Review of Measures of Private Sector External Debt in a Small Offshore Financial Center

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Abstract

In the past decade Mauritius has emerged as an international financial centre, and has recently attracted global attention. Studies on the architecture of cross-border financial interconnectedness categorize Mauritius as an important node for emerging G20 countries. In response to a request of the Mauritian Authorities to adhere to the SDDS data initiative, the IMF recommended that the central bank extend the coverage of the external sector statistics to include the cross-border transactions and positions of Special Purpose Entities (SPEs) in the offshore sector. Results of the 2011 survey of global business corporations holding a category 1 licence (GBC1s) domiciled in Mauritius indicate foreign assets holdings of above USD360 billion. Because GBC1s are considered residents of the Mauritian economy for statistical purposes, their foreign debt liabilities have been accounted for as private external debt of the country. However for a small country with a domestic GDP of roughly US$12 billion, having such a disproportionate private external debt ratio to GDP distorts its gross external debt indicators and overstates its external vulnerability. These entities, though they do have real activity in Mauritius, are mostly engaged in financial intermediation between non-residents. The paper shares the view that the global statistical standard-setters may have inadequately treated special purpose entities (SPEs) and understated their special role in the global financial network.

Key Words: Private sector external debt, external vulnerability, special purpose entities, external liabilities, balance sheet

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** The views expressed in this article are those of the author and do not necessarily reflect the views of the Bank of Mauritius*

I. Introduction

In 2006, the authorities initiated discussions with the IMF on the adherence of Mauritius to the Special Data Dissemination Standards. A subsequent IMF review of the country's external sector statistics (ESS) concluded that the International Investment Position Statement had significant data gaps and did not reflect the country's status as an international financial centre due to the exclusion of the offshore vehicles' cross-border transactions and positions. Counterpart economy data estimates in the CDIS and CPIS mirror data showed substantial discrepancies.

In an effort to fill these data gaps, the central bank – which is the authority responsible for the compilation and dissemination of ESS data – initiated under IMF technical assistance a foreign assets and liabilities survey and a survey on offshore vehicles having a type 1 Global Business licence. Five years on, there has been significant progress in terms of data coverage but challenges remain. As in most small island offshore financial centres, the cross-border transaction and position data of offshore vehicles are disproportionately large relative to the size of the domestic economy. A recent IMF study describes the Mauritian Offshore Centre as a critical regional node holding 18.1 per cent and 10.7 per cent of developing Asia's and emerging G20 countries' external liabilities. Comparatively the size of the domestic economy is roughly US$12 billion. Extending the statistical coverage to offshore entities also led to a sizeable increase in the measure of private external debt, which as at end-December 2011 reached a staggering figure of USD221 billion.

Offshore entities are effectively special purpose entities (SPEs). While it is generally accepted that SPEs are residents of the economy in which they are incorporated, registered or legally domiciled, there are still concerns among data compilers about this classification. In the recent Experts Group Meeting on Monetary and Financial Statistics Manual and Compilation Guide Revision held in February 2012, there were discussions about making a distinction between SPEs which could be treated as separate institutional units and SPEs which need to be consolidated with their controlling entities. BPM6 has addressed the issue of globalisation of production of goods and provided greater clarity to the treatment of outsourced physical processes by adding the dimension of ownership but it falls short of providing the same clarity to the treatment of financial globalisation, in particular SPEs with little or no physical presence used for holding assets. Likewise in the forthcoming External Debt Statistics Guide, though it is acknowledged that inclusion of offshore entities' external debt is problematic for small economies, it is recommended that external debt of SPEs is attributable to the economy in which they are legally incorporated or registered.

In the current context of the G-20 work agenda to, among others, strengthen data collection and improve the coverage of significant financial centres, the theme of discussion may be seen as trying to go against the tide. The issue is not new; it has been discussed before but not sufficiently from the perspective of a small island economy. The status quo has prevailed except for presentational purposes where the concept of net debt has been highlighted. The paper attempts to highlight some the areas which may be taken into consideration in the future research agenda on the statistical treatment of SPEs, in particular pass-through funds.

The paper is structured as follows: section II briefly presents the offshore sector in Mauritius and its inclusion in the coverage of private external debt, using 2011 data. Section III summarises the treatment of SPEs in the internationally accepted statistical manuals. Section IV highlights the issues relevant from a small island offshore centre's perspective and finally concludes with the way forward.

II. Offshore Entities and Private External Debt

There are two types of global business licences for corporates in the offshore sector namely the type 1 licence (GBC1s) and the type 2 licence (GBC2s). GBC1s are considered tax residents of Mauritius and have the benefit of the double taxation agreements (DTAs) provided that the business is managed and controlled from Mauritius, it has at least 2 directors resident in Mauritius, maintains at all times its principal bank account in Mauritius as well as its accounting records at its registered office in Mauritius. GBC2s are not considered tax residents and they cannot benefit from the DTAs. GBC1s have to file audited financial statements with the regulatory authority while GBC2s submit a yearly financial summary according to a specified schedule. The legislation requires that Management Companies administer GBC1s and act as registered agents for GBC2s. At end-December 2011, there were 9,758 GBC1s and 14,166 GBC2s.

Effective 2010, the central bank embarked on a survey of GBC1s for inclusion in the ESS of Mauritius. Because GBC2s have to file a financial summary and not fully audited accounts, the collection of data on GBC2s was postponed at a later date. For the 2012 exercise, the survey frame was expanded to cover ninety-five per cent of the total assets held by the population of GBC1s and cross-border transactions and positions data were requested for year 2011. Survey results showed that out of total external assets of USD360 billion, USD342 billion were held with affiliated non-residents. External liabilities due to affiliated non-residents and unaffiliated non-residents amounted to USD257 billion and USD72 billion respectively. Total external debt liabilities held by affiliated and unaffiliated non-residents were USD 213 billion. Eighty-five per cent of the GBC1s in the survey frame were either investment holdings (75 per cent) or collective investment schemes (10 per cent) and were essentially pass-through funds with the funds originating from non-resident shareholders and lenders staying at most 3 months in the country before being re-invested abroad.

The External Debt Guide 2003 is unequivocal about the inclusion of SPEs in the gross external debt liabilities and these have to be attributed to the country in which the *entity−that has the liabilities on its balance sheet, and so on whom the creditor has a claim−is legally incorporated, or in the absence of legal incorporation, is legally domiciled*. Private external debt, inclusive of gross external liabilities of SPEs, shown in the Table below in USD million becomes meaningless and clearly overstates the country's debt distress.

Though the EDS Guide recognizes that for private entities *increasingly active in international markets*, the net external debt position may be used for the external debt sustainability analysis (DSA), there is no prescribed treatment and leaves the door open for interpretation. Debt sustainability could be based on the gross measure or the net measure depending on the subjective assessment of the analyst.

Gross Private External Debt Position				*USD million*
External Debt	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**
Other Deposit Taking institutions	**6,472**	**6,346**	**7,105**	**7,284**
Short-term	1,900	1,661	1,562	1,569
Long-term	*4,572*	4,685	5,543	5,715
Other Sectors	**203,727**	**206,466**	**210,583**	**213,560**
Short-term	91	128	101	86
Long-term	203,636	206,338	210,482	213,474
o/w Global Business	203,289	206,005	210,129	213,454
Total	**210,199**	**212,812**	**217,688**	**220,844**

Author's calculations

III. Statistical Treatment of SPEs

In SNA2008, SPE is used as a generic name to classify corporate structures set up for a specific purpose. SPEs are *always related to another corporation, often as a subsidiary*. SPEs share common characteristics: *they have little physical presence and are managed by employees of another corporation and to which the SPE pays fees for services rendered to it*. In short, the SPEs generally have an embryonic relationship with their parent company or shareholder though they may have their own set of accounts and board of directors. Decision-making is rarely independent from the parent company as both parent and subsidiary may have common directors and control is exercised directly or indirectly over the SPEs' assets and liabilities.

The treatment of SPEs in BPM6 is consistent with SNA2008. BPM6 provides for separate identification of SPEs *in economies where they are important, possibly referring to their limited physical presence and ownership by non-residents for* supplementary data on ultimate investing economy and ultimate host economy. But the focus remains on *providing data on an immediate counterparty basis to adequately monitor flows and positions because (a) they are an integral part of a direct investor's financial transactions and positions with affiliated enterprises; (b) the exclusion of these funds from direct investment would distort and substantially understate direct investment financial flows and positions at aggregate levels; and (c) the inclusions of these data in direct investment promotes symmetry and consistency among economies*.

The forthcoming EDS Guide also recognises that *for an economy increasingly integrated with the rest of the world, analysis of the gross external debt position needs to take into account positions in external assets* and provides for the concept of net external debt as an alternative presentation. But in line with the definition of the g*ross external debt as the* *outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to non-residents by residents of an economy*, it attributes the external debt of the SPEs to the economy in which they are legally incorporated or legally domiciled.

The OECD Benchmark Definition of FDI 2008 provides perhaps the most elaborate treatment of SPEs and financial globalization as it recommends that *countries i) in their standard FDI presentation exclude funds going through resident SPEs but to present them as a separate series; and ii) on a supplemental basis looking through all (resident and non-resident) SPEs to the first non-SPE in the inward or outward chain to contribute to economically more meaningful data.* The reason is that inclusion of *transactions and positions merely reflecting the channelling of funds via the country hosting the SPEs lead to a significant overstatement of FDI activity and distort the geographical and industry breakdowns*.

The apparent contradiction between the treatment of SPEs in BPM6 – *that its exclusion would distort and substantially understate positions* - and in the OECD Benchmark Definition – *that its inclusion would overstate transactions and positions* – is evidence of the lack of consensus of how to treat SPEs with regard to FDI. The same rationale could apply to external debt position.

IV. Issues and Way Forward

The paper identifies three issues with regard to the statistical treatment of SPEs. First, while the globalisation of physical production processes has been taken on board in BPM6 with the distinction between manufacturing on own account and manufacturing services on physical inputs owned by others, similar guidance on financial globalisation is not provided: SPEs are treated as residents of the economy in which they are legally incorporated or legally domiciled with no distinction of when to treat them as separate institutional units and when to consolidate them with their controlling entities. SPEs' functional role, in particular for "pass-through funds", in the financial globalisation process, which is to improve the overall efficiency of their parent company by reducing transaction costs and risks, ought to have been the overriding principle for consolidation of their activity with their parent. Going forward, on that principle, the external debt transactions and positions of SPEs could be separately identified and excluded from the host country's external debt position.

The second issue relates to the residency concept and its asymmetric treatment in the ESS. While the centre of predominant economic interest/principal place of dwelling and engaging in economic activities on a significant scale fundamentally determine the residence of an institutional unit for a number of transactions/positions in the ESS, none of the two criteria are met for a SPE and yet they are considered residents of the economy in which they are located on the basis of legal incorporation or legal domiciliation. The residence of SPEs attributed to the economy in which they are located seems to be more a matter of convenience because they have to be somewhere. The third and final issue is with regard to the gross debt versus net debt: which of the BPM6 treatment to include SPEs positions or the OECD Benchmark Definition to exclude them makes more sense for a small island offshore financial centre? While net debt is currently a presentational issue, what could be the pre-conditions for the concept of net debt to supersede gross debt?

Way forward

The central bank envisage over time to pursue its work on extending the coverage to all offshore entities and by enhancing the data quality, contribute in a modest way to the global agenda to fill data gaps. One of the reasons why small island economies hosting offshore financial centres are reluctant to treat offshore entities as residents of their economy is because the conceptual framework is not adequate from their perspective. The future research agenda of BPM6 and the EDS Guide should address these issues while the IFC work to look beyond the residency-based approach is timely.

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