A Typology of Captive Financial Institutions and Money Lenders (sector S127) in Luxembourg

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Abstract:

The paper presents a typology of captive financial institutions and money lenders (sector S127) in Luxembourg. Given data availability, the analysis relies on a sub-sample of the whole population of S127 firms. This sub-sample features S127 firms whose total assets are at least equal to EUR 500 million. As of Q4 2018, this sub-sample represents about 5% of the total number of S127 firms in Luxembourg, and about 85% of the total assets held by S127 firms in Luxembourg. The period of analysis spans Q4 2014 to Q4 2019. In terms of number and on average over the period Q4 2014 – Q4 2019, the sample of S127 corporations regroups holding corporations (42%), intragroup lending companies (25%), mixed structures (19%), conduits (7%) and loan origination companies (4%). These corporations represent about 98% of the total number of S127 companies whose total assets of at least EUR 500 million. The remaining types that complete the sample of S127 entities consist of captive factoring and invoicing corporations, companies with predominant non-financial assets, extra-group loan origination firms, wealth-holding entities and captive financial leasing corporations. In addition, on average over the period Q4 2014 – Q4 2019, holding corporations own the largest share of total assets (55%) followed by intragroup lending companies (22%), mixed structures (14%), conduits (6%) and loan origination companies (2%). These corporations account for about 99% of the total assets held by S127 companies whose total assets are at least equal to EUR 500 million. The relative importance of holding corporations, intragroup lending companies, mixed structures, conduits and loan origination companies suggests that Luxembourg plays the role of a global financial centre for MNEs. The latter benefit from Luxembourg as a financial platform to manage their business activities and structure their corporate investments.

Keywords:

Captive financial institutions and money lenders, Sector S127, Typology

1. Introduction:

The manuals of statistics published by the main international bodies define captive financial institutions and money lenders as "institutional units providing financial services other than insurance, where most of either their assets or liabilities are not transacted on open financial markets. It includes entities transacting only within a limited group of units, such as with subsidiaries or subsidiaries of the same holding corporation, or entities that provide loans from own funds provided by only one sponsor" (OECD (2008), UN (2009), IMF (2009), EC (2013), IMF (2017))[1].

The adjective "captive" means that the financial company is here *owned and controlled by* and typically for the sole use of an organisation: the parent. Within a MNE's structure, captive financial entities generally lie between the decision body (i.e. the headquarters) and the operational affiliates (i.e. those relating to the production activities).

Thereby, captive financial entities can serve different investment and financial purposes by the means of different types of corporations. Whether directly or indirectly, they usually own the share capital of one or several operational entities of the group and can manage the decisions of its subsidiaries. They are often used to optimise the management of liquidities and the financing of a group's entities. Such activities cover the pooling of cash proceeds from the operational affiliates, the granting of intragroup loans, the raising of funds on external markets for lending on behalf of its parent, the centralised management of treasury activities and accounts receivables, etc.

Owing to their role of financial intermediary within the group, captive financial institutions and money lenders are often located in jurisdictions that act as global financial centres and share the following structural characteristics: openness to trade and financial flows, political and economic stability, international tax treaty network, access to different forms of finance, reliable communication and financial infrastructures, skilled and multilingual workforce, etc.

When settled in these jurisdictions, captive financial institutions and money lenders often contribute to an increase, sometimes substantially so, in the flows of foreign direct investment at national level. In this context, there is a need to understand these influential players on the scene of international capital flows. This topic is of importance for Luxembourg

[1] For more information, the reader can refer to OECD (2008)'s Benchmark Definition of Foreign Direct Investment p. 162-163, p. 77-78, UN (2009)'s SNA2008 framework Para 4.113 to 4.114 p. 77-78, IMF (2009)'s BPM6 Para. 4.82 to 4.87 p. 65-66, EC (2013)'s European System of Accounts ESA 2010 Para 2.98 to 2.99 p. 42, IMF (2017)'s Monetary and Financial Statistics Manual and Compilation Guide Para. 3.181 to 3.188, p. 46-47.

since this global financial centre features a large amount of foreign direct investments whose flows are predominantly initiated by captive financial institutions and money lenders.

A potential way to understand captive financial institutions and money lenders is to establish a typology of these entities. To our best knowledge, two pioneering papers in the literature came up with elements of a typology for the sector S127: ECB-Eurostat-OECD (2013) and IMF (2018). The ECB-Eurostat-OECD (2013)'s typology relies essentially on qualitative criteria pertaining to institutional sectors and economic activity[2]. In addition to the latter criteria, the IMF (2018)'s typology includes qualitative criteria regarding the resident parent, the production and the FDI pass-through investment. More importantly, the IMF (2018)'s typology puts forward prototype balance sheets assigned to specific types of corporations. Despite the advances made, neither of these papers attempted to test a typology of sector S127 empirically.

Against this background, the paper presents an empirical typology of the sector of captive financial institutions and money lenders (S127) in Luxembourg.

2. Methodology:

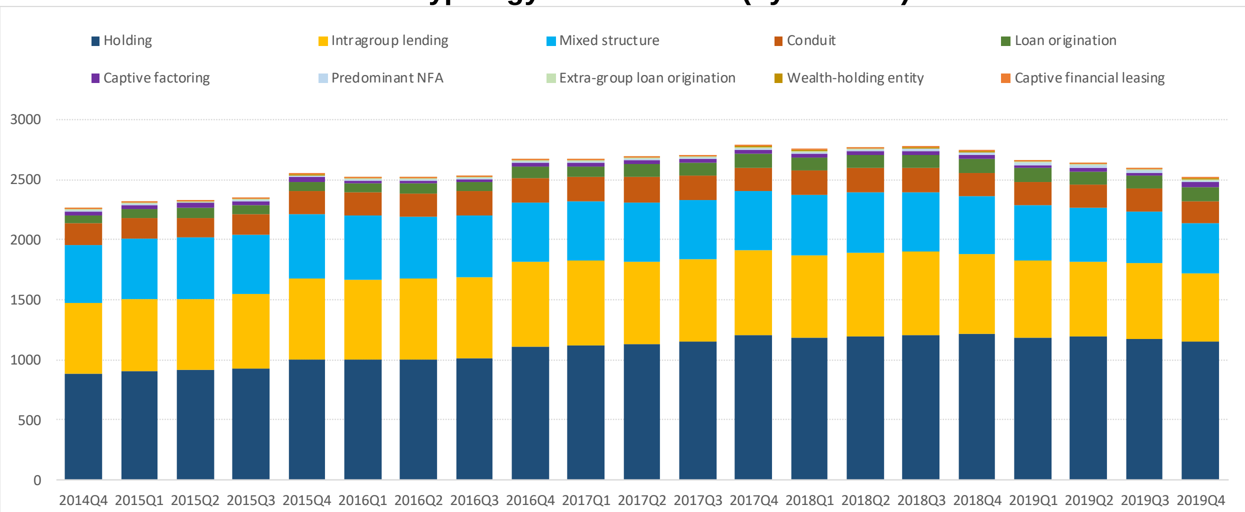
This paper contributes to the literature in various aspects. It fine-tunes definitions of the potential types of S127 entities along with their respective prototype balance sheets. In addition, the paper presents a simple and robust qualitative method to identify all the potential types of S127 entities, based on the relative predominance of a given balance sheet item over the others. This method highlights not only the prototype balance sheet of S127 entities put forward in the literature (ECB-Eurostat-OECD (2013), IMF (2018)), but also variants of the prototype balance sheets defined in this paper as well as new prototype balance sheets of S127 entities which may be peculiar to the case of Luxembourg. Thanks to this method, it becomes possible to draft an initial empirical typology of S127 entities in Luxembourg, a global financial centre where the sector S127 is of notable importance, particularly in terms of FDI stocks.

[2] Institutional sectors rely on the UN (2009)'s System of National Accounts 2008 (SNA2008) and EC (2013)'s European System of Accounts 2010 (ESA2010) classifications while economic activity is based on the UN (2008)'s International Standard Industrial Classification of All Economic Activities (ISIC), Revision 4.

3. Result:

Chart 1 presents the typology of S127 firms in Luxembourg, by number of firms. On average over the period Q4 2014 – Q4 2019, the sample of S127 corporations regroups holding corporations (42%), intragroup lending companies (25%), mixed structures (19%), conduits (7%) and loan origination companies (4%). These corporations represent about 98% of the total number of S127 companies with at least EUR 500 million in total assets. The remaining types that complete the sample of S127 entities consist of captive factoring and invoicing corporations, companies with predominant non-financial assets, extra-group loan origination firms, wealth-holding entities and captive financial leasing corporations.

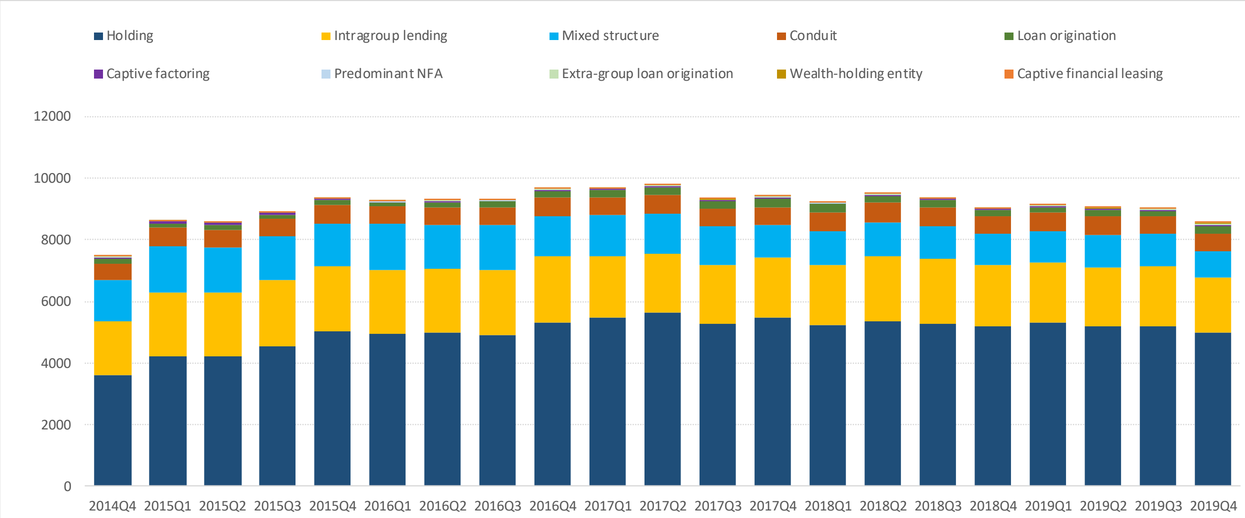
Chart 1: Typology of S127 firms (by number)



Source: Authors' calculations. Units: Number of S127 firms.

Chart 2 presents the typology of S127 firms in Luxembourg, by total assets held. On average over the period Q4 2014 – Q4 2019, the most important asset holders are holding corporations (55%), followed by intragroup lending companies (22%), mixed structures (14%), conduits (6%) and loan origination companies (2%). These corporations represent about 99% of the total assets held by S127 companies with at least EUR 500 million in total assets. The remaining types that complete the sample of S127 entities consist of captive factoring and invoicing corporations, companies with predominant non-financial assets, extra-group loan origination firms, wealth-holding entities and captive financial leasing corporations.

Chart 2: Typology of S127 firms (by total assets held)



Source: Authors' calculations. Units: EUR billion.

4. Discussion and Conclusion:

Altogether, the relative proportion of the different types of S127 entities remains stable over time, whether in terms of number or in terms of total assets. The most important types of S127 entities are holding corporations, followed by intragroup lending companies, mixed structures, conduits and loan origination corporations.

The relative importance of holding corporations, intragroup lending companies, mixed structures, conduits and loan origination companies suggests that Luxembourg acts as a global financial centre for multinational enterprises (MNEs), which benefit from Luxembourg as a financial platform for managing their business activities and structuring their corporate investments.

According to the literature (Moyse et al. (2014), Hoor (2018)), several factors can explain the attractiveness of Luxembourg as a platform for MNEs to structure their investment and financing activities. These factors include an open economy, an international tax treaty network and a stable legal and regulatory environment. Moreover, Luxembourg also boasts a qualified, experienced and multilingual workforce and financial infrastructures (e.g. access to the Eurobond market via the Luxembourg stock exchange, clearing entities to settle transactions with Clearstream, large number of foreign banks) that contribute to its integration within the network of financial centres worldwide.

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