BOPCOM-03/23

Sixteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington D.C., December 1–5, 2003

The Statistical Treatment of Unit Trusts

Prepared by the South African Reserve Bank

THE STATISTICAL TREATMENT OF UNIT TRUSTS

Introduction

Unit trusts were established in South Africa in 1965. At first the growth in total assets under management of by unit trusts remained sluggish, but from the beginning of the 1980s it accelerated substantially. The number of funds increased from 30 funds in the late 1980s to 460 in 2002 and the number of accounts from 0,5 million to 2,1 million over the same period.

The total net assets under management of the South African unit trust industry, excluding domestic fund of funds, represented approximately 11 per cent of the total assets of domestic non-bank financial intermediaries, i.e. unit trusts, insurers, private and official pension funds and mortgage participation bond schemes at the end of December 2002. Of the R180 billion assets under management of unit trusts in December 2002, 79 per cent originated from retail business and 21 per cent from institutional business. Foreign investors acquired units in South African unit trusts since 1995, but the value of these investments accounted for only 0,1 per cent of the total value of net assets in December 2002.

The exposure of the South African unit trust industry to foreign assets amounted to nearly 10 per cent of total assets under management at the end of December 2002. Offshore foreign holdings were concentrated in equities at 75 per cent and units in foreign unit trusts at 18 per cent of foreign assets, while the remaining 7 per cent consisted of fixed-interest securities and money-market instruments. Direct offshore investments by residents in foreign collective investment schemes amounted to R55,4 billion at the end of December 2002.

These figures indicate that the statistical treatment of unit trusts in the national accounts and balance of payments of South Africa is important. The differences that currently still exist in international standards could have a significant impact on these accounts. The

evaluation of the different statistical treatments can perhaps best be achieved by an understanding of the legal framework and operational structure of the unit trust industry.

Legal framework and operational structure of the South African unit trust industry

The principal act regulating the activities of unit trusts and management companies is the "Collective Investment Schemes Control Act, No 45 of 3 March 2003". In terms of this Act a collective investment scheme means a scheme, in whatever form, including an open-ended investment company, where two or more investors contribute money or other assets to a portfolio and share the risk and benefit in proportion to their participating interest. The Registrar of Collective Investment Schemes of the Financial Services Board supervises the industry, a Collective Investment Scheme Advisory Committee advises the Registrar and the Minister on related matters, and a number of persons carrying on the business of a collective investment scheme has formed an Association of Collective Investments.

South African *unit trusts* (mutual funds) are financial intermediaries providing a conduit for investor participation in the financial markets. In short, unit trusts issue units to investors (unit holders) and offer professional management of funds received in diversified portfolios of financial assets in accordance with declared investment objectives.

The Monetary and Financial Statistics Manual (MFSM 2000), the European System of Accounts (ESA 1995) and the System of National Accounts (SNA 1993) *classify* institutional units such as unit trusts, mutual funds, investment trusts and other collective investment schemes as *investment pools* in the subsector other financial intermediaries within the sector other financial corporations, and the main sector financial corporations. In investment pools, investors usually purchase shares (units) which represent a fixed proportion of the net worth of the unit trusts (market value of net assets). Unit trusts' classification as *financial intermediaries* are related to the primary activity of incurring liabilities through issuing shares (units) and transforming these funds received from investors into assets through the acquisition of financial instruments.

The *fundamental premise* underlying a unit trust is relatively simple: a large and diverse number of investors pool money in order to obtain a diversified portfolio of professionally managed assets. Individually investors cannot normally obtain such diversification benefits because dealing costs (brokerage) make it uneconomical to buy a large number of relatively small holdings.
The *diversification* benefits offered by unit trusts reduce the risk exposure of investors, as a wide range of asset holdings moderate the effect that any one asset can have on the overall performance of a portfolio. Investors benefit from reduced administration costs and the expert knowledge of *professional management* ought to enhance returns.

The *price of units* in unit trusts are calculated daily and published in the media. The prices equal the net asset value of the unit trust, i.e. the value of assets plus any income not yet distributed divided by the number of units issued. The unit price fluctuates along with movements in the market price of the underlying assets.

Management companies are authorised to *make a market in the unit of unit trust* under their management. In an *open-ended unit trust*, the management company can create units to meet demand from investors and cancel or terminate units when repurchasing units from investors. The types of investment plans ranges from open-account or lump-sum payments to regular savings plans.

ESA 1995 endorses the concept that the market value of units reflects changes in the value of unit trust assets and liabilities (net worth) and states that units in unit trusts must be valued at the current redemption value when redeemable by the unit trust itself. The Balance of Payments Manual (BOP5, 1993) classifies units in unit trusts as *portfolio investments.* ESA 1995, *classifies units or shares issued by unit trusts*, whether open-ended, semi-open ended or closed-end funds, as *mutual fund shares*. These mutual fund shares must be revalued regularly on the basis of the market prices of the various financial instruments in the portfolio.
Investors in unit trusts decide whether *income* (interest from fixed-interest assets and dividends from shares) must be paid out in cash or reinvested in units. According to ESA 1995, income earned by unit trusts on their investments and assigned to unit

holders, even if capitalised, is classified as either *other interest* in the event of interest received, or *distributed income* in the case of dividends. In the case of unit trusts, ESA 1995 defines income receivable by the entitled owner of a financial asset placed with a unit trust as property income. However, property income excludes holdings gains and losses on financial assets owned by unit trusts. Property income received by unit trusts, net of management costs and assigned to unit holders, when reinvested, increases both liabilities and assets through an increase in the number of units outstanding and acquired financial assets, respectively.

A *unit trust structure* comprises three separate entities. They are the fund, the trustees and the management company.

The *fund* is the pool of assets. The investment pool is in turn divided into identical *units* (mutual fund shares) and each unit represents the same proportion of the net worth of the fund. The fund cannot become insolvent but could be liquidated in which case unit holders are repaid. The *trustee* is the custodian of the investment pool and ensures that the investment pool (property of the unit holders) is managed in accordance with the approved trust deed and investment objectives. The *management company* is responsible for the administration of the fund and the investment of unit holders' funds. The financial position of the management company has no effect on the assets of the fund. ESA 1995 states that unit trusts are institutional units separate from the management company and comprise investment portfolios owned by participating unit holders.

Unit trust are medium to long-term investments and the product is *marketed* through both proprietary distribution channels and independent intermediaries, including linked-product providers.

The *operational structure* of a collective investment scheme can be summarised as follows:

Statistical issues

A number of statistical issues regarding the treatment of transactions of mutual funds in the national accounts and balance of payments was raised by the International Monetary Fund, Belgium and Japan at the Meetings of the IMF Committee on Balance of Payments Statistics in Tokyo and Canberra. In Table 1 an attempt is made to summarise the various issues and the differences in treatment.

Table 1 Statistical issues

Basic issues	Treatment and implication	Manuals
Mutual funds are classified as financial intermediaries	**Treatment:** Financial intermediaries **Implications:** Treat them as *separate entities* and not as *'look through'* where the assets of the mutual fund are directly attributed to unitholders	BPM5; ESA95; MFSM2000; SNA1993
Units or mutual fund shares are classified as equities	**Treatment:** Units classified as equities even if fund solely holds debt instruments **Implications:** This treatment creates liabilities for the mutual fund and assets are not directly attributable to unit holders, *separate entity approach*	SNA93 shares and other equity ESA95 mutual fund shares BPM5 equity securities
Units in unit trusts are classified as equity portfolio investments	**Treatment:** Investment in units are classified as portfolio investments even if such investments in a specific enterprise is 10 per cent or more of the ordinary shares or voting rights **Implications:** In Japan, and perhaps also in some other countries, ownership of 10 per cent or more of equities is regarded as direct investment	BPM5
Income generated by mutual funds	**Treatment:** Units are regarded as shares (equity portfolio investment) and the general *rules of portfolio investment in equities* apply even in the case of income from debt instruments, *separate entity approach* S income generated by mutual funds (interest and dividends) distributed as dividends S undistributed income is regarded as retained earnings and deemed to be savings of mutual funds S dividends are payable when declared S income from debt instruments is recorded on an accrual basis **Implication:** Mutual funds investing in bonds receive income on a continuous basis (income from debt instruments accounted for on accrual basis) but distribute dividends only periodically	BPM5 BPM5 and SNA93 S undistributed income treated the same as income receivable from equity portfolio investments S undistributed income is regarded as retained earnings and deemed to be savings of mutual funds S for foreign investors credit current account with distributed and undistributed income and debit financial account with reinvested earnings

Basic issues	Treatment and implication	Manuals
Income generated by mutual funds (continued)	**Treatment:** All income of mutual funds must be attributed to unit holders in same period, *'look through' approach* **Implications:** S Amount and timing on asset side determine amount and timing on liability side S Income is attributed to unit holders regardless of whether it is distributed or not	SM
Income generated by mutual funds (continued)	**Treatment:** All income or property income whether distributed or not (interest and dividends) is deemed payable to unit holders and is directly assigned to unit holders, even if capitalised, but exluding holding gains and losses, *'look through' approach* **Implications:** S All income is distributed, i.e. unit holders do not only receive the distributed dividends S Interest is inconsistent with the accrual principle	ESA95

From this table it seems as if there is still not concensus about the treatment of the following issues:

(1) Should unit trusts and, for that matter, other collective investment schemes be classified as financial intermediaries?
(2) Should units of mutual funds be classified as equities?
(3) Should units in unit trust always be classified as equity portfolio investments?
(4) Should the general rules of equity portfolio investments be applied to the treatment of income generated by unit trusts?

(1) Classification as financial intermediaries

Unit trusts can either be classified as separate entities which form part of financial intermediaries or the "look through" approach can be adopted where all the assets of unit trusts can be regarded as assets held by unit holders. In

MFSM2000, SNA1993, BPM5 and ESA95 unit trusts are classified as financial intermediaries in accordance with the separate entity approach. This seems to be a logical classification as they are separate legal entities which play an important part in the investments of households and other institutions. Such a classification has implications for the treatment of the income generated by the unit trusts, but there is not general agreement on how this income should be entered in the balance of payments and national accounts.

(2) Classification as equities

In all the manuals the units of mutual funds are classified as equities even if the assets of the fund only consist of debt instruments. Such a classification is consistent with the separate entity approach. This implies that unit trusts have liabilities and that assets cannot be directly attributed to the unit holders. Taking into account the growing importance of unit trusts in many countries it may be useful to distinguish a separate form of equity investments, such as "equities in collective investment schemes".

(3) Classification as equity portfolio investments

In view of the operational structure of unit trusts it seems logical to classify all investments in units as portfolio investments. Even when investments amount to 10 per cent or more of the total value of units in a unit trust, such an investor does not have an effective say in the activities of the unit trust.

However, it is conceivable that unit trusts may own 10 per cent or more of the equity of organisations other than collective investment schemes, which could give them an effective say in the policies of such organisations. The unit trust as a separate entity could then have direct investments in such organisations.

(4) Treatment of income generated by unit trusts

Following from the classification of unit trusts as separate entities or financial intermediaries and that they own assets and incur liabilities, it seems as if the general rules of portfolio investment in equities should apply i.e. undistributed profits should not be allocated to unit holders but should be treated as saving of unit trusts. Although such undistributed profits are included in the prices of units, the same principle applies for portfolio investments in other types of equity investments. A possible and also recommended approach for the treatment of income generated by unit trusts is then to record:

S distributed income generated by mutual funds (dividends, interest and other income) as dividends on equity investments;

S dividends received or paid on equities (distributed income from equities) when receivable or payable;

S interest on investments in debt instruments on an accrual basis. It is recognised that this will lead to a distortion between the time of recording on the asset side and liability side of the balance sheet, i.e. income will accrue continuously but will only be distributed as dividends periodically; and

S interest received and accrued on debt instruments, dividends on equities and other income received and accrued separately.

If this treatment of income generated by unit trust is accepted as the norm, it could require a revision of the treatment of the technical reserves of life insurance and pension funds.

Conclusion

Unit trusts as financial intermediaries contribute meaningfully to the allocation of funds between surplus and deficit sectors in the economy. It is therefore important that they be classified as separate legal entities. The treatment of income generated by mutual funds remains contentious. There is a definite need to harmonise the treatment of income generated by collective investment schemes between the

SNA1993 and BPM5 on the one hand, and the ESA1995 on the other hand.

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