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Retained Earnings of Mutual Funds

Prepared by the Bank of Belgium

RETAINED EARNINGS OF MUTUAL FUNDS

Treatment in Balance of Payments and in the National Accounts

Introduction

The way to report income of mutual funds¹ (MFs), received and distributed, is described in the *European System of Accounts 1995 (ESA95)*. In contrast, the fifth edition of the *Balance of Payments Manual, (BPM5)* and *System of National Accounts 1993 (1993 SNA)* do not deal specifically with the income of mutual funds but state general principles that differ from those of *ESA95*. The purpose of this paper is to draw out the differences in treatment of the income of mutual funds between, on the one hand, *ESA95* and, on the other hand, in *BPM5* and the *1993 SNA*.

Mutual Fund: definition and types

A mutual fund can be defined as a legal entity that issues shares or units, which are subscribed by investors. The collected funds are invested in different assets (nonfinancial as well as financial) and the investors receive a combination of income and/or holding gains (or losses).

There are two different types of mutual funds: *open-ended*, meaning that there is no limit to the number of shares/units on issue, and *closed-ended*, where the number of shares/units on issue is fixed. The shares/units can be quoted or unquoted.

A mutual fund may pay periodic dividends, capitalize the income or a combination of those approaches, depending on the terms set out in its prospectus.

The prospectus also set out the investments that the MF can acquire, so that the investor is aware before placing funds with the MF what are potential risks and benefits to which he/she/it is being exposed. The prospectus may indicate only a limited array of investments in which the MF can invest, such as short-term instruments — (money market mutual funds — (virtually) risk free investments), or a wider investment strategy (such as bonds, equities, real estate), by market or region (Asian, American, European, emerging markets), by currency, or any other investment strategy.

Some funds are may be generally characterized as “growth” funds (which means the focus is on capital gains), whereas others may be characterized as “income” funds, (where the

¹ Also included under the term *mutual funds*, are unit trusts and similar collective investment schemes that evidence

investments are structured to produce a regular stream of income, through interest and/or dividends). The MF's prospectus will indicate whether it can undertake any leveraging activity, and through which type of leveraging device (e.g., through straight borrowing, through repurchase agreements, or via more exotic means such as by the use of financial derivatives). The terms and conditions for redemption (for open-ended funds) or the means of sale (for closed-ended funds) are also set out in the prospectus. MFs are managed by professional investors who may offer a variety of funds with their own market orientation.

Investment in shares of MFs

Paragraph 388 of *BPM5* indicates that the shares/units issued by a mutual fund are regarded as equities, regardless of which instruments the MF invests in. *ESA95* is in line with this approach. The European Central Bank's *European Union Balance of Payments/International Investment Position Statistical Methods (SM)* also regards shares/units in MFs in the same manner (see subsection 3.8.1). An MF is regarded as a financial intermediary² as it is considered to create new liabilities to its owners (the shares/units), rather than "looking through" the mutual fund and attributing the assets directly to the MF's shareholders/unit holders. This treatment is consistent with that for other collective investment schemes (such as pension funds).

The Treatment of the Income of MFs

While there is agreement between *BPM5*, *ESA95* and *SM* on what MFs are, how to classify them as institutional units, and what the claim of the shareholders/unit holders represents, there appears to be disagreement between users of these documents on how income of MFs should be attributed.

As noted, *BPM5* does not deal explicitly with the treatment of income to, and by, MFs. However, as shares/units in MFs are treated as the equivalent as portfolio investment equity holdings³, in the absence of other specific statements on MFs, the general principles for portfolio investment equity holdings apply.

In that way, all income earned by the MF, except for that portion which is distributed, is regarded as being retained by the MF. As the investment in the MF is recorded as equity, the income distributed must be regarded as dividends, even when the assets of the MF are entirely invested in debt instruments. As such, the dividends are payable when declared

² In the draft Coordination Portfolio Investment Survey Guide, Second Edition, mutual funds are considered to be resident in the jurisdiction in which they are registered.

³ See BOPCOM01/22 for a discussion as to whether holdings in mutual funds can represent direct investment relationships. Should such a situation arise, the treatment of the income of mutual funds would need to be reconsidered in that light. However, for the benefit of this paper, all investment in MFs is considered to be portfolio investment.

(paragraph 282⁴): it was felt that the accrual principle does not apply in the case of dividends as “the level of dividends is not unambiguously attributable to a particular earning period” (1993 SNA, Para. 3.99). Interest is payable on an accrual basis (see BPM5, Para. 282). Under this interpretation, an MF will *receive* interest on a continuous basis and dividends periodically, and that it will *pay* dividends on a periodic basis. Any difference between these two will be deemed to be the (dis)saving of the MF (abstracting for other administrative costs and other income).

ESA95 and SM treat the issue of income of MFs somewhat differently. For this reason, it is probably worth quoting SM at some length (see subsection 3.4.6.3 *Compilation of accrued interest with collective investment institutions*).

“While the treatment of the income of the CIIs (collective investment institutions) as such (asset side) is covered by the BPM5 and the recommendation about the recording of money market instruments, bonds, zero-coupon bonds and other bonds on an accruals basis, the treatment of the investors’ income in the CIIs (liability side) needs some clarification due to the different distribution policies of these institutions.

*“Following a pragmatic approach, all income raised on the asset side as a result of the investments made by the CIIs (either from equities or debt securities) 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 of the income on the asset side that determine the amount and time of recording of the income on the liability side. **Application of this method means that all income is assigned to the investors, regardless if whether it is distributed or not.** The undistributed earnings must, of course, also be recorded in the financial account.*

“ The recording of the income attributed to the investors is as follows in the actual b.o.p.: a resident CII records, as a first step, (i) the entire income flow (which is attributable or owed to nonresident investors) as a debit entry under investment income, with an offsetting credit entry, representing the reinvestment of the capitalised income in the CII, in the portfolio investment account. Second (ii) when the CII pays out a dividend to the nonresident investors, this payment is not recorded under investment income, but rather as a debit entry, representing a reduction in the CII liabilities, in the financial account.” (emphasis added)

⁴ Para. 282 states “dividends are recorded as of the date payable”. However, the 1993 SNA (paragraphs 3.99, 14.72) state that “dividends are to be recorded as of the moment they are declared payable.” In accordance with accrual accounting practices, the 1993 SNA is correct; BPM5 is a cash based concept. In view of this conflict between the two systems, this is an issue that will be clarified with the next manual on balance of payments statistics.

ESA 95 uses the same approach, with the exception that the income distribution by type on the assets side determines the distribution by type on the liabilities side. Paragraph 4.49 b) states that “other interest” covers, inter alia,

*“interest received by mutual funds ... from the investments they have made, and **which is assigned to shareholders, even if it is capitalised.** It excludes holding gains and losses ...”* (emphasis added)

Paragraph 4.54 b) states that, included under “dividends”, are

*“dividends received by mutual funds .. from the investments they have made, and **which are assigned to shareholders, even if they are capitalized.** It excludes holding gains and losses ...”*(emphasis added)

Possible Rationale for the *ESA95* and *SM* approaches

No rationale is provided for this approach in *ESA95* or *SM*. However, it may be based on the same principles that the *1993 SNA* uses for other collective investment schemes, pension funds and the technical reserves of insurance enterprises. For pension funds, *1993 SNA* states:

*“Pension funds consist of the reserves held by autonomous funds established by employers and/or employees to provide pensions for employees after retirement. The reserves, and the income received by investing the reserves in financial assets, land or buildings, are treated in the same way as technical reserves and investment income associated with life insurance taken out under a social insurance scheme. The pension funds are assets of the households entitled to receive pensions in the present or future periods and constitute liabilities of the institutional units administering the funds. **The investment income receivable by the pension funds is therefore recorded as being payable by the pension funds to the entitled households in the primary income accounts of the pension funds and the households under the heading property income attributed to insurance policyholders.** Households are then treated as paying an equal amount back again to the funds as premium or contribution supplements in the secondary distribution of income account.”* (1993 SNA, Para. 7.127) emphasis added.

For the treatment for the technical reserves of insurance enterprises, the *1993 SNA* states:

*“...the property income earned on the reserves of certain life insurance funds is deemed to be paid out to policyholders and paid back again as premium supplements even though in actuality the property income is retained by the insurance enterprises. **As a result, the saving of persons or households includes the amount of the rerouted property income while the saving of insurance enterprises does not.** This alternative picture of saving is indeed the purpose of the rerouting.” (1993 SNA, Para. 3.27) emphasis added.*

For both pension funds and the technical reserves of insurance enterprises, the 1993 SNA indicates that the saving measures for households (and for the financial enterprises sector) would be analytically flawed if the earnings of these institutional units were not attributed to households. The 1993 SNA implies, in effect, that pension funds and the net equity of households in life insurance reserves do not have saving. In essence, the argument seems to be based on the view that pension funds and the net equity of households in life insurance reserves represent “association of individuals”. As such, all the earnings should be routed back to households. However, for analysis of financial market activity, it is considered beneficial to show them as separate statistical units rather than record all the assets as being held directly by households. To do the latter would overlook the very important role that these units play in their own right as players in financial markets.

A similar rationale seems to have been applied to MFs by *ESA95* and *SM*: MFs have a visible and valuable role in financial markets, which should be identified as separate activities in the macroeconomic statistical system, but, by their nature as collective investment schemes, they do not have their own saving in their right and it would be analytically inappropriate to record their retained earnings as saving of the financial enterprise sector.

Annex I presents the differing ways in which the income of direct investment enterprises, other (i.e., non-MF) collective investment schemes, and other investments (including portfolio investment) are treated in the 1993 SNA, and compares these with the way the earnings of MFs would be treated under the *ESA95* and *SM* approach.

Another argument in favor of attributing all income receivable by MFs directly to the shareholders/unitholders is that it may provide a more meaningful measure of gross national income (GNI) in certain circumstances. For example, in countries with a small domestic economy but with a disproportionately large mutual fund industry, if most of the shareholders/unitholders are nonresident, and most of the income receivable by the MFs is reinvested, the resultant measure of GNI may not be very meaningful, especially if it were analyzed on a per capita basis.

Annex II provides an example of how MFs are treated in Luxembourg using the approach of attributing all the income receivable by MFs to the shareholders/unitholders.

Implications

The implications that flow from the *SM* and *ESA95* approach are:

- a) MFs have no saving of their own, as all earnings are deemed to pass directly to the shareholders/unit holders;
- b) although this treatment is in line with the treatment of other collective investment schemes (such as pension funds), it is not in line with the treatment for investment in other types of portfolio investment where the income of the entity into which the shareholder invests is not deemed to pass directly on to the shareholders, with the result that the corporation may have its own saving. For example, if a nonresident investor holds 100 shares in a bank, when the bank has 1 billion shares on issue, and the bank earns 50 cents per share, after depreciation and taxes, and pays a dividend of 10 cents a share, the 40 cents per share is recorded as being the saving of the bank; it is not routed back to the investor, with an immediate reinvestment in the financial account;
- c) in *ESA95*, the interest that MFs receive is deemed to be payable as interest to the shareholders/unitholders, even though their investment is treated as equity investment. This approach is not in line with *SM* where the income payable on the liabilities side is always payable as dividends, not interest, regardless of the instruments in which the MF invests;
- d) in *ESA95*, interest is receivable by the shareholders/unitholders on a continuous basis (accrual accounting) whereas dividends are recorded when declared. This approach is not in line with *SM* where the distribution of income on the liabilities side is payable as dividends only when declared, not on an accrual basis;
- e) the treatment of the undistributed income receivable by the MF as if it were all passed directly to the shareholders/unitholders is more in line with the treatment of reinvested earnings of direct investment enterprises, rather than of portfolio investment

Questions for the Committee

- 1. Does the Committee agree that the paper correctly describes the treatment of the earnings of mutual funds in the various systems? Should the retained earnings of mutual funds be treated differently from other collective investment schemes such as life insurance and pension funds?***
- 2. Does the Committee have a preference, on conceptual grounds, between the various methods outlined in the paper?***

3. Does the Committee have a preference, on practical grounds, between the various methods outlined in the paper?

4. Does the Committee consider that the treatment of the income of the earnings of mutual funds should be on the agenda for inclusion in BPM6?

ANNEX I

Retained Earnings –1993 SNA Treatments

This table shows the flows and effect on the 1993 SNA balancing items for units that own an entity that retains 100 of its earnings.

	Life Insurance	Other Insurance	Pension Funds	Mutual Funds per ESA95	Direct Investment Enterprises	All Other
Primary Distribution of Income Account: Dividends received	Res. 100	Res. 100	Res. 100	Res. 100	Res. 100	0
Balance of primary incomes	Res. 100	Res. 100	Res. 100	Res. 100	Res. 100	0
Secondary Distribution of Income Account: Premiums paid	0	Use 100	Use 100	0	0	0
Disposable income	Res. 100	0*	0*	Res. 100	Res. 100	0
Use of Disposable Income Account: Adj for net equity of households in pension funds	0	0	Res. 100	0	0	0
Saving	Res. 100	0	Res. 100	Res. 100	Res. 100	0
Capital and Financial Accounts: Net lending/borrowing	Res. 100	0	Res. 100	Res. 100	Res. 100	0
Holding gains	0	Res. 100	0	0	0	Res. 100
Net worth	Res. 100	Res. 100	Res. 100	Res. 100	Res. 100	Res. 100
Reference: 1993 SNA BPM5	7.123-124 281	7.123-124 281	7.127 281	ESA 4.54(b)	7.119-121 278, 285-9	3.99 282

Balancing items shown in bold.

Res. = Resource (equivalent to DR in BOP)

The income accounts are combined in BPM5, but there would still be some offsetting entries for insurance premiums and income.

* i.e., net effect of zero as the imputed income is offset by the imputed premium supplement.

Treatment of different types of retained earnings

from point of view of parent, investor, policyholder, etc.

Note: BPM5 consolidates SNA's income accounts into a single account

1993 SNA account <i>1993 SNA item</i>			Sources
Resource		Use	Comments
Direct investment reinvested earnings	Alloc of primary income account <i>Reinvested earnings on direct foreign investment</i>	Financial account	BPM5 278, 285-9, SNA 7.119-121 Saving shown as being by parent, not subsidiary.
Property income attributed to holders (life, nonlife, pension funds)	Alloc of primary income account <i>Property inc attributed to policyholders</i>	Secondary distribution of income ac <i>Premium supplements</i>	Life and nonlife insurance and pension funds the same in the Pension funds also influence use of income account. BPM5 281, SNA 7.123-124, 7.127 Saving shown as by policyholder, not company or fund.
Mutual funds - ESA95	Alloc of primary income account <i>Property income</i>	Financial account <i>Acquisition of shares and other equity</i>	ESA 4.50, 4.54. Saving shown as by investor, not fund.
Other retained earnings	<i>No transaction but increase in net worth through revaluation account</i>		Saving shown as by corporation etc, not investor.

ANNEX II

A. The Luxembourg approach in National Accounts

In Luxembourg about 2000 Mutual Funds, representing about 5000 separate compartments, are active.

The Luxembourg approach is fully consistent with *ESA95*

The entire income generated by the MFs' investments, distributed or not, is reverted to the shareholders:

In practice;

- the income of all MFs marketed abroad is allocated to the Rest of the World account (ROW)
- the MFs which are marketed in Luxembourg:
 - o those promoted by Luxembourg institutions with no or very few Luxembourg customers, the income also is allocated to the ROW
 - o those promoted by resident institutions with Luxembourg customers, the income is allocated partly to Luxembourg and partly to the ROW
Here the overall income by instrument of all these MFs is aggregated (the hypothesis is that the distribution of the assets is the same for each holder). From these amounts (by instrument) the calculated income is subtracted for the sectors of which the investments in Luxembourg mutual funds are known (banks, pension funds, insurance companies). The rest is attributed to the household sector.

The same reasoning of transparency applies for pension funds and life insurance companies, where the actuarial reserves are regarded as belonging to the household sector but here the income on these assets is considered to be savings.

Concerning pension funds, when the voluntary social contributions exceed the pension payments, this surplus is considered as savings for the households and is transferred to this sector in order not to decrease the savings of the households.