SNA/M1.12/2.6.2

7th Meeting of the Advisory Expert Group on National Accounts, 23-25 April 2012, New York

Agenda item: II

ISSUES NOTE: THE DELINEATION AND CLASSIFICATION OF HEAD OFFICES, HOLDING COMPANIES AND SPEs

ISSUES NOTE: THE DELINEATION AND CLASSIFICATION OF HEAD OFFICES, HOLDING COMPANIES AND SPEs

INTRODUCTION

1. This issue note regarding the delineation and classification of head offices, holding companies and Special Purpose Entities (SPEs) is a follow-up of exchanges during the OECD Workshop on the Implementation of the 2008 SNA which took place in Paris on 25-27 October 2011. It includes the definitions currently available in the *System of National Accounts 2008* (2008 SNA), further clarification and developments in other international manuals as well as a short presentation of the main practical issues, as well as suggestions for dealing with them.

2. A need for further clarification of a number of issues was expressed at the OECD Workshop. In particular, some countries presented their experience in classifying head offices, holding companies and SPEs, also in relation to the new classification of financial subsectors, shared the problems they encountered and raised questions in relation to the delineation and classification of institutional units within these new sub-sectors.

3. Moreover, a survey was launched to better identify the difficulties experienced or envisaged by OECD countries when implementing the 2008 SNA and a large number of countries highlighted the difficulties regarding the delineation of the more detailed subsectors within financial corporation sector (and the provision of information relate to them), expressed the effects they envisaged due to the creation of new financial subsectors and to the move of SPEs and holding companies from the non-financial corporation sector (S11) to the financial corporation sector (S12), and stressed the need for further guidance.

4. This issues paper will serve as a basis for discussions and possible extended follow-up by the ISWGNA and AEG.

CURRENT INTERNATIONAL GUIDANCE

Head offices and holding companies

5. While the 1993 SNA did not give explicit guidance for the treatment of head offices, it recommended that holding companies were to be assigned to the institutional sector in which the main activity of the group of subsidiaries was concentrated. Consequently, they were to be classified as financial corporations only when the main activity of the group of corporations they controlled was financial. More precisely, financial holding corporations were to be allocated either to a specific financial subsector according to the type of financial activity carried out by the group it controlled, or to the subsector "Other financial intermediaries, except insurance corporations and pension funds", if a certain type of financial activity was not predominant; see 1993 SNA, para. 4.100.

6. According to the 2008 SNA, head offices are explicitly distinguished from holding companies. While a head office is assumed to be actively engaged in production, a holding company does not undertake any management activities.

7. The activities of a head office, as defined in section M class 7010 of the ISIC Rev. 4, are as follows:

> *This class includes the overseeing and managing of other units of the company or enterprise; undertaking the strategic or organizational planning and decision making role of the company or enterprise; exercising operational control and manage the day-to-day operations of their related units.*

It includes the production of non-financial or financial services depending upon the type of output of its subsidiaries. The 2008 SNA (para. 4.53 and 4.112) recommends that the head office should be allocated to the non-financial corporations sector (S11), unless all or most of its subsidiaries are financial corporations, in which case it is treated, by convention, as a financial auxiliary (S126) in the financial corporations sector (S12).

8. According to section K class 6420 of the ISIC Rev. 4, holding companies are defined as follows:

> *This class includes the activities of holding companies, i.e. units that hold the assets (owning controlling-levels of equity) of a group of subsidiary corporations and whose principal activity is owning the group. The holding companies in this class do not provide any other service to the enterprises in which the equity is held, i.e. they do not administer or manage other units.*

In para. 4.54 of the 2008 SNA, it is stated that "the type of unit properly called a holding company is a unit that holds the assets of subsidiary corporations but does not undertake any management activities". Such units are always allocated to the financial corporations sector and more precisely to the new sub-sector captive financial institutions and money lenders (S127), even if all the subsidiary corporations are non-financial corporations. (2008 SNA, para 4.114).

Special purpose entities

9. The 1993 SNA did not give explicit guidance for treatment of special purpose entities (SPEs). Currently, a variety of definitions of SPEs exist and there is no universal definition of such units. The 2008 SNA (para. 4.55 to 4.58) affirms that a number of institutional units may be described as special purpose entities (SPEs) or special purpose vehicles, but that there is no common definition of an SPE. Instead it gives some of the characteristics which may apply to SPEs (para. 4.56):

- Often no employees and no non-financial assets;

- Little physical presence beyond a “brass plate” confirming their place of registration;
- Always related to another corporation, often as a subsidiary;
- Often resident in a territory other than the territory of residence of the related corporations.

10. Furthermore, the 2008 SNA recommends that these units are treated in the same way as any other institutional unit by being allocated to sector and industry according to their principal activity, either to the non-financial corporation sector (S11) or to one of subsectors of the financial corporation sector (S12), unless they fall into one of the three following categories (para. 4.59 – 4.67):

a. *Captive financial institutions*: units with the characteristics as described in paragraph 9 above, holding companies simply owning the assets of subsidiaries, investment and pension funds and units used for holding and managing wealth for individuals and families, units used for holding assets for securitization, units used for issuing debt securities on behalf of related companies, securitization vehicles to carry out other financial functions.

b. *Artificial subsidiaries of corporations*: these types of SPEs do not satisfy the definition of an institutional unit in the SNA because they lack the ability to act independently from their parent corporation. They are thus treated as an integral part of their parent and their accounts are consolidated with those of their parent, unless they are resident in an economy different from that where their parent is resident.

c. *Special purpose units of general government*: these units, set up by the general government, do not have the power to act independently. As a consequence, if they are resident, they are treated as an integral part of general government and not as separate units, and if they are non-resident, they are treated as separate units.

11. In relation to captive financial institutions, the 2008 SNA goes on saying that, leaving apart the SPEs controlled by non-residents which are to be considered as separate institutional units by convention, “the degree of independence from its parent may be demonstrated by exercising some substantive control over its assets and liabilities to the extent of carrying the risks and reaping the rewards associated with the assets and liabilities”. Such units having a resident parent and having the characteristics of an institutional unit should be classified in S127 (Captive financial institutions and money lenders), together with the captive financial institutions controlled by non-residents. Artificial subsidiaries of corporations controlled by a non-resident parent are to be incorporated according to their main activity, whereas special purpose units of a non-resident general government are to be classified according to their main activity (probably in S125, Other financial intermediaries, except insurance corporations and pension funds, or S127).

SUMMARY OF PRACTICAL ISSUES

12. As stated above, a large number of OECD countries encounter difficulties to classify head offices, holding companies and SPEs to institutional sectors according to the (revised) definitions of the 2008 SNA. Most of them ask for additional clarification in definimg these three types of institutional units (e.g., the significance of the operational activity in distinguishing head offices from holding companies), but also a more precise identification of the corporations to be allocated to the new financial subsector S127 (captive financial institutions and money lenders).

13. Given the absence of clear definitions and guidance to assist countries, the decision of national compilers to allocate entities to the non-financial or financial corporations, and even more to the new financial subsectors may be quite different across countries, following their own interpretations and available sources. These ambiguities could lead to differences in national statistics and may seriously limit their comparability.

Head offices and Holding companies

14. One of the main challenges is the correct identification of head offices and holding companies according to the more precise definitions of both kind of units, i.e. the delineation of passive holders of financial assets (holding companies) from corporations having real economic activity by providing services to other units (head offices). Head offices, for which no guidance existed in 1993 SNA, are now to be treated either as non-financial corporations or, by convention, as financial auxiliaries. Holding companies, which used to be broadly defined in the 1993 SNA, possibly encompassing head offices, are now to be allocated exclusively to the subsector S127.

15. For some countries like Austria the consequence of the change in the sector allocation of holding companies from S11 to S12 is a decrease in assets and liabilities of the non-financial corporations sector (S11), and, as a result, a quite dramatic impact on some ratios (like the debt to equity ratio or leverage ratios) of S11 and S12. Furthermore, the position of the new subsector S127 (captive financial institutions and money lenders) will exceed the financial positions of all other financial subsectors (except S122 – Deposit-taking corporations except the Central Bank).

16. Israel has encountered some problems when trying to apply the new treatment in their accounts. The Central Bureau of Statistics found it unclear what level of management control is required to classify a unit as a head office or as a holding company, in particular in the case when the company is responsible for the main business decisions for the entire group and exercises managerial control over the companies of the group. It wonders whether such companies which carry out management type functions but are not actively engaged in production should be classified as holding companies rather than as head offices.

17. Furthermore, Hungary has questions regarding the institutional independence of holding companies. As they state, according to the 2010 ESA (para. 2.14), “head offices and holding companies are institutional units”, whereas according to the 2008 SNA, for holding companies linked to resident corporations, the independence test should be applied (2008 SNA, para. 4.60). On the other hand, the 2008 SNA (para. 4.59) states that holding companies “that simply own the assets of subsidiaries” are to be treated as captive financial institutions. This text phrase seems to suggest an absence of institutional independence. Also para. 4.114, defining the content of S127, contains the same ambiguity, although to a lesser extent. Finally, Hungary wonders about the treatment of holding companies owning only a single corporation, as the definition of holding companies refers to companies holding the assets of a group of subsidiary corporations.

Special Purpose Entities (SPEs)

18. Several definitions of SPEs as well as several denominations (special purpose entity, special purpose vehicle, financial vehicle corporation, special financial institution...) exist in various statistical manuals and there is no internationally standard definition of such entities.[1] Even if an important step forward was made in the 2008 SNA to provide some guidance on the characteristics of SPEs as well as some guidance regarding their allocation to financial subsectors (see above), it does not go into great detail and leaves room for interpretation, and as a consequence for various national statistical treatments.

[1] The OECD Working Party on Financial Statistics is currently establishing a Glossary of main terms and concepts used in the context of the securitization process, of which SPEs.

19. Despite the additional guidance, the criteria for identifying SPEs are not clear enough, which not only results in a set of different types of SPEs, but also in the treatment of other entities as SPEs even if not stricto sensu SPEs. The guide “The Impact of Globalization on National Accounts” dedicates a complete chapter to the statistical treatment of SPEs, and gives practical examples and problems encountered by countries. It also includes decision trees proposed by Eurostat (page 44) and the Netherlands (page 49) which could be useful operational tools for the identification SPEs by national compilers. The same is true for the Eurostat classification scheme on page 64-65 of the same guide, although the groups of units considered as SPEs seems to be very broad.

20. In Hungarian accounts, SPEs, which are all foreign-controlled resident corporations, are identified and separately presented among the non-financial corporations since 2006, because they do not fulfil the criteria laid down in the 1993 SNA for being financial intermediaries and in particular, because none of them are engaged in securitization transactions. According to the new rules in the 2008 SNA, the relevant units should be reclassified into the new S127 subsector (captive financial institutions and money lenders). In this respect, they make a distinction between (i) foreign-controlled SPEs having financial links exclusively with non-residents, to be recorded as captive financial institutions, (ii) other foreign-controlled SPE-type units having financial links with resident corporations, also to be recorded as captive financial institutions, and (iii) SPEs controlled by residents, to be consolidated with their parent.

21. However, Hungary questions the recording of foreign-controlled SPEs having financial links with resident corporations. They would prefer to classify these units in the non-financial corporations sector (consolidated with resident partners). Their balance sheet amounts are not significant enough to distort the figures of the non-financial corporations sector or to improve the quality of the financial corporations sector, but their reclassification into S127 would impact the foreign direct investment transactions and thus not promote the presentation of the Hungarian economic reality. Indeed, large cross-border financial transactions are typical for this category of SPEs which in some countries may form the largest group of SPEs like in the Netherlands.

SPECIFIC POINTS FOR DISCUSSION

22. The items highlighted above are not meant to be exhaustive, nor are they categorized in order of importance. Many may only be marginal issues in terms of their economic importance or correspond to difficulties raised by OECD countries. Some however merit further discussion and so the AEG's views are sought on the following:

(a) What further guidance may need to be developed to define the new financial subsectors: S125 (Other financial intermediaries, except insurance corporations and pension funds), S126 (Financial auxiliaries) and S127 (Captive financial institutions and money lenders)? Which reliable data sources should be developed to better capture these three categories?

(b) What is the exact difference between head offices and holding companies? In particular, what level of management control over its subsidiaries is required for a company to be classified as head office? How to measure the borderline between “providing” and “not providing” any other services? Is a company which has no significant production at its own and does not undertake any day-to-day operations, but issues bonds and provides part of the management services a holding company or a head office? Can a head office hold the assets of its subsidiaries? Is there a more precise definition of the assets held by holding companies? Does the income of holding companies only relate to the assets of the group of the subsidiary corporations?

(c) What are the defining characteristics to test the independence of holding companies? Should a company which only hold the assets of a single corporation be treated the same way as holding companies which are defined as units that hold the assets of a group of subsidiary corporations?

(d) Are all head offices to be classified as financial auxiliaries, when most of their subsidiaries are financial corporations, even if these subsidiaries belong to the same financial subsector, for example insurance corporations (S128)?

(e) What is the difference between Financial Vehicle Corporations (FVCs) engaged in securitization, to be classified in S125, and SPEs holding assets for securitization, to be classified in S127?

(f) In which subsector should SPEs of non-resident general government be classified?

(g) More generally, could the AEG provide more guidance on the definition and classification of SPEs?

REFERENCES

The System of National Accounts 2008
Link: http://unstats.un.org/unsd/nationalaccount/sna2008.asp

The Impact of Globalisation on National Accounts
Link:
http://www.unece.org/fileadmin/DAM/stats/publications/Guide_on_Impact_of_globalization_on_national_accounts__web_.pdf

OECD Workshop on the Implementation of 2008 SNA:
New Financial sector delineation in ESA 2010: First assessment for the financial accounts in Austria [COM/STD/DAF(2011/5], by Michael Andreasch, Austrian National Bank
Enlargement of the financial corporations sector: sector classification of holdings companies and other captive institutions – Methodological questions and practice in Hungary [COM/STD/DAF(2011/6], by Béla Simon, Central Bank of Hungary
The classification of holding companies and head offices: Problems encountered by the ICBS [COM/STD/DAF(2011/7], by Noemi Frisch-Tsekhman, Israeli Central Bureau of Statistics

OECD countries' replies to the OECD Questionnaire on the Implementation of the 2008 SNA / ESA 2010 (launched in October 2011)