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Directorate C: National and European Accounts

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Mr. Ari Tyrkkö
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**Subject: Follow-up of Eurostat dialogue visit
Revision of the property income from mutual funds**

Dear Mr Tyrkkö,

Following up on the discussion with the Finnish statistical authorities during the EDP dialogue visit that took place on 29-30 November 2007 in Helsinki on the issue of the revision of the property income earned by government on its mutual funds investments, I would like to inform you of the views of Eurostat on the above-mentioned case.

The accounting issue

The issue concerns the revision of general government revenues relating to capitalised (reinvested) property income earned on mutual funds investments, particularly employment pension schemes invested in mutual funds abroad.

Documentation provided

The issue was shortly described by the Finnish statistical authorities in a background note provided before the EDP dialogue visit in November 2007, and further discussed during the visit. In addition, Statistics Finland (SF) provided on 28 January 2008 a detailed note (attached) describing the reason for the revision, the scope and effect of the revision, as well as the calculation methods.

Description of the case

According to ESA95 methodology, the rule of retained earnings for mutual funds (ESA 4.49b and 5.54b) prescribes that interests and dividends received by mutual funds are to be recorded as property income of its shareholders, even when they are not distributed but capitalised. The

property income earned by mutual funds is to be recorded as resources of mutual funds, and, simultaneously, is to be recorded as a use of mutual funds and resources of shareholders, as if distributed.

However, existing data sources available at SF did not provide comprehensive information on reinvested property income for foreign mutual funds. Therefore, reinvested property income (interest and dividends) relating to foreign investment funds, as well as capitalised interest from investments in domestic mutual funds, had not been recorded in the Finnish national accounts in the past.

It is worth mentioning that the data sources for the rest of the world do not easily cover information on capitalised property income, notably because the Balance of payment manual 5th edition (BPM5) deviates from ESA95 in this respect.

Since investments in mutual funds significantly increased during the last several years in Finland, property income earned by and on mutual funds has become increasingly important for the Finnish economy. As far as the general government sector is concerned, noticeable investments of employment pension schemes in mutual funds abroad have been in particular observed.

Therefore, the Finnish statistical authorities felt that the approximation hitherto applied in the Finnish national accounts, which neglected some property income flows, should be discontinued. Accordingly, they felt a need to incorporate the missing part of the property income generated by mutual funds in national accounts. To this effect, estimation methods have been elaborated and calculations done for each sector, including the general government sector.

As far as domestic mutual funds are concerned, information on interest and dividend income, distributions, and share holdings by individual sectors is available for each individual fund from Mutual fund statistics. Concerning foreign mutual funds, such information is not available and there was a need to find a proper estimation approach: based on data pertaining to domestic investment funds property income yields.

The revision of national accounts, starting from 1998, which led to incorporating the missing part of the property income from mutual funds, had a positive impact on general government revenues and thus a positive impact on the Maastricht deficit, the general government net lending / net borrowing. A more pronounced impact is observed in recent years, and is expected to be even higher in coming years.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

The Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA95) in Community Legislation. Of particular relevance in this case are §§ 4.49b, 4.54b, 5.141b of ESA95.

Availability of national accounting analysis

SF provided on 28 January 2008 a detailed note describing calculations of capitalised income of domestic mutual funds and calculations reflecting estimations of the property income generated by foreign mutual funds.

Analysis

Applying ESA95

Eurostat welcomes that SF has taken steps to bring the Finnish national accounts more in compliance with the ESA95 rules, in this case with applying the reinvested property income rule foreseen for mutual funds under ESA95 paragraphs 4.49b, 4.54b and 5.141b.

Eurostat understands the source data difficulties associated with this rule, notably with respect to domestic investments in foreign based mutual funds. It is nonetheless thought that given the size and relevance of the income in question (including a GNI impact) resorting to estimating these flows is appropriate in national accounts as a whole, including for general government accounts.

We note that the size of those investments is such that government revenue (and surplus) has been revised upwards by 0.29% of GDP in 2007, progressing rapidly from 0.25% in 2006 and 0.15% in 2005 (0.05% in 2001).

SF proposed method

Finnish calculation methods

According to the SF note, different methods are applied to domestic and foreign mutual funds owing to differences in data sources availability.

a) Domestic mutual funds: Since statistics on mutual funds in Finland provide exhaustive data on interest and dividends received by domestic funds and on distribution of profits, capitalised income is derived by deducting distributions from earned property income. The allocation of the capitalised property income by individual creditor sector is based on the proportion of their investments in mutual funds shares. Calculations have been carried out separately for money market funds and for other investment funds.

b) Foreign mutual funds: The calculation of the property income generated by foreign funds is, by hypothesis, mainly based on observed domestic funds yields. The amounts of interests as well as of dividends earned on foreign funds are estimating using domestic investment funds property income yields. Particular attention is given to the estimation of the property income of employment pension schemes (i.e. government revenue). In this specific case, calculation is done more in detail, distinguishing fund categories: money market funds, long-term interest funds, equity funds, mixed funds and leveraged/hedge funds. As in the case of domestic funds, capitalised income on foreign funds is derived by deducting distributions from earned property income.

As for the future, the Finish statistical authorities plan to use direct data on property income generated by foreign funds derived from the European Central Banks' database on securities (CSDB). This database covers information on property income from mutual funds shares located in the euroarea.

Treatment in national accounts: results

The results of these calculations have led to revisions across the national accounts for accounting for mutual funds shareholders income, i.e. interest revenues (D.41) on domestic and foreign funds,

and dividends (D.42) on foreign funds. Simultaneously, mutual fund shares (F.52) have been also revised in the financial accounts, as a counterpart entry.

Eurostat agrees with the calculation approach and with the undertaken accounting treatment concerning the property income from mutual funds recording, as described by the Finnish statistical authorities. Taking into account restricted availability of important data sources, Eurostat finds the estimation method acceptable, but encourages the Finnish statistical authorities to use direct data sources as soon as they are available.

Hedge funds

Eurostat noted that, according to SF note, the investments concerned by the revision in method include investments in hedge funds. It would be a question whether such hedge funds can be understood to be mutual fund in the ESA95 meaning and to benefit from the reinvested property income rule of ESA95.

Eurostat draws SF attention to the fact that the ESA95 rule on reinvested property income for mutual funds concerns entities regulated by ESA 95 paragraphs 2.36 and 5.97. ESA 5.97 in particular states: "*Sub-category AF.52 includes the shares issued by financial corporations called, according to country, mutual funds, unit trusts, investment trusts and other collective investment schemes, e.g. UCITS, whether they are open-ended, semi-open or closed-end funds. These shares may be quoted or unquoted. When they are unquoted, they are usually repayable on request, at a value corresponding to their share in the own funds of the financial corporation. These own funds are revalued regularly on the basis of the market prices of their various components.*"

Conclusion

Based on the above analyses and considerations, Eurostat agrees with the approach taken by the Finnish statistical authorities for estimating property income (interest and dividends) earned by mutual funds shareholders. Eurostat notes the non-negligible and growing impact on the government balance, as well as on the GNI estimate, and encourages resorting to more solid source data once available.

Procedure

This view of Eurostat is based on the information provided by the country authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with the amended Council Regulation 3605/93 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC.

Eurostat intends, therefore, to publish all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In addition, Eurostat finds it useful publishing the valuable background document on the revision of the calculation of property income of mutual funds prepared by the Finnish statistical authorities and sent to Eurostat on 28 January 2008, and asks you to kindly confirm permission to do so. In case you have comments to the text above or objections to publication concerning this specific case, we would appreciate if you let us know. In

any case (regardless of whether you have objections or not) we would like to receive an answer from you on these issues no later than 27 June 2008.

Yours sincerely,



Lurs Nørlund
Director