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ENLARGEMENT OF THE FINANCIAL CORPORATIONS SECTOR: SECTOR CLASSIFICATION OF HOLDINGS COMPANIES AND OTHER CAPTIVE INSTITUTIONS

METHODOLOGICAL QUESTIONS AND PRACTICE IN HUNGARY

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This document has been prepared by Béla Simon (Central Bank of Hungary) and will be presented under item 1.a. of the draft agenda

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METHODOLOGICAL QUESTIONS AND PRACTICE IN HUNGARY

In Hungary, financial accounts are compiled by the Central Bank (CB) while the responsible institution for the production of non-financial national accounts is the Central Statistical Office (NSI). There is a close cooperation between the two institutions involved in financial statistics to ensure consistency among the statistics produced. An important part of the cooperation relates to the sector classification of units.

The implementation of the SNA 2008 and ESA 2010 requires a deeper coordination of tasks between CB and NSI. The authorities elaborated an action plan and listed the main methodological changes concerning their statistics. One of the main challenging topics in the course of preparation for the implementation of the new methodology is the classification of units according to the new institutional sectors, especially the *reclassification of captive financial institutions from the non-financial corporations sector into the financial corporations sector*.

1. Methodological background

According to the SNA 1993 and ESA 1995, the financial corporations sector consists of units engaged in *financial intermediation* or/and in *auxiliary financial activities*. Financial intermediation is defined as a service provided for the public (transacting on the market), generally under the control of a supervisory authority. Corporations providing financial services only for a limited group of units are excluded from the sector (ESA 95: 2.32, 2.37).

SNA 2008 and ESA 2010 extended the boundary of the financial corporations sector. Beside the financial intermediaries and financial auxiliaries, *other financial corporations* have to be included in the new financial corporations sector. An additional sub-sector has been created for these other financial corporations: Captive financial institutions and money lenders (S.127). According to the new regulation, this sub-sector consists of holding companies (redefined category), SPEs (newly defined category) and corporations engaged in lending from own funds and/or to limited partners.

One of the main steps forward carried out in the SNA 2008 and ESA 2010 is the definition of Special Purpose Entities (SPEs) and the delineation of passive holders of financial assets (holding companies) from corporations having real economic activity by providing services for other units (head offices). The proper separation of *service-providers* and *passive holders of assets* and the existence of *decision-making autonomy* became key factors of sector classification of the units concerned. Corporations with passive holding or financing functions which are independent units have to be reclassified into the financial corporations sector. For this reason, clear and detailed rules should be established to ensure a consistent treatment of this issue among countries.

In the case of head offices (ISIC/NACE 7010) and holding companies (ISIC/NACE 6420) the SNA 2008 and the ESA 2010 explicitly refer to the revised ISIC (rev. 4) and NACE (rev. 2) classifications promoting the proper sectorisation of units. The new definition of holding companies is as follows: *units that hold the assets (owning controlling-levels of equity) of a group of subsidiary corporations and whose principal activity is owning the group. The holding companies in this class do not provide any other service to the businesses in which the equity is held, i.e. they do not administer or manage other units.* (In contrary to the head offices which excercise operational control and manage their related units.) Regarding the application of the rules, the following questions arise:

1. How to measure whether the corporations concerned are independent institutional units or not? Is it an important factor in the classification process?
2. How to measure the borderline between "providing" and "not providing" any other service?
3. Why is the statement included in the definition of holdings that they own a group of subsidiary corporations? If a company controls only a single corporation, can it be treated as a holding company or not?

These questions are closely linked to the problem of institutional independence of holding companies which is detailed below.

Describing the characteristics of captive financial institutions, SNA 2008 and ESA 2010 underline that *an entity of this type that cannot act independently of its parent and is simply a passive holder of assets and liabilities is not treated as a separate institutional unit unless it is resident in an economy different from that of its parent*. If it is resident in the same economy as its parent, it is treated as an "artificial subsidiary" and its accounts are consolidated whit those of the parent. This regulation refers of course to all entities, but explicitly mentioned, to captive financial institutions and especially to SPEs.

The question is whether the "institutional independence test" should be applied to holding companies or not? The ESA 2010 (2.14) states that *head offices and holding companies are institutional units*. The same sentence does not appear in the SNA 2008. However, the ESA 2010 (2.20) itself declares that *captive financial institutions, artificial subsidiaries and special purpose units of general government with no independence of action are allocated to the sector of their controlling body.* We assume that this general rule refers to all types of captive financial institutions including holding companies as well. At the same time, different and contradictory wording of the manuals may lead to different classification practice of holding companies among countries.

In addition to the above, the question of institutional independence explicitly mentioned with SPEs is directly applicable to holding companies as well because, in our view, *they are substantially SPEs*. Main characteristics of holding companies which express the passive holding function and distinguish holding companies from head offices in practice are: no employees, no non-financial assets, little physical presence, no production, relation with other corporations. The same characteristics have been defined in the manuals for identifying SPEs. Following this train of thought, **corporations to be classified into the new financial sub-sector "captive financial institutions and money lenders" are substantially SPEs which are controlled by non-residents.**

2. Hungarian practice of sector classification of units according to SNA93 and ESA 95

In Hungarian national accounts a detailed sectoral breakdown of the resident economy is available. The basis of the sector classification of institutional units is the business register maintained by the NSI using various sources (tax register, register of budgetary institutions, non-profit register, firm register) and the supervisory register received from the Hungarian Financial Supervisory Authority.

Since 2006, because of their great significance, SPEs are identified and separately presented among non-financial corporations in our statistics. In our practice, SPEs are foreign controlled resident corporations or limited partnerships with passive holding or group financing activities carried out exclusively for non-resident partners. The NSI and the CB together establish and maintain the list of SPEs applied in national accounts, financial accounts and balance of payments statistics. Out of the more than 400,000 operating non-financial corporations, we mark about 800 as SPEs. SPEs represent nearly one third of the total balance-sheet and half of the financial assets of the non-financial corporations sector (see Table 1).

All foreign controlled SPEs are classified into the non-financial corporations sector because they do not fulfil the criteria laid down in the SNA 93 and ESA 95 for being financial intermediaries. Holding companies (old definition) and other group financing corporations are also classified as non-financial corporations since their related units (subsidiary or other corporations in the group) are mainly non-financial corporations.

The financial corporations sector consists of five sub-sectors in our statistics according to the sector delineation of the SNA 93 and ESA 95. Data collections and register information enable a deeper sectoral breakdown as well. Total assets of monetary financial institutions amounts to more than 75% of the non-consolidated balance-sheet of the sector (and 136% of the GDP). Other financial intermediaries and financial auxiliaries play only a less significant role in our economy (total assets amount to 22 and 1% of the GDP). The relatively small balance-sheet of these sub-sectors is in connection with the following facts:

- we do not have any holding companies predominantly managing financial corporations,
- we do not have any FVCs or other units engaged in securitisation transactions and
- all of our SPEs are treated as non-financial corporations.

Table 1: Composition of financial and non-financial corporations sector in Hungary according to the detailed SNA 93/ESA 95 sector classification

Sectors and subsectors	**Number of entities**	**Total assets (GDP %)**
Non-financial corporations	ca. 400000	400
o/w foreign controlled SPEs	800	124
Central bank	1	36
Other monetary financial institutions	238	130
o/w credit institutions	182	125
o/w money market funds	56	5
Other financial intermediaries	776	22
o/w other mutual funds	431	9
o/w other institutions	345	13
Financial auxiliaries	1500	1
Insurance corporations and pension funds	183	25
o/w insurance corporations	72	10
o/w pension funds	111	15

Table 2: Foreign controlled (normal) SPEs, holding and other group financing companies classified as non-financial corporations according to SNA 93/ESA 95

SPEs, holding and group financing companies (currently NFCs)	Number of entities	Total assets (GDP %)	Total assets of biggest 20 (GDP %)
Foreign controlled SPEs	800	124.0	78.0
Holding companies (Class 6420)	1420	8.0	5.0
o/w operating without employees	1320	7.0	5.0
Other companies (Class 6492 or 6499)	580	0.5	0.4
o/w operating without employees	560	0.4	0.3

Table 2 presents the main figures concerning "normal" SPEs having financial links exclusively with non-residents, holding companies (new definition) and other group financing corporations which have been classified in our statistics as non-financial corporations according to the SNA 93 and ESA 95. While separation of SPEs in our statistics has a long tradition using balance-sheet information and register items, delineation of holding companies and other group financing corporations (out of "normal" SPEs) just began. The starting point in identification of these holding and lending corporations is the new NACE (rev. 2) code which has been given by the corporations themselves during the NACE revision process. Most of these corporations have no employees and revenues from sales (like "normal" SPEs). They have only financial assets, mainly equity and/or loans. As in case of "normal" SPEs, we also have to examine the corporations which have not classified themselves as holding or lending companies but, according to their balance-sheet and other information, they belong to these classes.

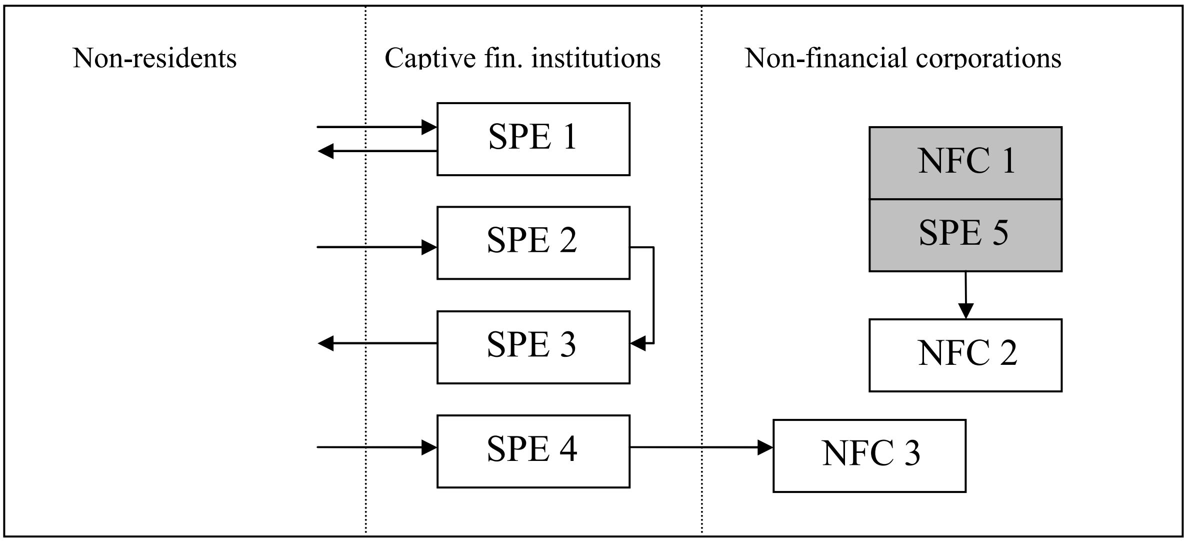
3. Application of the new rules on financial corporations in our statistics

According to the SNA 2008 and ESA 2010, the financial corporations sector is subdivided into nine sub-sectors. Eight sub-sectors out of these have been created by further splitting of the existing five sub-sectors. The delineation and separate presentation of these sub-sectors in national accounts do not cause any problems because the detailed register information and the data sources are available. The newly created ninth sub-sector named "captive financial institutions and money lenders" (S.127) will consist of units currently recorded as non-financial corporations in our statistics. **By all means, foreign controlled "normal" SPEs will be reclassified into this new sub-sector. According to our plans, other SPE-type units (holding and group financing companies having contacts with resident partners as well) will remain in the non-financial corporations sector.**

As a further effect of the methodological changes, the balance-sheet of the non-financial corporations sector will also decrease due to the consolidation of holding and other group financing companies not treated as separate institutional units and eliminated or kept with their parents in the sector. For this reason, all resident holding and group financing companies (SPE-type units) have to be identified irrespective of their institutional independence.

Followig the rules laid down in the SNA 2008 and ESA 2010, foreign controlled SPE-type units have to be recognised as independent institutions and reclassified into the financial corporations sector, into the captive financial institutions and money lenders subsector. Other (resident-controlled) units should remain in the non-financial corporations sector and should be consolidated with their parents. The strickt application of the rules would results in the following sector classification issues.

Chart 1 Possible sector classification of foreign controlled and other SPEs according to the strickt application of SNA 2008 and ESA 2010



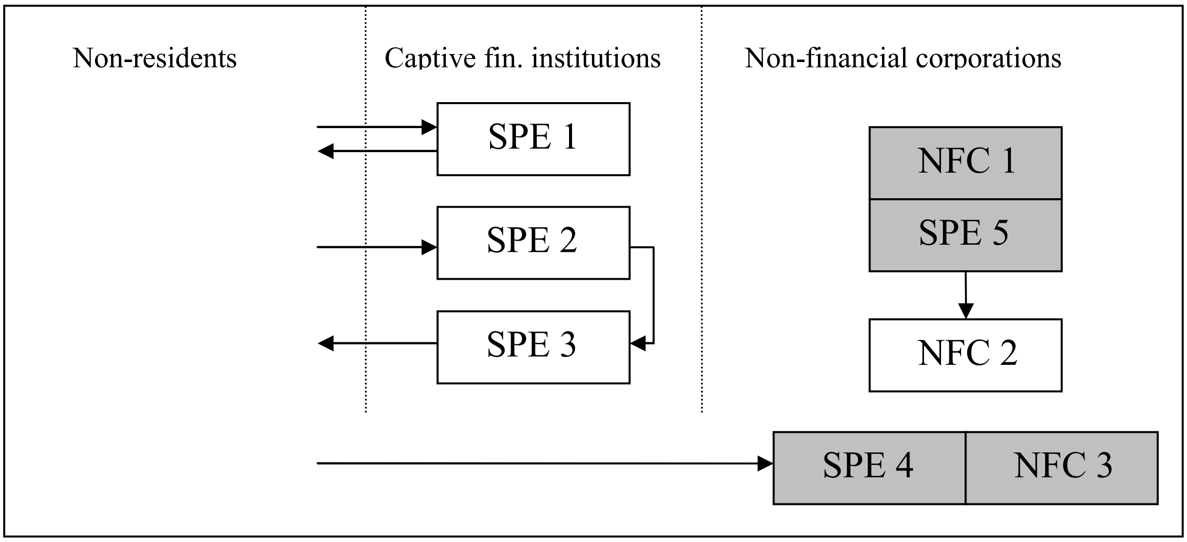
Three main groups of resident special purpose entities (broad concept) may exist:

1. Foreign controlled "normal" SPEs with financial links exclusively to non-residents (narrow concept of SPE, treated as SPE-type non-financial corporations in our ESA 95 national accounts)
2. Foreign controlled SPEs with financial links to non-residents as well (holding and other group financing companies treated as normal non-financial corporations in our ESA 95 national accounts)
3. SPEs controlled by residents (holding and other group financing companies treated as normal non-financial corporations in our ESA 95 national accounts)

According to the new SNA and ESA sector classification, foreign controlled SPEs, having financial links exclusively to non-residents (directly or through another SPEs), have to be classified as financial corporations (SPE1, SPE2 and SPE3 in Chart 1). Foreign controlled SPEs, having financial links to resident units (NFC3) as well, should also be reclassified into the financial corporations sector (SPE4 in Chart 1). SPEs controlled by resident units should be kept in their sector and consolidated with the parents (SPE5 consolidated with NFC1 in Chart 1).

In contrast to the above classification issues, we would prefer a partially different solution in our statistics (see Chart 2). Foreign controlled SPEs, having financial links exclusively to non-residents (directly or through another SPEs), will be classified as financial corporations (SPE1, SPE2 and SPE3 in Chart 1 and 2). SPEs controlled by resident units will be kept in their sector and consolidated with the parents (SPE5 consolidated with NFC1 in Chart 1 and 2). **Foreign controlled SPEs, having financial links with resident units (NFC3) as well, will also be kept in the non-financial corporations sector (SPE4 in Chart 2).** According our plans, these corporations will be eliminated or consolidated with their subsidiary corporations.

Chart 2 Preferred sector classification of foreign controlled and other SPEs
according to the rules of SNA 2008 and ESA 2010



4. Practical effects of the transition to the new SNA and ESA on our statistics

The reclassification of *foreing controlled "normal" SPEs* recognised as independent institutional units will significantly decrease the total assets of the non-financial corporations sector and increase the balance-sheet of the financial corporations sector. The reclassification of foreign controlled "normal" SPEs will reduce the balance-sheet of the non-financial corporations sector by more than 120% of the GDP (see Table 1). The reclassification gives the possibility of separate presentation of these units as captive financial institutions (S.127).

Other foreign controlled SPE-type units (holding and group financing companies with financial links to resident corporations as well) form a small group consisting of less than 50 corporations. Their balance-sheet represents an insignificant part of the total assets of the non-financial corporations sector to which they belong now. The possible reclassification of these units would rise the balance-sheet of the captive financial corporations sub-sector by about 5% of the GDP only (see Table 2).

From practical point of view, beside the advantage of clearing and simplification of the non-financial corporations sector, the reclassification of these other foreign controlled SPE-type units (holding and group financing companies) has *serious drowbacks* as well. Most of the holding companies concerned are parts of an ownership chain (direct investment chain) through which the foreign owners control resident non-financial corporations. The reclassification of holding companies (as elements of the chain) would split these investment links between the foreign investors and the ultimate subsidiary corporations. *With this presentation, according to the new SNA and ESA, the real purpose of foreign direct investments will be invisibe because the foreign investors obtain control ower captive financial corporation in our statistics, however, in relity they control non-financial corporations engaged in production through a passive ownership chain.*

Conclusions

Among other methodological changes relating to the implementation of the SNA 2008 and ESA 2010, the new sector classification of units will appear in 2014 in our statistics. The introduction of the Captive financial institutions and money lenders sub-sector (S.127) may lead to reclassification and separate presentation of SPEs which, due to their significant financial assets and relating property income, make now a serious distortion in our non-financial corporations sector. A further improvement of our national accounts can be achieved through the consolidation of resident-controlled SPEs with their parent corporations in the non-financial corporations sector.

However, the proper treatment of the third type of SPEs (foreign controlled holding and group financing companies with financial links to resident corporations as well) is a key question for us. Their balance-sheet amounts are not significant to distort the figures of the non-financial corporations sector (if they will remain there) or to improve the quality of the financial corporations sector (if they will be reclassified). Strictly applying the new rules, they should be treated as independent institutional units classified as captive financial institutions (like "normal" SPEs) because they can not be consolidated with their foreign owners. This solution would not promote the presentation of economic reality in our statistics, especially for foreign direct investment transactions. For this reason, we would prefer the consolidation of these entities with their subsidiaries within the non-financial corporations sector. Most of the holding companies concerned control only one subsidiary corporation (are they holdings at all?) which makes the consolidation technically possible. We arrive at the same outcome in our statistics if we look through these units as if their parent and subsidiary corporations would have direct financial contacts with each other.