

Special Purpose Entities in the Public Sector

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SPECIAL PURPOSE ENTITIES IN THE PUBLIC SECTOR¹

I. INTRODUCTION

The statistical treatment of Special Purpose Entities (SPEs) in general, and specifically those to which the units of government are a participant, need clarification in statistical guidelines and possibly in the System of National Accounts (SNA). The purpose of this paper is to present alternatives for the treatment of these entities in the government sector for consideration by the Task Force on Harmonization of Public Sector Accounting (TFHPSA). The focus of this paper is specifically on SPEs in which general government units are participants. The information in this paper primarily follows on the earlier background paper on *Special purpose entities and the Public Sector* presented at the TFHPSA in March 2005, as well as work done by the Balance of Payments Committee of the IMF (BOPCOM),² European Central Bank (ECB),³ and Eurostat,⁴ respectively.

This paper is structured as follows: Section II, issues in determining whether SPEs are institutional units are discussed. Section III deals with SPE residence issues. For the SPEs that are deemed resident institutional units, Appendix I describes issues regarding these units' sectorization.

II. SPECIAL PURPOSE ENTITIES AS INSTITUTIONAL UNITS

In dealing with SPE's in macroeconomic statistics, the main decision pertains to determining whether the SPE is an institutional unit.

Background information

The *System of National Accounts 1993 (SNA93)* identifies two main kinds of institutional units, namely households and legal entities (*SNA93*, par 1.13). *SNA93* considers institutional units as essentially those units that are capable of owning goods and assets, incurring liabilities, and engaging in economic activities and transactions with other units **in their own right**. In addition, a complete set of accounts can be compiled for them, including a balance sheet.

The *European System of Accounts 1995* defines institutional units similarly by indicating that it is "an elementary **economic decision-making centre** characterized by uniformity of behavior and **decision-making autonomy** in the exercise of its principal functions and either keeps a complete set of accounts or it would be possible and meaningful, from both an

¹ Literature use the term Special Purpose Entity (SPE) interchangeably with the term Special Purpose Vehicle (SPV). This paper will use the terminology SPEs to refer to those entities.

² BOPCOM Issues papers 7, 9, 9A, 9B and 10.

³ ECB paper on *Statistical treatment of special purpose vehicles and related issues*.

⁴ Several Eurostat publications.

economic and legal viewpoint, to compile a complete set of accounts if they were required.” Indicators of autonomy of decision in respect of its principal functions are, owning assets in its own right, taking economic decisions for which it is held directly responsible and accountable by law, and incurring liabilities on its own behalf.

Treatment of SPEs as an institutional unit

SPEs are **intentionally** created as separate legal entities, with various degrees of operational autonomy, and various arrangements establishing their relationships to the originators, partners and investors. Although SPEs are legal constructs, the macroeconomic statistical community agrees that **economic substance, rather than legal form**, should determine whether entities are institutional units or not. However, due to complex financial and management arrangements, determining the level of decision-making autonomy of SPEs could be very difficult. An SPE’s autonomy over its principal economic functions is derived from its special purpose delegated by the originator. The level of autonomy allowed by the originator can vary considerably depending on the SPE arrangement—ranging from so-called “brain dead” units to units with a fair amount of autonomy.

The options on the institutional treatment of SPEs originating from government units are as follows:

Option 1.1 – In line with the SNA guidelines, investigate each SPE separately, for its level of autonomy to determine whether it constitutes an institutional unit. Indicators can be used to determine the autonomy of the SPE.

Option 1.2 – Consider SPEs created by government units as ancillary units because the nature of their activities could be regarded as ancillary, as defined⁵ in guidelines currently available.

Option 1.3 – Consider all SPEs as separate institutional units.

⁵ Ancillary activities as defined by the *SNA93* comprise productive activity undertaken with the sole purpose of producing one or more common types of service for intermediate consumption within the same enterprise (*SNA93*, par 4.41). These ancillary corporations are not treated as separate institutional units in the SNA system (*SNA93*, par 4.43), but are treated as an integral part of the parent institutional unit.

Following this line of thinking, the *Government Finance Statistics Manual 2001 (GFSM 2001)* indicates two units that are to be seen as ancillary units and classified to the general government unit that controls it:

- Internal service organizations selling their output mainly to other government units, and
- A unit that appears to be a financial corporation, that borrows on the market at commercial terms, but lends only to general government units.

It follows that SPEs complying with the above two criteria would not be seen as separate institutional units under the current treatment. It should however be noted that the treatment of ancillary units in statistical systems is under discussion by an Electronic Discussion Group of the Inter Secretariat Working Group on National Accounts.

Option 1.4 – (A mix of option 1 and 3) Consider all SPE incorporated in an economic territory other than that of its owners as separate institutional units (option 3), and investigate if SPEs incorporated in the same economic territory as its owners are institutional units (option1).

The net impact on general government will vary according to the option selected. Both the non-institutional unit SPE and ancillary unit will be treated as part of government. On the other hand, an SPE that is a separate institutional unit may be treated as government if it is involved in non-market activities or as a public corporation if involved in market activities.

III. RESIDENCE OF SPECIAL PURPOSE ENTITIES

This section considers the residence of SPEs by firstly referring to the background to the debate on the issue, before reviewing the treatment of government sector SPEs created abroad.

Background information

Based on BOPCOM recommendations, the Advisory Expert Group (AEG) recommended in December 2004 that, “an SPE incorporated in an economic territory other than any of its owners should be treated as a separate institutional unit and resident in its country of incorporation.” At the same time, the AEG indicated that the BOPCOM and TFHPSA should consult to ensure consistency across statistical manuals.

The TFHPSA provided to the July 2005 AEG meeting a document for information on this subject. It indicated that the March 2005 meeting of the TFHPSA proposed that SPEs created abroad by the government, for purposes such as defeasance or securitization of assets, should be treated as part of the general government sector. It was further noted that a Eurostat taskforce on SNA review (government finance and financial accounts) took a similar stance in April 2005. The Eurostat taskforce “*supported the view that SPEs created abroad by the general government to manage its financial interest should be classified inside the general government sector (and not the rest of the world)*”

The rationale for this TFHPSA stance is that government establishes SPEs abroad for financial and/or strategic considerations. These SPEs are usually not institutional units because they often do not put themselves at risk, as they do not have economic autonomy. In this case, the general government’s fiscal risk exposure could become especially “hidden” in SPEs created abroad, with possible severe consequences on fiscal sustainability. However, if the SPEs are a financial intermediary and do not simply act as an agent for another institutional unit(s), it places itself, and not the government, at risk by incurring liabilities on its own account (SNA93, par. 4.78).

The BOPCOM meeting in June/July 2005 supported work to consider the issue in a wider context of balance of payments, government finance, and national accounts.

Treatment of government sector SPEs abroad as nonresident

The following presents options for the treatment of nonresident government SPEs and/or their transactions in the macroeconomic statistical systems:

Option 2.1 – Take the position that government SPEs established abroad are ancillary units of the general government sector and should be treated as an integral part of the general government sector.

Option 2.2 – Expand the concept of economic territory to include SPEs that originated from general government units primarily with the purpose to borrow abroad. However, BOPCOM has indicated that such a treatment would not be acceptable—they consider that only embassies operate under the jurisdiction of the home country.

Option 2.3 – Consider SPEs incorporated in an economic territory other than any of its owners (in this case the government unit) as a separate institutional unit and resident of the country of incorporation. However, the flows and stocks recorded should reflect the economic substance of the relationship between the government unit and the SPE. The following are the alternative treatments under this option:

- Options 3A - Consider the SPEs created abroad as public corporations and treat them as direct investment of government. All the flows between the originator government and the SPEs will be recorded in the general government data, and the net asset value of the SPE presented as a financial asset in the balance sheet of the originator government unit. In addition, the statistical system can require that all the borrowing of these nonresident SPEs that carry explicit or implied risks to government be disclosed in the same way as government guarantees. However, **this option should only be followed if** (a) the asset to be used in the securitization transaction complies with the recognition criteria for an asset which require that the asset exist prior to the securitization transaction (b) a “true sale”,⁶ occurred during the securitization, and (c) the majority of the risks associated with the SPE are transferred to the creditors of the SPE with little or no recourse to the resources of the originator. If these conditions are not met, the SPE should be treated as an ancillary unit of government.
- Option 3B - Consider the SPE created abroad by government as a unit of general government and consolidate it with general government. The impact of such a decision would be that the notion of general government comprising only resident units would have to change. Such a treatment will result in total general government comprising resident and nonresident units, and will necessitate the introduction of the concept of resident/domestic general government in the national accounts in order not to create confusion with the general government concept used in the *GFSM 2001*.

⁶ A “true sale”⁶ is evidenced by the relationship between the selling price and market value of securitized assets/liabilities, and the recourse the originator has to reverse the transaction on demand.

(Total general government will equal domestic general government accounts plus nonresident general government accounts)

- Option 3C - Use the principle of reassignment in the accounts to reflect the transactions of a government controlled, nonresident SPE as government transactions. Reassignment is often used in the macroeconomic statistical systems when one unit acts as an agent for another unit. In this case, the SPE can be regarded as being an agent for the originator general government unit, and its transactions are thus reassigned to reflect them as if they are entered into by government directly.

Option 1, 3B, and 3C will result in the same net position for general governments units, although the way in which that net financial position was derived will be different.

Sectorization of Special Purpose Entities

Resident SPEs that are identified as institutional units should be assigned to the appropriate sector of the economy. Owing to the almost limitless combinations of legal arrangements, organizational structures, assets, liabilities, and participants involved in SPEs, it is not practical to have specific classification criteria applicable only on SPEs. Therefore, it is proposed that *general* sector classification guidelines be used to determine the sector classification of SPEs. This section describes how SPEs can be sectorized according to general indicators of control and economic activity.

Determine the control of domestic SPEs

Some intended accounting objectives of SPEs, such as balance sheet restructuring, hiding assets and liabilities, and manipulating outcomes could only be achieved if SPEs are treated as institutional units separate from the government units that create them. For this reason, originator entities often keep their legal ownership in SPEs low enough so that they do not have to consolidate the SPE according to general accounting rules. However, using indicators of control⁷ other than those related to the legal ownership of SPEs to determine a statistical need to consolidate, can solve the problem of intended misrepresentation of economic substance.

The TFHPA working group on government/public sector delineation issues proposed several indicators of control⁸ that can be used to establish government's control of a SPE. Combinations of several of these indicators of control are applicable to SPEs. Originators are, by definition, in control of the nature of activities of SPEs. However, other indicators of control may also indicate control by one of the other participants to the SPE. In the case of SPEs created by government, the level of exposure to the risks and rewards of the SPE will be good indicators of control.

The International Accounting Standards Board is deliberating consolidation issues, including those pertaining to SPEs. The Project summary⁹ indicates that deliberations are focused primarily on the notion of control, and that it is the Board's intention that the consolidation principles it develops would apply to all entities, including SPEs.

⁷ Indicators of control in *SN493* are (a) determining the corporate policy, (b) appointing the majority of directors, (c) ownership of more than half of the voting shares, and (d) special legislation/regulation determining corporate policy.

⁸ TFHPA, Issues Paper for the July, 2005 AEG Meeting, *Government/Public Sector/Private Sector Delineation Issues*, 18 May 2005.

⁹ International Accounting Standards Committee Foundation, *Consolidation (including special purpose entities) Project Summary*, 23 November 2004.

Determine the price at which the SPE operates

Once government control was established, the price at which the SPE activities are concluded will determine whether the entity is classified to the public corporation or general government sector. General government activities are clearly distinct from that of the corporate sector and could assist in making the classification. Governments assume responsibility for the provision of goods and services to the community as a whole or to individual households on a non-market basis, make transfer payments to redistribute income and wealth and finance their activities directly or indirectly by means of taxes and other compulsory transfers from units in other sectors of the economy. (*GFSM 2001*, par. 2.20) Proposals on how to make the distinction between market/non-market production based on the concept of economically significant prices falls within the tasks of the working group on delineation.

Determining the nature of the activities of the SPE

The nature of the primary activities of the SPE should be considered to distinguish between financial and nonfinancial institutional units, both in the case of entities controlled by government and other private sector entities. The European System of Central Banks (ESCB) has agreed to specify six groupings¹⁰ of institutional units belonging to the sub-sector *Other financial intermediaries, except insurance corporations and pension funds* (OFIs). The ESCB considers two of the groupings, Financial Vehicle Corporations and Financial Holding Corporations, to include some categories of SPEs. However, the ESCB classification does not recognize some SPEs separately because their nature or their activities result in them being included in the broader categories for either financial auxiliaries or investment funds.

The ECB indicated that SPEs involved in securitizing government assets would only be considered as financial if the government assets to be sold to the SPE existed in the government's balance sheet before the arrangement started, and if the SPE has taken over the full risks of the assets (so that the transactions can be considered a true sale). Otherwise, the SPE will not be an institutional unit and be classified with the originator government unit.

The TFHPSA should consider the alternatives for the treatment of domestic SPEs and/or their transactions in the macroeconomic statistical systems. It is the opinion of the working group that these alternatives comprise the following options:

Option 1 – Expand the subsector *Other financial intermediaries, except insurance corporations and pension funds* (OFI's) to specifically include the group of entities *Financial Vehicle Corporations* and *Financial Holding Corporations*, respectively. However, since these entities are not the focus of the TFHPSA, the taskforce should withhold comment on this issue.

¹⁰ These groupings are (i) investment funds (IFs), (ii) financial vehicle corporations (FVCs) created to be the holders of securitized assets, (iii) financial corporations engaged in lending (FCLs), (iv) financial holding corporations (FHCs), (v) security and derivative dealers (SDDs), and (vi) other which comprise all OFIs not covered by the first five groupings.

Option 2 – Include additional guidance in the new SNA on the classification of government-controlled SPEs as public financial corporations. Government-controlled SPEs will only be regarded as a public financial corporation when: (a) the asset used in the securitization transaction complies with the recognition criteria for an asset and existed on the balance sheet of the government unit prior to the securitization transaction; (b) a “true sale”,¹¹ occurred during the securitization; and (c) the majority of the risks associated with the SPE are transferred to the creditors of the SPE with little or no recourse to the resources of the transferor.

¹¹ A “true sale” is evidenced by the relationship between the selling price and market value of securitized assets/liabilities, and the recourse the originator has to reverse the transaction on demand.