

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTTEG)

ISSUES PAPER (BOPTTEG) # 9A

SPECIAL PURPOSE ENTITIES

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Special Purpose Entities

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

The Balance of Payments Manual, Version 5 contains the concept of a Special Purpose Entity (SPE). Typically, a SPE is set up to facilitate the financing of a group's activities worldwide and/ or to contribute to cost minimisation and profit maximisation worldwide by taking advantage of different economic, legal or fiscal regimes. They can take the form of financing subsidiaries, holding companies, or corporations set up in tax havens or in different jurisdictions. Often the activities concern only financial flows and there is no visible activity such as manufacturing or the delivery of tradeable services in the host economy.

SPEs have some or all of the following characteristics:

- set up in an economy other than that in which the main activity of the group takes place
- engaged predominately in international transactions, with few links to the local economy
- can be set up with a very narrow purpose e.g. to channel one large loan or securitisation activity
- are on auto-pilot, with the functions of the SPE agreed by those setting it up and with little or no need for day to day direction or management so that control may not be visible.

SNA/BPM5 recommends that SPEs be treated in the same way as any other unit in the compilation of economic accounts. The standards provide guidelines for the partition of the globe into economic territories, the identification of institutional units, the determination of the relationship between an economic territory and a unit known as residence and the allocation of units to institutional sectors and industries.

The usual steps are:

- (1) Determine if there is an institutional unit.
- (2) If there is an institutional unit, determine in which economic territory the unit is resident.

(3) Determine to which institutional sector the unit belongs.

(4) Determine to which industry the activities of the unit should be allocated.

This process is straightforward in many cases, for example in the case of a small manufacturing company, privately owned. It can be more complicated in determining residence, sector and industry in the case of SPEs, but the same treatment applies nevertheless.

II. Concerns and shortcomings of the current treatment

Determining whether an SPE is an institutional unit does not pose any particular problems. The normal SNA/BPM criteria can be applied.

There are complications in the allocation of residence to SPEs. However, with the broadening of the criteria used to determine residence to include place of incorporation and legal domicile for enterprises which do not have a physical presence and/or do not undertake production, as proposed as part of the current revisions, this should no longer be a problem. It would be preferable for the additional criteria could be included in an expanded list of criteria to be used as a guide (rather than to be used prescriptively) in determining residence without their restriction to units with no physical presence and/or which do not undertake production (in fact these terms could be challenged - even brass plate companies could be said to have a physical presence and be undertaking production).

There are difficulties in allocating SPEs to institutional sector. The sectors group units with similar economic objectives, functions and behaviour. For example, if an SPE has the sole function of holding equity or channelling funds for a group whose main activity worldwide is manufacturing, questions arise as to the economic objectives, functions and behaviour of the SPE. If viewed in isolation, that is as a unit in its country of residence with no relation to other units in the economic territory, the allocation to sector could be quite different to that decided upon if the SPE is viewed as being part of a broader group which includes units in other economic territories.

There are difficulties in classifying SPEs by industry. The problems are similar to those encountered in allocation to sector, whereby the conclusion reached by considering the unit in isolation may differ from that reached if it is considered as part of a group which includes non-resident units.

The current standards leave room for ambiguity on the allocation of sector and industry. For instance, SNA 4.100 recommends allocating holding companies to sector according to the sector of "the corporations it controls". It does not specify that these corporations must be in the same economic territory as the holding company

In compiling statistics which will provide the appropriate signals for policy development,

there are perceived shortcomings in treating SPEs in the same way as all other units and in recording their transactions and positions indistinguishably from those of other units. The usual reason given is that the legal, ownership and control structures mean that the application of the basic principles will lead to the definition of units and the recording of stocks and flows which do not reflect economic substance. The claim usually made is that artificial arrangements entered into for, for example, taxation purposes, produce units whose transactions and positions are motivated by legal and fiscal incentives rather than "real" economic incentives, and to recognise these units and record their stocks and flows does not give a useful reflection of the economic substance. For instance, in the case of direct investment, it is claimed that, in some cases, SPEs create transactions and positions which have little real impact on the economy in which they are investing, for instance the creation of new productive capacity or employment. It is argued that this could give the wrong policy signals.

An example is of a large economy with a manufacturing company owned by shareholders resident in the same economy. If a holding company is set up in an offshore centre, with the holding company owning the manufacturer and the shareholders having an equity claim on the (non-resident) holding company rather than on a domestic company, FDI in the economy will show an increase. There is an argument that the "real" situation has not changed and that the increase in FDI, if it is not identified as not being "real" FDI, could send the wrong policy signals.

III. Possible alternative treatments

Proposed solutions to the problems of sector and industry classification seem piecemeal and appear to be addressing problems which are not unique to BOP. These include the treatment of holding companies and ancillary units. The fact that the holding company or ancillary unit is an SPE and is resident in a different economic territory from the companies to which it is related results in proposals to adopt different treatments for this case and for the case where the holding company or ancillary is in the same economic territory as the companies to which it is related. This results in some contentious proposals, such as considering SPEs whose sole role is channelling finance as financial intermediaries while their onshore counterparts which perform exactly the same functions are not considered financial intermediaries.

Attempts to remedy the perceived shortcoming of data not representing economic substance fall into two categories. The first is to accept the existence of an institutional unit and a transaction/ position and to reclassify the transaction/ position away from the aggregate it is perceived to be distorting. In the example of direct investment given above, this would mean reclassifying direct investment by SPEs in another category of investment to give a better measure of "real" direct investment.

In this case, it would be enough to ensure that compiling countries make available data on an SNA/BPM basis. If they choose to present memorandum data for policy and analytical purposes, it should be made clear that the data are not on an SNA/BPM basis and are therefore not comparable internationally. A full reconciliation with data on an

SNA/BPM basis should be provided. Exceptions to this would be made only when there is broad agreement that they result in more analytically useful data, such as in the case of \$2 subsidiaries issuing bonds as described in the Balance of Payments Textbook paragraph 544.

The second category is to allow certain transactions/ positions to be ignored when compilers consider that the transactions/ positions arrived at by following the guidelines do not reflect the economic substance of the situation. This option is fraught with difficulty. The SNA/BPM framework has as its basic aim the compilation of consistent, symmetrical economic accounts. Firm guidelines are put forward to ensure that transactions are recorded at the same time, in the same place and at the same value. With few exceptions, each asset must have a corresponding liability, with the residence of the parties recorded in the same way.

Allowing compilers the option of deciding that, in certain cases, the legal manifestation of transactions and positions can be ignored and replaced with transactions and positions which are deemed to have more economic substance introduces an element of arbitrariness into the compilation of the accounts. Because of their very nature, the incidence of SPEs will rise and fall as economic, legal and fiscal relativities change over time. For instance, work by the OECD to expose tax havens has already resulted in several countries applying stricter regimes, with SPEs moving on to other countries. The evolving security situation worldwide could see SPEs moving from one country to another. Allowing each country to interpret each new situation as it arises as they see fit in terms of their view of economic substance seems a poor basis for coherent, symmetrical statistics worldwide.

However, close inspection reveals that the proposals are effectively to net out transactions/ positions where they are deemed to be misleading. In the direct investment example, this means that the investment positions in and out of the offshore centre in the example above would be netted out, leaving an investment position between residents of one economic territory. Investment in a manufacturing company in a third country via an offshore centre would be recorded as direct investment in the third country.

By netting out transactions, compilers are effectively consolidating within a group of units which comprises units resident in different economic territories. The compilers are implicitly constructing a global group. In allocating holding companies, ancillaries etc. to sector and industry in a way which is consistent regardless of their residence, the idea of taking into account the classification of the companies in a global group also arises. The draft annotated outline of the new BPM implicitly recognises such a group in proposing that, in determining the sector of holding companies based on the preponderant sector of the group of companies of which the company is part, the group include companies resident in other economic territories.

The current standards leave room for ambiguity on this issue. For instance, SNA 4.100 recommends allocating holding companies to sector according to the sector of "the

corporations it controls". It does not specify that these corporations must be in the same economic territory as the holding company, although this conclusion may be reached as the recommendation follows a lengthy discussion of the allocation of resident units to sector. If SNA 4.100 and related recommendations are interpreted as referring only to resident units, it follows that the only relationships between residents and non-residents which are to be recorded or taken into account in compiling economic accounts are ownership relationships. In this case, the desire to use characteristics other than ownership relationships to determine sector and industry and to consolidate within a global group indicate that statistics based on a SNA/BPM view of the world which only allows grouping within economic territories have been found wanting in serving policy purposes, and compilers are finding ways around it to reflect a more global view of groups.

If the current standards are interpreted to mean that the group of companies to be taken into account in, for instance, determining sector and industry can include units in different economic territories, questions arise as to the nature of the group and in what cases the group can be taken into account. The group could be taken into account in determining sector and industry and for consolidation purposes. Another option is to use the group to determine sector and industry, then allow consolidation only between related units in the same economic territory.

Regardless of the interpretation of the current standards, a decision needs to be made as to whether a global group is to be recognised as part of the standards. If so, guidance must be provided as to the definition of such a group. There are starting points in the views based on nationality such as that used by BIS and globalisation studies are starting to build up a picture of global groups.

If the possibility of a global group of companies is envisaged, there remain problems in the treatment of ancillary units, head offices, holding companies etc, but the issues will be the same whether the units are in the same economic territory as others in their group or not. Solutions can be found which apply to both cases, rather than having to have separate treatments for each case.

If it is agreed that the standards should recommend the grouping only of units resident in the same economic territory, partial, creeping recognition of such groups and their use to determine sector and industry and as a basis for consolidation in the absence of an agreed definition of such groups must be avoided. In this case, the only way to produce a consistent set of data is to insist on full observance of the standards. While this may lead to the need for different treatments of SPEs from their domestic counterparts, at least these will be consistent across countries. For instance, in allocating sector and industry of units which, if they were in the same economy as the companies to which they provide services, would be considered ancillary, the unit needs to be considered in isolation.

IV. Points for discussion

Do BOPTEG members agree that the sector and industry allocation of SPEs require the recognition of a global group, that is a group containing units from more than one economic territory?

If so:

Do members agree that the standards need to be explicit on the definition of such a global group?

Do members agree that consolidation of transactions and positions should only be allowed between units in a group in the same economic territory and that work should continue on developing an alternative set of accounts that reflects a view of the world beyond that based on economic territory?

If not:

Do members agree that the standards need to be explicit on the definition of group of companies to make it clear that it is made up only of companies resident in the same economic territory?

Do members agree that, in the absence of a concept of group which includes companies in different economic territories, the determination of sector and industry of SPEs and the consolidation of transactions and positions should only be allowed in groups of companies in the same economic territory, with any data compiled on other bases presented as memorandum items?

Do members agree that work should continue on developing an alternative set of accounts that reflects a view of the world beyond that based on economic territory?

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