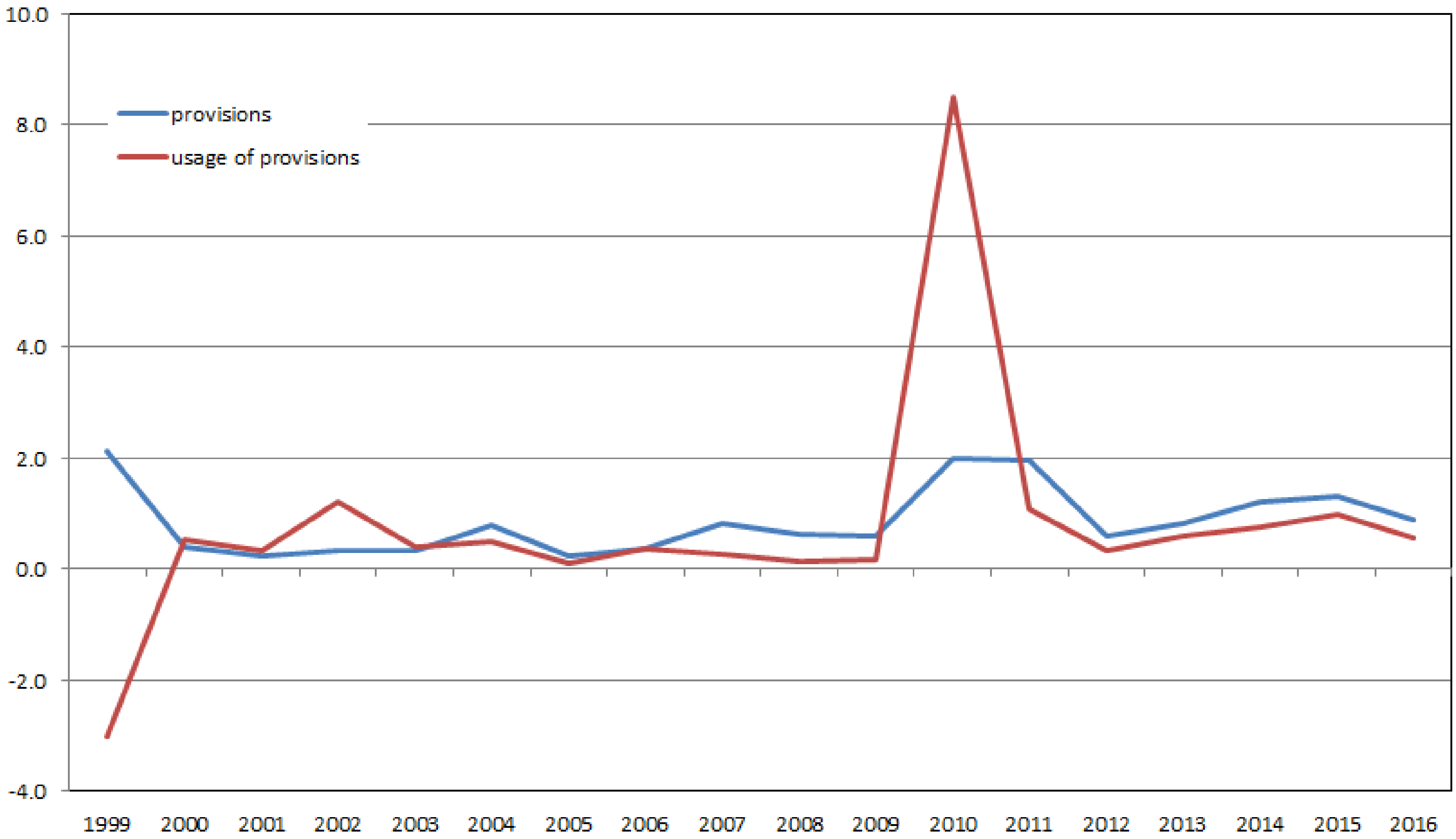
- The final goal of NA is to measure macroeconomic variables (i.e. production, consumption, investment, saving)…
- …and describe the sectoral links (i.e. the flow of financial saving from more to less abundant sectors, the role of financial markets and intermediaries)

- While for BA is to measure profits or losses - and to supply an evaluation of the corporation (or group) – at an individual level….
- ….without any need to measure and balance the counterpart sectors.

.....National Accounts vs Business Accounts (continued)

- Then NA pick up only a subset of business statement entries, disregarding some, and imputing others (not included in business accounting).
- Less controversial examples include tips, recompenses in the form of goods and services supplied free of charge, implicit insurance fees….
- More controversial entries refer to Provisions and Holding Gains: with increasing relevance in the banking industry; omitted in NA for several reasons.

Provisions and discrepancy in non-financial corporations: Italy (ratio of provisions over discrepancy)



Source: Cerved and Banca d'Italia,Financial Accounts.

Accounting for provisions

- In business accounting, provisioning is a technique used to put aside resources for already expected losses: saving amounts from distribution of income today in order to limit losses tomorrow.

- In NA, **provisions for bad-debt** are treated as book-keeping entries that are internal to the producer unit and are not recorded. This means that **the capital and financial accounts should not record anything**, at the time when the expectation of loss arises…

- On the other hand, at the time when the event takes place, "The writing-off of debt is not a transaction between institutional units and therefore is not recorded in either the capital account or the financial account" (ESA2010, 4.165).

- The **write-off** is recorded in the "other changes in volume": i.e. it reduces the stock of loans, without entering any transaction in national accounts.

Substance over form

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doubt on ECB plan to rein in bad loans

Minister questions 'method and substance' of idea for banks to hold more collateral

The ECB's proposals would require lenders to post collateral against the entire unsecured part of non-performing loans
years © Reuters

OCTOBER 9, 2017 **James Politi** in Rome and **Claire Jones** in Frankfurt 17

Pier Carlo Padoan, Italy's finance minister, has voiced "doubts" about the European Central Bank's plan to force banks to increase provisions for non-performing loans, as the rift between Rome and Frankfurt over how to fix the

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European Central Bank

ECB asks banks to set aside more cash for bad debt amid €1tn problem

Central bank attempts to prevent creation of new eurozone debt pile by making it more expensive to hold problem loans

This article is 2 months old

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Jill Treanor City editor

Wednesday 4 October 2017 10.19 BST

Inconsistencies and solutions

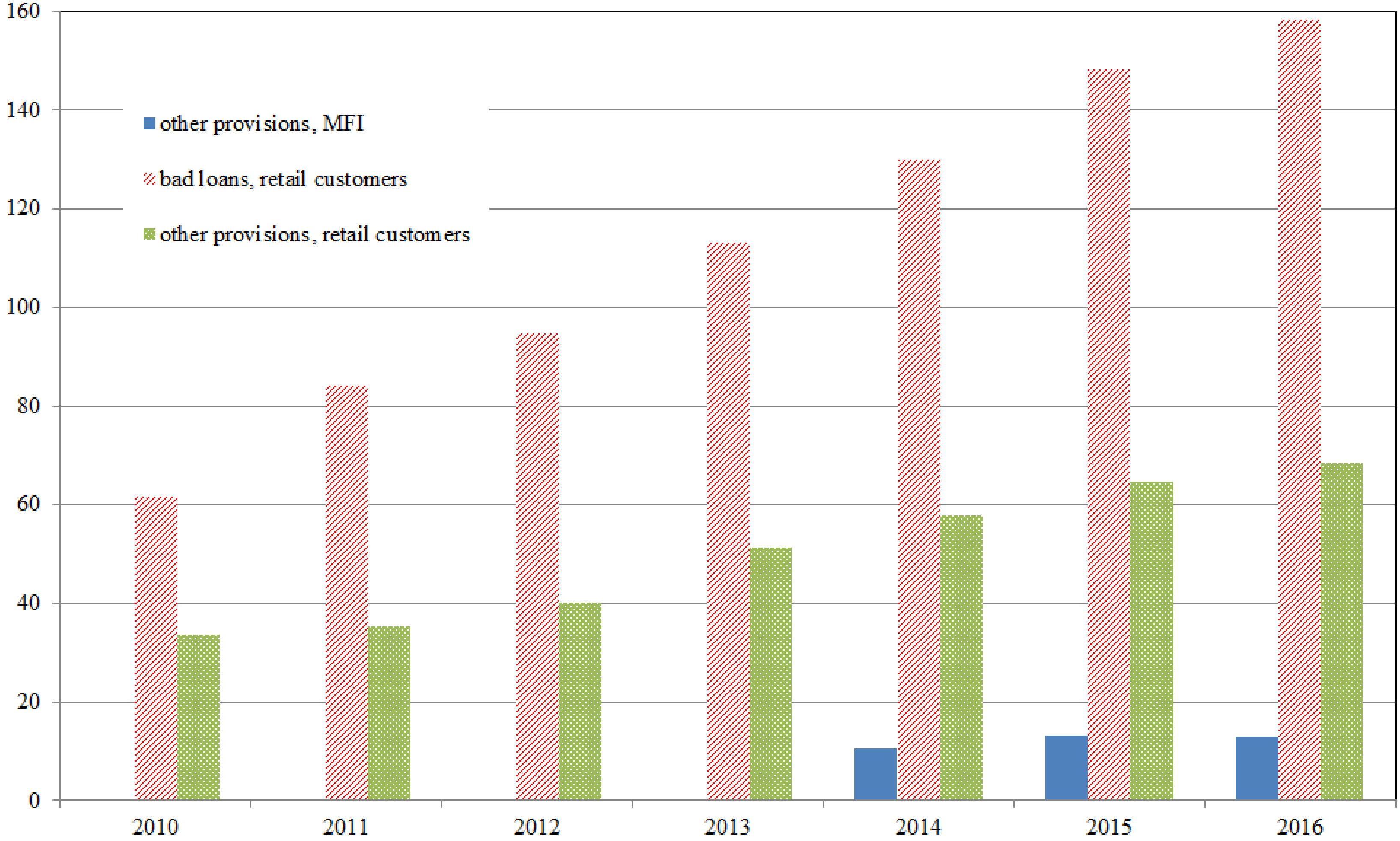
- We show that this treatment cannot be generalized. Consistent guidance should first distinguish **(1) provisions for future events involving cash disbursement** (i.e. legal or fiscal risks) from (2) **provisions for risks affecting assets recorded in the balance sheet** (i.e. loans or trade credit).

- For case (1), we propose to: correct the non-financial account with the usage of the fund for provisions, even though still ignoring the moment when provisions are accumulated. Need to preserve the economic substance.

- The case of bad debt (2) is more complex. We conclude that the ESA treatment works in ante-IAS scenario. For banks adopting IAS a different solution is needed, impacting on financial accounts.

- The impact of credit allowances moved to capital has been sizeable in previous years. The shift from an "incurred loss model" to an "expected credit loss" standard, that will come into effect between 2018 and 2021 (Cohen and Edwards, 2017).

Loan Provisions in the Italian banking system
(stocks; ratio over value added of financial sector)



Source: Banca d'Italia, Supervisory report.

Holding gains and financial production

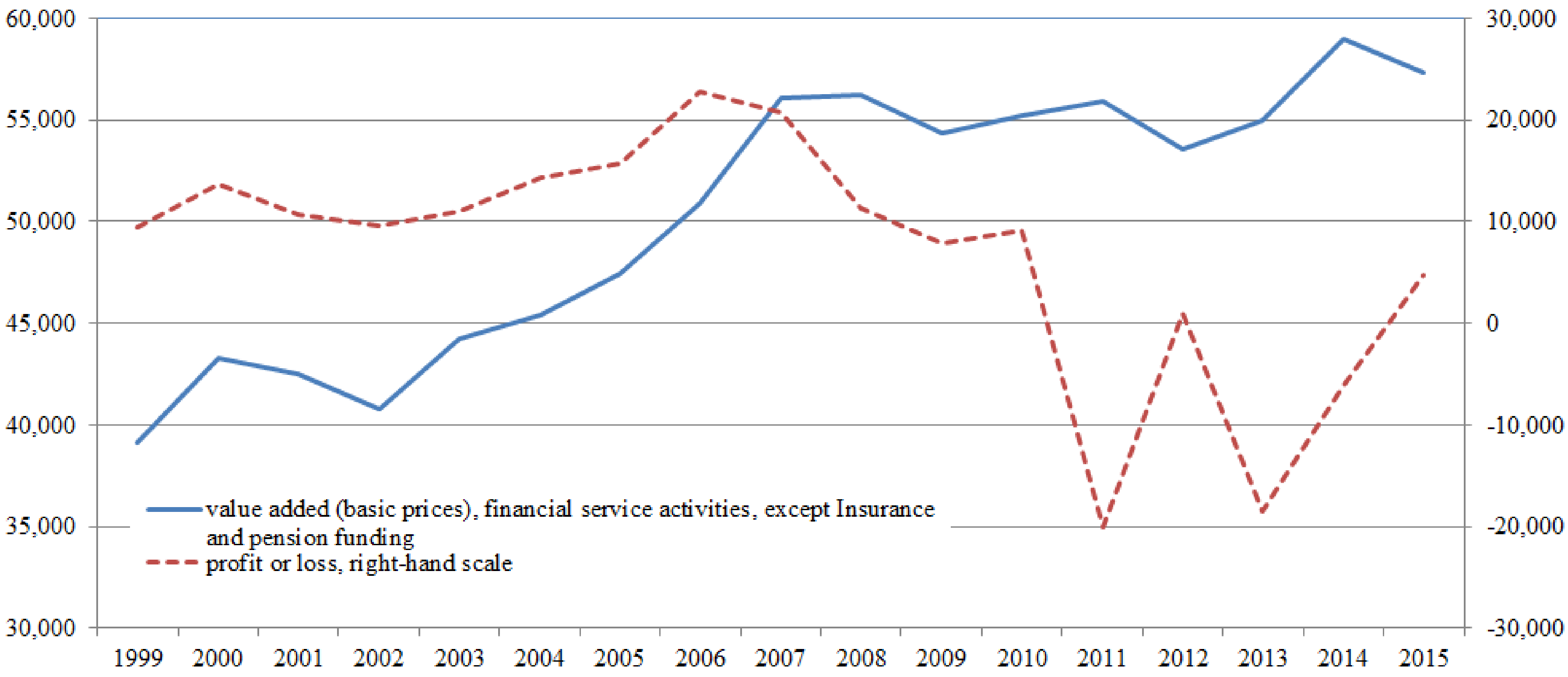
- The generally understood concept of disposable income could be defined as the maximum amount that a unit can consume without reducing its real net worth. This would be of course increased as a consequence of holding gains.

- The SNA and ESA exclude holding gains and losses from production first; more in general, they exclude holding gains and losses from the definition of transactions. The only admitted impact is on the net worth.

- The origin is in the need to represent the real-sector production, distinguishing the genuine contribution to production attributable to the actions of the firm, from any accidental event affecting the value of inventories, including exogenous price changes (SNA 2008, para 6.143).

- The treatment of financial intermediaries is directly borrowed from nonfinancial production. It is aimed at eliminating all increases in value that are due to price effects. Only few exceptions are admitted, where differences in price are so predictable to be compared to the case of season goods (Durant et al., 2015).

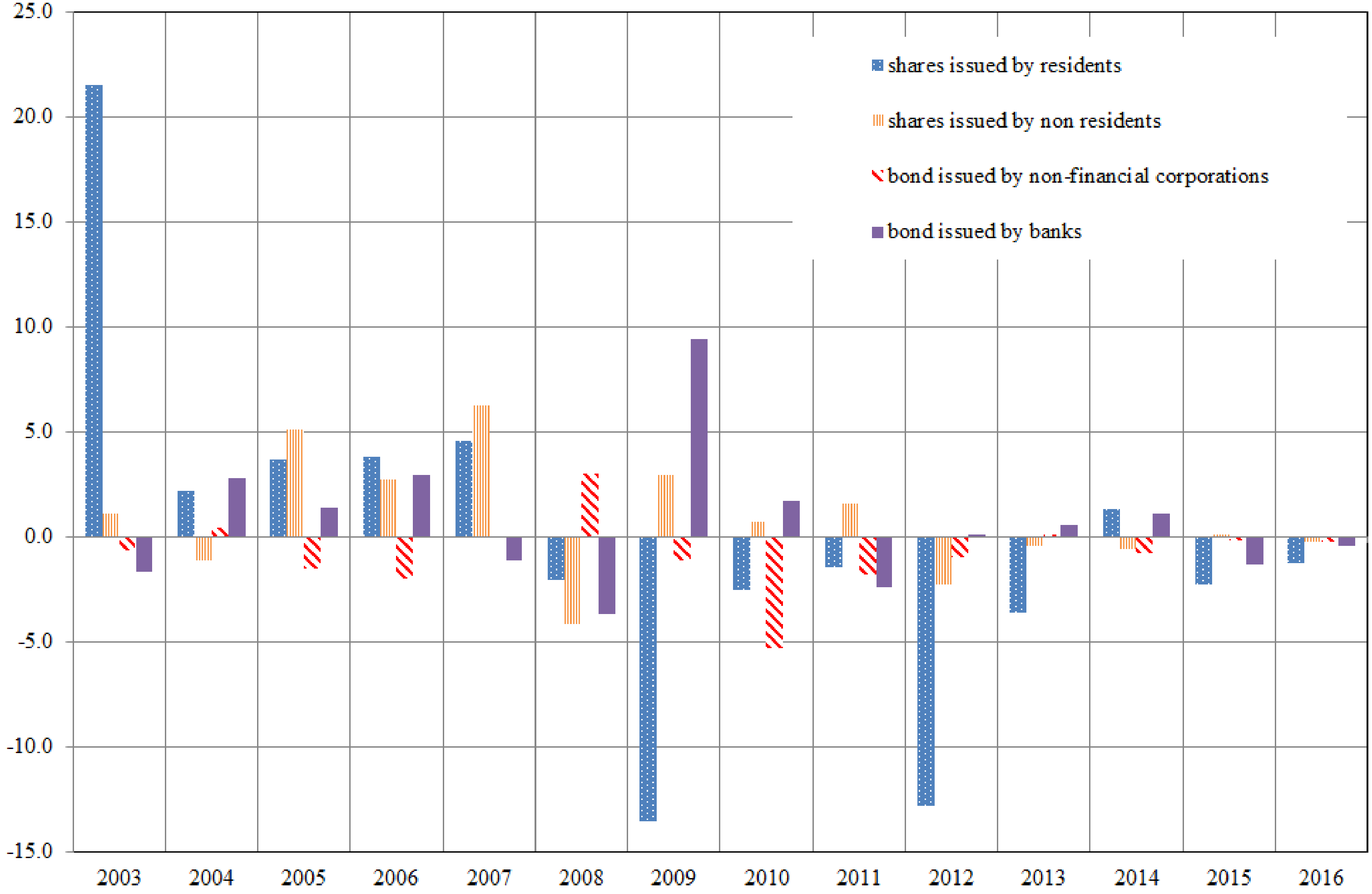
Value added vs. Income statement of financial intermediaries – Italy (EUR millions)



Source: Istat and Banca d'Italia, Supervisory report.

Holding gains for the banking sector - Italy

(ratio over the value added of the financial sector)



Source: Banca d'Italia, Supervisory report.

Holding gains and financial production

- In non-financial production, the role of storage and repackaging amounts to a little contribution, since most of the value added comes from physical transformation and other activities...

- Whereas for financial activity the "storage and repackaging" of assets is by no means a marginal task.

- The current approach attempts to capture the relevant financial activity through indirectly measured “financial services”, regardless of the importance of holding gains in the business balance sheets. The need to go beyond this survived in a number of issues in the “SNA Research Agenda”

Holding gains and financial production

- For the banking sector, we would at least distinguish between banking book (with securities to be kept until maturity) and trading book (with instruments purchased and sold to profit from trading spreads between the bid and ask prices, or to hedge against various types of risk, as well as to facilitate trading for the customers.

- While individual prices remain quite unforeseeable, sophisticated risk metrics are adopted to manage and mitigate risk in the trading books portfolio as a whole. Gains obtained in this way should not be regarded as fully accidental or independent from the company decisions and processes.

Holding gains and financial production

- In the case of negotiable instruments, the major doubts on holding gains reflect the contribution to income and the split between transactions and other flows; but the measurement of stocks, thanks to anchoring to a market valuation, does not raise issues.

- In the case of loans difficulties concerning flows are exacerbated by the anchoring of valuation to a legal concept. A reconciliation device is foreseen by the national accounts. However we argue that this is limited to volume effects, and works for write-offs but not for write-downs.

- While internally consistent, this treatment is able to miss the economic substance of some kinds of intermediation. What is a profitable business turns out to be depicted as a sequence of "surprise" losses of value (even though repeated and systematic).

- Our proposal foresees the resetting for the value of traded loans according to the "creditor principle" and extending the coverage of capital transfers on loans.

Sale of loans: a Counterintuitive example

Opening balance sheet

Credit institution

Asset		Liability
F2 (deposits)		
F4 (loans)	100	

Specialized OFI

Asset		Liability
F2 (deposits)	30	
F4 (loans)	0	

Financial account

Credit institution

Δ-Asset		Δ-Liability
F2 (deposits)	+30	
F4 (loans)	-30	

Specialized OFI

Δ-Asset		Δ-Liability
F2 (deposits)	-30	
F4 (loans)	+30	

Revaluation account

Credit institution

Δ-Asset		Δ-Liability
F4 (loans)	-70	

Specialized OFI

Δ-Asset		Δ-Liability
F4 (loans)	+70	

Closing balance sheet

Credit institution

Asset		Liability
F2 (deposits)	30	
F4 (loans)	0	

Specialized OFI

Asset		Liability
F2 (deposits)	0	
F4 (loans)	100	

Conclusions

- The existing guidance on **provisions** is not adequate. Even in the current framework, it should distinguish between **asset deterioration** and **future expenses**.

- Implied drawbacks likely to increase for banks following the IAS, and worsen with the IASB-FASB and Basel transitional requirements from 2018. Suggested treatment for financial and capital accounts.

- Elimination of **holding gains/losses** may fail to capture structural elements of financial production. It may provide a biased measure for transactions in net lending and imply a stock reconciliation that would not fit economic analysis.

- Possible **corrections on net lending and stocks** (but not production) may be arranged broadly in line with the **current framework**. A profound rethinking of financial production should be taken into account at the next revision of the statistical standard.

Thank you for your attention

gabriele.semeraro@bancaditalia.it