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Income of Mutual Funds

Prepared by the National Bank of Belgium

INCOME OF MUTUAL FUNDS

Introduction

During the previous BOPCOM in Tokyo, a paper was presented by the Fund and by Belgium on 'retained earnings of mutual funds'. But in a way, the scope was broader and extended to the treatment of income received and distributed/retained by the funds.
A comparison was made between the approaches in SNA93, ESA95, BPM5 and SM (European Union BOP and IIP Statistical Methods).

No clear- cut decision came out of the meeting, other than that the subject will be placed on the list of items to be revised within the framework of BPM6.

This note briefly outlines the issues of the previous paper, reflects Belgium's stance on the treatment of the income of mutual funds in balance of payments, but also advances some ideas on the subject in view of the next revision of the balance of payments manual.

2001 paper on 'Retained earnings of mutual funds' (MF)

The basic elements of this paper are listed below;

- in BPM5, SM and in ESA95 too, MF's are regarded as financial intermediaries, issuing shares/units which are looked upon as equities, irrespective of the instruments in which the assets of the MF's are invested. This means that a MF creates liabilities to its owners, rather than "looking through", where the assets of the MF are directly attributed to the holders of the units/shares.
- although there is conformity between the above- mentioned manuals on the treatment of funds, there is a divergence of views on how to deal with the income generated by the MFs. BPM5 is not very clear on this, but as the shares issued by the MFs are regarded as equities, the general rules of portfolio investment in equities apply.
- the income generated from equities and distributed are thus dividends – even if the assets are invested in debt instruments-, which is also the case for the MFs. The non distributed income is regarded as 'retained earnings'. According to BPM5, dividends are payable when declared, whereas income from debt instruments is registered on an accrual basis. This would imply that a MF which only invests in bonds e.g. receives interest on a continuous basis, while the distribution of the income by the MF to the holders of its units only occurs on a periodic basis (dividends).
- the SM specifies that all income raised by the MF (or CII) is to be attributed to the holders of the units over the period under review. In other words, it is the amount and the time of recording on the asset side that determines the amount and the time of recording of the income on the liability side.
  This means that in this methods application all income of the MF is attributed to the investors, regardless of whether it is distributed or not.
- ESA95 follows the same approach, where interest received by MFs is directly assigned to the shareholders. The same applies to dividends received by MFs. The income is assigned to the shareholders too, even if it is capitalized.
- comparisons were made with other collective investment schemes such as pension funds and life insurance companies where the income is attributed to the entitled

households as well. This implies that pension funds and life insurance companies do not have saving (except saving generated by their own funds).

- MFs, pension funds and life insurance companies act in their own right as important players in the financial markets. For that reason, and for analytical purposes, it would be interesting to treat them as separate units.

Current stance of Belgium on the treatment in balance of payments

The current treatment of the income by and from MFs should not be changed for the time being. This treatment involves that income received by the MFs is registered according to the instruments invested in; interest generated by investments in short-term or long-term debt instruments is recorded on an accruals basis and, distributed income from equities, or dividends is registered when it is payable. On the liability side, income paid by the MFs has to be regarded as a dividend.

The entire income, whether distributed or not, both on the asset and on the liability sides should be registered as income and appear in the current account of the balance of payments. For the non- distributed parts of the income, an off-setting entry should be made in the financial account as a new portfolio investment.

As for debt instruments, income is recorded on an accrual basis, the income earned but not paid yet should also be the object of an off-setting entry. When the payment is effectively made, only the financial account (other investment) is affected, no longer the income component.

This approach implies that there might be a distortion between the asset side and the liability side with regard to the time of recording, especially when the investments of the MFs mainly include debt instruments. The current treatment is not in accordance with SM. This problem should be seriously tackled[1] in the future.

Aspects which are relevant to economic analysis

As it is interesting to consider the MFs (such as pension funds and life insurance companies) as separate financial institutions (instead of 'looking through') in order to observe their behaviour and influence on the financial markets, it might also be advantageous for economic analysis to detail the distributed and retained income on the liability side according to the instrumental breakdown on the asset side. This is especially true because the income distribution policy of the MF is certainly influenced by the income received on its assets.

How this should be organized in the field is a different matter.

The way forward: adjustments to be made within the framework of BPM6

The methodology proposed in BPM5 is quite similar to that of SNA93 (ESA95), but some differences remain, such as the treatment of MFs and their distributed income.

[1] Within the ESCB, a Task Force currently deals with the income from Portfolio investments. The final report of this TF is scheduled for the end of this year..

This treatment of income should be the same in both National Accounts and Balance of Payments, since the current account of the latter represents the 'rest of the world' account of the former.

The options include considering the MFs as separate financial institutions, as it is the case now in BOP, or regarding them as a simple screen between the assets and the liabilities, meaning that the owners[2] of the shares/units directly hold the assets (looking through).This has its impact on the treatment of income.

Each solution has its pros and cons in BOP;

- separate financial institutions;

  + MFs are legal entities of the country in which they reside and should be treated as such
  + it allows to observe their behaviour and impact in the financial markets
  + the collection of data and their treatment in balance of payments is easier
  - the possible distortion between income from assets and income on liabilities in terms of time of recording
  - the analytical utility of the distributed income, regarded as income from equities - where the income received by the MF could be interest only - also remains poor

- 'looking through';

  + income will be treated in the same way on the assets side and on the liability side and recorded at the same time. It will also allow the economic analysis of the income
  + for income this is the treatment already applied in National Accounts
  - possible difficulties into collecting information at a regular frequency with a tight timeliness and with sufficient details.
  - the analysis of the behaviour in the financial market will not be very easy.

A combination of both would be the best solution, which means continue to consider the MFs as separate financial entities, and breakdown the income from the investments in MF shares according to the nature of income on the asset side.

Whatever the solution adopted, it should be the same in BOP and NA[3].

This issue should be placed on the list of the items to be revised for BPM6.

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[2] These are not necessarily households, but can also be financial institutions, non financial institutions or general government.
[3] Within this context , the sector breakdowns in both statistics should also be aligned.