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Retained earnings of mutual funds,
insurance companies and pension funds

RETAINED EARNINGS ON MUTUAL FUNDS, INSURANCE CORPORATIONS AND PENSION FUNDS

by Eurostat and the
European Central Bank Directorate General Statistics

UPDATE OF THE 1993 SNA – ISSUE NO 42

Retained earnings on mutual funds, insurance corporations and pension funds

Background paper prepared for the e-discussion of the AEG on National Accounts by Eurostat and the European Central Bank Directorate General Statistics

Executive Summary

In July 2005, the ECB and Eurostat proposed to the AEG an extension of the treatment currently applicable to the retained earnings of insurance corporations, pension funds and direct investment enterprises to the retained earnings of investment funds. The AEG unanimously supported the proposal, but requested a number of clarifications with regard to (i) the exact recording of the property income flow; (ii) the definition of retained earnings and (iii) an elaboration of the parallel with insurance transactions. In dealing with these points, the AEG explicitly asked for clarifications on the role of holding gains (and losses) in the attribution of income to shareholders and on other definitional aspects.

This paper deals with these issues by analysing the current treatment applicable to these three different cases in the *1993 SNA*, the *1995 ESA* and the *BPM5*. In reviewing current standards, the paper recommends excluding holding gains and losses arising from investment funds' investments from the property income to be attributed to investment funds' shareholders, which would be exclusively based on the net operating surplus of investment funds. Should a more general review of the concept of income be finally deemed necessary, the special case of property income generated by investment funds and other collective investment schemes could be re-visited in a broader context beyond the current SNA review process.

The paper makes a number of proposals: recording all property income generated by investment funds (comprising both distributed dividends and retained earnings) on an accruals basis as if they were distributed to shareholders under a single (new) property income category with two sub items:

D.46 Property income attributed to holders of investment funds.

D.461 Dividends distributed to investment fund shareholders
D.462 Retained earnings attributed to investment fund shareholders

Some other adjustments would be necessary in *D.42* [to be renamed as "*Distributed income of corporations (excluding investment funds)"]* and in *(A)F5 "Shares and other equity"* [to be split into *(A)F5 "Equity"* and *(A)F6 "Investment fund shares/units"].*[1]

Following these proposals, the property income entries recorded under *D.462* should be offset by financial account entries under *F.6*.

Finally, with a view to clearly defining the scope of application of the proposed change, it would be necessary to provide an explicit definition of investment funds. This is outlined in papers on the classification and terminology of financial assets and liabilities and of financial corporations to be discussed during the forthcoming fourth AEG meeting in January/February 2006.[2]

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[1] The codes used in this note for financial transactions (F) and for financial balance sheet positions (AF) are those as proposed in the paper on "Classification and terminology of financial assets and liabilities in the updated SNA" to be presented and discussed during the forthcoming fourth AEG meeting and also used in the table of the annex.

[2] See the papers as mentioned in footnote 1 and "Classification and terminology of financial corporations in the updated SNA."

Introduction

1. In July 2005, the AEG considered how to treat retained earnings on mutual funds and other collective investment schemes following a paper presented by the ECB and Eurostat. At present, the *1993 SNA* follows the general rule that retained earnings of an entity are considered as income and saving of the entity, rather than of the owner. The only exceptions to this general rule apply to life insurance corporations, pension funds and (foreign) direct investment companies, for which imputed transactions are recorded as distribution of income to policyholders, beneficiaries, and direct investors (respectively), with offsetting entries in the financial account, as if the earnings were distributed and then reinvested in the companies.

2. The ECB/Eurostat paper[3] proposed extending this treatment to investment funds, inter alia on the grounds of extending consistency across collective investment schemes. The outcome of the discussion can be summarised as follows:

- The AEG unanimously supported the principle of recording retained earnings of investment funds in a similar way to income attributed to insurance policy holders
- The AEG requested further clarification on (i) the exact recording of the property income flow; (ii) the definition of retained earnings and (iii) an elaboration of the parallel with insurance transactions. In dealing with these points, the AEG explicitly asked for clarification on the role of holding gains (and losses) in the attribution of income to shareholders.
- In addition, the AEG considered that the definition needs to be further refined and the terminology to be adopted for the unit and the instrument should be re-examined.

3. These aspects should be reconsidered by the AEG through an electronic discussion before its January 2006 meeting.

4. With a view to contributing to this discussion, the present paper is in three sections. Section 1 deals with the current statistical treatment in the *System of National Accounts* (*1993 SNA*), in the *European System of Accounts* (*1995 ESA*) and in the IMF *Balance of Payments Manual, 5th edition* (*BPM5*) of retained earnings in the case of insurance corporations, pension funds, (foreign) direct investment enterprises and investment funds. Section 2 tackles the issue of how to define retained earnings in the three cases, in particular, whether holding gains and losses should be part of the income attributed to shareholders/policy holders. Section 3 presents some proposals with regard to the instrument breakdown that could accompany the

[3] Ref. "Retained earnings of mutual funds" (SNA/M1.05/17.2)

modification of the current methodology applicable to retained earnings of investment funds and some other definitional issues that are part of the proposal.

1. Current statistical treatment in the 1993 SNA, the 1995 ESA and the BPM5

5. As mentioned in the introduction, in the *1993 SNA* the general rule is that retained earnings of an entity are recorded as income and saving of the entity and not of its owners. The only exceptions to this general rule at present refer to life insurance corporations, pension funds and foreign direct investment companies.

Insurance corporations and pension funds

6. According to paragraph 7.124 of the 1993 SNA, "Insurance technical reserves are invested by insurance enterprises in various ways. They are commonly used to purchase financial assets, land or buildings. The insurance enterprises receive property income from the financial assets and land, and earn net operating surpluses from the renting or leasing of residential and other buildings. The total of the primary incomes received in this way from the investment of insurance technical reserves is described as investment income. It does not, of course, include any income received from the investment of insurance enterprises' own assets. However, as the technical reserves are assets of the insurance policyholders, the investment income receivable by insurance enterprises must be shown in the accounts as being paid by the insurance enterprises to the policyholders. The income payable by insurance enterprises to policyholders in this way is described as property income attributed to insurance policyholders. However, this income is retained by the insurance enterprises in practice. It is therefore treated as being paid back to the insurance enterprises in the form of premium supplements that are additional to actual premiums payable under the terms of the insurance policies. […]"

7. In the *1995 ESA*, the attribution of income to insurance policy holders is fully consistent with what is stated above (ref. paragraphs 4.68 to 4.71). The *BPM5* also recommends following a similar methodology.[4]

Foreign direct investment

8. According to paragraph 7.120 of the 1993 SNA, "Actual distributions may be made out of the entrepreneurial income of direct foreign investment enterprises in the form of dividends or withdrawals of income from quasi-corporations. The payments made in these ways to foreign

[4] According to paragraph 274 of the *BPM5*, *"[…] Also, in principle, income is imputed to households from net equity in life insurance reserves and pension funds and included indistinguishably under other investment."*

direct investors are recorded in the accounts of the SNA and in the balance of payments statistics of the IMF as international flows of property income. However, both systems also require the saving or retained earnings of a direct foreign investment enterprise to be treated as if they were distributed and remitted to foreign direct investors in proportion to their ownership of the equity of the enterprise and then reinvested by them. In other words, two additional entries are required in the accounts of the enterprises and their foreign owners, one of which is the imputed remittance of retained earnings, while the other is the imputed reinvestment of those earnings. The imputed remittance of these retained earnings is classified in the System as a form of distributed income that is separate from, and additional to, any actual payments of dividends or withdrawals of income from quasi-corporations."

9. The methodology addressed by the *1995 ESA* (ref. 4.59) and the *BPM5* is fully consistent with the above-described treatment. Furthermore, paragraph 278 of the *BPM5* provides a precise definition of reinvested earnings: *"Reinvested earnings comprise direct investors' shares—in proportion to equity held—of (i) earnings that foreign subsidiaries and associated enterprises do not distribute as dividends and (ii) earnings that branches and other unincorporated enterprises do not remit to direct investors. (If that part of earnings is not identified, all branch earnings are considered, by convention, to be distributed.) Thus, reinvested earnings may be calculated as the entrepreneurial income (net operating surplus) of the direct investment enterprise, plus any income or current transfers receivable, minus any income or current transfers payable. The latter include any current taxes payable on income, wealth, etc."*

Current treatment of retained earnings of investment funds in the *1995 ESA*

10. According to paragraph 4.49 of the 1995 ESA, "The following are also treated as interest: […] (b) interest received by mutual funds (see paragraph 2.51.b), from the investments they have made, and which is assigned to shareholders, even if it is capitalized."

11. Additionally, paragraph 5.141 includes among the components of mutual funds shares (F.52): "[…] (b) Property income received by mutual funds, net of a part of management costs, and assigned to shareholders, even though it is not distributed, has a counterpart entry in the financial account under mutual funds shares. The effect is that property income is reinvested."

12. As previously mentioned, neither the *1993 SNA* nor the *BPM5* record under property income any retained earnings by investment funds, but just the dividends distributed by the investment funds to shareholders.

13. In comparing the treatment of income attributed to insurance policy holders and foreign direct investors in the *1993 SNA* and the *1995 ESA* treatment of retained earnings of investment funds, there is a significantly distinctive feature: according to the *1995 ESA*, income attributed to

shareholders (i.e. accruing on investment funds' liabilities) is recorded under the same instrument as income on the investment funds' investments (i.e. accruing on investment funds' assets), namely as income on debt or income on equity, as appropriate. Hence, the imputed property income transaction from investment funds to households is recorded under either *D.41 (interest)* or *D.421 (dividends)*, which may create consistency problems with the original investment of the funds' shareholders (recorded under *F5 "Shares and other equity"*, irrespective of the instruments in which investment funds ultimately put their money).

2. The components of retained earnings in the different cases and the role of holding gains and losses

14. Generally speaking, the *System of National Accounts* (like the international/external accounts) is an integrated framework in which changes in stocks need to be justified via either transactions or other changes in the asset accounts, which can be further split into holding gains and losses/valuation changes (due to price or exchange rate changes) and other changes in volume.

15. In the case under review, establishing the borderline between transactions and other changes in the asset accounts may become slightly more complicated as it does not only affect a second level investment generating income but also profits and losses of an intermediate company (the investment fund), which is recognised in the accounts as a separate institutional unit. A review of some relevant parts in the current standards with regard to the three cases considered so far may shed some light on how this issue is being considered at present.

<u>Retained earnings of insurance corporations and pension funds</u>

16. The manuals are perhaps not explicit enough on the components which should be included/excluded from the income to be attributed to policy holders. The references of the *1993 SNA* quoted in the previous section mention "*property income from the financial assets and land, and earn net operating surpluses from the renting or leasing of residential and other buildings"* and explicitly exclude "*any income received from the investment of insurance enterprises' own assets*".

17. In particular, with regard to holding gains and losses that could come up out of the investments of insurance technical reserves, it appears from what is stated above that they should not be considered as part of the income attributable to policyholders (not being part of the net operating surplus).

Reinvested earnings of direct investment enterprises

18. Paragraph 7.122 of the *1993 SNA* describes in a more or less explicit way the contents of retained earnings of the foreign direct investment enterprises:

- *the operating surplus of the direct foreign investment enterprise*
  plus
- *any property incomes or current transfers receivable*
  minus
- *any property incomes or current transfers payable, including actual remittances to foreign direct investors and any current taxes payable on the income, wealth, etc., of the direct foreign investment enterprise.*

Thus, the retained earnings are equal to the entrepreneurial income of the foreign direct investment enterprise, plus or minus any current transfers receivable or payable, including any current taxes on income, wealth, etc. payable.

19. With regard to the way how reinvested earnings are measured, paragraph 285 of the BPM5 provides the following description: "Direct investment earnings are measured on the basis of current operating performance. **Operational earnings** represent income from normal operations of the enterprise and **do not include any realized or unrealized holding (capital) gains or losses arising from valuation changes**, such as inventory write-offs; gains or losses on plant and equipment from the closure of part all of a business; write-offs of intangibles, including goodwill, because of unusual events or developments during the period; write-offs of research and development expenditures; losses on the write-offs of bad debts or on expropriation without compensation; abnormal provisions for losses on long-term contracts; exchange-rate-related gains and losses. Unrealized gains or losses resulting from the revaluation of fixed assets, investments, and liabilities and any realized gains or losses resulting from the disposal of assets or liabilities should be excluded from direct investment earnings; that is, gains should not be added in and losses should not be deducted. In addition, valuation changes resulting from unforeseen obsolescence, catastrophes, and depletion of natural resources are treated as holding losses at the times that the decreases in values actually occur. Because data for many countries are available only on an all-inclusive basis, when holding gains and losses and other extraordinary income are included in reported earnings, those countries that report earnings on either an operating basis or all-inclusive basis should collect and publish supplementary information on holding gains and losses and other extraordinary items. This practice would enhance international comparability for both flows and stock positions." [added emphasis]

20. In regard to holding gains and losses arising from the investments of direct investment enterprises, paragraph 609 of the *Balance of Payments Compilation Guide* reads as follows: *"As previously noted, the calculation of* ***reinvested earnings should not include reinvested earnings***

***derived from capital items**, even if these are included in enterprise profit and loss statements. For example, if an enterprise sold an asset on which it made a windfall profit—that is, the sale price of the asset was greater than the purchase price—a direct investor's share of that profit should be shown in the BOP as a distribution of capital and the subscription of new capital and not included as part of the calculation of reinvested earnings."* [added emphasis]

<u>Should holding gains and losses arising from investment funds' investment be included or excluded from the property income attributed to investment funds' shareholders?</u>

21. The current version of the manuals advocates the exclusion of holding gains and losses resulting from the investments of the institution concerned (insurance corporations, pension funds or foreign direct investment enterprises). As stated in the previous section, the current treatment addressed by the *1995 ESA* to these instruments also excludes holding gains and losses from the retained earnings of investment funds. According to paragraph 4.49 of the *1995 ESA*, *"The following are also treated as interest: […] (b) interest received by mutual funds (see paragraph 2.51.b), from the investments they have made, and which is assigned to shareholders, even if it is capitalized. **It excludes holding gains or losses on financial instruments belonging to unit trusts, which are not recorded as property income**."* [added emphasis]

22. Against this background, at this stage on conceptual grounds[5] it seems appropriate to exclude any holding gains and losses resulting from the investment funds' investments from the income attributable to shareholders, which would be exclusively based on the net operating surplus of investment funds.

23. At a later stage, the question could be part of a broader discussion, in particular of the definition of income itself, for which the IMF Balance of Payments Committee had suggested to the AEG the creation of a working group that could work on the issue beyond the publication of the next edition of both the *SNA* and the *BPM*. Depending on the AEG's views concerning the appropriateness of participating in this group, the special case of property income generated by investment funds and other collective investment schemes could then also be re-visited in such a broader context. The creation of this group should nevertheless not impede the consideration of this consistency issue with regard to retained earnings of investment funds in the current *SNA* revision process.

[5] Practical problems to make the distinction between income and holding gains and losses from the books of the funds may arise, especially resulting from the generalisation of the new international accounting standards.

3. Specific aspects of the proposal and definitional issues

The proposed new income category

24. The joint ECB/Eurostat paper presented in July 2005 included a proposal to make an imputation to investment funds' shareholders of retained earnings of investment funds along the following lines: all investment funds' earnings (comprising both distributed dividends and retained earnings) would be recorded as if they were distributed to shareholders under a single (new) property income category: *D.46 Property income attributed to holders of investment funds*. This would imply a difference with regard to the current treatment in the *1995 ESA* (as stated in the previous section).

An additional subdivision would be as follows:

D.461 Dividends distributed to investment fund shareholders

D.462 Retained earnings attributed to investment fund shareholders

25. Additionally, the current category D.42 would be renamed as follows: D.42 Distributed income of corporations (excluding investment funds)

26. This proposal implicitly points to the need to separately identify investment funds' shares in the financial account and financial instrument classification for the sake of consistency. This could be achieved by introducing an additional split in *(A)F5 Shares and other equity* along the following lines:

(A)F5 Equity [which could be further subdivided into (A)F51 quoted shares; (A)F52 unquoted shares; and (A)F53 other equity]

(A)F6 Investment fund shares/units

Recording

27. Following these proposals, the property income entries recorded under *D462* should be recorded on an accruals basis and should be offset by corresponding financial account entries under *F6* as if the retained earnings were actually distributed to shareholders and immediately reinvested in the fund.

Definition of investment funds

28. Since the recommended treatment for the recording of income on investment funds is different from that applicable to income on other equity investments, it seems necessary to provide a clear definition of the scope of application of this methodology. For this reason, it is

proposed that the new SNA includes an explicit definition of investment funds as outlined in the paper on the "Classification and terminology of financial corporations."[6]

Questions

1)	Do you agree to exclude holding gains or losses arising from investment funds' financial investment from property income attributed to holders of assets in these funds resulting from the net operating surplus of investment funds? At a later stage, the question could be part of a broader discussion, in particular of the definition of income itself, beyond the publication of the next edition of the SNA.
2)	Do you agree that property income attributed to holders of investment funds on an accruals basis should be recorded as a new property income category '*property income attributed to holders of investment funds'* which should be further split into '*dividends distributed to investment fund shareholders'* and '*retained earnings attributed to investment fund shareholders'*?
3)	Do you agree that the counter-entry of '*retained earnings attributed to investment fund shareholders'* should be recorded as a new financial asset category '*investment fund shares/units'*?

[6] These definitions have also been elaborated in the context of the work undertaken by the ESCB to develop OFI statistics.

Annex

Table: Proposed classification of financial assets and liabilities in the new SNA[7]

Financial instrument	SNA code
Monetary gold and special drawing rights (SDRs)	**F.1**
Monetary gold	F.11
Special drawing rights (SDRs)	F.12
Currency and deposits	**F.2**
Currency	F.21
Deposits	F.22
Transferable deposits	F.221
Other deposits	F.222
Loans	**F.3**
Short-term	F.31
Long-term	F.32
Debt securities	**F.4**
Short-term	F.41
Long-term	F.42
Equity	**F.5**
Quoted shares	F.51
Unquoted shares	F.52
Other equity	F.53
Investment fund shares/units	**F.6**
[o/w Money market fund shares/ units]	
Bond fund shares/units	
Equity fund shares/units	
Real estate fund shares/units	
Mixed fund shares/units	
Hedge fund shares/units]	
Financial derivatives and employee stock options	**F.7**
Financial derivatives	F.71
[o/w in terms of risk category	
Interest rate	
Equity	
Foreign exchange	
Credit-linked	
Other commodity]	
Employee stock options	F.72
Insurance technical reserves	**F.8**
Net equity of households in life insurance reserves and in pension funds	F.81
Net equity of households in life insurance reserves	F.811
Net equity of households in pension funds	F.812
Prepayment of premiums and reserves against outstanding claims	F.82
Reserves for calls on standardised guarantees	F.83
Other accounts receivable / payable	**F.9**
Trade credit and advances	F.91
Short-term	F.911
Long-term	F.912
Other	F.92
Memorandum item:	
Direct foreign investment	
Equity	
Debt	

[7] See paper on "Classification and terminology of financial assets and liabilities in the updated SNA" to be discussed during the forthcoming AEG meeting.