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# Investment Companies: What are they, and Where Should they be Classified in the International Economic Accounts?

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**Introduction:**

1. Existing international statistical standards recommend treating positions and transactions with or between financial intermediaries, including investment companies, in a different manner than those involving other kinds of companies. To clarify existing treatments, and to help resolve questions about treatment in the time frame available for updating the Balance of Payments Manual, several papers were prepared for the 2001 and 2002 annual meetings of the IMF=s Committee on Balance of Payments Statistics. The following is a partial list of these BOPCOM papers:

- 01/12 - Legal Structure, Economic Function, and Statistical Treatment of Trusts
- 01/20A - Clarification of Foreign Direct Investment Recommendations
- 01/20B - Clarification of the Recommended Treatment of Selected Foreign Direct Investment Transactions
- 01/21 - Transactions with Affiliated Financial Intermediaries
- 01/22 - Mutual Funds and AFund of Funds@: Portfolio Investment or Direct Investment
- 01/31 - Retained Earnings of Mutual Funds
- 02/35 - Exploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment
- 02/36 - Treatment of Corporate-type Mutual Funds
- 02/41 - Income of Mutual Funds
- 02/42 - Varying Treatments of Income of Collective Investment Schemes in the 1993 SNA, BPM5, and ESA95

2. The above papers were highly informative and useful, and served to broaden our understanding of different types of financial or investment companies and of the difficulties that compilers face in accounting for them appropriately. They are invaluable in our endeavor to update the Balance of Payments Manual.

3. The purpose of this paper is to extend the prior discussions, by more comprehensively identifying and differentiating among the many different types of investment companies in U.S. statistics. It also extends the prior discussions by providing additional information about classification concerns confronted by the United States. As such, this paper builds upon BOPCOM 02/35 (ΑExploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment@) presented by the United States last year, which covered many more types of borderline direct investment situations but did not have the investment company area as its primary focus and, unlike this paper, dealt solely with direct investment-related issues.

4. This paper discusses issues about the classification of positions and transactions by or with various types of investment companies. To avoid repetition, income, financial flows, and direct investment positions are not discussed separately. However, it should be recognized that, in the integrated framework of the international economic accounts, the classification of income and financial flows must be consistent with the classification of associated positions. That is, if a position is classified in a direct investment or other functional category, it follows that the associated income and financial flows are also to be classified in that same functional category.

**Major types of investment companies:**

5. The following 8 types of investment vehicles or companies are distinguished in this paper:

A. Mutual funds
B. Hedge funds
C. Holding companies
D. Trusts
E. Estates
F. Shell corporations
G. Insurance companies
H. Other types of investment companies

## A. Mutual funds

6. The United States has developed rules regarding where to classify investments *in* Aordinary@ mutual funds (i.e., mutual funds that accept investments directly from unaffiliated customers instead of through feeder/master arrangements) where the investment interest exceeds the 10 percent threshold that is used to define direct investment; where to classify investments *by* ordinary mutual funds where the investment interest abroad exceeds 10 percent; and where to classify Afeeder/master@ arrangements. The U.S. treatments in the first two cases were summarized in BOPCOM-02/35. That paper explained that investments by, and investments in, a mutual fund were generally not included in direct investment in U.S. statistics. However, the question of where to classify feeder/master arrangements was not discussed.

7. Mutual funds (and/or hedge funds) sometimes utilize a feeder/master arrangement. When this occurs, a fund manager establishes a Afeeder fund@ for the purpose of accepting and channeling funds to a Amaster fund.@ Feeder and master funds are often located in different countries; in the typical U.S. example, the feeder fund is organized in the United States and the master fund is organized offshore. However, both the feeder and master funds are under the control of the same manager. The ownership interest by the feeder fund in the master fund typically exceeds 10 percent (and would be as high as 100 percent, if the master fund accepts capital solely from its feeder fund). The question is whether the feeder fund equity position in the master fund should be included in direct investment. In U.S. statistics, the equity position by the feeder fund in the master fund <u>is</u> included in direct investment, provided it represents at least a 10 percent equity interest. (However, if the equity interest is under 10 percent, or if it fluctuates around the 10-percent level, then the investment is excluded from direct investment.)

8. One argument to <u>exclude</u> from direct investment a feeder fund=s equity investments in its master fund may be that the invested funds originate with investors whose primary purpose is to invest in a mutual fund, and the feeder/master arrangement could be viewed as an

inconsequential detail that should not affect classifications of these mutual fund investments. However, the rationale for the U.S. treatment is that the feeder fund/master fund arrangement is not dissimilar to those existing between many other U.S. nonfinancial and financial businesses, which establish overseas finance affiliates or holding companies for the primary or sole purpose of making investments on their parent=s behalf. It is also relevant to note that the master and feeder funds have the same manager, and so the arrangement between these entities cannot be construed as being passive or at arms length.

9. (The close relationship between feeder and master funds may be contrasted with the lack of control associated with an investment in or by an ordinary mutual fund. An investment in an ordinary mutual fund (even a large investment interest made by a single investor) is generally not for the purpose of managing or controlling the mutual fund - instead, it is usually made for precisely the opposite purpose, which is to be relieved of responsibility for managing the company. Similarly, an investment by a mutual fund is ordinarily for the purpose of obtaining a passive investment return in the form of interest, dividends, or capital gains rather than for the purpose of influencing or controlling the management of the company whose shares are acquired.)

**B. Hedge funds**

10. U.S. securities firms and investment managers often establish hedge funds offshore, typically in a tax haven country. A hedge fund is usually organized as a private limited partnership, where the fund managers are general partners and the outside (nonmanaging) investors are limited partners. (General partners have unlimited liability for the obligations of the partnership, whereas losses to limited partners generally are limited to the amount of funds that they have contributed to the partnership.) Hedge funds often utilize sophisticated investment techniques, move large amounts of capital rapidly into and out of Aexotic@ investments, and may leverage capital through various means including substantial use of derivative financial instruments.

11. Because hedge funds clearly are financial companies and, most often, are organized as limited partnerships, it follows that a general partner in the partnership holds a direct investment ownership interest, if its interest is at least 10 percent and the partner resides in a country different from that of the hedge fund.

12. An additional issue pertaining to hedge fund classification is that, as noted, the feeder/master fund type of arrangement discussed under Mutual Funds may also be employed in connection with hedge funds. In this case, the U.S. treatment (and the rationale for that treatment) is the same for hedge funds as it is for mutual funds.

**C. Holding companies**

13. A key question here is whether a given holding company is a financial or nonfinancial company.

14. Foreign affiliates that are holding companies account for a large and growing proportion of U.S. direct investment abroad (USDIA). As of yearend 2002, the direct investment position at historical cost in Amanagement of nonbank companies and enterprises@ (which includes nonbank holding companies) was $425 billion, or about 30% of the total value of the U.S. direct investment position abroad.[1] It substantially exceeds the U.S. direct investment abroad position in any other major industry sector, including manufacturing.

15. Until recently, BEA identified financial and nonfinancial companies in its international economic accounts with reference to the 1987 Standard Industrial Classification (SIC) System. However, the United States subsequently adopted the North American Industry Classification System (NAICS). The SIC classified holding companies in the Finance, Insurance, and Real Estate Division, but NAICS classifies most holding companies in a new sector (specifically, sector 55), Management of Companies and Enterprises, which is outside of the finance and

[1] Data for bank holding companies are included in BEA=s estimates for banks and are not available separately.

insurance sector (NAICS sector 52). Notwithstanding this change, the National Income and Product Accounts and the Flow of Funds Accounts in the United States have continued to classify holding companies in the financial sector. (This decision was largely based on a review of tax data that showed that the nonbank holding companies included many with large financial subsidiaries.) The United States is interested in learning where other countries classify holding companies, and whether they content with their current classification or are they considering a change.

16. Another issue that arises in connection with holding companies in BEA=s data is that their relative size might be viewed as being understated in the inward direct investment accounts. As noted, holding companies account for a substantial share of USDIA. In contrast, they account for only a small share of foreign direct investment in the United States (FDIUS). The difference in share size largely reflects differences in consolidation rules. In general, a foreign holding company affiliate and the company(ies) that it holds cannot be consolidated with one another in reports to BEA if they are located in different countries or industries, whereas those that reside in the same country and industry may be consolidated. In practice, foreign affiliate holding companies often own no other affiliates in their same industry and country of location; as a consequence, BEA receives a report for the holding company affiliate, which it classifies in the holding company industry in the country in which the holding company is located. In contrast, a U.S. holding company affiliate typically owns other companies located in the United States. But in this case, BEA receives a single, consolidated report, representing the holding company affiliate and the other U.S. company(ies) owned by the holding company -- that is, here the consolidation rules do require entities in different industries to file a consolidated report. The report is classified in the industry of the operating company(ies) rather than in the holding company industry, because (upon consolidation) the assets, liabilities, income, and other financial data for the consolidated company almost entirely represent transactions and positions of the operating companies rather than those of the holding company.

17. A question that arises is what industry classification practices are followed by other countries. For example, foreign affiliate holding companies might be classified by some compilers based upon the predominant industry of the operating companies that they own. BEA did not adopt this methodology, because it would result in data shown for countries with a substantial holding company presence being classified in manufacturing when the operations being conducted within that country=s physical borders are entirely holding company-type activities. However, an analytical limitation of the data is that they convey no information on the industries and countries of the operating affiliates that U.S. direct investors indirectly own or control through offshore holding companies.

**D. Trusts**

**E. Estates**

**F. Shell corporations**

18. Similar issues may arise among these 3 different types of organizations - trusts, estates, and shell corporations. Each of these types of organizations is a legal entity that can hold ownership of companies, but that typically does not operate those companies.

19. Under the SIC, trusts were classified as financial entities; estates were not. Shell corporations were not explicitly mentioned. Under NAICS, trusts and estates are also both classified as financial entities; shell corporations (arguably) are not classified as financial entities (and appear to be classified in sector 55, Management of Companies and Enterprises).

20. In its international economic accounts, the United States has consistently treated trusts, estates, and shell corporations as financial entities. However, before 2003, these entities were never treated as financial SPEs, whereas beginning this year, with the adoption of NAICS-based industry coding, trusts and estates (but not shells) are treated as financial SPEs.

21. The treatment of trusts, estates, and shells should be reviewed in the context of the revision of the Manual, and with reference to the treatment of the other types of entities that hold

ownership of companies but do not operate those companies. How do other countries treat trusts, estates, and shell corporations? That is, are these considered financial entities and, if so, are they treated as financial SPEs?

**G. Insurance companies**

22. There might be sizable debt positions between affiliated insurance companies. This is because affiliated insurance companies may engage in reinsurance transactions, and such transactions may be sizable in a country=s statistics. Some questions have arisen in the United States about exactly what affiliated insurance company positions should be recorded in direct investment. Our current thinking (but not our current practice) is that most affiliated debt positions between insurance companies probably should be excluded from direct investment, but we would appreciate further discussion.

23. Existing international standards do not identify insurance enterprises as financial SPEs. However, BPM paragraph 379 states:

> Because of their rather complex operations, insurance enterprises may present some difficulties as to data available from direct investment branches and subsidiaries. Nonetheless, the transactions of insurance companies are treated in the same manner as transactions of industrial and commercial enterprises, except that the technical reserves (e.g., actuarial reserves against outstanding risks, prepayments of premiums, reserves for with-profits insurance, and reserves against unsettled claims) of insurance enterprises are excluded from the stock of *direct investment*.

24. The issue here is that insurance and reinsurance claims that either have been presented for payment, or that (using actuarial assumptions) an insurance company expects to be presented for payment, seemingly are components of the insurance company=s actuarial or technical reserves against outstanding risks. Because this paragraph says that technical reserves should be excluded

from direct investment, it would follow that intercompany positions that represent claims payable (which, in turn, usually comprises the largest component of affiliated debt positions) are to be excluded from direct investment.[2] What treatments are followed by other countries? That is, are debt positions between affiliated insurance companies usually classified outside direct investment?

**H. Other types of investment companies**

25. There are a number of examples of financial or investment companies that do not fall into one of the above categories. Most of these have been described in earlier discussion papers (see BOPCOM-02/35), and are mentioned again here for the purpose of presenting a complete list rather than for further detailed discussion. Also listed below are several examples of investment <u>positions</u> (as opposed to investment <u>companies</u>) that do not fall into one of the categories discussed above and that may pose classification challenges; most of these, too, have been discussed previously.

1. The Aplain vanilla@ example of positions between a foreign affiliate financial SPE and its parent should be mentioned. This refers to the case of an affiliated financial intermediary debt position between securities brokers or other financial SPEs. The debt position in this case is removed from U.S. direct investment and reclassified to other investment, consistent with BPM5 paragraph 365. This case raises no special issues or complexities.

2. Private equity funds - these investment companies often purchase a controlling share of an operating company, and then become heavily involved in managing that company. For example, they often place someone on the board of directors of the operating

[2] As noted, the United States has not consistently been excluding affiliated debt positions of insurance companies from direct investment. This treatment is under review for the June 2004 revision of the international economic accounts.

company. The investment in the operating company is often of short to moderate duration, such as between 1 and 5 years. Should investments made overseas by private equity funds be included in direct investment when the ownership interest exceeds 10 percent? (In the U.S. international economic accounts, these are included in direct investment.)

3. Questions have arisen regarding the classification of financial affiliates where the parent is not in a financial industry. (In particular, the U.S. treatment of Netherlands Antilles finance affiliates was described in the BOPCOM-02/35.)

4. There also is the case of Apermanently invested debt@ between affiliated banks or financial SPEs. BOPCOM-02/35 described some of the challenges associated with identifying/defining permanently invested debt.

5. Positions associated with corporate inversions were also discussed in BOPCOM-02/35.

6. Derivatives - This item is included here for completeness and not because the classification of derivatives poses special problems. The Committee agreed at its 2001 meeting that financial derivatives should be excluded from direct investment and classified instead in the separate functional category (or as a reserve asset), even where the position in derivatives is between related parties that are not banks or other types of financial intermediaries. The United States concurs with this recommendation.

## VI. Questions for the Committee

The views of the Committee members would be appreciated on the following questions:

Does the Committee have comments or suggestions regarding the appropriateness of the treatment of investment companies in the United States statistics? In particular,

> For mutual funds and hedge funds: in the case where a Afeeder fund@ holds an equity interest of 10 percent or more in a master fund, should that equity interest be included in direct investment?
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> Should all holding companies be classified in the financial sector (even those that hold only nonfinancial companies)? If so, should holding companies be treated as financial SPEs (resulting in certain affiliated debt positions with them being excluded from direct investment)?
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> For inward or outward direct investment, do you consolidate holding company affiliates with the operating companies that they hold, or do you classify them in a holding company industry and not consolidate them? Under international statistical standards, should some holding companies be considered nonfinancial companies, or should they all be considered financial companies?
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> Should trusts, estates, and shell corporations be classified in the financial sector?
>
> Are affiliated debt positions between insurance companies included or excluded from direct investment in your published statistics? Do you differentiate between positions that represent claims payable (which are a component of insurance company technical reserves) and other positions?

Are there additional investment company issues that the Committee should discuss in the context of the update to BPM5?