BOPCOM-02/42

Fifteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Canberra, Australia, October 21–25, 2002

Varying Treatments of Income of Collective Investment Schemes in the *1993 System of National Accounts,* the *Balance of Payments*, Fifth Edition, and the *European System of Accounts, 1995*

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VARYING TREATMENTS OF INCOME OF COLLECTIVE INVESTMENT SCHEMES IN THE *1993 SYSTEM OF NATIONAL ACCOUNTS,* THE *BALANCE OF PAYMENTS*, FIFTH EDITION, AND THE *EUROPEAN SYSTEM OF ACCOUNTS, 1995*

This paper addresses some of the issues that were raised in BOPCOM/01/31, and discussed at the October 2001 meeting of the IMF Committee on Balance of Payments Statistics (the Committee). It addresses the differences in approach to the measurement of saving of collective investment schemes in the *1993 System of National Accounts (1993 SNA),* the *Balance of Payments*, fifth edition *(BPM5*), and the *European System of Accounts, 1995* (*ESA95)*. For the purposes of this paper, a collective investment scheme is defined as:

a pooling of assets to meet some definite or possible future event and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively. The schemes are usually managed by professionals, on behalf of the investors. The schemes may acquire a variety of assets (financial and nonfinancial) which are designed to provide investment income and/or holding gains or protection against an insured event. The investors will (usually) have a claim on the assets, in proportion to the contributions made or earned.

This paper divides these schemes into three different types: life insurance, pension funds, and mutual funds (and similar investment devices). General insurance might also be included under this rubric but as its primary role is not to serve as a savings avenue, it is not included. (For a discussion of general insurance issues, see papers BOPCOM/02/65 through BOPCOM/02/67)

Life insurance

The *1993 SNA* describes the technical reserves of insurance companies as:

> *"The technical reserves held by insurance enterprises consist of the actuarial reserves against outstanding risks in respect of life insurance policies, including reserves for with-profits policies which add to the value on maturity of with-profit endowments or similar policies, prepayments of premiums, and reserves against outstanding claims …[T]echnical reserves are held in trust for the benefit of policy holders or beneficiaries … The reserves are, therefore, considered to be assets of the policyholders or beneficiaries and liabilities of the insurance enterprises. In the financial accounts, the claims of the holders … over the insurance enterprises are described as the net equity of households on life insurance reserves.*" (7.123).

BPM5 describes insurance technical reserves in a similar manner:

> *"Insurance technical reserves cover actuarial reserves against outstanding risks and reserves for with-profits insurance, prepayments of premiums, and reserves against unsettled claims."* (*BPM5*, footnote to para. 257).

ESA95 defines insurance technical reserves as:

> *"Technical provisions of insurance corporations and (autonomous and non-autonomous) pension funds against policy holders and beneficiaries as laid down in the Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings" (ESA95*, para. 5.98)

and life insurance technical reserves as:

> *" Provisions set aside in the corporations concerned for the purpose of obtaining, once the established conditions are met, the claims and benefits foreseen." (ESA95*, Annex 7.1)

The income of life insurance companies on these technical reserves, although receivable and retained by the insurance companies, is then deemed to be payable, as property (investment) income, to the policyholders and beneficiaries. This income is payable to the policy holders (or beneficiaries) in the primary distribution of income account.[1] In turn, this property (investment) income is then deemed to be replaced with the insurance companies by the policyholders as financial account transactions. (see *1993 SNA*, para. 7.124). In this fashion, the property (investment) income is part of the saving of the policyholders or beneficiaries (overwhelmingly, either resident or nonresident households).

In *BPM5*, the treatment, in principle, is the same as for the *1993 SNA*. But it is not fully explored. It receives a single sentence entry:

> *"This category* [other investment income] *also includes, in principle, imputed income to households from net equity in life insurance reserves and in pension funds."* (*BPM5*, para. 281).

Table 7, in *BPM5*, indicates the entries in the balance of payments are as follows:[2]

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[1] Even though the assets that are the counterpart of technical reserves may be held in the form of either produced assets (such as on buildings) or nonproduced nonfinancial assets (e.g., land) or financial assets, technical reserves are considered to be financial assets—the (financial) claims that policyholders have on the insurance companies. Accordingly, all income on technical reserves, when payable to households, is deemed to be property (investment) income as it represents returns on financial assets.

[2] Table 7, in *BPM5*, lists Balance of Payments Standard Components and Additional Detail. The entries marked * are not standard components but are "details necessary for reconciliation with classifications used in the *1993 SNA* Rest of the World Account" (*BPM5*, Table 7, footnote).

1. B. Income Account

2.3 Other investment

*2.3.3 Imputed income of households from net equity in life insurance and in pension funds** *Cr.* *Dr.*

2. B. Financial Account

3.1 Assets

3.1.4 Other assets

3.1.4.4 Other sectors

3.1.4.4.1 Long-term

*3.1.4.4.1.1 Net equity of households in life insurance reserves and in pension funds**

3.2 Liabilities

3.2.4 Other liabilities

3.2.4.4 Other sectors

3.2.4.4.1 Long-term

*3.2.4.4.1 Net equity of households in life insurance reserves and in pension funds**

In *ESA95*, the treatment is the same as the *1993 SNA*, in fact, virtually the same wording is used. See *ESA95,* para. 4.69

Pension funds

In the international standards, the manner in which the income of the assets of pension funds is treated is different from life insurance corporations. In *1993 SNA*, pension funds "are treated in the same way as technical reserves and investment income associated with insurance companies taken out under a social insurance scheme. The pension funds are assets of households." (*1993 SNA,* 7.127). However, the manner in which the income to households (residents or nonresidents) is deemed payable is somewhat different.

> *"The investment income receivable by the pension funds is ….. recorded as being payable by the pension funds to the entitled households in the primary income account … under the heading property income attributed to insurance policyholders."* (*1993 SNA,* 7.127)

The reason for this different treatment is that the acquisition and disposal of financial assets by households in this fashion "may not accord with the perception of the households concerned, especially pensioners' households, who tend to regard the pensions they receive as income in the form of current transfers" (*1993 SNA*, 9.14). As a consequence, a series of entries are made. First, households are deemed to pay back to the pension funds, through the secondary income account, an amount equal to the premium or contribution supplements they are deemed to have received in the primary income account (*1993 SNA,* 7.127). However, in order to ensure that the correct treatment is properly reflected in the accounts (i.e., that a payment of a pension is shown as a reduction in an asset—*net equity of households in pension funds*, and not as a current transfer), a further entry is shown in the use of income account (*adjustment for the change in net equity of households in pension funds*). In this manner, the saving estimate for households is unaffected (all other things being equal) and the addition to (subtraction from) *net equity of households in pension funds* is shown as a financial account. In the effect on saving, the treatment for pension funds, vis-à-vis, policyholder's claims on insurance corporations, is the same.

In *BPM5*, the treatment is the same as for *1993 SNA* (see again para.281). The entries are as described above for life insurance.

In *ESA95*, the treatment is the same as in *1993 SNA*. See para. *ESA95,* 4.141 through 4.144.

Mutual funds

The three international standards are in agreement that investments in mutual funds (and equivalent investment vehicles) are regarded as being in *shares and other equity* (see *1993 SNA*, para. 11.86–97, and *ESA95*, para. 5.96–97) and as *equity securities* (*BPM5*, para. 388),[3] irrespective of what assets the mutual fund has acquired. Therefore, even if a mutual fund solely holds debt instruments, the shares in the fund are still regarded as equity instruments. However, the treatment of income of the funds, vis-à-vis, the share (unit) holders is different between *ESA95* and the *1993 SNA* and *BPM5*. In the *1993 SNA* and in *BPM5,* the undistributed income of mutual funds is not treated any differently from the income receivable from any other equity portfolio investment. In *ESA95*, the income is attributed to shareholders, then reinvested in the same manner as for life insurance and pension funds.

In *1993 SNA* and *BPM5***,** for undistributed income of mutual funds, it would appear that the income of mutual funds that is not distributed as dividends is regarded as being retained by the funds, and is treated as saving of 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. Paras. 7.119 through 7.122 in the *1993 SNA* and paras. 285 through 289 in *BPM5* discuss the treatment of income of direct investment enterprises. These paragraphs set out the argument for showing undistributed earnings of direct investment entities as being distributed (in the primary income distribution account/current account) and then reinvested (through *shares and other equity/portfolio investment: equity investment*) in the financial account, proportional to the direct investor's

[3] *BPM5*, para. 388, appears to describe investment in mutual funds as a portfolio equity investment, although the wording is les than clear. See also footnote 4 ahead.

holding of the entity's equity. The rationale for this treatment is set out in *1993 SNA*, para. 7.121:

> *"The rationale behind this treatment is that, since a direct foreign investment enterprise is, by definition, subject to control, or influence, by a foreign direct investor or investors, the decision to retain some of its earnings within the enterprise must represent a conscious deliberate investment decision on the part of the foreign direct investor(s).*"

As a corollary, the income of portfolio investment (equity) assets (i.e., 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) is regarded as being passive. Consequently, the only earnings of portfolio investment that are recorded as being received by the shareholders are dividends. As mutual funds are all treated as equity portfolio investment[4], it follows that any earnings that are retained by mutual funds are deemed to be the saving of the mutual funds, and not the shareholders.

In *ESA95,* on the other hand, all income of the mutual funds is deemed payable to the share holders, regardless of whether or not it is distributed. In other words, the mutual fund is deemed to have no independent income of its own. However, there are difficulties in the manner in which this treatment is to be applied. On the one hand, in para. 4.49 of *ESA95*, any **interest** "received" by mutual funds is deemed to pass, as **interest** (not as dividends), directly to the shareholders: it is to be "assigned to shareholders, *even if it is capitalised*" (emphasis added). On the other hand, para. 4.54 (b) of *ESA95*, using the same words states that dividends received by mutual funds are also to be passed, as dividends, to shareholders, even if capitalized.

There are a number of problems with this situation. The first is that there seems to be no basis for arguing that all investment income of mutual funds (whether distributed or not) should pass directly to shareholders, given that mutual funds are regarded as *portfolio investment*. It conflicts with the treatment of income on other types of portfolio investment, where the only income receivable by the shareholders is dividends distributed by the entity in which the funds have been invested (as noted above).

Secondly, "interest", as described in *ESA95,* para. 4.49, is inconsistent with the accrual principle: interest accrues over time, and so increases the financial asset that is earning the interest. Para.4.49 implies that interest is "received", not accruing. Thirdly, it is inapplicable to show interest being earned on equity instruments.

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[4] It is possible that some mutual funds may have direct investors. This issue is still to be resolved by the Committee. However, even were the Committee to decide that the "10 percent rule" were to apply to mutual funds, the argument for not distributing income to the non-direct investors in these funds would remain the same.

Further inconsistencies?

In view of the foregoing, apart from the apparent inconsistencies in *ESA95* in regard to the treatment of income of mutual funds (both as dividend and as interest), are there any other aspects of the treatments of the income of collective investment schemes that prompt reconsideration? For example, are there good reasons that the income (and use of income) — and hence saving — of some collective investment schemes (life insurance and pension funds) in the *1993 SNA* and *BPM5* should be treated differently from other collective investment schemes (mutual funds)? Is the thrust, though not perhaps the detail, of *ESA95*, more appropriate? In other words, should the income of all collective investment schemes be treated as though it is receivable, directly (though the primary income distribution account) or indirectly (through the secondary income distribution account) by those with a claim on the schemes?

There would appear to be two opposing arguments. On the one hand, it could be argued that the treatment in the *1993 SNA* and *BPM5* is appropriate. Attributing all income on the technical reserves of these types of institutional units to those with the asset claim reflects an economic reality: that these types of investment vehicles are essentially shells through which households (resident and nonresident) make saving decisions, and that the earnings on those savings are, therefore, more appropriately allocated to households. While it might be questioned why the *1993 SNA* has chosen to show receipts from pension funds as income (when the stated reason could readily be accommodated through supplementary information or a satellite account, without requiring countervailing entries), the outcome remains the same: saving of households is unaffected. There is a direct and meaningful link between the saving and the investing households. At the same time, to treat investment in mutual funds as no different from any other type of portfolio investment seems defensible. That is, if the income of nonfinancial corporation X that is not distributed to its portfolio investor is regarded as being the saving of X, why should any other type of portfolio investment be treated differently?

It is a question of whether there should be consistency of treatment of "income" for all equity instruments or whether some equity should be treated differently. Is it legitimate to regard investment in pension funds and life insurance as somehow different in nature and purpose than any other type of passive portfolio investment? If so, why? Moreover, if there are legitimate arguments for allocating all earnings of the technical reserves of life insurance corporations and pension funds (as well as those of the direct investment entities) to the ultimate investor, why should the income of other portfolio investment type entities be treated differently? What marks the investment in the former type of investment vehicles from those in the latter? Should all the retained earnings of all entities, regardless of type, be allocated to the ultimate owner, and treated in an analogous manner to reinvested earnings of direct investment or the income of technical reserves of insurance companies and pension funds? Or, perhaps, on the other hand, should all dividend income on equity type investment be regarded as a withdrawal of capital? Given that there is not a strong link between earnings of an entity and its dividend payment, would it not be more appropriate to treat dividends as a reduction in owners' equity? Why should the return to a portfolio investor in one company, which distributes dividends (income), be regarded as being different from the returns to a portfolio investor in another company (ceteris paribus) which retains all its earnings (holding gains, in the Other Changes in Asset Account, and when realized, solely as a financial account transaction)? Moreover, many companies have discontinued paying dividends so that the benefits of ownership are reflected in rising values of the companies. There may also be other reasons for a discontinuation of dividends, such as a differential tax treatment between dividends and capital gains. But, in the final analysis, dividends are paid out of owners' equity and it could be reasonably argued that they should be treated solely as financial account transactions.

There are four options for the treatment of "income" on equity:

1. The status quo: that is, all dividends are regarded as "income" and the retained earnings of direct investors and the earnings of technical reserves of insurance corporations and pension funds would be attributed to the ultimate owners and then be reinvested (to show an increase in financial assets of the policyholders and beneficiaries in *net equity of households on life insurance reserves and in pension funds*). The disadvantage of this approach is that it results in an inconsistent treatment between similar types of investors – on the one hand, between different types of passive investors (portfolio investors versus policyholders and beneficiaries of the technical reserves of life insurance and pension funds), and, on the other hand, between investors with a voice in the operation (i.e., between those who are nonresidents (i.e., direct investors) and those domestic investors in other resident enterprises in which they have a substantial holding).

2. Treat all earnings on equity instruments (whether through (i) *direct investment: equity capital*; (ii) *portfolio investment: equity securities (shares and other equity)* or (iii) *net equity in life insurance technical reserves and pension funds*) as having been distributed to the owners (both dividend income and retained earnings) and that the "retained earnings" element of this "income" would be reinvested through the financial account (in the same manner that the reinvested earnings of direct investors and the policyholders and beneficiaries of technical reserve holdings of insurance companies and pension funds are at present). This would have the virtue of treating the income on all equity instruments in the same manner but would result in more imputed transactions.

3. Include in the income account only dividends payable, i.e., reinvested earnings would not be regarded as a transaction. This would serve to reduce imputations in the system. It would also ensure consistency between resident:resident relationships (where the investor has a major shareholding) and those between direct investors and direct investment enterprises, while, at the same time, avoid inconsistency between some passive investors (portfolio investors) and other passive investors (policyholders' and beneficiaries' net equity in technical reserves of insurance companies and pension funds).

4. Regard all dividends as withdrawal of owners' equity, thereby removing them from the income account. There would be no imputed transactions for retained earnings for direct investors and for policyholders and beneficiaries of insurance technical reserves and pension funds. Moreover, given the full array of accounts in the system, that integrate production, income, consumption, current transfers, capital accumulation (financial and nonfinancial), other changes in assets account, and the opening and closing balance sheets, the analytical framework is complete. Changes in position that arise from transactions or from other changes are identifiable, so that opening and closing balance sheets are reconcilable. In light of this, a change of wealth between the opening and closing balances may be as easily, and perhaps more legitimately, be shown through the other changes in asset account, than through the imputation of a transaction (such as attributing income of the technical reserves of life insurance or pension funds to households). In other words, is it perhaps more appropriate to reduce imputations and to focus more on balance sheets and changes in those balance sheets? If the purpose of household saving for a future event (such as retirement or death) is the accumulation of assets, does it matter whether the saving is shown to occur in the household sector or the financial sector if, in the end, the net result is the same – that households' claims are increasing in value? While such an approach would affect the sectoral distribution of saving, the impact on sectoral balance sheets would be unaffected. It would also make the presentation clearer.

Questions for the Committee

1. Does the Committee agree that the treatment of income of mutual funds in *ESA95* as both dividends and interest income is inconsistent?

2. Does the Committee agree that the argument for attributing investment income on the technical reserves of life insurance and pension funds to the policyholders and households appears inconsistent with the treatment of income of other collective investment schemes and other portfolio investment and should be reviewed in light of the upcoming revision to *BPM5*?

3. Does the Committee agree that the various options for the treatment of income on equity should be examined in the context of the upcoming revision to *BPM5* and the *1993 SNA*?