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Data on Special Purpose Entities: Compilation and Dissemination—Russian Experience

Data on SPEs: Compilation and dissemination - Russian experience

Special purpose entities or vehicles (SPEs or SPV) are legal entities that have no or a minimum number of employees; they do not make substantial economic decisions and have no physical location in the countries of incorporation which, in turn, differ from the countries of holding companies. SPV are frequently used as an instrument of raising funds or as a way to hold assets and liabilities on their balance sheets, and they are usually not engaged in production activities in the country of registration.

The main purposes of establishing SPEs include tax optimization, gaining access or the facilitation of access to foreign advanced financial markets in order to attract relatively “cheap” borrowings, providing a means of “masking” true business owners.

Russia has high tax rates on profits, and high borrowing costs. Furthermore, most of advanced countries, including the EU and the United States, have imposed economic sanctions on the Russian Federation which hamper cross-border funds’ flows. In this regard, Russia is not perceived as a transit economy for international cross-border financial flows, and there are no SPEs in Russia.

Despite the absence of economic grounds for SPEs activities, the Bank of Russia conducts biannual statistical surveys of Russia’s financial sector aimed at identifying SPEs presence in Russia.

At the same time, Russian enterprises traditionally use SPEs registered abroad in the conduct of their economic activities.

In general, Russian companies use the following types of SPEs.

Holding companies.

In external sector statistics of the Russian Federation the SPEs category includes foreign holding companies having the following typical features:

- The enterprise is controlled by nonresident shareholders;
- The enterprise has no or a small number of employees, it does not produce anything or the volume of production in the country of residence is miniscule, or it has no physical presence in the country;
- Assets of the enterprise represent investment in the countries other than the country of incorporation.

In Russia's practice, Russian shareholders usually establish holding companies in other jurisdictions to channel investment into Russian enterprises for the following reasons:

- Facilitating foreign investors' access to acquire the holding company's shares traded on external markets;
- Opportunities for reducing the companies' tax burden;
- Greater abilities for legal protection of business in Russia, as the shareholder under the shell of the holding company is treated like nonresident;
- In some cases, the objective is to mask the names of true owners of the companies.

In most cases, such holding companies are of an "open" nature:

- There is a free float of SPE's stocks;
- The holding company publishes financial reports on the results of its financial activities in accordance with international standards;
- The holding company raises funds in the international financial markets, the proceeds of which are then channeled to develop business in Russia or in other countries;
- As a rule, the holding company officially discloses information about its major shareholders controlling the business.

Nevertheless, there are also "closed" holding companies whose main features are as follows:

- There is no free float of stocks;
- No financial information at all;
- The company is not presented in open financial markets;
- The list of shareholders is closed; the information about true owners is of an informal nature (from mass media reports, occasional interviews with companies' management).

Thus, irrespective of the holding type, the SPEs established by Russian investors are often engaged in round tripping transactions.

Foreign investors in some cases use SPEs for investing in Russia's economy; however, the volume of such transactions is considerably smaller.

Most popular jurisdictions for establishing holding companies for investing in Russia include Cyprus, the Netherlands, Bahamas, Bermuda, and British Virgin

Islands. According to the Bank of Russia's data as of March 31, 2016, the aforementioned five countries accounted for 62% of direct investment in the Russian Federation (under the directional principle). The established holding companies control real sector enterprises operating in Russia.

Holding companies often have similar investments in other countries but in much smaller volumes. It complicates the assessment of the companies' size, as it makes the assessment of the market value of the Russian subsidiary within the group more difficult.

Gradually, under the circumstances of economic sanctions imposed by a number of foreign countries, the ban on the participation of companies with foreign shareholders in state procurement orders, and the continuation of the tax amnesty declared by the Russian Government, many holding companies reregister in Russia, which gradually reduces the volume of round tripping.

Direct bank's reports, OFCs and NFCs are the main information source on SPEs. Owing to amendments introduced in the Federal Law on the Bank of Russia, starting from 2015 the Bank of Russia has been granted the authority to receive reports from the NFCs on direct investment. That was the first time the Bank of Russia collected reports from NFCs. In addition, a reporting form for banks on direct investment was considerably expanded in 2015 to include new indicators. Russian banks and companies in their reports on direct investment identify countries of immediate direct investors and countries of ultimate controlling investors. Nevertheless, in some cases Russian enterprises encounter difficulties in identifying the country of ultimate ownership. In most cases, when the country of the immediate direct investor is included in the list of off-shore jurisdictions, whilst the ultimate controlling investor is registered either in Russia or in the country that is not an off-shore country, one can conclude that there is an attribute of a holding company representing SPV.

Transactions with holding companies are reflected in Russia's direct investment statistics in accordance with BPM6 recommendations albeit without separate detail.

Companies created for buyback operations.

In recent years, a new type of SPEs has emerged in the Russian practice. Russian companies establish SPEs in foreign jurisdictions with the task of conducting buyback of ordinary shares of the parent company in external markets. Principal goals of buying stocks back include raising capitalization of the parent company and/or business reorganization, including through reregistering the company in Russia's or other foreign jurisdiction.

Like in the case of establishing holding companies, Russian companies choose off-shore countries or Cyprus for registration of such SPEs aimed at optimization of tax payments.

As a rule, the following mechanism is used for such transactions:

1. A joint-stock company establishes a SPE in a preferred jurisdiction;
2. The parent company extends a loan to the SPE for conducting buyback transactions;
3. The SPE makes a public offer to buy back stocks from shareholders in the open financial markets;
4. The SPE buys back stocks of the parent company from, mostly, portfolio investors;
5. Depending on the chosen management policies of the joint-stock company, the last stage may vary:
 - The parent company buys back stocks from the SPE using the proceeds to extinguish the loan and then, in most cases, liquidates the SPE;
 - It continues to hold stocks on the accounts of the special purpose entity, maintaining the claim on the SPE under the loan until the company's exogenous circumstances that determined the rationale for the buyback change.

As the offer to buy stocks back in the international markets is made public, Russian companies fully disclose in their official press-releases information about SPE owners, the size of the buyback and the number of shares held by the SPE or about a reduction in its stock holdings after the buyback completion. However, such information is difficult to systematize, as presently there is no integrated database of such transactions including in the framework of M&A transactions.

Information on buyback transactions is included in direct investment reports of Russian companies albeit without separate detail. Nevertheless, one can make indirect judgments about the volume of such phenomenon based on the size of reverse investment in the equity of Russian companies by their direct investment enterprises located in off-shore countries.

Conduit companies.

The main rationale for establishing conduit companies by Russian companies is to attract cheap borrowings from international financial markets. Conduit companies issue debt securities in the international financial markets. As a rule, the issue of debt securities is undertaken by conduit companies on behalf of Russian borrowers on the European financial market, but since the previous year conduit

companies have been attempting to access the Asian debt markets. The issued securities are guaranteed by a parent company which receives the proceeds of the market borrowings from its direct investment enterprise in the form of a loan, usually implying the terms identical to the provisions of a debt securities issue.

While choosing a country of registration for conduit companies, Russian residents prefer the simplicity of registration and minimal capital requirements as well as relatively low tax payments. Most popular jurisdictions for such SPEs are Ireland and Luxembourg.

The volume of such borrowings declined due to the deterioration of the economic condition of a number of major Russian borrowers and the imposition of economic sanctions.

The volume of parent companies' investment in the equity of such SPEs is miniscule, while borrowings that Russian companies draw from such direct investment enterprises are more important. The principal sources of information on borrowings are banks' and other sectors' reports on loans. However, the report forms do not contain an attribute identifying borrowings from conduit companies. The Bank of Russia uses data on Eurobond placements stored in specialized databases of commercial websites for qualified investors, i.e. Cbonds.ru and Rusbonds.ru, and also data from Bloomberg and Reuters. Thus, the Bank of Russia forms a database of issued securities placed in the international financial markets for the benefit of Russian companies. Using the data, borrowings drawn in the framework of Eurobond placements are identified. At the same time, certain difficulties exist in compiling such statistics. First, borrowed funds may not come to the parent company directly being transferred instead to finance implementation of projects in other countries. Second, under the circumstances of active borrowing in the financial markets of Ireland and Luxembourg, there appeared companies that are not affiliated with Russian companies offering them financial intermediation services in arranging the issues of such securities. In similar cases, Bank of Russia undertakes additional work aimed at identifying discrepancies between the volumes of issued securities and the volumes of loans received from SPVs within the framework of direct investment.

In external sector statistics such SPEs loans are included in the volume of reverse investment. From 2015 the Bank of Russia started publishing data on stocks of foreign assets compiled according to the directional principle. The volume of negative balances on debt instruments with Ireland and Luxembourg allows to estimate the volume of funding received by Russian companies with the help of conduit companies. Besides, data on the volume of loans attracted through Eurobond placements by foreign companies are published on the Bank of Russia's website. As of March 31, 2016 the volume of borrowings drawn by the private sector of the

Russian Federation through the use of the Eurobonds' instrument amounted to \$118 billion.

Thus, the Bank of Russia accounts transactions with foreign SPEs in accordance with BPM6 recommendations. Presently, the separate identification of data on such transactions is not provided, however, the Bank of Russia is working on the compilation and dissemination of data on direct investment flows going "through" SPEs' registration countries in the future.

Mirror statistical comparisons of direct investment volumes undertaken by the IMF have showed that main asymmetry in direct investment statistics of the Russian Federation exists for the home countries for SPEs involved in direct investment relationships with Russian enterprises.

Presently, Bank of Russia elaborate practical approaches to exchange information with the countries for which there is the greatest asymmetry in the mirror statistical data on direct investment, including the countries of SPV incorporation. The main problem continues to remain in safeguarding the confidentiality principle that does not allow countries to provide each other with the most granular data on individual enterprises, making bilateral comparisons extremely difficult.