Changes in the content and breakdown of the Financial corporations sector Methodological and practical issues in Hungary

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Summary

The new statistical standards of National Accounts (SNA 2008 and ESA 2010) extended the scope of the Financial corporations sector and introduced a more detailed sectoral breakdown. In this paper, the Central Bank of Hungary presents the methodological questions raised and the solutions found in the course of preparation for the implementation of the revised Manuals related to the changes in the content and details of the financial sector. The most important part of the paper refers to the reclassification of captive financial institutions from the non-financial corporations to the financial corporations sector which has a significant effect on the balance-sheet of these sectors.

I. Introduction

The recent revision of international statistical standards of National Accounts (SNA 2008, ESA 2010) did not introduce substantial changes in the system. However, the *extension of the coverage* of the Financial corporations sector and the creation of detailed sub-sector breakdown may cause significant changes in the sources, compilation and content of Financial Accounts and may strongly affect the statistical measures, aggregates derived from Financial Accounts.

The implementation of detailed sectoral and instrumental breakdown recommended by the new Manuals requires the reconsideration of sector classification of different financial institutions and the modification of data sources enabling the compilation of appropriate statistics. Beside these changes in the presentation of sectoral and instrumental details, the *extension of the boundary* of the Financial corporations sector according to the revised standards is of great importance regarding Financial Accounts. Not only the details but also the content of the financial corporations sector must be changed by reclassification of institutional units from the Non-financial corporations sector to the Financial corporations sector.

This enlargement of the Financial corporations sector in line with the revised Manuals may result in the clearing and simplification of the content of the Non-financial corporations sector. The more detailed breakdown of the Financial corporations sector gives the possibility of separate presentation of the aptive financial institutions forming the additional part of the sector reclassified from the Non-financial corporations sector. However, the removing of holding companies and other group financing corporations from the Non-financial corporations sector may split the inter-company relationships and makes the intra-sectoral consolidation impossible.

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 Statistical Office plays a leading role in the general classification process. However, in the field of financial corporations, the Central Bank is deeply involved in the sector classification of units.

The preparation for the implementation of the SNA 2008 and ESA 2010 requires a deeper coordination of tasks between the Central Bank and the Statistical Office. 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 and sub-sectors, especially the *reclassification of captive financial institutions* from the Non-financial corporations sector into the Financial corporations sector. The preparational work started in 2010 with the detailed examination of the revised statistical Manuals and with the systematic detection and registration of changes. New or modified data collections will be introduced from 2013 and the first revised National and Financial Accounts will appear in 2014.

II. 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). The Manuals explicitly refer to the sector classification of holding companies and group financing corporations but the lack of detailed definitions leaves room for different classification practices. For this reason, there are huge differences among coutries regarding the size and content of the Financial corporations sector.

The 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 (re-defined category), special purpose entities (newly defined category) and corporations engaged in lending from own funds and/or to limited partners. With the new definition, holding companies, SPEs and other group financing corporations become part of the financial corporations sector.

Chart 1. Effect of the revision of the Manuals on the content and sub-sectors of the Financial corporations sector (S.12)

SNA 1993/ESA 1995		SNA 2008/ESA 2010	
S.121	Central bank	S.121	Central bank
S.122	Other monetary financial institutions	S.122	Other deposit-taking corporations
		S.123	Money market funds (MMF)
S.123	Other financial intermediaries	S.124	Non-MMF investment funds
		S.125	Other financial intermediaries
S.124	Financial auxiliaries	S.126	Financial auxiliaries
		S.127	Captive financial institutions and money lenders
S.125	Insurance corporations and pension funds	S.128	Insurance corporations
		S.129	Pension funds

Broad overview of the sectoral changes:

- Split of Other monetary financial institutions (old S.122) sub-sector into two parts without modification of the content of the sub-sector.
- Division of Other financial intermediaries (old S.123) sub-sector into two parts without substantial modification of the content of the sub-sector.
- Split of Insurance corporations and pension funds (old S.125) sub-sector into two parts without significant changes in the coverage of the sub-sector.
- Introduction of the Captive financial institutions and money lenders (new S.127) sub-sector containing institutional units mainly reclassified from the Non-financial corporations sector.

Minor changes in the content of the financial sub-sectors can occur due to the introduction of new financial assets as well. For instance, new definition of standardized guarantees (AF.66) and life annuity entitlements (part of AF.62) as financial assets (insurance technical reserves) may result in reclassification of units providing services with these instruments into the Insurance corporations sub-sector. These institutions have been classified according to the old rules possibly as financial auxiliaries or non-financial corporations.

New definition of SPEs, holding companies and head offices

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 redefinition of holding companies through 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.

The main characteristics of the SPEs described in the Manuals are as follows: They have often no employees and no non-financial assets. *They have little physical presence in the country of registration. They are always related to another corporation, often as a subsidiary. According to description in the SNA 2008, SPEs are often resident in a territory other than of the related corporations.* At the same time, ESA 2010 defines the SPEs as corporations only having links to non-residents (narrower definition of SPEs, "often" is missing).

Using the definition of SPEs in the SNA 2008 and ESA 2010, *SPEs as financial corporations* can be identified. SPEs like holding companies, trusts, securitisation vehicles or group financing corporations, having the criteria for beeing separate institutional units, are to be classified as captive financial institutions. However, SPEs engaged in non-financial activites such as trading, merchanting or royalty companies can be identified in the practice as well. Due to the existence of significant non-financial assets (ownership of patents, other intangible assets) or related flows (merchanting, trading), separation of SPEs among non-financial corporation could be of great importance in addition to the SPEs presented as captive financial institutions as well.

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.)

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 with those of the parent.*

III. Methodological questions concerning application of the new rules

During the preparation for the implementation of the rules laid down in the revised Manuals, the following questions arose in connection with the content of the Financial corporations sector:

1. How to measure whether the corporations concerned are *independent institutional units* or not? Is it an important factor in the classification process of specific financial institutions?
2. What is the relationship among the different special institutional categories introduced by the new Manuals like captive financial institutions, holding companies, SPEs?
3. How to measure the difference between *providing and not providing* any other service in the case of holding companies and head offices?
4. What does it mean that holding companies are owners of *a group of subsidiary corporations*? If a company controls only a single subsidiary corporation, can it be treated as a holding company or not?

Institutional independence

The basic building elements of the institutional sectors in National Accounts are the institutional units. The *autonomy of decision* in respect of the principal functions of the entities is crutial for being institutional units in statistical sense. According to the Manuals, the criteria of institutional independence should be assessed for all economic units, especially for entities with little or no physical presence (SPEs).

The Manuals recognize that units to be included in the new Captive financial institutions sub-sector (S.127) usually cannot act independently of their parent and are to be treated as separate institutional units only if the parent is non-resident. Otherwise, captive institutions with no independence of action (artificial subsidiaries) are allocated to the sector of their controlling body. However, the ESA 2010 (2.14) states that head offices and holding companies are institutional units. This statement could also be interpreted in that way that no "institutional independence test" is required in the case of classification of holding companies, they should automatically be treated as captive financial institutions. The same sentence does not appear in the SNA 2008. Different wording of the Manuals may lead to different practices in sector classification of units which result in different size of institutional sectors.

Identification and treatment of holding companies

Following the rules in the revised Manuals, SPEs can be classified as

- non-financial corporations if they deal with non-financial assets
- other financial intermediaries if they are FVCs engaged in securitisation of assets
- captive financial institutions if they are passive holders of financial assets (mainly loans and/or equity)

Holding companies and SPEs are separately decribed in the Manuals as special cases of corporations. Holding companies that simply own the assets of subsidiaries and SPEs dealing with financial assets are mentioned as two main examples of captive financial institutions (see SNA 2008: 4.59). However, holding companies can be seen as a sub-category of SPEs that are passive holders of financial assets. Characteristics of holding companies which express the passive holding function and distinguish them 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. This means that *holding companies are substantially SPEs and should be treated in the same way as SPEs, regarding their sector classification.*

Summarizing the above train of thought, corporations to be classified into the new financial sub-sector Captive financial institutions and money lenders (S.127) are SPEs or substantially SPEs which are treated as institutional units (controlled by non-residents).

<u>Treatment of holding companies with one subsidiary corporation</u>

According to the definition, holding companies are owners of controlling levels of equity of a *group of subsidiary corporations*. However, there are corporations, also called holding company, which form part of a simple ownership chain by *controlling only one subsidiary corporation*. The existence of these special corporations separately from their subsidiary can usually be explained by administrative reasons. It is not clear whether the control over a group of subsidiary corporations is a crutial part of the definition of the holding companies or not. However, for practical reasons, it is worth excluding holding companies with one subsidiary from the Captive financial institutions sub-sector and consolidating them with their subsidiary corporation (because the parent is non-resident).

III. Current practice of sector classification of units in Hungarian National and Financial Accounts

<u>Sectorisation of units using statistical registers</u>

In Hungarian National and Financial 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, supervisory register, register of budgetary institutions, non-profit register, firm register). The starting point of the sector classification of market producers are the legal form and the main economic activity of the units described by the NACE classification. The NACE codes are given by the reporting units (self-assessment) when the apply for the tax identification number. The corporations have to update their NACE codes whenever they modify their main activity. However, the reporting units can not always precisely determine their code of main activity, so the NSI makes regular corrections in the register.

The Financial corporations sector consists of five sub-sectors in Hungarian National Accounts statistics according to the sector delineation of the SNA 1993 and ESA 1995. However, data collections and register information enable a more detailed sectoral breakdown as well:

- Money market funds (MMFs) and other (non-MMF) mutual funds can be separately identified in most (direct and indirect) data sources.
- Insurance companies (IC) and pension funds (PF) can be broadly separated using direct sources.

The Financial Accounts compilers at the CB recognised that the NACE codes available in the business register are not detailed enough for the proper classification of financial corporations. The precise delineation and the detailed breakdown of the financial corporations sector can only be achieved using a complete list of financial corporations updated on regular (monthly) basis. The compilaton of this detailed list intensively rely, beside other sources, on information received from the Financial Supervisory Authority. The list of financial corporations serves three different purposes. It promotes:

- the sectorisation of financial corporations during the internal compilation process,
- the conduction of data-collections and selection of data-suppliers and
- the sectorisation of counter-parties by the data-suppliers (because the list is available for the public).

Chart 2. Composition of financial and non-financial corporations sectors in Hungary according to the detailed SNA 1993/ESA 1995 sector classification (data refer to 2010)

Corporate sectors and subsectors	**Number of entities**	**Total assets (GDP %)**
Non-financial corporations (S.11)	**ca. 400000**	**400**
o/w foreign controlled SPEs	500	124
o/w holding and group financing companies	2000	15
Financial corporations total (S.12)	**3198**	**214**
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	2000	1
Insurance corporations and pension funds	183	25
o/w insurance corporations	72	10
o/w pension funds	111	15

Special purpose Entities in Financial Accounts and Balance of Payments statistics

Since 2006, because of their great significance, special purpose entities are identified and separately presented among non-financial corporations in National Accounts and Balance of Payments statistics. In the Hungarian statistical practice, SPEs are foreign controlled resident corporations or limited partnerships with passive holding or group financing activities carried out exclusively for non-resident partners. As SPEs do not represent an independent legal category in Hungary, they may be identified and separated in the statistics on the basis of business accounting or statistical indicators, using the criteria established by the statistical authorities.

Chart 3. Criteria established for identification of SPEs in Hungarian National Accounts and Balance of Payments statistics

Non-financial assets are negligible in the balance-sheet
Financial asets are mainly composed of loans and equity
Assets and liabilities are related exclusively to non-residents
Number of employees is very low (0-3 persons)
Turnover does not exceed HUF 500 million annually
Material cost is negligible
Name of the company refers to the off-shore nature of the activity

The NSI and the CB together maintain the institutional list of resident SPEs used parallelly in National Accounts, Financial Accounts and Balance of Payments statistics. Out of the more than 400,000 operating resident non-financial corporations, Hungarian statistical authorities mark about 500 as SPE. SPEs represent nearly one third of the total balance-sheet and half of the financial assets of the Non-financial corporations sector (see Chart 2). All foreign controlled SPEs are classified into the Non-financial corporations sector because they do not fulfil the criteria laid down in the SNA 1993 and ESA 1995 for being financial intermediaries. According to the Hungarian practice, 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.

<u>Size and compostition of the financial sector</u>

According to the data of Financial Accounts compiled in line with the old methodology, the total assets of monetary financial institutions amount to more than 75% of the non-consolidated balance-sheet of the Financial corporations sector (and 136% of the GDP). Other financial intermediaries and financial auxiliaries play only a less significant role in the Hungarian economy (total assets amount to 22 and 1% of the GDP). The relatively small balance-sheet of these two sub-sectors is in connection with the following facts:

- there are no holding companies predominantly managing financial corporations (which should be classified as financial corporations according to the old Manuals),
- holding and group financing companies are treated as non-financial corporations (according to the strict application of the old methodology),
- there are no FVCs or other units engaged in securitisation transactions and
- all SPEs are treated as non-financial corporations.

IV. Application of the new rules on financial corporations in Financial Accounts

Revised time-series in line with the new standards will appear in Hungarian National and Financial Accounts in 2014. 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 big problems because detailed register information and most of the data sources are available.

Chart 4. Effect of the changes in sector classification rules on the compilation of Hungarian Financial Accounts

Description of changes in classification	Understanding of the new rules	Application of the new rules	Effect on the Financial Accounts
Delineation of credit institutions and money market funds (MMF)	Easy	Easy	Not significant (split of sub-sectors)
Delineation of non-MMF investment funds and other financial intermediaries	Easy	Easy	Not significant (split of sub-sectors)
Delineation of insurance corporations (IC) and pension funds (PF)	Easy	Partially difficult	Not significant (split of sub-sectors)
Collection of captive financial institutions into a newly created financial sub-sector	Problematic	Difficult	Significant

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 Hungarian statistics. Two main groups of special corporations have been identified for reclassification into the new financial sub-sector:

- SPEs having financial links exclusively to non-residents (until now classified as SPEs among non-financial corporations)
- SPE-type units having financial links with resident partners as well (until now classified as normal non-financial corporations)

Followig the rules laid down in the SNA 2008 and ESA 2010, foreign controlled SPEs and 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 special units controlled by residents and considered as artificial subsidiaries should remain in the Non-financial corporations sector (because related units are mostly non-financial corporations) and should be consolidated with their parents.

While separation of SPEs in Hungarian statistics has a long tradition, delineation of SPE-type units like holding companies and other group financing corporations just began. The starting point of identification of these holding and lending corporations is the new NACE (rev. 2) code which was given by the corporations themselves during the NACE revision process. As in case of SPEs, statisticians have to examine also the corporations which have not classified themselves as holding or group financing companies but, according to their balance-sheet and other information, they belong to these classes. Criteria for identification of holding companies and other group financing corporations should be established, similarly to the criteria applied for SPEs.

Effects of the transition to the new standards on Financial Accounts

The reclassification of *SPEs having financial links exclusively to non-residents* 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 these SPEs will reduce the balance-sheet of the Non-financial corporations sector by more than 120% of the GDP. The reclassification gives the possibility of separate presentation of these units as captive financial institutions (S.127). (The separate presentation of SPEs is carried out in the current system in that way that the Central Bank produces and disseminates two sets of Financial Accounts and Balance of Payments statistics: with and without SPEs.)

Other foreign controlled SPE-type units (holding and group financing companies with financial links to residents as well) form a small group inside the Non-financial corporations sector to which they belong now. Their balance-sheet represents an insignificant part of the total assets of the Non-financial corporations sector. The possible reclassification of these units would rise the balance-sheet of the Captive financial corporations sub-sector by about 10-15% 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 SPE-type units (holding and group financing companies) has *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 these holding companies (as elements of the chain) would split the investment links between the foreign investors and the ultimate subsidiary (non-financial) corporations. *With this presentation, resulting from the new SNA and ESA rules, the real purpose of foreign direct investments will be invisibe because the foreign investors obtain control over captive financial corporation in BoP and FA statistics, however, in reality they control non-financial corporations engaged in production through a passive ownership chain.*

Some holding companies concerned control only one subsidiary (non-financial) corporation resident in Hungary. According to the interpretation of the new rules on holding companies, these corporations will be excluded from the Captive financial institutions sub-sector and will remain in the Non-financial corporations sector in the future too. With this solution, companies which are members of a simple ownership chain may be consolidated inside the Non-financial corporations sector.

V. 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 National Accounts 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 the Non-financial corporations sector. Some other SPE-type corporations (holding and group financing companies with financial links to residents as well) will also be reclassified into the new financial sub-sector with less significant effect on the sectoral balance-sheets.

The new presentation of these holding and group financing corporations among captive financial institutions needs new data-sources and register information for monitoring and selection of units concerned and for compilation of statistics. New quarterly data collection for Financial Accounts purposes will be introduced from 2013. Back data will be estimated from annual reports of the corporations. Selection of the corporations and updating of the register will be carried out on annual basis using the annual reports of large resident corporations.