Measuring the Service Earnings of Financial Intermediaries: The Role of The Balance Sheet in the Production Process

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Wherever goods or services are produced commercially, it is normally possible to arrive at broadly reliable estimates of their contribution to domestic output. The situation for financial intermediaries is different because of the special role of the financial balance sheet in their business.

The System of National Accounts' (SNA) concept of value added – essentially gross output less intermediate inputs - generally forms the principal building block for the assessment of sector or industry performance from which meaningful estimates of the operating surplus can be derived. The basic SNA framework separates non-financial from financial assets, with only the former seen as contributing to the productive process. But, for financial intermediaries, the financial balance sheet is the main tool used to generate revenue and profit.

Financial intermediaries stand between would-be counterparties to transform what would otherwise be a mismatch in their maturity or risk preferences. Thus, a credit grantor may attract short-term deposits and use the funds to finance longer term lending, or a market maker may buy/sell financial assets against a prevailing market swing.

Recognising the use of the financial balance sheet as part of the productive process raises conceptual difficulties. These stem from the structure of the SNA, where flows of property income and the realisation of holding gains and losses are viewed as re-distributions of income and net worth. Under such a framework, the intermediary might record production costs (intermediate consumption) but no sales (gross output), and hence would show negative value added in the Production Account and a persistent operating deficit.

Central to this view is the principle that the acquisition or disposal of a financial instrument is not wealth enhancing. At the time of a transaction, the "purchaser" acquires one asset in return for another of equal value. The net worth of the counterparties is unchanged. The value added of the intermediary is therefore not embedded in its tangible "products" but rather in the less tangible process of risk transformation or liquidity provision.

Linking the earnings of the intermediary to the specific services provided therefore raises further conceptual and methodological difficulties. The key question concerns the basis for partitioning of the revenues earned by the intermediary from its balance sheet operations in a way which reflects the value of the services received by different counterparties. A second, but no less important issue is whether all of the balance sheet revenue earned can be attributed to the provision of financial services or whether a further partitioning of revenue is required between that part which is directly linked to financial intermediation, and that which reflects the intermediaries' use of its own funds to deliver a return on savings, in the same way as is assumed for other economic sectors.

On the first question, economic theory suggests that the provision of intermediation services will expand to the point where marginal costs equal marginal revenues. Put another way, so long as the intermediary can maintain a spread between prices/rates charged and paid, there will exist an incentive to undertake additional business. In the presence of efficient money and securities markets, the prevailing "market" price, available to the intermediary for inter dealer trading, provides the limiting price below which he will not be prepared to sell, or above which he will not be prepared to buy. It is this pure market price which therefore defines the boundary for the partitioning of earnings and its attribution as an imputed charge for services received by counterparties. This theoretical construct is adopted by the SNA as the basis for recording value added by financial intermediaries, including market makers – but it has not yet been implemented in most countries.

The answer to the second question relating to the partitioning of earnings appears to follow from the answer to the first. If the value of services delivered is given by these accumulated "spread earnings", this will typically not account for the whole of balance sheet earnings. What remains can reasonably be interpreted as the return on own funds, and thus contribute to broader measures of income but not to value added or the national accounting concept of the operating surplus.

This conclusion is likely to have its greatest impact on estimates of the service earnings of market makers. A substantial part of balance sheet earnings for such firms will typically result from short term position taking, arising both from passive entry into open positions, associated with the pattern of customer driven trades, as well as more active portfolio management. The issue here then is whether it is reasonable to exclude such earnings from estimates of value added, as implied by the simple application of theory and as required by the SNA, or whether such activities form an indistinguishable part of the role of traders in the promotion of efficient and liquid capital markets.

The case for inclusion of such revenues would seem to be strongest when based on the premise that informed and active own account trading has a stabilising influence on markets, by encouraging intervention as prices move through a perceived floor or ceiling. In practice, empirical support for this view is difficult to gather but, even if it were possible to substantiate, at least two consequential difficulties would arise: how to allocate this additional activity between consuming sectors; and why in any case it is only the own account trading of intermediaries which constitutes a productive activity.

On the former question, neither theory nor pragmatism offer any reliable guidance. If own account trading revenues are to be viewed as service earnings, then the benefits (valued added) must be seen as impacting across all market users, including potential new issuers and investors. However, the nature of these revenues is that they are generated, in some sense, from offsetting changes in the net worth of other sectors, but in a way which may be almost inversely related to the likely benefits received – a household that sells securities in a falling market only to buy them back later at a higher price as the market recovers, may perceive little benefit from the trader's role in limiting and reversing a potentially deeper market collapse.

On the latter question, the argument for regarding the own account trading of intermediaries as different in nature from that of other sectors may be stronger. Market making requires the intermediary to quote two way prices and to accept or deliver securities resulting from consequential trades. This will normally imply the need to hold stock, so that the temporary existence of short or long open positions is an integral part of the business process. Moreover, since all own account trading relies upon the intermediary's market intelligence and investment strategy, it is reasonable to regard revenue generated by this wider aspect of own account trading as equally
linked to the primary activity of market making, because of its scope for spreading overheads and thereby contributing to a competitive narrowing of dealing spreads.

In summary, it does appear that the balance sheet earnings of certain economic units represent productive activity. What is less clear is whether, for these cases, it is meaningful to regard total earnings from the balance sheet as added value in the national accounting sense, or whether it is necessary to partition earnings using some theoretical rule.

RESUME

Chaque fois que des marchandises ou des services sont commercialement produits, il est normalement possible d'arriver à des estimations généralment fiables sur leur contribution à la

production nationale. La situation pour les intermédiaires financiers est différente en raison du rôle spécial du bilan financier dans leur activité.