IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 9

THE SECTOR CLASSIFICATION OF SPECIAL PURPOSE ENTITIES

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Issue: The sector classification of SPEs

In particular: SPEs that are holding companies owning enterprises in the host economy

I. Introduction

This paper has been written as a consequence of the discussion on holding companies at the June 2004 BOPTEG meeting. In this discussion, the BOPTEG members agreed that SPEs, resident in another economy than the parent company, should be classified as separate autonomous institutional units on the basis of their own function in that economy. The sector classification of the parent company and affiliated group companies in other (third) economies should not be decisive in this respect. If the holding company owns no enterprises resident in the host economy, the holding company should be included in the financial sector (still to be determined as other financial intermediaries or financial auxiliaries). From the discussions, it did not become clear what the sector classification should be in the case that a holding company owns (also) enterprises resident in the host economy. This issue paper is meant to be a starting point for further discussion on this yet unresolved issue. Two situations will be distinguished: SPE/holding with and without affiliates in the host economy.

II. Sector classification of SPE/holding companies resident in another economy than the parent company and <u>not</u> owning enterprises in the same economy

At the June 2004 BOPTEG meeting it was already agreed that SPE/holding companies resident in another economy than the parent company not owning enterprises resident in the host economy, should be classified on the basis of their own economic function in the host economy as a unit belonging to the financial sector. The proper sector classification within the financial sector (other financial intermediaries or financial auxiliaries) was still to be determined.

<u>Current international standards for the statistical treatment of the issue</u>
In our view, this kind of holding companies complies with the definition of other financial intermediaries (S.123) according to SNA 4.95 (see also SNA 4.100) based on their function of financial intermediation. Although, SNA 4.42/43/44 states that subsidiaries that are established for tax reasons (artificial units) to perform a special task (for example to act as lease company) only within the group of companies, should be treated as an integral part of the parent as an ancillary corporation <u>within that economy</u>. This does not hold for the type of SPEs treated in this paper, which are holding companies in another economy than the parent company. Therefore, we are of the opinion that they should be classified in the subsector other financial intermediaries (S.123).

Concerns/shortcomings of the current treatments
With the proposed treatment of these SPEs, SPE/holding companies and 'normal' holding companies of the financial sector (holdings with no single type of financial activity clearly predominant in the group[1]) would both be classified in the same sector. This could hamper the analysis of the impact of SPE/holding companies on the direct investment figures.

Possible alternative treatments
For analytical purposes, it would be recommendable to classify SPE/holding companies in a separate subsector. The direct investment positions and transactions via these SPEs could then easily be distinguished from other companies in the financial sector.

Points for discussion

- Do BOPTEG members agree with the classification of these SPE/holding companies in the sector OFIs?
- Do BOPTEG members agree with the analytical need to distinguish the positions and flows of SPE/holdings from other companies in the financial sector and do BOPTEG members agree with the recommendation of a separate subsector for SPEs (miscellaneous OFIs)?
- Some of the currency union experts are concerned about classification that is determined with reference to its subsidiaries in a particular economy. For example, it would raise the possibility that a holding company in the Netherlands with subsidiaries in other euro zone countries may be classified to one sector for Netherlands data and another sector for euro zone data. Of course this is caused by the change in the residency status from a national residency criterion into an European euro zone residency criterion. Do BOPTEG members share this concern?

III. Sector classification for SPE/holding companies resident in another economy than the parent company owning enterprises in the host economy

Current international standards for the statistical treatment of the issue
No specific guidelines are provided in SNA and BPM.

Concerns/shortcomings of the current treatments
There is a clear need for guidance regarding the sector classification of this kind of holding companies.

Possible alternative treatments
In this paragraph, we will treat some different cases from practice with an increasing complexity.

Firstly, the issue is treated whether SPEs should be classified in a sector either as autonomous entity or as non-autonomous entity being part of the group of enterprises in the host economy. According to SNA 4.42/43/44 each individual corporation, with the exception of ancillary corporations, should be treated as a separate institutional unit. Institutional units are normally

[1] According to the European System of National and Regional Accounts (ESA 95), holding companies which only control and direct a group consisting predominantly of insurance corporations and pension funds, but which are not insurance corporations an pension funds themselves, are classified in sub-sector S.123 (§2.63).

classified according to their main activity. However, when institutional units only perform tasks within a group of companies, as is the case with holding corporations, the institutional unit is classified according to the predominant sector of the group (SNA 4.100). When the SPE/holding is resident in an economy without local subsidiaries, with the parent company in another economy, we are of the opinion that the SPE/holding should be considered as an autonomous entity. However, for SPE/holding companies owning enterprises in the host economy, it would be possible, in analogy to 'normal' holding companies, to look at the main activity of the whole group, consisting of that SPE/holding company and its subsidiaries in the host economy. It is not quite clear in such cases whether the whole subgroup of enterprises in the host economy should be classified in the same sector or each entity separately, according the SNA.

In addition to the SPE/holding company with only subsidiaries in another economy four different cases can be distinguished. First, local holding companies with only subsidiaries in the host economy (SPEs?). Second, SPE/holding companies with (only) other SPEs in the host economy and subsidiaries in another economy. Third, SPEs/ holding companies with both subsidiaries in the same economy and in an other economy. Fourth, SPE's/ holding companies with only sister companies in the same economy. These four cases will be explored hereafter
The following cases can be distinguished:

1. *Local holding companies that are established in an economy to own all the local subsidiaries/production entities in the host economy (see annex 1, case 1).* In our view, the sector classification of the holding company should be based on the predominant activity of the group of subsidiaries (for example, a holding company owning subsidiaries (factories) in the food sector, should be classified then in the non-financial sector) in line with the regular classification of holdings.
2. *A SPE/holding company owning (only) SPE/holding companies in the host economy that exclusively own subsidiaries in a third economy (see annex 1, case 2).* In our view, this group should be classified in the sector OFIs (S.123) based on the predominant activity of that entire group, namely holding activities.
3. *A SPE/holding company owning both subsidiaries in the host economy (not exclusively SPEs) and in another economy (see annex 1, case 3).* The treatment of SPEs/ holding companies owning both subsidiaries in the host economy and in another economy is less straight forward. At the one end the SPE/ holding company is a holding of companies in the same economy which would lead to the same conclusion as in case1. At the other end the SPE/ holding company is a holding of companies in another economy which could lead to the conclusion of an autonomous unit. Two strategies seem possible:
   a) the SPE/ holding company is always classified in the predominant sector of the subsidiaries in the same economy, or
   b) on the basis of a number of criteria the SPE/ holding company is classified as autonomous or as part of a group. To determine the predominant activity of such a group, there are a number of relevant criteria that could be used, amongst others:
   - the percentage of foreign assets in the total assets of the SPE/ holding company (for example if foreign assets are more than 75% of the total, the SPE is an autonomous unit);
   - whether the subsidiary in the same economy is of a significant size in terms of personnel or turnover;
   - the net asset value of each entity and the value added of each entity to the national economy.

Besides of the difficulty to find the proper criteria, the approach has the disadvantage in case the SPE/holding company is classified as autonomous, that the total cross-border position of the SPE/holding company (including implicitly the value of its participations in the production units) will be included in the inward direct investment position in the sector OFIs. This could give a misleading picture of the sector breakdown in the inward direct investment, in case of substantial non-financial subsidiaries (in the Netherlands, there are some good examples of substantial non-financial subsidiaries of SPE/holding companies). Although this second option seems an acceptable strategy it should be noted that it would imply an innovation with regard to the treatment of holdings in the statistical manuals such as the SNA.

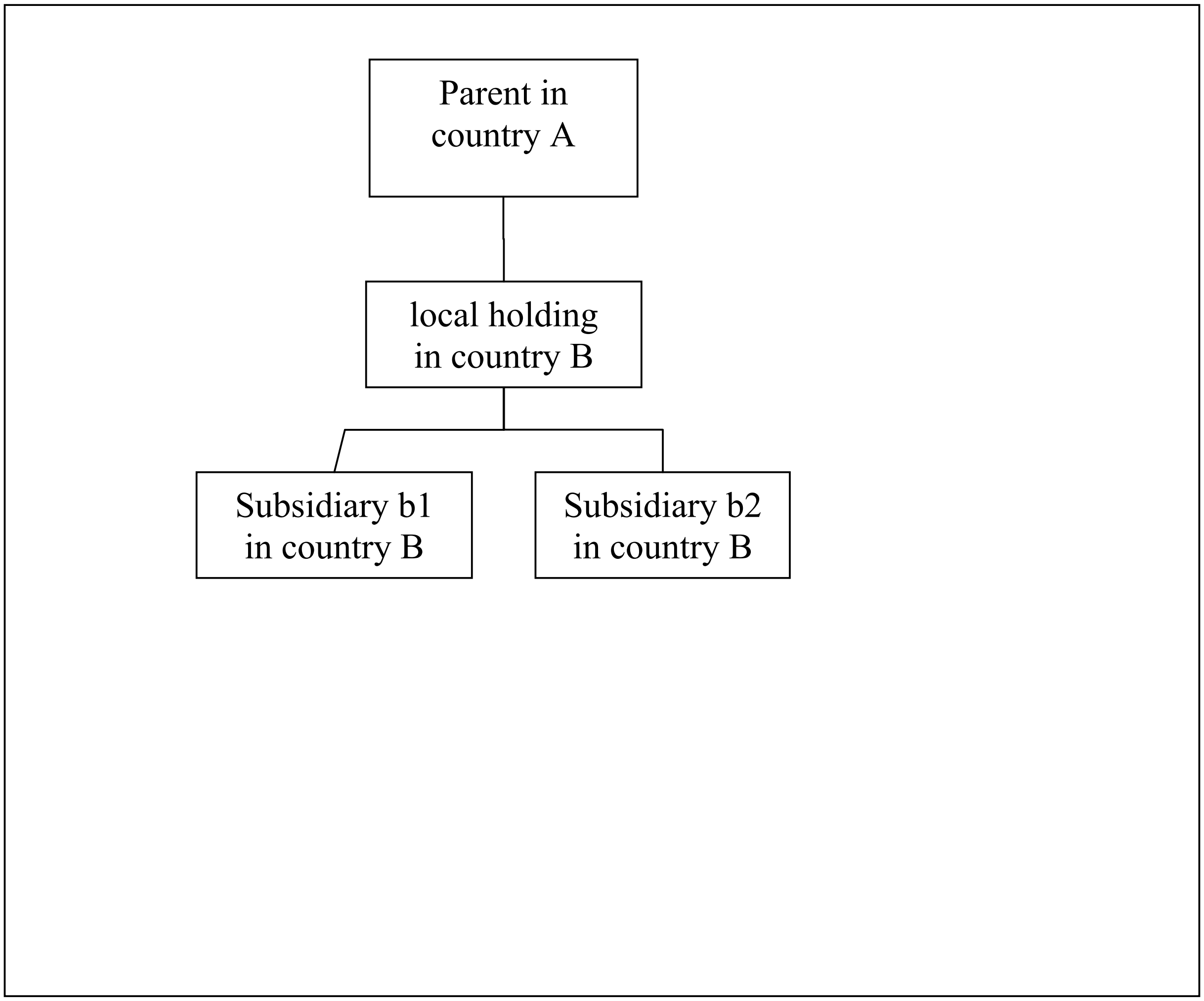
4. *A SPE/holding company owning subsidiaries in a third economy and having non-financial sister companies in the host economy (see annex 1, case 4).* In our view, there is no need to classify them as a group. They should be classified as autonomous entities on basis of its own economic functions.

Points for discussion

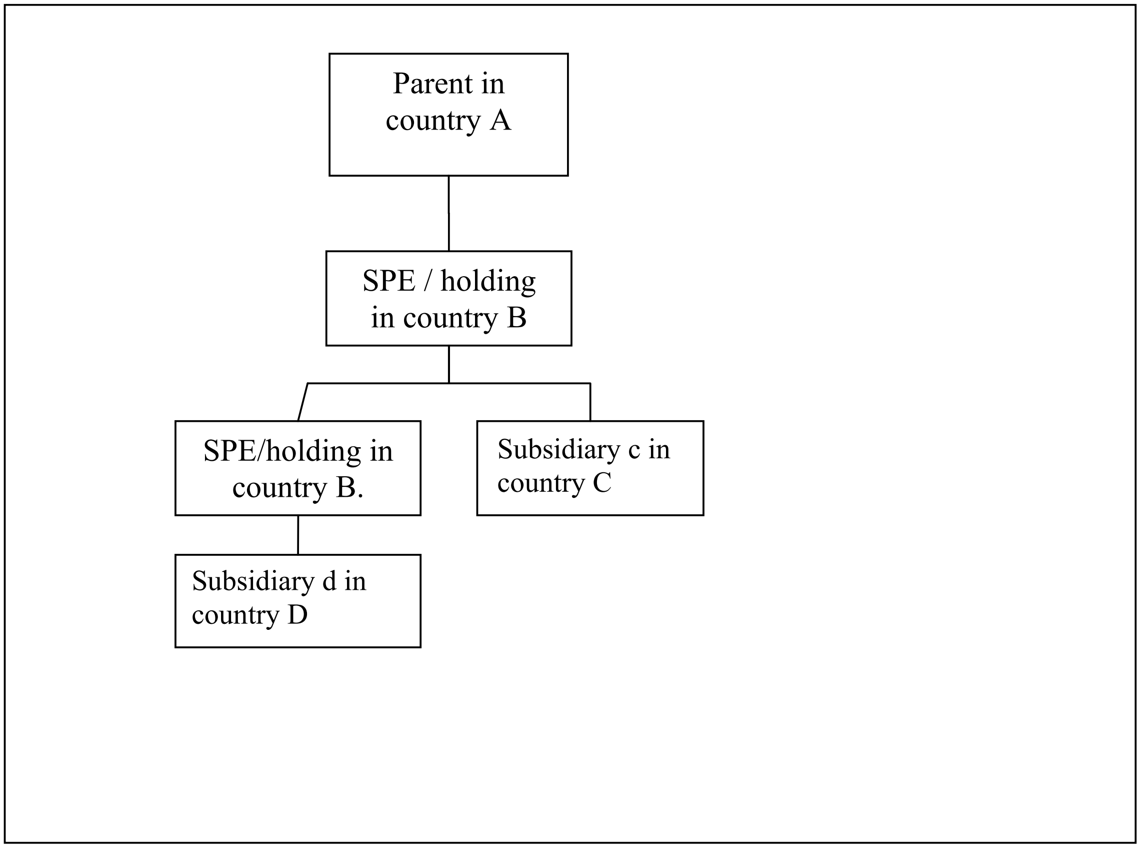
- Do BOPTEG members agree that a classification issue exists if the SPE/holding company owns non-financial entities in the host economy?
- Do BOPTEG members agree that classifying SPEs/ holding companies as autonomous units, even though it has subsidiaries in the same economy, is a proper treatment if they primarily have subsidiaries in an other economy and that this is an innovation to the SNA?
- Do BOPTEG members agree that to classify each individual entity as an autonomous entity has the advantage that the sector classification is rather simple, but has the disadvantage that it can give a misleading picture of the sector breakdown of the total cross-border position of the holding company (including implicitly the value of its participations in the production units)?
- Do BOPTEG members agree that if the SPE/holding company and its subsidiaries within the host economy would be classified as a group, the predominant activity of that group would have to be determined, and that it is not clear how one should do so according to the SNA?
- Do BOPTEG members have an opinion on what criteria could or should be used to determine the predominant activity and how one should balance these different criteria.
- What is the opinion of the BOPTEG members on what should be done if there are no predominant domestic activities in that group?

Annex 1 Organization chart of the various cases:

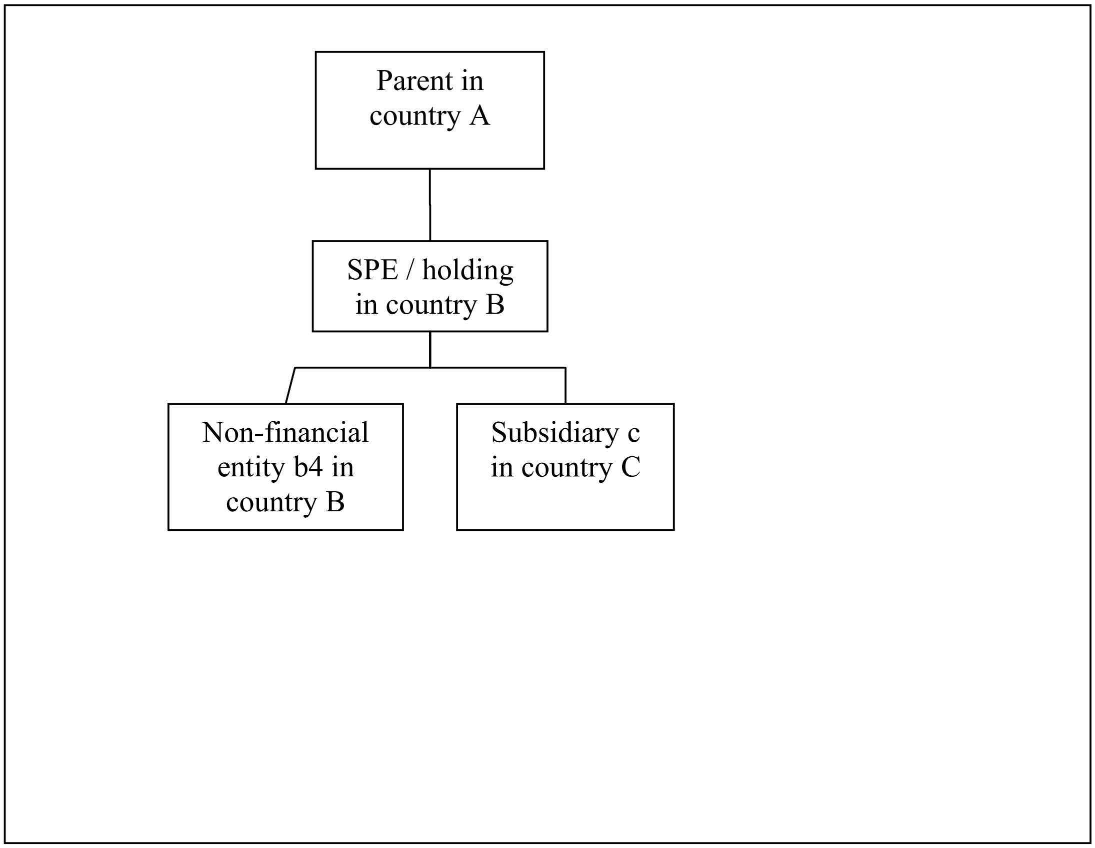
Case 1: local holding and its subsidiaries in the host economy



Case 2: SPE/holding company owning holding companies in the host economy that exclusively own subsidiaries in a third economy



Case 3: SPE/holding company owning both subsidiaries in the host economy (not exclusively SPEs) and in another economy



Case 4: SPE/holding company owning subsidiaries in a third economy and having non-financial sister companies in the same economy