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RETAINED EARNINGS OF MUTUAL FUNDS AND OTHER COLLECTIVE INVESTMENT SCHEMES

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BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP

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Retained earnings of mutual funds and other collective investment schemes

There are inconsistencies in the current treatment of the retained earnings of various collective investment schemes. For mutual funds, regarded as portfolio investment in *BPM5*, their undistributed earnings are not deemed to be distributed[1], whereas the net earnings of pension funds and the technical reserves of life insurance companies are deemed to be distributed as income, and then returned to these institutional units, also in the financial account[2].

I. Current international standards for the statistical treatment of the issue

In the *1993 SNA*, *BPM5*, (and *ESA95*) life insurance enterprises and pension funds are deemed to have no retained earnings (other than that attributable to shareholders' funds in life insurance companies): the excess of net property income receivable over costs of production is channeled to policy holders or beneficiaries (households and nonresidents) through the primary distribution of income account. These funds are deemed to be reinvested, through the financial account, by the policyholders in these institutional units through *net equity on life insurance reserves and pension funds*. The rationale for this treatment in the *1993 SNA* (para. 7.124) is that, 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.

The *1993 SNA, BPM5* (and *ESA95*) classify investments in mutual funds in the same way, that is, as *shares and other equity* in the financial account and balance sheet in the national accounts' framework (see *1993 SNA*, para. 11.86–97, and *ESA95*, para. 5.96–97) and as *equity securities* in the balance of payments (*BPM5*, para. 388[3]), irrespective of what assets the mutual fund has acquired.[4] Therefore, even if a mutual fund invests solely in debt instruments, the shares in the fund are still regarded as equity instruments.

[1] In the *European System of Accounts, 1995*, (*ESA95)* the undistributed earnings of mutual funds are deemed to be distributed, and then reinvested in portfolio investment, in the financial account.

[2] After certain adjustments are made to allow for the measurement of production.

[3] *BPM5*, para. 388, appears to describe investment in mutual funds as a portfolio equity investment, although the wording is less than clear.

[4] In the *Monetary and Financial Statistics Manual, 2000,* however, shares/units in money market mutual funds are treated as deposits, rather than as shares, because of their approximation to "money".

In *1993 SNA* and *BPM5*, it would appear that any income of mutual funds that is not distributed as dividends is regarded as being retained by the mutual funds. This is not explicitly stated in either document but can be inferred from the discussion regarding the income of portfolio investment versus that for direct investment in *BPM5*.

II. Concerns regarding the current treatment

Treating the retained earnings of mutual funds, in one manner, and those of other collective investment schemes, in another manner, raises questions about consistency of treatment.

- The argument for routing all the retained earnings of the technical reserves of life insurance and pension funds to their policyholders and beneficiaries[5] would appear to apply to mutual funds as they are similar in their economic function, that is, as investment vehicles. It is, presumably, for this reason that *ESA 95* states that all undistributed earnings of mutual funds should be deemed distributed. It is not clear that the assets held by life insurance enterprises and pension funds are any more "the assets of the policyholders" than the assets of mutual funds are the assets of the shareholders in the mutual funds (or indeed of any portfolio investor[6]).

- Investment in mutual funds is regarded as equity under portfolio investment (PI)[7] and PI 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. Given that investment in mutual funds is treated as PI, the retained earnings of mutual funds should be treated in the same way.

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[5] That is, as the technical reserves are the assets of the beneficiaries and policyholders, the investment income receivable is shown as being paid by these enterprises to the policyholders and beneficiaries.

[6] Indeed, given that such policyholders and beneficiaries have very little voice (if any) in the investment decisions of the technical reserves of life insurance enterprises and pension funds, and often have no option (or very expensive options) for removing their funds, it could be argued that the logic should be applied the other way round: that portfolio investors should have the retained earnings of the entities in which they have invested routed to them, and then be reinvested through the financial account, and that such an approach might not be applied to the technical reserves of life insurance and pension funds.

[7] That is, those with an equity claim that are not part of direct investment and which are not evidenced through claims on the technical reserves of insurance or pension funds.

- There is a similarity between the routing of the retained earnings of the technical reserves of life insurance enterprises and pension funds and reinvested earnings of direct investment entities, but the rationale is very different. The analytical importance of reinvested earnings lies in identifying the decision process through which a DIE utilizes internally generated funds (i.e., for accumulation of assets or repayment of debt). Reinvested earnings are deemed to be distributed and then reinvested as a deliberate act on the part of the DI, 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's retained earnings should be utilized, the DIE's retained earnings should be deemed[8] to be distributed (in the income account) and then reinvested earnings (in the financial account). For policyholders'/ beneficiaries' claims on the technical reserves of life insurance enterprises and pension funds, 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, they are separate institutional units[9]). This rationale runs contrary to the rationale, in *1993 SNA*, for the treatment of investment, as "a conscious deliberate investment decision" (para. 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 enterprises and pension funds[10].

It is, however, important to note that the retained earnings will enter the wealth of the investor. The point in dispute is how they enter: whether by way of the Income Account or by way of the Other Changes In Financial Asset Account.

III. Possible alternative treatments

- **Deem all retained earnings of all collective investment schemes distributed (in the income account), and then reinvested (in the financial account).** In light of the differences noted above, a more consistent approach to the treatment of retained earnings of collective investment schemes, including mutual funds, would be to accrue all income to the owners/beneficiaries/policyholders, along the lines of *ESA95*, and have the undistributed portion of that income reinvested through the financial account.

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[8] In proportion to the DI's ownership share in the DIE.

[9] The logic of this approach would appear to point to all equity investment (whether in direct investment, portfolio investment, or in the technical reserves of insurance companies and pension funds) being treated the same way. The assets of all these entities could be regarded as being the "assets of the shareholders", so that all the saving of these units would accrue back to their owners, and the corporate sector would have no saving.

[10] Investors in mutual funds have more opportunity to indicate their support, or otherwise, for the mutual fund as, in the final analysis, they can sell their shares/units, whereas, for pension funds this is rarely possible, and for life insurance policies, there is usually a heavy penalty for redeeming their values before maturity.

- However, this approach would introduce more imputations into the system, and would make it very difficult for balance of payments compilers to calculate the value of the credit entries, in particular. Such an approach would also extend the concept of "reinvested earnings" (in one form or another) to areas well beyond direct investment, and would be a departure from the rationale for reinvested earnings, that is, that the DI has an influence in the retained earnings and investment decisions of the DIE. Such a rationale is not applicable to collective investment schemes (at least, not for the most part).

- **Discontinue rerouting of income and reflect changes in wealth through the Other Change in Assets Account for the technical reserves of life insurance enterprises and pension funds.** This approach would be more in keeping with the set of accounts in the *1993 SNA* and *BPM5*, with the integration of positions data, and other changes, with the financial account. The Other Changes in Assets Account has an analytical meaning in its own right, and it can be used to explain non-transaction changes in balance sheet levels. Consequently, there is now no need to show the rerouting of property income of the technical reserves of life insurance enterprise and pension funds as a transaction in order to reconcile differences between opening and closing balances.

    - This approach has implications in other parts of the system, notably for the measurement of the output of life insurance companies, as the rerouting is used as part of that calculation.[11] Involvement of the Advisory Expert Group for the revision of the *1993 SNA* will be important in resolving this issue.[12]

IV. Points for discussion

1. Do BOPTEG members have any views on the apparent inconsistencies in the treatment of income on collective investment schemes?

2. Do BOPTEG members think that there is a case for changing the present treatment of income on collective investment schemes? If so, are any of the alternatives presented acceptable?

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[11] The approach would not affect pension funds, as they are not productive units, and there is usually an explicit fee to a fund manager.

[12] The OECD Task Force on Nonlife Insurance has considered alternative means of measuring the output of nonlife insurance companies.

References

Annotated Outline 10.15

1993 SNA 7.123 -127

BPM5, footnote to para. 257,

ESA95, para. 5.98.

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