Statistics Netherlands

Division of Macro-economic Statistics and Dissemination

NEW DECISION TREE FOR CLASSIFYING SPEs

Maria Piszczek*

(Statistics Netherlands)

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This paper reflects the work and ideas of Working Group SPEs, cooperation between Statistics Netherlands and Dutch Central Bank

Introduction

The System of National Accounts (SNA) is together with the European System of Accounts (ESA) the main guideline in compiling the National Accounts (NA). The new version of this guideline: SNA 2008 introduced some changes in the variables and definitions of National Accounts . One of the changes concerns different sector assignation of the holding companies and headquarters. From now on the holding companies should be always assigned to the financial sector S.127 Captive Financial Institutions (CFI), regardless of the activities of the corporations they are controlling. Previously the holding companies were assigned to the sector of the preponderant activity of the group of corporations the holding was controlling. This new way of assignation has also implications for the Special Purpose Entities (SPEs), as most, if not all, of the holding companies are SPEs.

The treatment of SPEs is an on-going issue in the Netherlands. Already in the early 2000 Statistics Netherlands (CBS) in cooperation with Dutch Central Bank (DNB) has described SPE population and created a decision tree to detect and classify the SPEs. Thanks to this tree Statistics Netherlands was able to separate SPE data in a subsector (s.123B/S,127) of the sector financial institutions (S.12) and neutralise the effects of SPE data on the Gross Domestic Product (GDP). With the new guidelines the adjusting of the decision tree was indispensable (essential) . The new decision tree provides delineation of the SPE population as well as delineation of the Other Financial Institutions (OFI) subsectors.

The aim of this paper is to describe the way Statistics Netherlands treats all legal entities in order to come to SPE population. In the next paragraphs the following issues will be addressed: the base for the legal entity population, the assumptions that CBS and DNB made in order to implement CFI concept of SNA 2008 and the decision tree for SPE and CFI entities.

Methodology

Statistical Population

The population for most of the statistics is based on General Business Register (GBR), a database where the information from Dutch Chamber of Commerce (KvK) and Dutch Tax authorities are being matched and processed to statistical entities.

The fundaments of Dutch GBR are entries from Dutch Chamber of Commerce that are matched with the corresponding entries from Tax authorities. Each legal entity has marks like: legal form, size (number of employees), activity code (NACE-code). The marks are automatically assigned by the system (ABR): legal form information comes from KvK and activity code and size of an entity from Tax authorities. Legal entities are clustered into enterprises. The structures and the marks of an enterprise are initially based on the KvK and tax Authority information but in the case of big (and/or multinational) enterprises are often corrected during profiling activities (by CBS profilers). The marks of legal entity might as well be adjusted or corrected by CBS profilers as the external information not always meets CBS requirements.

As it can be understood from the above: the initial International standard Industrial Classification for All Economic Activities, Rev 4 (ISIC)class for all entities, thus also for the holding companies and head

office companies, is assigned automatically. If there is a reasonable doubt about the class, the entity might be investigated and the assignation might be reviewed.

General Business Register is the framework for the statistics and thus also for SPE detection and determination. The entities that are being submitted to SPE-CFI detection are coming from GBR. Thanks to cooperation with GBR department all SPEs are timely tracked and marked in GBR so that there are (almost) no entities with SPE characteristics that will be assigned to Non-Financial Corporation sector (NFC, S.11)

Assumption based on SNA 2008

Neither SNA 1993 nor SNA2008 is defining SPEs or, in the case of the last one, CFIs. For both categories a summary of the features is available. The entities of the subsector CFI are characterised as follow:

1. The assets and / or the liabilities of the entity are largely focused within the group;
2. The entity is (mostly) a "passive" holding company or finance company with no managerial activity (entity may have some control over its assets and liabilities);
3. The entity is often linked to a foreign group of companies.

Sub.1 This criterion is the main distinction from the sector S.125 (OFI). That this is not always clear shows the fact that SPV's and non-MFI daughters are classified as OFI, while the assets (in the case of SPVs) or liabilities (in the case of non-MFI daughters) are strongly linked to the affiliated banks (or other settings in the case of SPV).

Sub.2 If the entity concerned has management activity, it is classified as a head office and allocated in the sector non-financial corporations (S.11, NFC,) unless the subsidiaries are mostly financial institutions. In that case, the entity belongs to the sector financial auxiliaries (S.126, AUX).

Sub.3 The distinction between "Artificials" and CFI's plays an important role in the CFI –part of the decision tree. Artificials stands for "Artificial Subsidiaries of Corporations", a concept that SNA2008/ESA2010 applies to legal entities which are no independent institutional units. This means they have no independent decision-making powers or no full accounting (= balance sheet assets and liabilities). They are founded within a group with a specific economic, legal or tax purpose and are completely dependent on their mother or daughter[1]. For statistical use they are not separately distinguished as a unit but are counted with their mother or daughter, provided that the entity is located in the same economy as its mother or daughter. The entity that is classified as 'artificial' does not exist as an independent (statistical) entity. To reduce the administrative burden on reporters DNB and CBS have decided that the number of the independent reporting units where the term 'artificial' applies is minimal, with the precondition that the economic reality is not violated.

[1] SNA 2008 describes only the dependency from the mother. Consultation with ECB proved that the dependency from the daughter may also be an acceptable criterion.

Detection of SPEs and CFIs

Three factors are playing a key role in the detection of SPEs:

- The information from Dutch central Bank (DNB): the bank is actively searching for the new SPEs in all available sources;
- The information from CBS statistics: an abnormal production data of an entity combined with little or no employees and specific ISIC class may indicate SPE activities;
- The ISIC class (NACE code) form ABR (in case of CFIs): if the entity has ISIC class 6420 it might be a potential SPE/CFI.

All potential SPE entities are being verified by the decision tree.

Decision tree

The first decision tree was formulated by the working group SPE (WG SPE). This working group consists of specialists from CBS: National Accounts department and General Business Register Department and from DNB OFI department. The same group was working on the new decision tree.

Thanks to the fact that all interested parties are represented in the group, the group is able to make the decision and also to implement them (in the registers of DNB en CBS).

Description

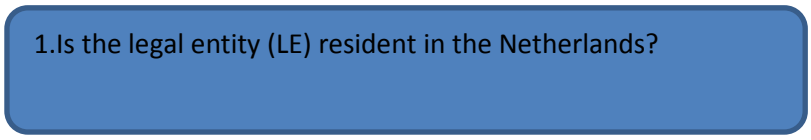
The decision tree consists of two parts: one to classify a legal entity as a SPE or non-SPE, second to determine whether an entity is SPE or belongs to other sector/subsector. Both parts of the tree are in some way complementary as the most of the CFIs are also SPEs.

The pictures 1 and 2 are showing the decision tree and appendix 1 and 2 the matching description. As it is to see on the pictures the first step in both cases is to specify whether the entity is an institutional unit and therefore needs to be taken in our statistics.

The main goal of the SPE decision tree is to clarify if an entity has SPE characteristics or not. The decision that is made is based on the objective criteria from the balance and Profit & Loss (P&L) account. To determine the nature of an entity it is necessary to know the ratio of foreign assets and /or liabilities. If the ratio is high, the entity might be a potential SPE.
Another criterion used to estimation are P&L-variables turnover and costs. The more turnover and costs concern activities with foreign group companies, the bigger the chance that an entity might have SPE character.

The CFI decision tree helps to determine if an entity has CFI features. The main criterion here is being a holding company that means principally controlling and owning the group companies and having no head office activities: no management control over the subsidiaries and no production on its own. As it's said before the classification of an entity as a holding company is define in General Business Register. It is not always correct, as the criterion management activities is not easy to implement in a database, but gives a rough estimation of the activities of an entity. Each holing company is being checked for the management activities and relations with its parent of its subsidiaries. A holding

Picture 1: SPE decision tree.



NO -> not in statistics

YES

2.Does one or more (in case of joint venture) foreign entity own, directly or indirectly, more than 50% ordinary shares or has voting power over the legal entity?

NO -> go to 8

YES

3.Does at least 90% of the turnover concern the export of services of royalties and licenses?

OR

4. Does at least 90% of the turnover and of the costs concern reinvoicing with foreign intra-group subsidiaries?

OR

5.Does at least 90% of the turnover and of the liabilities concerns foreign countries?

OR

6. Do the financial assets and financial liabilities of the LE (excl. trade credit/advances) consist of at least 90% (75%) of foreign assets/liabilities?

NO -> not SPE

YES

7.Is the domestic annual turnover of the LE higher than 25 million euro?

NO -> SPE

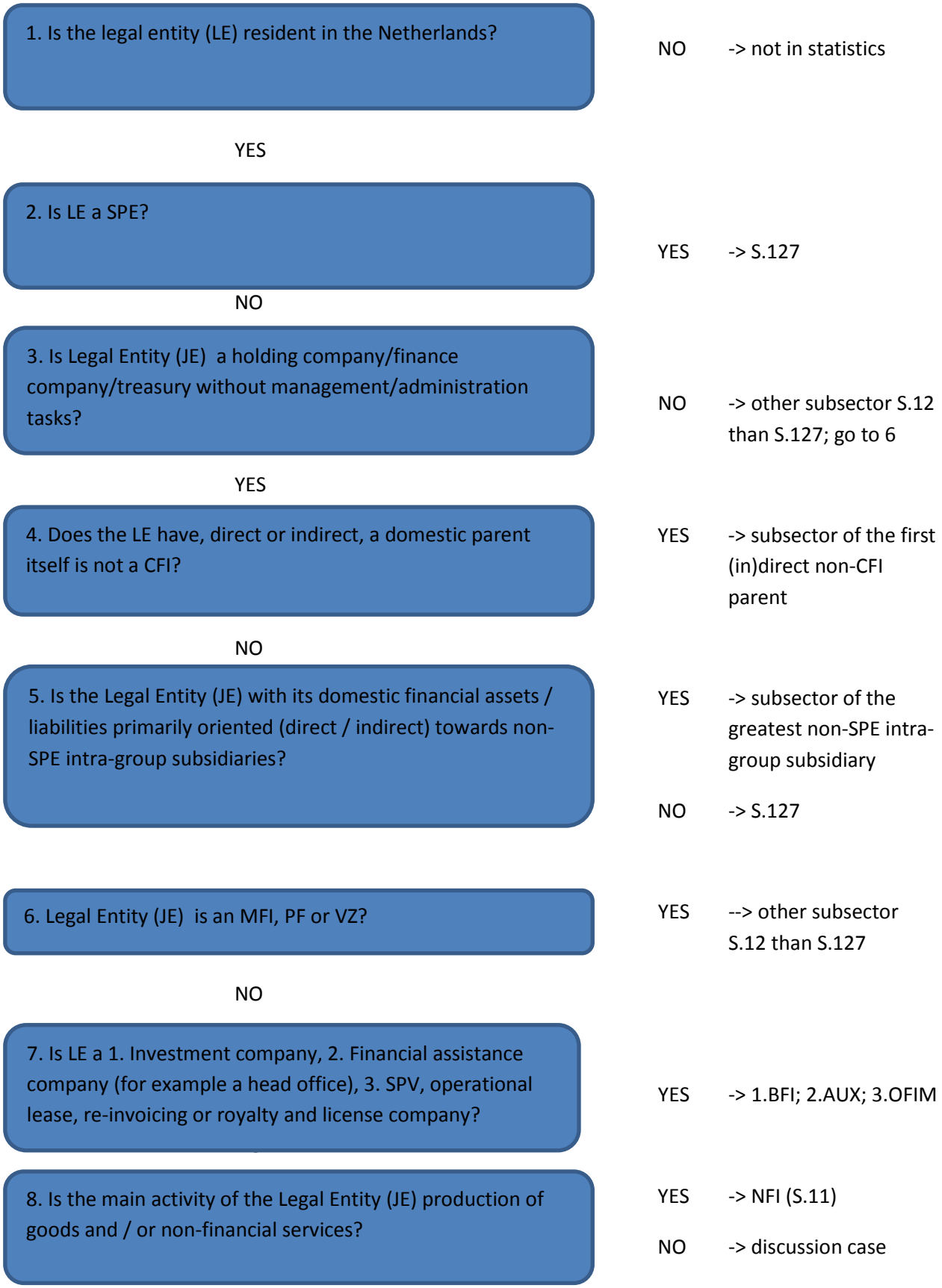
YES -> discussion case

8.Is the LE a SPV with foreign originator and does the LE satisfy the assets/liabilities criterion?

YES -> SPE

NO -> Not SPE

Picture 2. CFI decision tree



company that is not executing any management activities, has a direct foreign parent company will be classified as CFI. If the same holding company has no direct or indirect foreign parent company and is thus self a parent of a group of enterprises, will be classified as an artificial company. The entity cannot independently exist without its subsidiaries.

Results

The decision tree was realised in 2011 and implemented in the same year. The tree is implemented in the General Business Register and all new entities are being submitted to it. If an entity is not clearly a SPE, the working group is analysing it and making the decision.

The new decision tree results for CBS and DNB in:

- well defined population of SPEs
- no overlap between the populations of S.11 and S.123/S.127 sectors
- no double-counting in the S.11 and S.12 data
- harmonisation between DNB Balance of payments Data and CBS sector accounts and rest of the world accounts

CFI population

Statistics Netherlands and DNB agreed that all SPE's are also CFI, as the CFI characteristics is broader than the SPE. This decision is obvious in the case of SPE holding companies and finance companies, but this also applies to all other SPE's, namely royalty and license companies, re-invoicing companies, operational lease companies and SPVs (with foreign originator).
In the case of holding companies and finance companies implementation of the new CFI concept means that all entities meeting the criterion management activities shall be counted by or consolidated with the non financial corporation (NFC) entity as they are also headquarters.

The entities that are not a head office and are classified as an 'artificial' will also be counted by or consolidated with domestic NFC (mother or daughter).

In the specific case of holdings of domestic financial institutions the entities are classified as AUX (auxiliary financial company) if they are headquarter. (This is true whether the daughters are located (only) domestic and/or abroad.
They are classified as 'artificial' when they are not a head office and are driven by a domestic subsidiary or parent company and their data can be counted by or consolidated with this domestic entity.
If a holding of domestic financial institution has no head office function, has a foreign parent company (but not yet classified as SPE) and is not controlled by a domestic subsidiary, it will be classified as an independent reporting CFI.

The holding companies of NFCs (with no head office function) that are having foreign parent company and only foreign subsidiaries will be assigned to CFI sector, even if they do not meet SPE criteria.

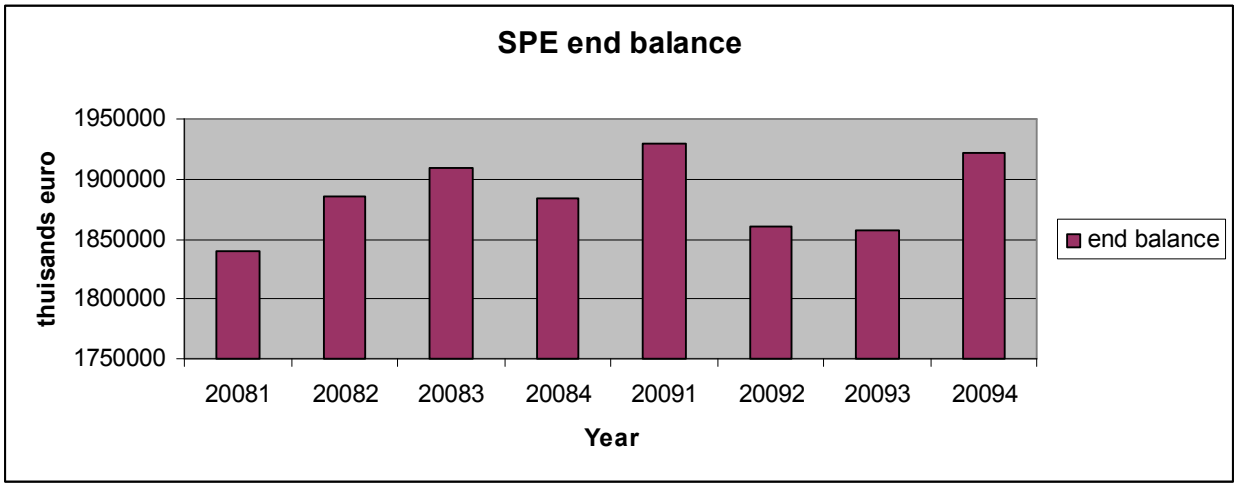
The current (2012) population of the financial and non financial corporations sectors is thus adjusted for SPEs and CFIs. All SPEs are present in current S.123 sector (S.127) and excluded from S.11 sector. There is thus no overlap or double counting in sector accounts between S.11 and S.123/127 sectors.

Quantifying CFIs

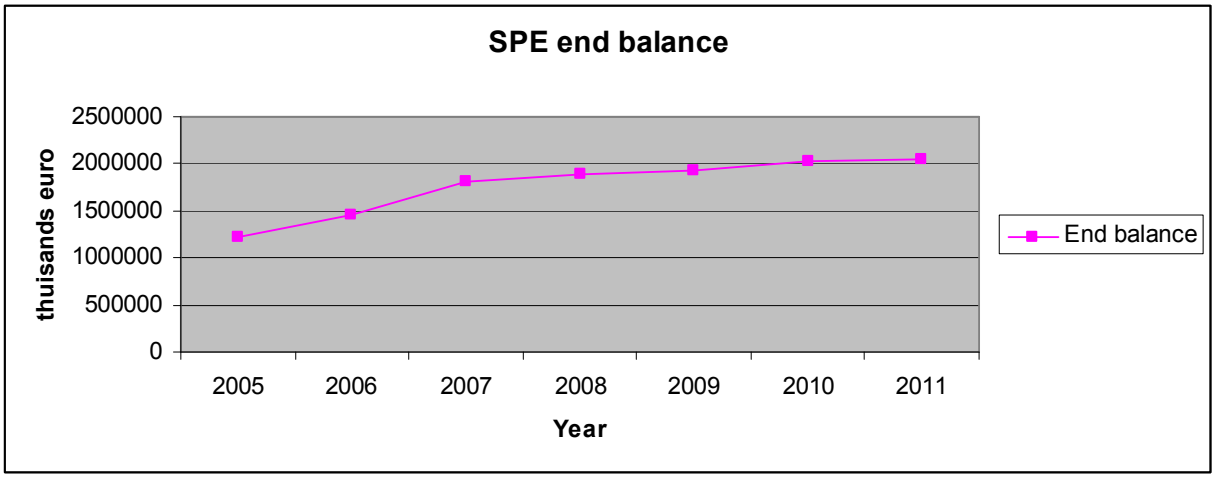
The population of SPEs is very volatile and the number of SPEs, especially the SPEs that are classified as holding companies, is constantly changing. At the moment the population of CFIs in the Netherlands consists of more than 15 thousand entities. The volatility of the SPE population makes it increasingly difficult to specify precisely the effect of the new decision tree on SPE population. Based on the ESA 1993 SPE population and changes that are made in the population as a result of the implementation of the new decision tree, the conclusion can be drawn that the new decision tree did not significantly change the number of the SPEs. Most of the entities that should be classified as an SPE according to the guidelines in ESA 2010, were detected with the old decision tree and there are only 5 SPEs (type CFI) added to the population as a result of the new SNA 2008 rules.

Quarterly, the balance data of SPEs (see graph.1) is as volatile as the number of SPEs. In the annual data, a growth in the balance data can be observed (see graph.2). Due to the limited changes to the population as a result of the implementation of the ESA 2010 decision tree, there is no adequate variable that can be used to quantify the impact of SNA 2008 on SPE population.

Graph.1 SPE balance data Q1 2008- Q4 2009



Graph. 2 SPE balance data 2005-2011



SPE in National Accounts

The collection of SPE data is done by DNB, CBS receives this information about the SPEs from DNB. As mentioned above, SPEs are classified in a separate S.12 subsector and are therefore excluded from S.11 data in the Netherlands.

Due to the current lack of data on the domestic transactions of the SPEs and the theoretic reasoning that SPEs have little or no impact on the domestic economy, the current methodology with respect to the Supply and Use tables neutralizes the impact of SPEs. This implies that the value added of SPEs is restricted to a certain margin around zero. The reason for this approach is the fact that the knowledge about the current account data at the time of the introduction of SPEs in the Dutch National Accounts was insufficient. The SPE data is collected by DNB and no details of the domestic transactions are reported by SPEs, because DNB only gathers Balance of Payment (BoP) data. This lack of information made it impossible to check whether the effect of SPEs that was measured is correct. For example, in the current data the value added of SPEs is often negative and this probably results from the SPEs not passing on all their costs to their foreign parent or subsidiaries. Because there is not enough information to revise this assumption, CBS decided to minimise the effect of SPEs on GDP by correcting SPE data.

Recently, a new questionnaire has been set up by DNB and CBS. The questionnaire has been specifically set up to gather data on the domestic transactions of SPEs, such as production and intermediate consumption. With the major revision of the reporting year of 2010, the direct information will replace the estimates that have been used for these national transactions, which are constructed with the use of BoP data. The results of the new survey are not utilized to improve currently published figures on SPEs, because of the substantial disturbance. Both Statistics Netherlands and The Dutch Central Bank are currently engaged in several development tasks to ensure continuous quality improvements in the results of the new methodology.

In the current approach DNB collects the data and passes this on to CBS. Due to the fact that the population of SPEs is defined and harmonised between these two institutions, the differences between the Balance of Payment Account and Sector Accounts/Rest of the World Account can be minimised.

Summary

The implementation of the SNA 2008 concerning new subsector S.127 is successfully completed. The decision tree is a result of ongoing cooperation between CBS National Accounts department, CBS GBR department and DNB OFI department. The entities that are belonging to this sector are specified with assistance of the new decision tree and are being added to SPE population in both institutions. This way the differences in population between CBS and DNB are being omitted.

The SPE data is collected by DNB and passed on to CBS. This one-locket approach minimised differences between Balance of Payment and Sector Accounts/Rest of the World accounts.

In the future Statistic Netherlands and Dutch central Bank are hoping to continue and expand this cooperation on other fields.

Literature and appendices:

1. Beslisboom voor Bijzondere Financiele Instellingen en Captive Financial Institutions", Working Group BFI, 19 April 2012.

Appendix 1: Description of the SPE decision tree

1. Is the legal entity (LE) resident in the Netherlands?
The answer is 'yes' if the entity meets both conditions:

- Registration at the Dutch Chamber of Commerce
- Dutch tax regime applies (with or without ruling)

2. Does one or more (in case of joint venture) foreign entity own, directly or indirectly, more then 50% ordinary shares or has voting power over the legal entity?

There can only be a SPE as a foreign Ultimate Parent/Owner is a foreign joint venture.

If the answers on questions 1 and 2 are "yes", go to the following questions 3 t / m 6 to determine whether the entity is a potential SPE and what kind of SPE it might be.

If only the first question (1) is answered with “yes” the entity still can be a SPE-SPV. Please go to question 8.

3. Does at least 90% of the turnover concern the export of services of royalty and licenses (LE is a royalty and license company)?
If 90% or more of the turnover is realised abroad and passed on to foreign group companies the entity is SPE of the type royalties and license. There are two kind’s of this type of SPEs: SPE that is annuity- or license holder (rights are capitalized as intangible assets) and SPE that pass on revenue of tribal rights elsewhere in the group held.

4. Does at least 90% of the turnover and of the costs concern re-invoicing with foreign intra-group companies (LE is a re-invoicing company)?
If 90% or more of the turnover and 90% or more of the costs are realised cq made abroad and again passed on to foreign group companies, the entity will be classified as SPE.

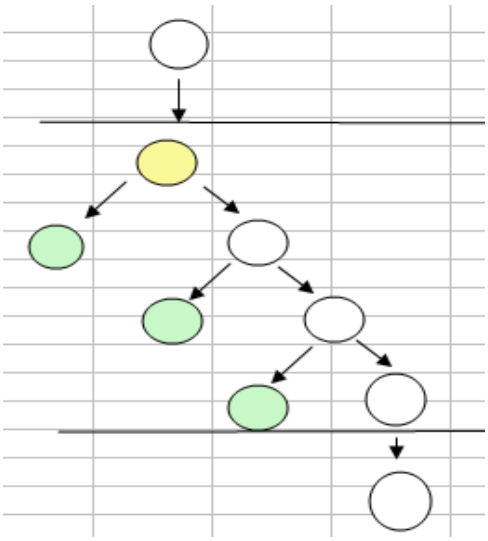
5. Does at least 90% of the turnover and of the liabilities concern foreign countries (the JE is an operational leasing company)?
The assets of some leasing companies are sometimes not registered abroad and are non-financial. Therefore, the turnover criterion is effective. In the case of more than 90% foreign realised turnover and foreign liabilities, the entity is a SPE.

6. Do the total assets and liabilities of the LE consist of at least 90% (75%) financial assets and liabilities of foreign assets and liabilities?

Trade receivables/liabilities do not count in the numerator and goodwill is not included in the numerator and denominator.
Entities that meet this criterion are the holding companies and finance companies, by far the largest group of SPEs. If the 90% criterion for the assets and liabilities is reached, the entity is a SPE. Where assets and/or liabilities are between 75% and 90% foreign and finance an individual trade-off is made, based on the following criteria:
1. Materiality: the entity ‘s assets exceed 500 million euro.
2. The nature of the assets and liabilities is examined to ensure that the 90% criterion is not reached. For example, a short-term domestic deposit does not need to cause the SPE status to be withdrawn.
3. The effect on the figures, as the extent of the imbalance and the arising of possible double counting.
4. In which direction rates will develop.
5. The picture that emerges as we look “through” Dutch-entities in the Netherlands.
In the case of possible clusters of SPE's operating in the Netherlands within a group, we apply the bottom-up method: in the first instance the subsidiaries under the group are tested only on foreign financial assets. If there is a potential SPE status detected, the daughter-company is counted provisionally in the direct-mother company as a foreign direct investment. When the mother SPE-status is found then the daughter is also a SPE and this may be a case of a stepped SPE-construction. If the mother nevertheless appears to be an NFC, the daughter will be examined again and this time the liabilities criterion will be included. If it appears that less than 75% or 90% of the liabilities may be identified as foreign liabilities, the daughter is not detected as an SPE.
The situation mentioned above, can be made clear on the basis of an example. In a group of

enterprises shown in figure 1 the bottom-up approach is used. The yellow marked unit will be characterised as a SPE if the interest in the NFC in the deeper layers of the structure in each case is less than 10%. In the group as a whole the proportion of NFC units is much higher then non-NFC-units, namely the sum of the three NFC's. When the combined share of the three green units NFC's is concerned more than 10% of the consolidated balance sheet total, than the yellow unit is marked as NFC-unit.

Figure 1 Schematic representation of stepped construction SPE



Legend: green spheres are NFCs (non financial corporations)

7. Is the domestic annual turnover of legal entity higher than € 25 million? (Possible exclusion criterion)
This is the turnover from the production or services realized by the Dutch entity, thus excluding transit. This criterion is used to determine whether there is a production/service-activity within the entity, to such an extent that classification as SPE is undesirable even if the above criteria are met, because production figures will be missed. Such cases are in agreement between CBS and DNB further weighed, among others the number of employees is taken into consideration.

8. Is Legal Entity (LE) an SPV with foreign originator AND does the LE satisfy the assets-liabilities criterion?
SPV-SPEs form a separate category because they are the only type SPE having no foreign Ultimate Beneficent Owner (UBO). They are in compliance with the 90% asset-liability- criterion.

Appendix 2: Description of the CFI decision tree

1. Is the legal entity (LE) resident in the Netherlands?
The answer is yes if both the following criteria met:

- Registration at the Dutch Chamber of Commerce
- Dutch tax regime applies (with or without ruling)

2. Is Legal Entity (LE) SPE?
If so, then it is also a CFI.
Steps 3 t / m 5 are intended to be taken when the unit may be regarded as an artificial and can be consolidated with parent company or subsidiaries.

3. Is Legal Entity (LE) a holding company/finance company/treasury without management/administration tasks?

If the answer is "No" then the entity is not a CFI, belongs to a different (sub) sector and will be prosecuted to question 6. If the answer is yes, we continue with question 4, which further limited the term CFI.

4. Does the Legal Entity (LE) have, directly or indirectly, a domestic parent which itself is <u>not</u> a CFI?
If the answer is yes, we can speak of a so-called artificial, i.e. a non-institutional unit not required to report independently. LE will belong to the subsector of the first (in) direct non-CFI parent.

If the answer is no it can still be a CFI and we continue to question 5.

5. Is the Legal Entity (LE) with its domestic financial assets / liabilities primarily oriented (direct / indirect) towards non-SPE intra-group subsidiaries?
If the answer is yes, we consider the unit as artificial. If the answer is no, there is a CFI.

6. Legal Entity (LE) is an MFI, PF or VZ?
If the answer is yes the LE belongs to other sector than OFI.

If none of these (sub) sectors applies we continue with question 7.

7. Is LE a 1. Investment company, 2. Financial assistance company (for example a head office), 3. SPV, operational lease, re-invoicing or royalty and license company?
If the answer is yes, LE is a different type of OFI such as a Non-MMF investment funds (BLI), other financial institution (OFIM; including SPV or non-SPE operating lease, re-invoicing and royalties / license companies), or financial assistance company (AUX, including head offices with management).

If the answer is no question 8 should be answered.

8. Is the main activity of the Legal Entity (LE) production of goods and / or non-financial services?
If the answer is yes, then LE is an NFC If not, then it is a case that should be discussed.
For the discussion criteria see point 6 in appendix 1.