

Methodological notes on the statistical treatment of special purpose entities (SPEs)

Hungary has compiled the BOP and IIP separately including and excluding special purpose entities since January 2006. As a result of the amendment of the act on the corporate income tax in November 2002, after 1 January 2003 no off-shore companies could be established in Hungary and the existing off-shore firms had to be transformed into normal status by 1 January 2006.

When their legal status was withdrawn, there were two typical types of off-shore companies present in Hungary. In one of them, the Hungarian companies mostly played a passive intermediary role in transactions, thus they had negligible income from transactions with residents. Unless they changed their activities, we classified them among special purpose entities. The other class consisted of off-shore enterprises that also had some real economy operations or that switched to normal operation. These were reclassified as normal enterprises.

According to the international statistical recommendations, an off-shore firm is resident in the country in which it is registered, similarly to any other enterprise. Accordingly, data on flows and stocks of these enterprises must be recorded on a gross basis, as these overall figures allow for international comparisons of statistics and for bilateral comparisons.

However, the data on enterprises playing a role in the intermediation of substantial financial resources within groups of company distort the statistics underlying the real economic and financial processes of the national economy. The reason for this is that these firms set up business in a given country in order to exploit taxation advantages; they play an intermediary role within a given group of company due to channelling funds (the direction and size of which are controlled by their parents), rather than being a target for direct investment (net flows on various financial instruments are close to zero taking a longer period).

The MNB defines the scope of special purpose entities in conjunction with the HCSO. For the compilation of the SPE register, we use those of the available indicators that capture the main characteristic of these undertakings, i.e., that they predominantly operate abroad and they have minimum links to the domestic economy.

Some criteria used in practice:

- They are always 100% foreign owned.
- In their balance sheets, the ratio of non-financial assets is negligible as compared to financial assets, with the latter consisting mainly of equity, long-term loans and securities.
- Their turnover derives primarily from export revenue and it does not exceed HUF 500 million annually.
- The number of staff tends to be very low (less than 3 persons).
- They typically have high registered capital (capital reserve), which they lend immediately or they purchase equity participations abroad or establish branches abroad.
- They have no subsidiary in Hungary. If, however, the SPE criteria are satisfied both for a resident enterprise and its resident subsidiary, i.e., their operations dominantly relate to the rest of the world, the two enterprises together are considered to be an SPE.
- Their material cost is negligible.
- The name of the enterprise refers to the off-shore nature of the activity.

Issues relating to the presentation and treatment of special purpose entities in the balance of payments:

- According to the definition, special purpose entities operate primarily abroad, with minimal or no link to the economy of the country concerned, and they mainly play a passive intermediary role in transactions, with their income deriving from transactions with non-residents being negligible.
- Their activities do not influence significantly the current account balance calculated on an accruals basis, only the gross figures.
- In the case of SPEs, inflows and outflows often appear under different instruments in the balance of payments. The equity often leaves the country in the form of lending, or a loan leaves as equity investment or income, rendering the interpretation and analysis of the transactions more difficult.

As an important feature of enterprises operating abroad, they move around relatively large volumes of capital, thus their transactions inflate particularly the gross components of the financial account. In respect of the financing of the current account, the relative role of debt-creating and non-debt-creating instruments is particularly significant. Decision makers, investors and rating agencies all consider this information to be crucial for the vulnerability of the Forint and the sustainability of the external equilibrium. This issue arises if the assets and liabilities of an enterprise operating abroad fall into different classes of instruments: this may distort the proportion of debt-creating and non-debt-creating financing.

- The typical activities of SPEs have changed in Hungary over time.

In 2006, they would typically on-lend the equity they received to a non-resident member of the company group. Later, they would more commonly use their capital to purchase equity participations, then establish branches abroad and transfer their business to those branches. Since 2001, they have increasingly recovered the capital from the foreign branch and established a subsidiary in yet another country.

This causes a significant shift in the level of net assets relative to earlier periods. An explanation for this is that, according to the methodology the value of the stock of foreign direct investment abroad has to be recorded according to the books of the non-resident foreign direct investment enterprise. While in the case of foreign branches the stock value in the books of the data provider (owner [investor]) is the same as it is stated in the books of the foreign branches, in the case of foreign subsidiaries the value stated in their books (own fund at book value) is different from the value as it is stated in the data provider's (owner) book. The difference is influenced by the value of income generated at subsidiaries and by the amount they declared as dividends.

- The definition of SPEs may also change over time.

Under our former approach, SPEs by definition were not allowed to engage in real economic activities. This meant that the balance of payments compiled for SPEs contained items mostly in the instruments of direct investment. Recently, however, some enterprises appeared with such items (certain types of services) and volumes in their balance sheets and income statements that call for the reconsideration of our past approach, which strictly prohibited to perform real economic activity. At the time of the methodological change in 2014, the system of criteria for SPEs will be revised.

Furthermore, another problem is that due to the diversification of enterprises, the classification of enterprises show the characteristics of SPEs because of their huge cross-border transactions; however, they work with a higher number of employees, as they also perform some activity linked to the resident economy. Yet they have huge "pass-through" transactions, which questions their "normal" enterprise status and undermines the usability of statistics. These problems also arise in a number of other countries with SPE presence. For more details, see Chapter 4 of the handbook (Guide on Impact of globalization on national accounts) prepared jointly by the UN Economic Commission for Europe (UNECE), Eurostat and the OECD, which deals specifically with the problem of SPEs.