SNA/M1.05/17.1

UPDATE OF THE 1993 SNA - ISSUE 42
ISSUE PAPER FOR JULY 2005 AEG MEETING

Retained Earnings of Mutual Funds and Other Collective Investment Schemes

John Joisce
Statistics Department
International Monetary Fund

Executive Summary

There are inconsistencies in the current treatment of the retained earnings of various collective investment schemes in the *1993 SNA* and *BPM5*. For mutual funds, their undistributed earnings are not deemed to be distributed[1], whereas the net earnings of pension funds and the technical reserves of life insurance companies are deemed to be distributed as income, and then returned to these institutional units, in the financial account[2].

The *1993 SNA* and *ESA95* also differ in their treatment of the retained earnings of mutual funds, with *ESA95* having an imputed distribution of income to owners and an equivalent reinvestment of that income.

The paper discusses the different treatments in terms of the differing underlying views about the nature of income and who is making saving decisions. It presents several options as to how *1993 SNA* should treat the income of mutual funds and other collective investment schemes, from the status quo to changes that extend or reduce the range of imputed distribution and reinvestment of income.

The paper also raises the possibility of a working group to consider the issue in the wider context of the concept of income generally.

[1] In the *European System of Accounts*, *1995*, (*ESA95)* the undistributed earnings of mutual funds are deemed to be distributed, and then reinvested in portfolio investment, in the financial account.

[2] After certain adjustments are made to allow for the measurement of production.

I. Current international standards for the statistical treatment of the issue

In the *1993 SNA*, *BPM5*, and *ESA95*, life insurance enterprises and pension funds are deemed to have no retained earnings (other than that attributable to shareholders' funds in life insurance companies): the excess of net property income receivable over costs of production is channeled to policy holders or beneficiaries (households and nonresidents) through the primary distribution of income account. These funds are deemed to be reinvested, through the financial account, by the policyholders in these institutional units through *net equity on life insurance reserves and pension funds*. The rationale for this treatment in the *1993 SNA* (para. 7.124) is that, as the technical reserves are assets of the beneficiaries and policyholders, the investment income receivable must be shown as being paid by these enterprises to the policyholders and beneficiaries.

The *1993 SNA*, *BPM5*, and *ESA95* classify investments in mutual funds in the same way, that is, as *shares and other equity* in the financial account and balance sheet in the national accounts' framework (see *1993 SNA*, para. 11.86–97, and *ESA95*, para. 5.96–97) and as *equity securities* in the balance of payments (*BPM5*, para. 388[3]), irrespective of what assets the mutual fund has acquired.[4] Therefore, even if a mutual fund invests solely in debt instruments, the shares in the fund are still regarded as equity instruments.

In *1993 SNA* and *BPM5*, it would appear that any income of mutual funds that is not distributed as dividends is regarded as being retained by the 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 in *BPM5*.

II. Concerns regarding the current treatment

Treating the retained earnings of mutual funds, in one manner, and those of other collective investment schemes, in another manner, raises questions about consistency of treatment.

- The argument for routing all the retained earnings of the technical reserves of life insurance and pension funds to their policyholders and beneficiaries[5] would appear to apply to mutual funds as they are similar in their economic function, that is, as investment vehicles. It is, presumably, for this reason that *ESA 95* states that all undistributed earnings of mutual funds should be deemed distributed. It is not clear

---

[3] *BPM5*, para. 388, appears to describe investment in mutual funds as a portfolio equity investment, although the wording is less than clear.

[4] In the *Monetary and Financial Statistics Manual, 2000,* however, shares/units in money market mutual funds are treated as deposits, rather than as shares, because of their approximation to "money".

[5] That is, as the technical reserves are the assets of the beneficiaries and policyholders, the investment income receivable is shown as being paid by these enterprises to the policyholders and beneficiaries.

that the assets held by life insurance enterprises and pension funds are any more "the assets of the policyholders" than the assets of mutual funds are the assets of the shareholders in the mutual funds (or indeed of any portfolio investor[6]).

- Investment in mutual funds is regarded as equity under portfolio investment (PI)[7] and PI is considered to be passive (given that portfolio investors do not have an "influence or voice in management" and so do not influence how internally generated funds are used). Accordingly, *BPM5* argues that the proportion of retained earnings that is attributable to portfolio investors should not be deemed to be distributed. Given that investment in mutual funds is treated as PI, the retained earnings of mutual funds should be treated in the same way.

- There is a similarity between the routing of the retained earnings of the technical reserves of life insurance enterprises and pension funds and reinvested earnings of direct investment entities, but the rationale is very different. The analytical importance of reinvested earnings lies in identifying the decision process through which a direct investment enterprise (DIE) utilizes internally generated funds (i.e., for accumulation of assets or repayment of debt). Reinvested earnings are deemed to be distributed and then reinvested as a deliberate act on the part of the direct investor (DI), on the basis that the DI has an "influence or voice" in the management of the DIE and so has an input into the decision on how the DIE's retained earnings should be utilized, the DIE's retained earnings should be deemed[8] to be distributed (in the income account) and then reinvested earnings (in the financial account). For policyholders'/ beneficiaries' claims on the technical reserves of life insurance enterprises and pension funds, there is no such influence. The system merely deems the assets to be (indirectly) those of the policyholders/beneficiaries (even though, in all other respects, they are separate institutional units[9]). This rationale runs contrary to the rationale, in *1993 SNA*, for the treatment of investment, as "a conscious deliberate

[6] Indeed, given that such policyholders and beneficiaries have very little voice (if any) in the investment decisions of the technical reserves of life insurance enterprises and pension funds, and often have no option (or very expensive options) for removing their funds, it could be argued that the logic should be applied the other way round: that portfolio investors should have the retained earnings of the entities in which they have invested routed to them, and then be reinvested through the financial account, and that such an approach might not be applied to the technical reserves of life insurance and pension funds.

[7] That is, 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.

[8] In proportion to the DI's ownership share in the DIE.

[9] The logic of this approach would appear to point to all equity investment (whether in direct investment, portfolio investment, or in the technical reserves of insurance companies and pension funds) being treated the same way. The assets of all these entities could be regarded as being the "assets of the shareholders", so that all the saving of these units would accrue back to their owners, and the corporate sector would have no saving.

> investment decision" (para. 7.121). In practice, policyholders of life insurance and beneficiaries of pension funds rarely have any voice in the management and investment decisions of their life insurance enterprises and pension funds[10].

It is, however, important to note that the retained earnings will enter the wealth of the investor. The point in dispute is how they enter: whether by way of the Income Account or by way of the Other Changes In Financial Asset Account.

III. Possible alternative treatments

Option 1: the status quo in *BPM5* and the *1993 SNA*

Under the status quo:

- income from investment in *mutual funds*, as portfolio investment, would only be **dividends**. If mutual funds retained any earnings, these would not be deemed to be distributed;

- all net income on the *technical reserves of life insurance enterprises and pension funds* (i.e., premium supplements) would be deemed to be distributed to the policyholders and beneficiaries and then be reinvested through the financial account, after taking account of the calculation of the service charge.

This approach results in an inconsistent approach for the treatment of income between one type of collective investment scheme (mutual funds) and another (technical reserves of life insurance enterprises and pension funds). However, it allows for the calculation of the service charge for technical reserves of life insurance companies.

Option 2: the *ESA95* approach

Under the *ESA95* approach:

- all undistributed earnings of *mutual funds* would be deemed to be distributed to the unit/shareholders in the same way in which the income had been received.;

- all net income on the *technical reserves of life insurance enterprises and pension funds* would be the same as for *BPM5* and the *1993 SNA.*

This approach offers some consistency between one type of collective investment scheme (mutual funds) and another type (technical reserves of life insurance enterprises and pension

---

[10] Investors in mutual funds have more opportunity to indicate their support, or otherwise, for the mutual fund as, in the final analysis, they can sell their shares/units, whereas, for pension funds this is rarely possible, and for life insurance policies, there is usually a heavy penalty for redeeming their values before maturity.

funds) as far as allocation of income flows is concerned. However, other inconsistencies emerge. Under the *ESA95* treatment (see para. 4.49(b)), as mutual funds accrue interest, the interest is deemed to be payable to the unit/shareholders as it accrues – as interest (and would then be considered to be reinvested back in the mutual fund.). The treatment means that interest would be payable/receivable on an equity instrument (investment in units/shares of mutual funds are considered to be equity). A second inconsistency is that mutual funds would be "looked through" for income flows, but not for positions data.

<u>Option 3: the modified *ESA95* approach</u>

Under this approach, all retained earnings of mutual funds would be deemed to be distributed to the unit/shareholders, and then reinvested, in the same way that retained earnings of technical reserves of life insurance enterprises and pension funds are presently treated in *BPM5* and *1993 SNA*. However, unlike the present treatment in *ESA95*, these earnings would accrue to the unit/shareholder as "reinvested earnings of mutual funds", not as the income receivable by the mutual funds.

The advantage of this approach is that there would be consistency in the manner in which the retained earnings of collective investment schemes would be treated. The disadvantages are (i) further imputations in the balance of payments, (ii) difficulty in measuring credits, and (iii) further fracturing in the manner in which income is treated between different types of portfolio investment (i.e., between mutual funds and all other types of portfolio investment).

<u>Option 4: Treat the retained earnings of pension funds in the same manner as mutual funds in *BPM5* and *1993 SNA*, but leave technical reserves of life insurance enterprises as they are presently treated in the *1993 SNA*</u>

Under this proposal, the income on *pension funds* would not be deemed to be distributed to beneficiaries, and the current *BPM5* and *1993 SNA* treatment of the income of *mutual funds* and *technical reserves of life insurance enterprises* would be retained.

The advantage of this approach is that there would be more consistency in the treatment of income between one kind of collective investment scheme (mutual funds) and another type (pension funds), but there would remain an inconsistency with another type (technical reserves of life insurance enterprises). The justification for this inconsistency is that the routing of income on the technical reserves is a necessary step to take to provide a measure of the service provided by the life insurance enterprise to its policyholders. Such a treatment is not necessary for pension funds as these are managed separately and are charged a separate fee by the enterprise managing the funds.

<u>Option 5: Treat the retained earnings of technical reserves of life insurance enterprises and pension funds in the same manner as mutual funds in *BPM5* and *1993 SNA*</u>

Under this approach, retained earnings of no collective investment schemes would be deemed to be distributed.

The advantage of this approach is that the retained earnings of all collective investment schemes would be treated consistently, and the imputation of flows would be avoided. The disadvantage of this approach is that the output of life insurance enterprises managing the technical reserves on behalf of policyholders would need to be estimated in another manner.

All the above suffer from the same problem: how to identify "mutual funds". There is no adequate definition. Increasingly, entities such as "hedge funds" or funds limited to only a very few (very wealthy) investors are constituted in similar ways to the standard mutual fund, that is, they serve as vehicles through which investors pool their resources for investment in a variety of assets[11]. What differentiates a "mutual" fund from an "investment company" is only its legal form, while its economic function may be very similar.

Recommendation

None of the approaches is completely satisfactory. There is no option that addresses all the problems, and as this issue is part of a larger debate on what constitutes "income" for which there is no satisfactory concept in either the balance of payments or the national accounts, a working group could be set up to develop the concept. In view of the shortness of time for the preparation of the new balance of payments manual and the revised *1993 SNA*, if such a working group was created its terms of reference might not be limited to finishing its work within that timetable. Indeed the IMF Statistics Department would have very limited capacity to contribute to the working group during 2005 through 2008. As a result, the working group may continue its work beyond 2008. If it were to do so, the timetables for the preparation of the new balance of payments manual and the revised *1993 SNA* should not be extended to accommodate the work of the working group. However, once the working group has concluded its work, a revision to the new manuals may be considered.

IV. Points for discussion

1. Which of the options is preferred?

2. What are the views on creating a working group on income that will continue its work beyond the finalization of the new balance of payments manual, and which may result in a subsequent revision?

[11] The entities themselves are asset holders only, that is, they are not involved in any productive activity.

References

Annotated Outline para.10.15

1993 SNA paras. 7.123 -127

BPM5 footnote to para. 257,

ESA95 paras. 4.49, 4.53, 5.98.

Differences in the Treatment in Macroeconomic Statistical Standards of Retained Earnings/Saving of Entities in Various Economic Relationships BOPCOM-03/25 (paper presented to the IMF Committee on Balance of Payments Statistics, at its meeting in 2003)

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 BOPCOM-02/42 (paper presented to the IMF Committee on Balance of Payments Statistics, at its meeting in 2002)

Reinvested Earnings in the National Accounts Dalgaard, E., Eff, C., and Thomsen, A. Review of Income and Wealth December 2000