UPDATE OF THE 1993 SNA - ISSUE No 42

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Retained earnings of mutual funds

Paper prepared by Eurostat and the European Central Bank Directorate General Statistics

Executive summary

In the 1993 SNA property income is received by the owners of financial assets and tangible non-produced assets, mainly land and subsoil assets. It accrues when the owners of such assets put them at the disposal of other institutional units. Property income in the form of retained earnings is treated as reinvested earnings on direct foreign investment (D.43) and attributed to insurance policy holders (D.44) in case of individual life insurance policies not taken out under social insurance schemes. In both cases they are recorded as if they were distributed to the investors and then reinvested by them. In the 1993 SNA interest accruing on loans, deposits, debt securities or trade credits is also treated as paid out to the owners of these financial instruments and reinvested. The 1995 ESA extended this treatment also to retained earnings from investments into mutual funds.

It is recommended to adopt a similar treatment for mutual funds also in the updated SNA and in the new BPM6, i.e. to record retained earnings of mutual funds as if they had been distributed to investors and reinvested into the funds. It is also proposed to record these reinvested earnings as a new income category "property income attributed to holders of mutual funds shares" (D.46). The main reasons for these proposals may be summarised as follows:

- *The treatment would bring consistency with the recording of other collective investment schemes that have similar features;*
- *The consistency issue has also been raised within the Balance of payments statistics[1];*
- *The amounts of cross-border transactions and positions in mutual funds are usually much smaller than between the institutional units within a national economy. However, the inclusion of mutual funds into the accounts alters substantially the household accounts and to a smaller extent the GNI;*

[1] *See BOPTEG issue notes # 19 and # 19A.*

- *Accordingly, using the updated measures on household income and saving would produce a more meaningful economic analysis of household consumption and saving ratios, which are presently underestimated in the 1993 SNA.*

The term "investment funds" is recommended and used throughout this note. Since expressions like mutual funds, unit trusts or collective investment schemes are also used for designating the institutional units issuing investment fund shares/units, it seems preferable to agree on a single naming and definition. Consequently a new classification of institutional units is proposed.

Questions for discussion by the AEG

1. **Does the AEG agree on the principle of recording retained earnings in investment funds in a similar way to income attributed to insurance policy holders, and thus avoid the risk of a noticeable distortion of household disposable income that the present SNA treatment creates?**
2. **Does the AEG agree that the 1993 SNA could be amended as proposed concerning the classification of property income payable to holders of investment funds?**
3. **Does the AEG agree on a new definition (and naming) of investment funds that would allow them to be considered as other financial intermediaries except insurance corporations and pension funds (S.123)?**
4. **Does the AEG agree to separately identify those funds issuing monetary liabilities within S.122?**

1. Background and main reasons for change in national accounts

1. Investment funds are a relatively new group of financial corporations with specific features. They are seen as financial intermediaries whose role is to transform funds obtained through the issue of shares so as to acquire mainly financial assets.

2. Investment funds were less important at the time of the discussions on the 1993 SNA. Indeed, perhaps surprisingly with hindsight, they are not mentioned at all in the 1993 SNA. By contrast, the 1995 ESA two years later took them into consideration and the manual specifies that "*mutual funds primarily incur liabilities through the issue of shares (AF.52). They transform these funds by acquiring financial assets and/or real estate. Therefore, mutual funds are classified as financial intermediaries.*" (See 1995 ESA, paragraph 2.36.)

3. However, the main difference between the treatment of investment funds in the 1993 SNA and in the 1995 ESA relates to the recording of retained earnings. In the 1995 ESA, this treatment is similar to the treatment already adopted for property income attributed to insurance policy holders in both Manuals.

4. In the 1993 SNA, the general rule is that retained earnings of a corporation are treated as the income of the corporation, rather than the income of the owner. However, a different treatment was adopted for life insurance corporations, pension funds and foreign direct investment corporations. In these cases, an imputed property income transaction to the owner is made, with corresponding reinvestment in the financial account.

5. The same basic underlying principle has then been applied in 1995 ESA to investment funds: income generated by those funds is recorded as if distributed to the owners who are supposed in return to reinvest them into the fund. It, therefore, achieves consistency with the treatment of property income attributed to insurance policy and pension funds holders (D.44).

6. Thus, the possibility of adopting the treatment of "retained earnings of investment funds" by the new SNA already implemented in the 1995 ESA has been put forward in the list of issues accepted for the 1993 SNA updating project by the AEG, under item # 42. In the context of the BPM revision process, a more general revision of income-related topics also addresses the issue of retained earnings of investment funds. The IMF BOPCOM will consider this issue at its meeting from 27 June to 1 July 2005.

7. The rationale for the new treatment in the 1993 SNA is based on two main reasons:

a. Analogy with similar treatments of distribution of retained earnings

As mentioned above, the new treatment achieves consistency of treatment with the other collective investment schemes, namely life insurance corporations and pension funds. Moreover, it would also be similar to the treatment of accrued interests on loans, deposits, bonds, or trade credits. Therefore, the present SNA treatment of investments funds appears to be more of an exception.

b. Impact on household income and saving

National accountants consider that the "transfer of property income" from corporations to households (and the corresponding counterpart entries in the financial transaction account) provides a better description of economic reality. The main justification is the structure of the "allocation of primary income account" and the resulting household income and saving. Incidentally, while the initiative to review this treatment in the present updating of the 1993 SNA originated in the balance of payments, which has also an impact on income and saving of the total economy (GNI), the vast majority of relations between households and investment funds occur within the national economy rather than cross border. Gross disposable income of households (B.6) can be seen as largely underestimated according to the current SNA treatment of investment funds whereas that of corporations would be symmetrically overestimated. Accordingly, the levels of household and corporate savings are better reflected through the proposed new treatment. To conclude, from an economic point of view, all ratios used to describe consumption as well as savings become economically more meaningful with this treatment.

2. Consistency with the balance of payments

8. From a balance of payments point of view, the new treatment removes some inconsistencies: First, an important consistency issue arises when the present treatment of investment funds' income in the 1993 SNA and the BPM5, which is directly consistent with the implicit handling of retained earnings in the 1993 SNA, is compared with the treatment of reinvested earnings on foreign direct investment in the 1993 SNA and in the BPM5, where such earnings are recorded when they are earned independently of being distributed or not.

9. Second, the earnings from life insurance and pension fund reserves are already deemed to be distributed and reinvested by the policyholders in these institutional units under the heading "*net equity of households in life insurance reserves and pension funds*" (F.61). The rationale for this treatment is given in the 1993 SNA, paragraph 7.124: as the technical reserves are assets of the

beneficiaries and policyholders, the investment income receivable must be shown as being paid by these enterprises to the policyholders and beneficiaries.

10. Given the specific common characteristics of investment funds and other collective investment schemes, which are different from other types of corporations, the same treatment seems appropriate regarding earnings retained in such collective investment institutions, but by analogy with pension funds and life insurance rather than with the general reinvested earnings issue.

11. Some concerns have however been expressed about the proposed new treatment, in particular BOPTEG Issue paper # 19, which may be summarised as follows:

a. The comparison with portfolio investment

Investment in investment funds is regarded by some as equity similar to portfolio investment, which is considered to be passive (given that portfolio investors do not have an "influence or voice in management" and so do not influence how internally generated funds are used). Accordingly, BPM5 argues that the proportion of retained earnings that is attributable to portfolio investors should not be deemed to be distributed. If investment in investment funds is considered to be like portfolio investment, the retained earnings of investment funds should be treated in the same way.

b. The comparison with direct investment and reinvested earnings

There is a similarity between the routing of the retained earnings originating from life insurance and pension funds and reinvested earnings of direct investment entities (DIE), but the rationale is very different. The analytical importance of reinvested earnings lies in identifying the decision process through which a DIE utilises internally generated funds (i.e., for accumulation of assets or repayment of debt). Retained earnings are deemed to be distributed and then reinvested as a deliberate act on the part of the direct investor, on the basis that the DI has an "influence or voice" in the management of the DIE and so has an input into the decision on how the DIE retained earnings should be utilized, the DIE retained earnings are shown as distributed in the income account and then reinvested in the financial account. For policyholders'/beneficiaries' claims on life insurance and pension fund reserves, there is no such influence. The system merely deems the assets to be (indirectly) those of the policyholders/beneficiaries (even though, in all other respects, these are separate institutional units). Some have suggested this runs contrary to the rationale in the 1993 SNA for the treatment of investment, as "a conscious deliberate investment decision" (see paragraph 7.121). In practice, policyholders of life insurance and beneficiaries of pension funds rarely have any voice in the management and investment decisions of their life insurance corporations and pension funds.

12. Nevertheless, the BOPTEG Issue paper # 19 also recognises the need for consistency with the treatment of earnings in life insurance corporations and pension funds.

3. Estimation of impact through a numerical example

13. The following numerical example is based on actual data from a typical, volunteer EU country. The figures give a likely representation of the magnitude of changes that would occur if the 1993 SNA were to be revised on this point. However, they cannot pretend to complete accuracy or to a full coverage of all possible cases.

14. Table 1 presents the proposed new treatment of retained earnings for both the resident sectors and the rest of the world.

15. The rows in this table include three categories of items:

- Specific transactions on income from investment funds only;
- Global figures from non financial accounts: total income, relevant balancing items;
- Significant financial and accumulation account items, including elements for revaluation.

16. The columns emphasise the distinction between households and other sectors and single out the investment funds.

17. The main relevant pieces of information supplied in Table 1 are the following:

- Investment funds shares are owned only partly by households (close to 60% in this case). The remaining 40 % represent investment by financial and non-financial corporations;
- ROW flows of income are very small compared to the resident ones (about 3 %);
- Relative importance of foreign assets in the country and growing external debt for that kind of equity; and
- Very large holding gains are observed in the revaluation account.

18. Table 2 shows the impact of the application of the current SNA to this data set, including a strict BPM5 treatment for the ROW account.

19. Within the economy, the treatment of investment funds according to the principles of the 1993 SNA results in a different allocation of earnings between sectors since they are all deemed to be retained by the issuing corporations and not the shareholders, though the total income of the economy

would stay constant. Therefore, the most significant result is a lower household income and a symmetrically higher income of corporations.

20. In this case the main effect is a decrease of around 1.9 % of household gross disposable income and close to 17 % on saving. However, because of the diminishing trend in household direct ownership of investment funds shares, the effect would most probably have been larger if measured in the eighties.

21. In practice, the situation is quite complex when it comes to actually recording those income flows. For the external transactions it can be problematical to estimate the inflows of retained earnings to residents from their shares in investment funds abroad. However this is probably not worse than some similar transactions with the rest of the world[2].

[2] How to capture this information in practice was studied by an ECB Task Force on Portfolio Investment Income, that recommended some practical approximations for the implementation of the 1995 ESA treatment (which is also the one by and large adopted by the euro area/EU balance of payments). In the future, the Centralised Securities Database should provide the requested information at the level of individual money market shares/units.

Table 1: Proposed treatment

ASSETS/USES							LIABILITIES/RESOURCES				
ROW S.2	Total ECO S.1	Investment Funds (IF)	Other Sectors	Households S14	**Transactions/Assets and Balancing items**		Households S14	Other Sectors	Investment Funds (IF)	Total ECO S.1	ROW S.2
					D4	**Domestic income related to IF**					
	30		*30*		*D4*	*interests + dividends received by IF*			*30*	*30*	
	30	30			D4	earnings recorded as distributed	18	12		30	
1	1.3	1.3			D4	**ROW income related to IF**	0.6	0.4		1	1.3
70	**456**		**422**	**34**	**D4**	**TOTAL Property income**	**124**	**330**		**454**	**72**
	1 300		**300**	**1 000**	**B.6**	**Disposable income**					
	75		**-35**	**110**	**B.8**	**Saving**					
2	**-2**		**-72**	**70**	**B.9**	**Net Lending/Net Borrowing**					
					F	**Financial transactions**					
1.3	30		12	18	F.52	Net acquis. of Invest. Funds shares			30.3	30.3	1
35	950		400	550	**AF** AF.52	**Financial Assets** Investment Funds shares (average)			940	940	45
7.2	82		33	49	AF.52	**Revaluation account** Investment Funds shares			85.7	85.7	3.5

Billion of Euros

Table 2: Present treatment in the SNA

ASSETS/USES | LIABILITIES/RESOURCES

ROW S.2	Total ECO S.1	Investment Funds (IF)	Other Sectors	Households S14	**Transactions/Assets and Balancing items**		Households S14	Other Sectors	Investment Funds (IF)	Total ECO S.1	ROW S.2
					D4	**Domestic income related to IF**					
	30		*30*		*D4*	*interests + dividends received by IF*			*30*	*30*	
					D4	earnings recorded as distributed					
					D4	**ROW income related to IF**					
69	**454.7**		**420.7**	**34**	**D4**	**TOTAL Property income**	**105.4**	**347.6**		**453.0**	**70.7**
	1 299		**317.6**	**981.4**	**B.6**	**Disposable income**					
	74		**-17.4**	**91.4**	**B.8**	**Saving**					
3	**-3**		**-54.4**	**51.4**	**B.9**	**Net Lending/Net Borrowing**					
					F	**Financial transactions**					
					F.5	Shares and other equity					
					AF	**Financial Assets**					
35	950		400	550	AF.5	Shares and other equity (average)			940	940	45
						Revaluation account					
8.5	112		45	67	AF.5	Shares and other equity			116	116	4.5

Billion of Euros

4. Recommended changes and implications of the changes

22. The main proposal for the 1993 SNA update aims at recording earnings (mainly interest and dividends) of the investment funds as if they were all distributed. Accordingly, there is an impact on the following accounts:

a. Non-financial accounts

23. The update of the 1993 SNA would have an impact on the allocation of primary income, especially property income (D.4). The 1995 ESA recommends the recording of income from investments in investment funds as if they are paid to the investors in the same form as that in which they are earned by the investment fund (interest or dividends). Hence, the imputed property income transaction from investment funds to households is recorded either under D.41 (interest) or D.421 (dividends).

24. In contrast, no such distinction is currently made in the 1993 SNA within the income from shares in life insurance corporations and pension funds. They are shown under item D.44 (property income attributed to insurance policy holders) without identifying the sources of income (i.e. the part coming from investment in shares, debt securities, etc).

25. For the updated SNA it is proposed to record the two categories of income (interest, dividends) when redistributed within a new property income category D.46 (property income attributed to holders of investment funds), which could *optionally* be further sub-divided into: D.461 (interest), D.462 (dividends), and D.463 (other income). Some experts doubt the necessity to subdivide D.46 in this way, especially in the balance of payments.

b. Financial accounts

26. The update of the 1993 SNA would have an impact on the transactions and positions in equity (F.52). Whereas in the current SNA all changes in the value of the assets and liabilities are recorded in the revaluation account, in the proposed new treatment, part of the changes is recorded as a financial transaction (reinvestment) and part continues to be revaluation.

27. It is proposed that the new SNA should include an explicit definition of investment funds, which could be accompanied with possible changes in the sub-sector classifications, as follows: Investment funds could be defined as *”collective investment undertakings investing in financial and non-financial assets to the extent that their sole objective is the investment of capital being raised from the public. Pension funds are excluded and also investment funds issuing highly liquid liabilities of a monetary*

nature. The latter institutions, known as money market funds, are classified in the sub-sector 'Other depository corporations' (S.122)."

28. Accordingly, investment funds (at least the non-money market ones) should be classified and identified as a sub-sub-sector within the sub-sector "other financial intermediaries, except insurance corporations and pension funds (OFIs)" (S.123). The ECB has suggested it should also be considered to define, in addition to investment funds, four other groupings of institutional units belonging to OFIs: (i) Financial vehicle corporations created to be the holders of securitised assets; (ii) Financial corporations engaged in lending; (iii) Financial holding corporations; and (iv) Security and derivative dealers. The institutional units of the OFI sub-sector not covered by the five groupings are allocated in a remaining grouping as "other."[3]

29. Money market funds issuing monetary liabilities (money market funds) should be part of sub-sector S.122 (other depository corporations) of the new SNA.[4] They may then be named "other monetary financial institutions", which is in line with the 1995 ESA sub-sector S.122.

30. Accordingly, a new financial instrument sub-category within F.5 could be created as investment funds further broken down into (non-monetary) investment funds (F.521) and money market funds (F.522). However, money market funds may not be worth identifying separately within this sub-category, as liabilities denominated under this category could be identified according to the sector (i.e. F.52 liabilities of S.122 would be money market funds and F.52 liabilities of S.123 would be investment funds).

6. Consistency with balance of payments issues

31. European compilers have already agreed to calculate as much as possible the accrued interest of undistributed income of investment funds. At the December 2004 BOPTEG meeting, the group recognised the need for consistency between treatments in the BPM, the SNA and the ESA. However, the discussion was not fully conclusive.

32. In this context, Eurostat's and ECB's representatives of the IMF BOPCOM have agreed to submit the current proposal as regards retained earnings of investment funds at the Committee's forthcoming meeting in June 2005.

33. The question of the treatment of cross-border investment fund links is important for some, often small, countries that host large financial operations ("off-shore"). The GNI of those countries would

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[3] This grouping has also been elaborated in the context of the work undertaken by the ESCB to develop OFI statistics.

[4] This would also be in line with the recommendation made in paragraph 92 of the IMF's MFSM that *the other depository corporations subsector consists of all resident financial corporations and quasi-*

be severely distorted if no outflow of retained earnings would be recorded. This clearly points to the merit of the proposed treatment of retained earnings. Concerning source data issues, it remains to be seen whether the existence of “funds of funds” creates more difficulties than those existing for other property income categories.

corporations that are mainly engaged in financial intermediation and that issue liabilities included in the national definition of broad money.

ANNEX

Relevant paragraphs from 1995 ESA on the treatment of "retained earnings in mutual funds" (to give a flavour of the kind of redrafting needed in SNA if this proposal is adopted)

2.36. Mutual funds primarily incur liabilities through the issue of shares (AF.52). They transform these funds by acquiring financial assets and/or real estate. Therefore, mutual funds are classified as financial intermediaries. As with other corporations, any change in the value of their assets and liabilities other than their own shares is reflected in their own funds (see paragraph 7.05.). Because the amount of own funds normally equals the value of the mutual fund's shares, any change in the value of the fund's assets and liabilities will be reflected in the market value of these shares.

Mutual funds investing solely in real estate are also regarded as financial intermediaries.

2.48. Definition:
The sub-sector other monetary financial institutions (S.122) consists of all financial corporations and quasi-corporations, except those classified in the central bank sub-sector, which are principally engaged in financial intermediation and whose business is to receive deposits and/or close substitutes for deposits from institutional units other than monetary financial institutions, and, for their own account, to grant loans and/or to make investments in securities.

2.51. The following financial intermediaries may also be classified in sub-sector S.122 where it is their business to receive repayable funds from the public whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities. Otherwise, they should be classified in sub-sector S.123:
a) corporations engaged in granting mortgages (including building societies, mortgage banks and mortgage credit institutions);
b) mutual funds (incl. investment trusts, unit trusts and other collective investment schemes, e.g. undertakings for collective investment in transferable securities-UCITS);
c) municipal credit institutions.

4.49. The following are also treated as interest:
a) interest charged on bank overdrafts, extra interest paid on deposits left longer than originally agreed, and payments to certain bond holders which are determined by lottery;
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 capitalised. It excludes holding gains or losses on financial instruments belonging to unit trusts, which are not recorded as property income.

4.53. Definition:
Dividends (D.421) are a form of property income received by owners of shares (AF.5) to which they become entitled as a result of placing funds at the disposal of corporations. Raising equity capital through the issue of shares is an alternative way of raising funds to borrowing. In contrast to loan capital, however, equity capital does not give rise to a liability that is fixed in monetary terms and it does not entitle the holders of shares of a corporation to a fixed or predetermined income.

4.54. This heading also includes:
a) shares issued to shareholders in payment of the dividend for the financial year. However, issues of bonus shares which represent the capitalisation of own funds in the form of reserves and undistributed profits and give rise to new shares to shareholders in proportion for their holdings are not included;
b) dividends received by mutual funds (see paragraph 2.51.b) from the investments they have made, and which are assigned to shareholders, even if they are capitalised. It excludes holding gains or losses on financial instruments belonging to unit trusts, which are not recorded as property income;

c) the income paid to general government by public enterprises which are recognised as independent legal entities though not formally constituted as corporate enterprises.

5.96. Definition:
The sub-category mutual funds shares (F.52) consists of all transactions in mutual funds shares (AF.52) that is shares issued by a specific type of financial corporation, whose exclusive purpose is to invest the funds collected on the money market, the capital market and/or in real estate.

5.97. Sub-category AF.52 includes the shares issued by financial corporations called, according to country, mutual funds, unit trusts, investment trusts and other collective investment schemes, e.g. (UCITS), whether they are open-ended, semi-open or closed-end funds. These shares may be quoted or unquoted. When they are unquoted, they are usually repayable on request, at a value corresponding to their share in the own funds of the financial corporation. These own funds are revalued regularly on the basis of the market prices of their various components.

5.141. Mutual funds shares (F.52):
a) transactions in mutual funds shares include the value of net contributions to a fund;
b) property income received by mutual funds, net of a part of management costs, and assigned to shareholders, even though it is not distributed, have a counterpart entry in the financial account under mutual funds shares. The effect is that property income is reinvested.

7.05. For the non-financial and the financial corporations sectors the calculation of own funds provides an analytically meaningful indicator.
Own funds are the sum of net worth (B.90) and shares and other equity (AF.5) issued.