Workshop on International Investment Statistics

ISSUES PAPERS (second DITEG meeting)

Joint IMF/OECD Direct Investment Technical Expert Group (DITEG)

6-9 December 2004

The present document includes the issues papers prepared for the second meeting of the joint IMF/OECD Direct Investment Technical Expert Group - DITEG. Related background papers complementing the issues papers are circulated in an addendum: DAF/INV/STAT(2004)1/ADD1.

The document incorporates contributions by representatives from IMF and OECD member countries and international agencies, in their quality as “expert”. The views expressed in the articles are those of the authors and do not necessarily represent the views of the institutions they represent.

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Issues papers were prepared by various representatives from IMF and OECD member countries and international agencies, in their quality as “expert”. The views expressed in the articles are those of the authors and do not necessarily represent the views of the institutions they represent.
INTRODUCTION

1. The establishment of the joint IMF/OECD Direct Investment Technical Experts Group (DITEG) was endorsed by the IMF Committee on Balance of Payments Statistics (the Committee) and the OECD Workshop on International Investment Statistics (WIIS). The main objective of the DITEG is to fully identify issues and make recommendations to the Committee and the WIIS on the revisions to the international standards on direct investment in the fifth edition of the IMF’s *Balance of Payments Manual (BPM5)* and the third edition of the OECD’s *Benchmark Definition of Foreign Direct Investment* (the *Benchmark Definition*). The DITEG will also be consulted by the IMF on matters relating to the feasibility of conducting a Coordinated Direct Investment Survey.

2. The work is undertaken within the context of the accounting principles of the System of National Accounts, 1993 (including its 2008 Update). The DITEG also considers (i) the work of the Inter-Secretariat Working Group on National Accounts (ISWNGA) on the revision of the SNA; (ii) the decisions made by the Committee and the WIIS regarding direct investment statistics; and (iii) the need for coherence with the statistical treatment of other types of investment.

3. The DITEG will provide by end-May 2005 recommendations to the Committee and to the WIIS on direct investment methodology and classification that should be addressed in the revision of *BPM5* and the *Benchmark Definition*. Decisions on the acceptance of the DITEG recommendations reside with the Committee and the WIIS.

4. DITEG operates as an electronic discussion group through a dedicated web site organised by the U.S. Bureau of Economic Analysis which is open to concerned international agencies and their committees. Moreover, DITEG scheduled three meetings: June 2004 (in Paris), December 2004 (in Washington D.C) and March 2005 (in Paris). Meetings are restricted to DITEG members designated in the terms of reference.

5. The present document includes the issues papers prepared for the second meeting of DITEG:

   (i) DITEG agenda for the meeting of 6-9 December 2004;

   (ii) The consolidated list of FDI item for the review of DITEG, combining the list established by the IMF Committee on Balance of Payments Statistics in December 2003 and the list established by the OECD Workshop on International Investment Statistics in March 2004;

   (iii) Issues papers relating to the items earmarked for DITEG’s review and recommendations at its second meeting.

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2. For DITEG members, please refer to the DITEG terms of reference.

3. Background document related to the discussion are circulated separately as an addendum to the present document [DAFFE/INV/STAT(2004)1/ADD1].
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND
OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

MEETING\(^4\), OF THE JOINT
IMF/OECD DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

To be held at IMF Headquarters,
700 19\(^{th}\) NW, Washington, D.C., Room 2-530

December 6 – 9, 2004

DRAFT ANNOTATED AGENDA

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**Monday, 6 December 2004 (starting at 9.30 a.m.)**

**9.30 a.m.**

Welcoming remarks

Administrative details

**10 a.m.**

- Review of outcome of the discussions on DITEG outcome papers by:
  
  (a) the OECD Workshop on International Investment Statistics (Ms. Bertrand)
  
  (b) the IMF Committee on Balance of Payments Statistics (Mr. Patterson)

- Review of outcome of discussions at BOPTEG (Mr. Patterson)

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\(^4\) Coffee will be available from approximately 8:45 a.m. each morning. The sessions will last from 9:00 a.m. until 5:30 p.m., except on the first day which will start at 9:30 a.m. and the last day which will finish at approximately 12.30 pm. Coffee breaks will be held at approximately 10:30 a.m. and 3:30 p.m. and last for fifteen minutes. Lunch breaks will be approximately from 12:30 p.m. to 2 p.m.
### Issues brought back from the June meeting for reconsideration

**10.30 a.m.**

| Issue #1 | Valuation of direct investment equity | New background document by the ECB |
| Issue #7 | Directional principle and Reverse investment | New issues paper by the United States |
| Issue #8 | SPEs, shell companies, holding companies | New issue paper on sectorization by the Netherlands |
| Issue #9 | Indirect investment – FCS, USM or 50 percent ownership | New issues paper on rules for implementing FCS by Australia |

### Issues not previously considered by DITEG

| Issue #3 | Indirect investment – FCS, USM or 50 percent ownership | New issues paper on rules for implementing FCS by Australia |
| Issue #20 | Define terms more clearly, including direct investor, affiliated direct investment enterprise, parent company, majority ownership and control, multinational enterprise | New issues paper by Canada |
| Issue #4 | Mergers and Acquisitions | Issues paper that was not discussed at the June meeting by Canada |
| Issues #4, 28, and 29 | Mergers and Acquisitions, Greenfield investments, and Extensions of capital | Revised issues paper combining the three topics as they are strongly related by the OECD |
| Issue #21 | Various special cases: | New issues papers (a) and (d). Paper (d) will be presented by the OECD on behalf of Greece |
| (a) Banking activities by Belgium | Issues papers on (b) and (c) are yet to be received. |
| (b) Natural resources exploration | |
| (c) Construction | |
| (d) Shipping by Greece | |
| Issue #22 | Other capital (focusing on short-term instruments) | New issues paper by the Netherlands |
| Issue #11(i) | SPEs: Inclusion of direct investment transactions between non-financial DIE and affiliated financial SPE | New issues paper by the ECB |
Issue #12(i)  Country identification (Ultimate beneficial owner/Ultimate destination and immediate host/investing country)  
by the United States  
by EUROSTAT  

New issues papers

Issue #13  Round tripping  
by Hong-Kong, China  

New issues paper

Issue #14  Permanent debt  
by Japan  
by the IMF  

New issues paper

Issue #15  Land and building owned by non-residents  
by the IMF  

New issues paper

Issue #16  Use of maturity and full instrument split for direct investment  
by the IMF  

New issues paper

Issue #17  Multi-territory enterprises  
by Australia  

BOPTEG (issue #6)  
For information

Issue #18  Application of direct investment to government  

For information (document not available)

Issue #23  Inter-company transactions and amounts outstanding with fellow subsidiaries  
by Italy  

New issues paper (to be presented by the OECD on behalf of Italy)

Issue #24  Direct investment stock (financial versus economic measurement)  
by Belgium  

New issues paper

Issue #25  Valuation of real estate  
by France  

New issues paper

Issue #26  Accounting methods and the IAS  

New background document  
by Russia

Issue #27  Principles for classification by industry (according to the direct investor or direct investment enterprise)  
by EUROSTAT  

New issues paper
<table>
<thead>
<tr>
<th>Time</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.00 a.m.</td>
<td>Recapitulation of the meeting’s discussions and future</td>
</tr>
<tr>
<td>12.30 pm</td>
<td>Close of meeting</td>
</tr>
</tbody>
</table>

**Thursday, 9 December 2004 (starting at 9.00 a.m.)**

Issue #30  Mutual funds (units, sectorization, residence, transactions)  New issues paper

by Japan
## IMF Committee on Balance of Payments Statistics and OECD Workshop of International Investment Statistics

### Consolidated List of Topics for the Direct Investment Technical Expert Group

As Revised at DITEG Meeting, June 17, 2004

<table>
<thead>
<tr>
<th>Topic</th>
<th>Agency responsible</th>
<th>Related Group</th>
<th>Meeting / Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Valuation of</td>
<td>US, ECB, Australia</td>
<td>IMF</td>
<td>June 2004</td>
</tr>
<tr>
<td>(i) direct investment equity</td>
<td>ECB (new background paper on OFBV issue for Dec. 2004 meeting)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) branches</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Direct Investment – 10 per cent threshold of voting power/equity ownership, employment</td>
<td>Luxembourg, OECD (Luxembourg)</td>
<td></td>
<td>June 2004</td>
</tr>
<tr>
<td>3. Indirect investment – FCS, USM, or 50 percent ownership</td>
<td>IMF, ECB/Eurostat, Japan (Netherlands)</td>
<td></td>
<td>June 2004</td>
</tr>
<tr>
<td>4. Mergers and Acquisitions</td>
<td>Canada, OECD (France, United Kingdom)</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>5. Reinvested earnings:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. as it affects national saving</td>
<td>Australia</td>
<td>BOPTEG</td>
<td>June 2004 (issue to be reconsidered in March 2005)</td>
</tr>
<tr>
<td>B. of indirectly owned direct investment enterprises</td>
<td>IMF</td>
<td></td>
<td>June 2004</td>
</tr>
</tbody>
</table>

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5 Where a topic is italicized, it is to indicate that another technical expert group has primary carriage; the topic has been included here as DITEG will have an interest in the issue.

6 The agency shown is to prepare an issues paper for consideration by DITEG.

7 Indicates which other group(s) are involved in the subject: BOPTEG = Balance of Payments Technical Expert Group, CUTEG = Currency Union Technical Expert Group, TFSITS = Task Force on Statistics on International Trade in Services

8 Indicates whether the topic is scheduled for initial discussion at the first DITEG meeting (June 2004 in Paris), the second DITEG meeting (December 2004 in Washington, DC), or the third DITEG meeting (March 2005 in Paris).

9 For those issues where DITEG has primary carriage, countries shown in italics have indicated that they will be preparing background papers.
|
|---|---|---|---|
| **Topic** | **Agency responsible** | **Related Group** | **Meeting*/Priority** |
| 6. Bring together all direct investment issues (stocks, flows, income, between affiliates) in an appendix to the Balance of Payments Manual | IMF | | June 2004 |
| 9. SPEs, shell companies, holding companies, off-shore enterprises (units, sectorization, residence, transactions) | IMF, Australia Netherlands (new issues paper on sectorization and industry, and new background paper on the definition of SPEs for December 2004) BOPTEG (CUTEG for information) | | June 2004 (Sectorization and industry to be reconsidered in Dec. 2004) |
| 10. Rules for identification of branches (for information) | IMF | BOPTEG | June 2004 |
| 11. SPEs | ECB (Netherlands) | | Dec. 2004 |
| 12 (ii). Geographic classification principles (debtor/creditor or transactor principle) (for information) | | CUTEG | |
| 13. Round tripping | Hong Kong SAR | | Dec. 2004 |

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10 For further clarification of issues relating to SPEs (and similar units) as they relate to direct investment, after discussion of broader issues in paper #9.
<table>
<thead>
<tr>
<th>Topic</th>
<th>Agency responsible³</th>
<th>Related Group⁷</th>
<th>Meeting⁶/ Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>15. Land and buildings owned by non-residents</td>
<td>IMF</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>16. Use of maturity and full instrument split for direct investment</td>
<td>IMF</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>17. Multi-territorial enterprises</td>
<td>IMF</td>
<td>BOPTEG (CUTEG, for information)</td>
<td>Dec. 2004 (for information)</td>
</tr>
<tr>
<td>18. Application of direct investment to government (for information)</td>
<td>IMF</td>
<td>BOPTEG (CUTEG, for information)</td>
<td>Deferred</td>
</tr>
<tr>
<td>19. Bring together all direct investment-related issues (transactions in goods and services, income, financial flows, stocks, between affiliates) as an appendix to the Balance of Payments Manual</td>
<td>IMF</td>
<td></td>
<td>June 2004</td>
</tr>
<tr>
<td>20. Define terms more clearly, including: Direct investor; Affiliated DI enterprise; Parent company; Majority ownership and control; Multinational enterprise; Loan guarantees; Debt forgiveness</td>
<td>Canada (excluding guarantees and debt forgiveness)</td>
<td>BOPTEG (for loan guarantees and debt forgiveness)</td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>21. Various special cases, including Banking activities; Natural resource exploration; Construction; and Shipping companies</td>
<td>Belgium: Banking Greece: Shipping Russia: Natural resource exploration, and Construction</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>22. Other capital (focusing on short-term instruments)</td>
<td>Netherlands</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>23. Inter-company transactions and amounts outstanding with fellow subsidiaries</td>
<td>Italy</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>24. FDI stock (financial versus economic measurement)</td>
<td>Belgium</td>
<td></td>
<td>Dec. 2004</td>
</tr>
</tbody>
</table>
### Topic

<table>
<thead>
<tr>
<th></th>
<th>Agency responsible</th>
<th>Related Group</th>
<th>Meeting/ Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>26. Accounting methods and IAS[1]</td>
<td>Russia</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>27. Principles for classification by industry (according to direct investor or direct investment enterprise)</td>
<td>Eurostat</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>29. Extensions of capital</td>
<td>OECD</td>
<td></td>
<td>Dec. 2004</td>
</tr>
<tr>
<td>30. Mutual funds (units, sectorization, residence, transactions)</td>
<td>Japan</td>
<td></td>
<td>Dec. 2004</td>
</tr>
</tbody>
</table>

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\[1\] This item is only for information for various issues relating to IAS. It is provided as a background document, and there will no issue paper.
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #7 AND #8

DIRECTIONAL PRINCIPLE AND

REVERSE INVESTMENT

Prepared by the United States

November 2004
Introduction

1. The existing international guidelines for differentiating between direct and portfolio investment, and between direct investment assets and liabilities, have generated interest and discussion. Situations that are being discussed by DITEG include those (a) where there is reverse equity investment, or reverse equity and debt investment, by the direct investment enterprise (DIE) in its direct investor (DI), (b) where there is equity and/or debt investment between siblings (i.e., companies that are both owned by another company, located in a third country), and (c) where there is equity and/or debt investment between grandparents and grandchildren.

2. In addition, changes in the presentation of data on reverse investment are being discussed. In an issue paper on DITEG issues 7 & 8 presented at the June 2004 DITEG meeting (Reverse Investment and Directional Principle, by the IMF Statistics Department), a potential new presentation scheme for reverse investment was explained, which was to more strictly follow an asset/liability presentation instead of netting assets and liabilities under direct investment classifications.

3. My paper touches on both of the above areas. It first discusses conceptual issues regarding what reverse positions should be included in direct investment. It then proposes an alternate presentation.

4. More specifically, the presentation scheme explained in the earlier DITEG paper works best if the following two assumptions hold true. The first assumption is that existing international standards regarding what constitutes direct investment equity (as opposed to portfolio investment equity) is maintained, and the second assumption is that data are of sufficient “density” that the new presentation scheme is workable by a substantial majority of countries. In this paper, I question each of these assumptions. I conclude with a proposal to classify reverse equity investment of less than 10 percent in a direct investor in portfolio investment instead of in direct investment, for both conceptual and practical reasons.

5. For clarity, two cases are briefly separately discussed below – (a) where the DIE owns 10 percent or more of the equity of the DI, and (b) the case where the DIE owns more than zero but less than 10 percent of the equity of the DI.
Discussion

6. The tables from the June 2004 DITEG paper that illustrate an alternative presentation scheme are reproduced below, with rows labelled for ease of reference:

Balance of Payments *

<table>
<thead>
<tr>
<th>Net changes in assets arising from transactions</th>
<th>Net changes in liabilities arising from transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct investment</strong></td>
<td><strong>Direct investment</strong></td>
</tr>
<tr>
<td>A1 Abroad</td>
<td>L1 In reporting economy</td>
</tr>
<tr>
<td>A2 Equity finance**</td>
<td>L2 Equity finance**</td>
</tr>
<tr>
<td>A3 Debt</td>
<td>L3 Debt</td>
</tr>
<tr>
<td>A4 In reporting economy (claims on direct</td>
<td>L4 Abroad (liabilities to direct investment</td>
</tr>
<tr>
<td>investors)</td>
<td>enterprises)</td>
</tr>
<tr>
<td>A5 Equity finance**</td>
<td>L5 Equity finance**</td>
</tr>
<tr>
<td>A6 Debt</td>
<td>L6 Debt</td>
</tr>
</tbody>
</table>

International Investment Position*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct investment</strong></td>
<td><strong>Direct investment</strong></td>
</tr>
<tr>
<td>A1 Abroad</td>
<td>L1 In reporting economy</td>
</tr>
<tr>
<td>A2 Equity finance**</td>
<td>L2 Equity finance**</td>
</tr>
<tr>
<td>A3 Debt</td>
<td>L3 Debt</td>
</tr>
<tr>
<td>A4 In reporting economy (claims on direct</td>
<td>L4 Abroad (liabilities to direct investment</td>
</tr>
<tr>
<td>investors)</td>
<td>enterprises)</td>
</tr>
<tr>
<td>A5 Equity finance**</td>
<td>L5 Equity finance**</td>
</tr>
<tr>
<td>A6 Debt</td>
<td>L6 Debt</td>
</tr>
</tbody>
</table>

* The table labelled Balance of Payments corresponds to table 3, and the table labelled International Investment Position corresponds to table 4, of the IMF’s June 2004 DITEG issue paper, on issues 7 and 8.

** Using terms in BPM5, “equity finance” is equivalent to equity capital and reinvested earnings.

7. Case where the DIE owns 10 per cent or more of the equity of the DI

(a) In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is a second direct investment relationship. Under these standards, each relationship would be recorded on a gross basis under the asset/liability principle.

(b) Under the existing standards and the June presentation scheme, entries will appear on rows A2 and L2 in the above tables (equity finance assets on direct investment abroad, and equity finance liabilities on direct investment in the reporting economy). No entries will appear on row A5 (equity finance claims on DIs in the reporting economy) or L5 (equity finance liabilities to DIEs).

(c) I have no concerns about the existing international standards or about the proposed method of presenting these transactions and positions.
8. Case where the DIE owns more than zero but less than 10 percent of the equity of the DI

(a) In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is reverse direct investment equity investment. In looking at the tables in the earlier DITEG paper, this is the only circumstance that would give rise to entries on row A5 or on row L5.

(b) Conceptual issue: In this circumstance, it is not obvious why reverse equity investment of less-than-10 percent is recorded in direct investment rather than in portfolio investment. The equity investment of less-than-10 percent is not for the purpose of exercising a significant degree of influence on the management of the enterprise, and so it would also be consistent with existing concepts to record this level of equity investment in portfolio investment. Stated differently, if there is a less-than-10 percent equity investment in both directions, both investments are classified in portfolio investment. It is unclear why, if one of the parties increases its investment in the other from less-than-10 percent to 10 percent-or-more, it necessarily leads to removal from portfolio investment of the equity investment that had been, and that remains, below the 10 percent threshold.

(c) Practical issue: As noted above, under the June DITEG proposal, the types of investments that are to be classified on rows A5 and L5 are quite narrowly defined. Entries would appear on one of these lines only in the case where there is a 10-per cent or more equity investment in one direction, and a greater-than-zero but less-than-10 per cent equity investment in the other direction. It is unlikely that these arrangements exist to an extent that data could be published at most bilateral levels or, for many countries, even at global levels. It would be inappropriate to develop new standard components for the BOP and IIP accounts where a sizable number of countries could not present any information due to confidentiality issues.

Recommendations

9. For both conceptual and practical reasons, I recommend recording equity investments of less-than-10 percent in portfolio investment rather than in direct investment. This would be a change from the existing international standards, but such a change seems warranted.

(a) I am not recommending any changes to the existing international standards in regard to the classification of debt positions. It perhaps could be argued that, if reverse equity investments of less-than-10 per cent are classified in portfolio investment, then debt positions in the same direction should also be classified in portfolio investment. But I believe that it could be argued even more strongly that it is consistent with broad concepts to record such debt investment in direct investment. Note that, if there is zero equity investment in the DI by the DIE, it is non-controversial that debt liabilities of the DI to the DIE are to be recorded in direct investment. The creation or existence of a small (i.e., of a less-than-10 percent) equity investment in the DI by the DIE does not provide justification for seriously considering reclassifying the debt liabilities of the DI from direct investment to portfolio or other investment.

10. If my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is accepted, then the presentation scheme for reverse investment described in the June paper cannot be accepted, because there will be no entries on the rows
pertaining to equity finance claims on direct investors or equity finance liabilities to direct investment enterprises.

11. Even if my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is rejected for some reason, the presentation scheme described in the June paper still should not be accepted, because it would add rows to the list of standard components for which very few countries could show substantial data before encountering confidentiality issues.

12. Finally, if my recommendation is accepted regarding the inclusion in portfolio investment of the less-than-10 percent equity investments, then I propose the presentation scheme shown on the following tables. Compared with the presentation illustrated in the June DITEG paper, the rows pertaining to reverse equity finance investment (A5 and L5) are eliminated (because such investment would be defined out of direct investment). In addition, the subtotals for reverse investment (that had appeared on rows A4 and L4) are replaced with new subtotals, for total debt (assets and liabilities):

### Balance of Payments

<table>
<thead>
<tr>
<th>Net changes in assets arising from transactions</th>
<th>Net changes in liabilities arising from transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct investment</strong></td>
<td><strong>Direct investment</strong></td>
</tr>
<tr>
<td>Equity finance</td>
<td>Equity finance</td>
</tr>
<tr>
<td>Debt</td>
<td>Debt</td>
</tr>
<tr>
<td>Debt (claims on DIEs)</td>
<td>Debt (liabilities to DI)</td>
</tr>
<tr>
<td>Debt (claims on DI)</td>
<td>Debt (liabilities to DIEs)</td>
</tr>
</tbody>
</table>

### International Investment Position

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct investment</strong></td>
<td><strong>Direct investment</strong></td>
</tr>
<tr>
<td>Equity finance</td>
<td>Equity finance</td>
</tr>
<tr>
<td>Debt</td>
<td>Debt</td>
</tr>
<tr>
<td>Debt (claims on DIEs)</td>
<td>Debt (liabilities to DI)</td>
</tr>
<tr>
<td>Debt (claims on DI)</td>
<td>Debt (liabilities to DIEs)</td>
</tr>
</tbody>
</table>

### Points for Discussion

1. **In regard to the IMF’s June 2004 issue paper on DITEG issues 7 & 8, do DITEG members agree that the rows in the classification scheme pertaining to equity finance claims on DI, and to equity finance liabilities to DIE, are very narrowly defined? If so, do DITEG members agree that this raises substantial concerns about their country’s or organization’s ability to show much data on these rows?**

2. **Do DITEG members agree that, on conceptual and/or practical grounds, there is merit in considering changing the existing international standards, to reclassify equity investment by the DIE in the DI from direct investment to portfolio investment in the case where the ownership interest is less than 10 percent?**

3. **Do DITEG members have comments on any of the other issues raised in this paper?**
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #9

THE SECTOR CLASSIFICATION OF SPECIAL PURPOSE ENTITIES

Prepared by the Netherlands

November 2004
Issue: The sector classification of SPEs

In particular: SPEs that are holding companies owning enterprises in the host economy

I. Introduction

13. This paper has been written as a consequence of the discussion on holding companies at the June 2004 BOPTEG meeting. In this discussion, the BOPTEG members agreed that SPEs, resident in another economy than the parent company, should be classified as separate autonomous institutional units on the basis of their own function in that economy. The sector classification of the parent company and affiliated group companies in other (third) economies should not be decisive in this respect. If the holding company owns no enterprises resident in the host economy, the holding company should be included in the financial sector (still to be determined as other financial intermediaries or financial auxiliaries). From the discussions, it did not become clear what the sector classification should be in the case that a holding company owns (also) enterprises resident in the host economy. This issue paper is meant to be a starting point for further discussion on this yet unresolved issue. Two situations will be distinguished: SPE/holding with and without affiliates in the host economy.

II. Sector classification of SPE/holding companies resident in another economy than the parent company and not owning enterprises in the same economy

14. At the June 2004 BOPTEG meeting it was already agreed that SPE/holding companies resident in another economy than the parent company not owning enterprises resident in the host economy, should be classified on the basis of their own economic function in the host economy as a unit belonging to the financial sector. The proper sector classification within the financial sector (other financial intermediaries or financial auxiliaries) was still to be determined.

Current international standards for the statistical treatment of the issue

15. In our view, this kind of holding companies complies with the definition of other financial intermediaries (S.123) according to SNA 4.95 (see also SNA 4.100) based on their function of financial intermediation. Although, SNA 4.42/43/44 states that subsidiaries that are established for tax reasons (artificial units) to perform a special task (for example to act as lease company) only within the group of holdings.
companies, should be treated as an integral part of the parent as an ancillary corporation within that economy. This does not hold for the type of SPEs treated in this paper, which are holding companies in another economy than the parent company. Therefore, we are of the opinion that they should be classified in the sub-sector other financial intermediaries (S.123).

**Concerns/shortcomings of the current treatments**

16. With the proposed treatment of these SPEs, SPE/holding companies and ‘normal’ holding companies of the financial sector (holdings with no single type of financial activity clearly predominant in the group\(^{13}\)) would both be classified in the same sector. This could hamper the analysis of the impact of SPE/holding companies on the direct investment figures.

**Possible alternative treatments**

For analytical purposes, it would be recommendable to classify SPE/holding companies in a separate sub-sector. The direct investment positions and transactions via these SPEs could then easily be distinguished from other companies in the financial sector.

**Points for discussion**

1. Do BOPTEG members agree with the classification of these SPE/holding companies in the sector OFIs?

2. Do BOPTEG members agree with the analytical need to distinguish the positions and flows of SPE/holdings from other companies in the financial sector and do BOPTEG members agree with the recommendation of a separate sub-sector for SPEs (miscellaneous OFIs)?

3. Some of the currency union experts are concerned about classification that is determined with reference to its subsidiaries in a particular economy. For example, it would raise the possibility that a holding company in the Netherlands with subsidiaries in other euro zone countries may be classified to one sector for Netherlands data and another sector for euro zone data. Of course this is caused by the change in the residency status from a national residency criterion into an European euro zone residency criterion. Do BOPTEG members share this concern?

**III. Sector classification for SPE/holding companies resident in another economy than the parent company owning enterprises in the host economy**

**Current international standards for the statistical treatment of the issue**

17. No specific guidelines are provided in SNA and BPM.

\(^{13}\) According to the European System of National and Regional Accounts (ESA 95), holding companies which only control and direct a group consisting predominantly of insurance corporations and pension funds, but which are not insurance corporations an pension funds themselves, are classified in sub-sector S.123 (§2.63).
Concerns/shortcomings of the current treatments

18. There is a clear need for guidance regarding the sector classification of this kind of holding companies.

Possible alternative treatments

19. In this paragraph, we will treat some different cases from practice with an increasing complexity.

20. Firstly, the issue is treated whether SPEs should be classified in a sector either as autonomous entity or as non-autonomous entity being part of the group of enterprises in the host economy. According to SNA 4.42/43/44 each individual corporation, with the exception of ancillary corporations, should be treated as a separate institutional unit. Institutional units are normally classified according to their main activity. However, when institutional units only perform tasks within a group of companies, as is the case with holding corporations, the institutional unit is classified according to the predominant sector of the group (SNA 4.100). When the SPE/holding is resident in an economy without local subsidiaries, with the parent company in another economy, we are of the opinion that the SPE/holding should be considered as an autonomous entity. However, for SPE/holding companies owning enterprises in the host economy, it would be possible, in analogy to ‘normal’ holding companies, to look at the main activity of the whole group, consisting of that SPE/holding company and its subsidiaries in the host economy. It is not quite clear in such cases whether the whole subgroup of enterprises in the host economy should be classified in the same sector or each entity separately, according the SNA.

21. In addition to the SPE/holding company with only subsidiaries in another economy four different cases can be distinguished. First, local holding companies with only subsidiaries in the host economy (SPEs?). Second, SPE/holding companies with (only) other SPEs in the host economy and subsidiaries in another economy. Third, SPEs/ holding companies with both subsidiaries in the same economy and in another economy. Fourth, SPE’s/ holding companies with only sister companies in the same economy. These four cases will be explored hereafter

22. The following cases can be distinguished:

(1) Local holding companies that are established in an economy to own all the local subsidiaries/production entities in the host economy (see annex 1, case 1). In our view, the sector classification of the holding company should be based on the predominant activity of the group of subsidiaries (for example, a holding company owning subsidiaries (factories) in the food sector, should be classified then in the non-financial sector) in line with the regular classification of holdings.

(2) A SPE/holding company owning (only) SPE/holding companies in the host economy that exclusively own subsidiaries in a third economy (see annex 1, case 2). In our view, this group should be classified in the sector OFIs (S.123) based on the predominant activity of that entire group, namely holding activities.

(3) A SPE/holding company owning both subsidiaries in the host economy (not exclusively SPEs) and in another economy (see annex 1, case 3). The treatment of SPEs/ holding companies owning both subsidiaries in the host economy and in another economy is less straightforward. At the one end the SPE/ holding company is a holding of companies in the same economy which would lead to the same conclusion as in case1. At the other end the SPE/ holding company is a holding of companies in another economy which could lead to the conclusion of an autonomous unit. Two strategies seem possible:
(a) the SPE/holding company is always classified in the predominant sector of the subsidiaries in the same economy, or

(b) on the basis of a number of criteria the SPE/holding company is classified as autonomous or as part of a group. To determine the predominant activity of such a group, there are a number of relevant criteria that could be used, amongst others:

- the percentage of foreign assets in the total assets of the SPE/holding company (for example if foreign assets are more than 75% of the total, the SPE is an autonomous unit);
- whether the subsidiary in the same economy is of a significant size in terms of personnel or turnover;
- the net asset value of each entity and the value added of each entity to the national economy.

Besides of the difficulty to find the proper criteria, the approach has the disadvantage in case the SPE/holding company is classified as autonomous, that the total cross-border position of the SPE/holding company (including implicitly the value of its participations in the production units) will be included in the inward direct investment position in the sector OFIs. This could give a misleading picture of the sector breakdown in the inward direct investment, in case of substantial non-financial subsidiaries (in the Netherlands, there are some good examples of substantial non-financial subsidiaries of SPE/holding companies). Although this second option seems an acceptable strategy it should be noted that it would imply an innovation with regard to the treatment of holdings in the statistical manuals such as the SNA.

(4) A SPE/holding company owning subsidiaries in a third economy and having non-financial sister companies in the host economy (see annex 1, case 4). In our view, there is no need to classify them as a group. They should be classified as autonomous entities on basis of its own economic functions.

**Points for discussion**

1. Do BOPTEG members agree that a classification issue exists if the SPE/holding company owns non-financial entities in the host economy?

2. Do BOPTEG members agree that classifying SPEs/holding companies as autonomous units, even though it has subsidiaries in the same economy, is a proper treatment if they primarily have subsidiaries in an other economy and that this is an innovation to the SNA?

3. Do BOPTEG members agree that to classify each individual entity as an autonomous entity has the advantage that the sector classification is rather simple, but has the disadvantage that it can give a misleading picture of the sector breakdown of the total cross-border position of the holding company (including implicitly the value of its participations in the production units)?

4. Do BOPTEG members agree that if the SPE/holding company and its subsidiaries within the host economy would be classified as a group, the predominant activity of that group
would have to be determined, and that it is not clear how one should do so according to the SNA?

(5) Do BOPTEG members have an opinion on what criteria could or should be used to determine the predominant activity and how one should balance these different criteria.

(6) What is the opinion of the BOPTEG members on what should be done if there are no predominant domestic activities in that group?
Annex 1 Organization chart of the various cases:

Case 1: local holding and its subsidiaries in the host economy

Case 2: SPE/holding company owning holding companies in the host economy that exclusively own subsidiaries in a third economy
Case 3: SPE/holding company owning both subsidiaries in the host economy (not exclusively SPEs) and in another economy

Case 4: SPE/holding company owning subsidiaries in a third economy and having non-financial sister companies in the same economy
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 3

INDIRECT INVESTMENT – FCS, USM AND 50 PER CENT OWNERSHIP
DETERMINING DIRECT INVESTMENT RELATIONSHIP

Prepared by Australia

November 2004
Introduction

23. In response to needs identified in recent international discussions of the Fully Consolidated System of identifying direct investment relationships, this paper attempts to identify the principle underlying the FCS and to clarify what the FCS prescribes. It interprets the US and EU systems, then makes some comments about these and other possible alternative systems in order to inform further discussion.

Current International Standards for the Statistical Treatment of the Issue

24. In the Balance of Payments Manual, 5th Edition (BPM5), direct investment is defined as a category of international investment that reflects the objective of obtaining a lasting interest by a resident in one economy in an enterprise resident in another economy. The primary distinguishing feature of direct investment is the significant influence that gives the direct investor an effective voice in the management of the direct investment enterprise.

25. A direct investment enterprise is defined as an enterprise in which a direct investor, who is resident in another country, owns 10 per cent or more of the ordinary shares or voting power. The direct investor and the direct investment enterprise are said to be in a direct investment relationship.

26. Paragraph 514 of the BOP Textbook extends the direct investment relationship to "direct investment enterprise subsidiaries, direct investment enterprise associates, and branches directly or indirectly owned by the direct investor", requiring the recording of direct investment relationships between a direct investor and an enterprise in which it has significant influence via an indirect equity holding.

27. In order to identify all direct investment relationships, it is necessary to determine how far down an investment chain the significant influence of a direct investor extends. To achieve this, it is necessary to determine which enterprises, in which the direct investor has an indirect equity holding, are in a direct investment relationship with the direct investor. The current standards define subsidiaries and associates to describe the extent of a direct investor's significant influence. Paragraph 514 of the Textbook defines these as follows:

- Enterprise X is a subsidiary of enterprise N only if:
  (1) enterprise N owns more than half of the shareholders' or members' voting power in X, or
  (2) enterprise X is a subsidiary of any other enterprise that is a subsidiary of N.

- Enterprise K is an associate of enterprise N only if:
  (1) enterprise N and its subsidiaries own 10 per cent or more of the shareholders' voting power in enterprise K and enterprise K is not a subsidiary of N, or
  (2) enterprise K is a subsidiary of any other enterprise that is an associate of N.
Paragraph 517 of the Textbook and paragraph 687 of the BOP Compilation Guide give the following illustration:

**Figure 1**

Enterprise N

<table>
<thead>
<tr>
<th>60%</th>
<th>10%</th>
<th>30%</th>
<th>9%</th>
<th>70%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>Company D</td>
<td>Company F</td>
<td>Company H</td>
<td>Company K</td>
</tr>
<tr>
<td>55%</td>
<td>60%</td>
<td>25%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Company B</td>
<td>Company E</td>
<td>Company G</td>
<td>Company J</td>
<td>Branch L</td>
</tr>
<tr>
<td>12%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company C</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Based on the definitions of subsidiaries and associates above, the guidelines conclude that enterprises A, B, C, D, E, F, K, and L are in direct investment relationships with N. The OECD's Benchmark Definition of Foreign Direct Investment (BMD) refers to these guidelines as the Fully Consolidated System (FCS).

Furthermore, the BOP Compilation Guide states that "these enterprises [A, B, C, D, E, F, K, and L] are considered to be in direct investment relationships with each other. Therefore, for example, transactions between company E and company K represent direct investment transactions" (paragraph 689).

Paragraph 330 of BPM5 states that "direct investment is... broken down into equity capital, reinvested earnings, and other capital". Equity capital refers to equity and share holdings, and other capital contributions. Reinvested earnings are the direct investor's share, in proportion to direct equity participation, of earnings not distributed. Other capital is associated with various inter-company debt transactions, such as the borrowing and lending of funds.

**Concerns/Shortcomings of the Current Treatment**

*Defining the Extent of the Direct Investor's Significant Influence*

At its meeting in June 2004, DITEG agreed that the FCS reflects the concept of direct investment needed to determine direct investment relationships. It is worth spelling out what this concept is.

The standards are clear that a direct investment relationship exists between a direct investor and some enterprises in which it holds equity, directly or indirectly, and that this relationship is based on the existence of significant influence. In the case of direct equity holdings, a 10 per cent or more ownership of the ordinary shares or voting power is the threshold used to determine significant influence.

The FCS is proposed as a system of determining direct investment relationships between a direct investor and chains of enterprises. The determination of direct investment relationships using the FCS is
based on the existence of significant influence of the direct investor at the top of the chain on an enterprise further down the chain. Once equity has been diluted to the extent that it cannot be considered that there is significant influence, no direct investment relationship is considered to exist and the enterprise falls out of scope of the FCS, that is, there is no direct investment relationship with the enterprise at the top of the chain.

35. The FCS uses a set of rules based on the categorisation of relationships between pairs of enterprises (links in the chain). The FCS produces different results from systems which use a mathematical calculation of indirect equity holdings, such as the US system. For example (using the diagram for the FCS in Appendix 1), with the application of the FCS rules:

- N is considered to have significant influence over D, despite indirectly owning only 7.26 per cent of D, and
- N is considered to have no significant influence over Q, despite indirectly owning 11.34 per cent of Q.

Whether these differences are material is discussed later in this paper.

**Residence**

36. There is no explicit reference in the standards to the residence of each enterprise in Figure 1 and how this affects the direct investment relationship. The most common interpretation, which fits with the logic of the system, is that each enterprise in the first layer (that is A, D, F, H, and K) is a resident of a different economic territory than the direct investor at the top of the chain (Enterprise N), and the residency of enterprises lower down in the chain does not matter.

37. However, Figure 1 could be interpreted as implying that all enterprises, other than N, are residents of the same economic territory, or that each column represents a separate economic territory from each other and from N.

38. At its first meeting in June 2004, DITEG was of the opinion that whatever the system applied in practice, indirectly owned companies which are, via a chain of ownership, in the same country as the direct investor should also be part of the foreign direct investment perimeter.

39. These different interpretations may be the cause of different interpretations of the FCS. The new standards need to be more explicit on residence to avoid different interpretations.

**Possible Alternative Treatments**

**Defining the Extent of the Direct Investor’s Significant Influence**

40. There are a number of alternatives to the FCS which aim to identify direct investment relationships based on significant influence. Two of these are the US system and the EU system.

**The US System**

41. The US system involves multiplying the percentage of equity holding down the investment chain in order to determine the indirect equity holding of the enterprise at the top of the chain (Enterprise N in Figure 1). When N's indirect equity falls below 10 per cent, N is no longer considered to have significant influence, and hence no direct investment relationship, with that enterprise.
42. The concept underlying this system is the same as that underlying the FCS. However, the results will be different in some cases. As the US system is based on a multiplication of equity holdings, the number of enterprises included will vary. For example, in a chain of ten enterprises where there is a 51 per cent equity holding at each link in the chain, the US system would only include the top four enterprises. If there is a 100 per cent equity holding at each link in the chain, the US system would include all ten enterprises. In the rules applied in the FCS, a 51 per cent or a 100 percent equity holding at each link in the chain both constitute control and are treated the same, that is, all ten enterprises would be included in both cases.

The EU System

43. The EU system, also known as the 10/50 method, uses the 10 per cent threshold for direct relationships and requires more than 50 per cent equity holding for indirect relationships, such that all directly owned subsidiaries and associates are included, as well as subsidiaries of these. Again, the concept underlying the EU system is the same as that underlying both the US system and the FCS. However, the EU system can produce different results from both systems in some cases. Generally, chains are shorter under the EU system.

44. The EU system will exclude direct investment that may occur after the first direct investment link into countries where foreign ownership of enterprises is restricted to below 50 per cent. For example, a direct investor has a 100 per cent equity holding in a holding company in another economic territory, which in turn has a 49 per cent equity holding in an enterprise in a third economic territory which restricts foreign ownership to below 50 per cent. In this case, there will not be a direct investment relationship between the direct investor and the enterprise owned 49 per cent by the holding company, as it has been agreed that the holding company must be recognised as an institutional unit in its own right and the position between the direct investor and the holding company must be recorded.

The IFRS System

45. The ABS proposed in an earlier paper that the rules of consolidation of the International Financial Reporting Standards (IFRS) for disclosure purposes be adopted to determine direct investment relationships. The IFRS system is based on the concepts of significant influence, used to define an associate (20-50 per cent voting rights), and control, used to define a subsidiary (more than 50 per cent voting rights).

46. Within accounting statements and reports, controlled entities are consolidated into the parent's financial statements, and influenced entities are equity accounted into the investor's financial statements. Paragraph 6 of IAS 28 states that "if an investor holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence" (see Appendix 2). An interpretation of the simple percentage method indicates that the investment relationship ends when N's percentage of voting rights falls below 20 per cent, similar to that used in the US system. However, paragraph 7 of IAS 28 contains criteria which can be used to override the simple percentage method (see Appendix 2). These include board representation and participation in policy-making processes. Enterprises must decide, based on the criteria in paragraphs 6 and 7, which entities it has significant influence over for purposes of disclosure.

47. The rejection of the change of the direct investment threshold from 10 per cent to 20 per cent and a preference for a strict rule rather than subjective criteria means that such a proposal is not feasible.
A Possible Hybrid System

48. During discussions with business accounting experts and subsequently with balance of payments experts, some common themes on the issue emerged. One of these is that, in any scheme used to determine direct investment relationships, control (more than 50 per cent equity holding) should be considered as effective control, that is, as if it were 100 per cent equity holding. This means that a 51 per cent equity holding is just as effective in determining control as a 100 per cent equity holding. In practical terms, this means that any equity holding above 50 per cent should be replaced by 100 per cent to represent this effective control in identifying direct investment relationships. This is a hybrid system, combining elements of the US system and the FCS's definition of a subsidiary.

49. For example, using Figure 1:

- under the FCS, C is in a direct investment relationship with N because C is an associate of one of N's subsidiaries.
- under the US system, N's indirect ownership of C is 3.96 per cent (60% x 55% x 12%), which is less than 10 per cent and therefore there is no direct investment relationship between N and C.
- under the EU system, because C is not majority-owned by B, there is no direct investment relationship between N and C.
- under the hybrid system, subsidiaries A and B have their equity holding expressed as 100 per cent, such that N's indirect control of C is 12 per cent (100% x 100% x 12%), and therefore C is in a direct investment relationship with N.

See Appendix 1 for a more comprehensive example.

50. While, under the hybrid system, equity above 50 per cent represents 100 per cent effective control, the actual equity percentages need to be used in recording reinvested earnings.

Direct Investment Transactions and Positions

51. In looking at how material the differences between the systems are, it is useful to look at what flows and positions are recorded between enterprises in a direct investment relationship. It is possible to divide direct investment into three categories:

1. Directly owned direct investment enterprises

52. This category refers to those enterprises in which the direct investor, who is resident in another economic territory, owns 10 per cent or more of the ordinary shares or voting power. The standards recommend recording all equity capital, reinvested earnings, and other capital transactions and positions between a direct investor and its directly owned direct investment enterprise.

2. Indirectly owned direct investment enterprises

53. This category refers to those enterprises that have a direct investment relationship with a direct investor through a chain of equity holdings. In this case, other capital transactions should be recorded between a direct investor and its indirectly owned direct investment enterprise. If there is no direct equity link, equity capital and reinvested earnings should not be recorded directly. Reinvested earnings should
only be recorded between a direct investor and directly owned direct investment enterprises. If reinvested earnings are recorded at each link in an investment chain, for example from Figure 1:

- B records 12 per cent of C's reinvested earnings,
- A records 55 per cent of B's reinvested earnings, which includes 6.6 per cent of C's reinvested earnings, and
- N records 60 per cent of A's reinvested earnings, which includes 33 per cent of B's reinvested earnings and 3.96 per cent of C's reinvested earnings

then there is no double counting and N's proportion of reinvested earnings in indirectly owned direct investment enterprises is captured correctly.

54. If there is a direct equity link of any percentage between a direct investor and an indirectly owned direct investment enterprise, for example, N owns 5 per cent of B directly, then this position, as well as reinvested earnings transactions, should be recorded directly between N and B.

3. "Sister" direct investment enterprises

55. This category refers to those directly and/or indirectly owned direct investment enterprises who have the same direct investor and, according to paragraph 689 of the Compilation Guide, are in a direct investment relationship with other. There are no equity capital positions and hence no reinvested earnings transactions between these enterprises. However, other capital transactions, for example a loan, should be recorded between "sister" direct investment enterprises.

Conclusion

56. The systems described in this paper are all sets of rules which aim to provide practical guidelines to determine the extent of direct investment relationships down a chain of ownership. Each system produces chains of varying length. An analysis of the positions and transactions recorded within the different length chains could result in significantly different amounts of other capital and reinvested earnings being recorded under direct investment.

Points for Discussion

(1) Does DITEG agree with the description of the concept underlying the FCS in this paper?

(2) Does DITEG agree with the detailed description of the mechanics of the FCS spelt out in this paper? If not, how can it be improved?

(3) What are DITEG's views on the materiality of the differences produced by the different systems?
References

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996.
DITEG Background Paper for Issue #3: Indirect Investment - Example from Practice (Big Multi), De Nederlandsche Bank, 2004
Appendix 1

Fully Consolidated System

- N
  - A
    - B
      - C
        - D
  - E
  - H
  - K
  - M

US System

- N
  - A
    - B
      - C
        - D
  - E
  - H
  - K
  - M

EU (10/50) System

- N
  - A
    - B
      - C
        - D
  - E
  - H
  - K
  - M

Hybrid System

- N
  - A
    - B
      - C
        - D
  - E
  - H
  - K
  - M
**Fully Consolidated System**

A is a subsidiary of N.
B is a subsidiary of A and therefore a subsidiary of N.
C is a subsidiary of B and therefore a subsidiary of N.
D is an associate of C and therefore an associate of N through N's subsidiary C.
E is an associate of N.
F is a subsidiary of E and therefore an associate of N through N's associate E.
G is an associate of F but not of N as F is only an associate of N.
H is an associate of N.
I is an associate of H but not of N as H is only an associate of N.
J is an associate of I but is neither a subsidiary nor an associate of N.
K is neither a subsidiary nor an associate of N.
L is a subsidiary of K but is neither a subsidiary nor an associate of N.
M is a subsidiary of N.
O is an associate of M and therefore an associate of N through N's subsidiary M.
P is a subsidiary of O and therefore an associate of N through N's associate O.
Q is an associate of P but not of N as P is only an associate of N.

**US System**

N has equity holdings of:
60% of A directly and therefore A is in a direct investment relationship with N.
33% of B indirectly (60% x 55%) and therefore B is in a direct investment relationship with N.
33% of C indirectly (60% x 55% x 100%) and therefore C is in a direct investment relationship with N.
7.26% of D indirectly (60% x 55% x 100% x 22%) and therefore D is not in a direct investment relationship with N.
20% of E directly and therefore E is in a direct investment relationship with N.
12% of F indirectly (20% x 60%) and therefore F is in a direct investment relationship with N.
4.8% of G indirectly (20% x 60% x 40%) and therefore G is not in a direct investment relationship with N.
30% of H directly and therefore H is in a direct investment relationship with N.
7.5% of I indirectly (30% x 25%) and therefore I is not in a direct investment relationship with N.
1.5% of J indirectly (30% x 25% x 20%) and therefore J is not in a direct investment relationship with N.
9% of K directly and therefore K is not in a direct investment relationship with N.
9% of L indirectly (9% x 100%) and therefore L is not in a direct investment relationship with N.
70% of M directly and therefore M is in a direct investment relationship with N.
31.5% of O indirectly (70% x 45%) and therefore O is in a direct investment relationship with N.
28.35% of P indirectly (70% x 45% x 90%) and therefore P is in a direct investment relationship with N.
11.34% of Q indirectly (70% x 45% x 90% x 40%) and therefore Q is in a direct investment relationship with N.
EU System

A is in a direct investment relationship with N as N owns more than 10% of A directly.
B is majority-owned by A and is therefore in a direct investment relationship with N.
C is majority-owned by B and is therefore in a direct investment relationship with N.
D is not majority-owned by C and is therefore not in a direct investment relationship with N.
E is in a direct investment relationship with N as N owns more than 10% of E directly.
F is majority-owned by E and is therefore in a direct investment relationship with N.
G is not majority-owned by F and is therefore not in a direct investment relationship with N.
H is in a direct investment relationship with N as N owns more than 10% of H directly.
I is not majority-owned by H and is therefore not in a direct investment relationship with N.
J is not majority-owned by I and is not in a direct investment relationship with N.
K is not in a direct investment relationship with N as N owns less than 10% of K directly.
L is majority-owned by K but as K is not in a direct investment relationship with N, neither is L.
M is in a direct investment relationship with N as N owns more than 10% of M directly.
O is not majority-owned by M and is therefore not in a direct investment relationship with N.
P is majority-owned by O but as O is not in a direct investment relationship with N, neither is P.
Q is not majority-owned by P and is not in a direct investment relationship with N.

Hybrid System

Under this system, any subsidiaries in the chain have their percentage of voting power recorded as 100%, so that N controls:

60% of A directly and therefore A is in a direct investment relationship with N.
55% of B indirectly (100% x 55%) and therefore B is in a direct investment relationship with N.
100% of C indirectly (100% x 100% x 100%) and therefore C is in a direct investment relationship with N.
22% of D indirectly (100% x 100% x 100% x 22%) and therefore D is in a direct investment relationship with N.
20% of E directly and therefore E is in a direct investment relationship with N.
20% of F indirectly (20% x 100%) and therefore F is in a direct investment relationship with N.
8% of G indirectly (20% x 100% x 40%) and therefore G is not in a direct investment relationship with N.
30% of H directly and therefore H is in a direct investment relationship with N.
7.5% of I indirectly (30% x 25%) and therefore I is not in a direct investment relationship with N.
1.5% of J indirectly (30% x 25% x 20%) and therefore J is not in a direct investment relationship with N.
9% of K directly and therefore K is not in a direct investment relationship with N.
9% of L indirectly (9% x 100%) and therefore L is not in a direct investment relationship with N.
70% of M directly and therefore M is in a direct investment relationship with N.
45% of O indirectly (100% x 45%) and therefore O is in a direct investment relationship with N.
45% of P indirectly (100% x 45% x 100%) and therefore P is in a direct investment relationship with N.
18% of Q indirectly (100% x 45% x 100% x 40%) and therefore Q is in a direct investment relationship with N.
Appendix 2

International Accounting Standard 28: Investments in Associates

**Paragraph 2: Definitions**

The following terms are used in this Standard with the meanings specified:

An **associate** is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Consolidated **financial statements** are the financial statements of a group presented as those of a single economic entity.

**Control** is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The **equity method** is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

**Joint control** is the contractually agreed sharing of control over an economic activity.

Separate **financial statements** are those presented by a parent, an investor in an associate or a venture in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.

**Significant influence** is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

A **subsidiary** is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

**Paragraph 6: Significant Influence**

If an investor hold, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

**Paragraph 7:**

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(a) representation on the board of directors or equivalent governing body of the investee;
(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
(c) material transactions between the investor and the investee;
(d) interchange of managerial personnel; or
(e) provision of essential technical information.
ISSUES PAPER (DITEG) # 20

DEFINE TERMS MORE CLEARLY: DIRECT INVESTOR, AFFILIATED DIRECT INVESTMENT ENTERPRISE, PARENT COMPANY, MAJORITY OWNERSHIP AND CONTROL, MULTINATIONAL ENTERPRISE

DEFINITION OF FOREIGN DIRECT INVESTMENT TERMS

Prepared by Canada

November 2004
IMF/OECD – DITEG: ISSUES PAPER #20
DEFINE TERMS MORE CLEARLY: DIRECT INVESTOR, AFFILIATED DIRECT INVESTMENT ENTERPRISE, PARENT COMPANY, MAJORITY OWNERSHIP AND CONTROL, MULTINATIONAL ENTERPRISE

DEFINITION OF FOREIGN DIRECT INVESTMENT TERMS

Prepared by Art Ridgeway
Statistics Canada, November 2004

57. One objective of the current round of revisions to the fifth edition of the IMF’s Balance of Payments Manual (BPM5) and the third edition of the OECD’s Benchmark Definition of Foreign Direct Investment (BD3) is to maintain and strengthen the harmonization of definitions used. While the process to date has witnessed the desire of the various parties to maintain harmonization, the drafting of the revisions to BPM5 and BD3 will be undertaken by separate drafting teams, each working under tight deadlines. It will be impossible to have the drafting teams consult with one another on every word. It is therefore important that a process be put in place to identify “key concepts and variables” for which explicit consultation will be required and to establish a process to ensure that the drafting teams and the decision bodies involved can efficiently consult on these key definitions that should be constant across the manuals.

58. This note addresses some principles and processes that could form the basis for ensuring the harmonization of definitions for FDI.¹⁴

I. Current international standards for the statistical treatment of the issue

59. Not applicable.

II. Concerns/shortcomings of the current treatment

60. It has been noted that even when there is general agreement on the definition of the concepts and variables, various manuals and documentation may contain a variety of wordings that can lead to differences in interpretation. There is also a desire to have definitions that are consistent with other statistical manuals such as the SNA93.

61. There are several glossaries in and out of manuals that provide definitions of many of the terms under consideration. There are differences in the wording of definitions across manuals that need to be resolved. The conflicts may arise due to differences in emphasis in the various sources.

¹⁴ This issue has been identified as a DITEG issue but it is also important to other domains in the revision process including the revision of the SNA. Consideration should be given to expanding the scope of this issue to other parts of the process.
III. Possible alternative treatments

Common definitions in glossaries

62. The proposition would be to have exactly the same wording for the basic definitions of “key concepts and variables”. Any effort to harmonize definitions should assure the use of basic terms in a consistent manner. For example, the definition of resident units is fundamental to all aspects of the balance of payments and FDI as well as the SNA. There should be a common definition of these terms that can be used in any other definition without ambiguity.

63. This suggests there will be a hierarchy of terms such that more complex terms will depend on the previously established common definitions of simpler terms. For example, in defining the term direct investment enterprise the use of the word “enterprise” should be fully consistent with the general definition of enterprise in SNA93 and other manuals.

A place to start

64. The IMF and OECD developed a glossary of FDI terms in preparing the report on the 2001 Survey on the Implementation of Methodological Standards for Direct Investment (SIMSDI) that is published on the IMF and OECD websites15. This could provide a starting point for the creation of a FDI glossary that could be included as part of both the next version of the balance of payments manual and of the next version of the Benchmark Definition16.

65. A working group could be established with country members from both drafting teams. It is proposed that this working group would work via e-mail given the already busy schedules of the participants. An e-mail process also has the advantage that a written process allows time for reflection on the subtle differences that come from alternative wording proposals.

66. The first step would be to identify the key concepts and variables that should have common definitions. As part of this process, it would be useful to identify basic definitions where there is already widespread agreement that would be useful in defining FDI terms e.g. non-resident.

67. Once a list of terms is defined for common definitions, it would be posted on the relevant IMF, OECD, and DITEG websites and a call for written submissions would be put forward. It is proposed that any suggested definition follow a simple basic format that would provide an explanation of the authors’ rationale for how the proposed definition change improves the existing definition, with explicit reference to other key terms and the glossaries of other principal manuals. (See Annex I.)

Principles to Follow

(i) Care should be taken not to define a general term to fit the context but to use the general term to develop the definition of the specific definition. (See Annex II for examples.)

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15 Foreign Direct Investment Statistics: How Countries Measure FDI, 2001. (See reference list for access details.)
16 The glossaries in the two manuals will, of course, each have definitions that go beyond the common FDI terms covered in this note. While the balance of payments glossary will cover subjects beyond FDI, the Benchmark Definition glossary will have an extended list of FDI terms needed for the more detailed presentation demanded in the Benchmark Definition.
(ii) A term should not be defined inside the definition of another term.

(iii) The hierarchy of definitions should be reviewed. Is there a logical flow between one term in the glossary and the use of that term to define other terms – e.g. enterprise, direct investment enterprise? (A practical test would be to substitute the definition of a term into its location in another definition. Does the definition still make sense?)

(iv) The exclusions, as well as the inclusions, implied by the definitions proposed should be considered. Do sub-classes completely exhaust the general class? Are there cases where it is not clear where to assign a particular transaction or position?

IV. Points for discussion

(1) Should glossaries of FDI terms be included in both the IMF’s Balance of Payments Manual and the OECD’s Benchmark Definition of Foreign Direct Investment?

(2) Should the definitions of “key concepts and variables” be identical in the two manuals?

(3) Should these glossaries use definitions from other manuals such as the SNA93, whenever possible?

(4) Should a working group be established that includes country members of the drafting teams of both manuals?

(5) Should the working group on common wording for these definitions function primarily by e-mail?

References:


Annex I

An example of a structure for proposing changes to definitions

I. **Existing Definition(s)**

*Foreign direct investment enterprise* is “defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.

“The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor” (§7 and §8 OECD Benchmark Definition).

II. **Points considered in proposal for new definition**

- An incorporated or unincorporated enterprise – does the reference to two specific legal forms clarify or restrict the definition?
  - Economic units can take a wide variety of legal forms and it is important to ensure that we do not inappropriately restrict coverage of the concepts by reference to specific forms.
  - SNA93 has addressed this issue by defining “corporations (including quasi-corporations)” in a broad manner such that it is not a unit's legal structure, but its economic goal, that determines its classification.
- **Enterprise** – this term has a specific definition in SNA93. Is the usage consistent?
  - SNA93 defines “enterprise” as the portion of an institutional unit undertaking production.
  - It also notes that enterprises in the financial, non-financial and NPISH sectors are complete institutional units. Therefore the term “enterprise” and the term “institutional unit” for units in these sectors are synonymous.
- Given the goal of foreign direct investment is it possible to identify specific types of economic units for which FDI would be defined?
  - Is it accepted that households and government units will never be foreign direct investment enterprises?
  - Is it clear that only non-profit units that are classified to the corporate sectors (financial or non-financial) would be potential foreign direct investment enterprises?
If the response is yes to both of these questions then, it follows that foreign direct investment enterprises would only be found in the financial and non-financial corporate sectors of an economy.

III. Proposed definition

*Foreign direct investment enterprise* is an *enterprise* (institutional unit) in the *financial or non-financial corporate sectors of the economy* in which a *non-resident* investor owns 10 per cent or more of the voting power of an incorporated enterprise or has the equivalent ownership in an enterprise operating under another legal structure.

- Words that are themselves well defined or are to be well defined as part of this process should be in italics to highlight the links between the definitions of key concepts and variables.
Annex II

Moving from the general to the specific – examples

Do not redefine a general term in a narrower way:

**IMF/OECD Glossary**

*Quasi-corporations:* are enterprises that produce goods and services in an economy other than their own, but do not establish separate legal corporations in the host country. Quasi-corporations that are in a direct investment relationship with the parent enterprise are deemed to exist if…….(page 157, *Foreign Direct Investment Statistics: How Countries Measure FDI, 2001.*)

**SNA Glossary**

“*Quasi-corporations* are unincorporated enterprises that function as if they were corporations, A quasi-corporation may be:

**Either** an unincorporated enterprise owned by a resident institutional unit that is operated as if it were a separate corporation and whose de facto relationship to its owner is that of a corporation to its shareholders: such as enterprise must, of course, keep a complete set of accounts

**Or** an unincorporated enterprise owned by a nonresident institutional unit that is deemed to be a resident institutional unit because it engages in a significant amount of production in the economic territory over a long or indefinite period of time.”

(SNA93, Paragraph 4.49)

The first definition seems to eliminate the possibility of a quasi-corporation being a direct investor, which was not likely intended.

**IMF/OECD Glossary**

*Market price:* is the amount of money that willing buyers would pay to acquire a financial asset from a willing seller. The use of market price for valuation of assets and liabilities is one of the key principles of balance of payments compilation. (page 156, *Foreign Direct Investment Statistics: How Countries Measure FDI, 2001*)

**SNA Glossary**

*Market prices* for transactions are the actual price[s] agreed upon by the transactors. (SNA93, paragraph 2.68)

The first definition would seem to limit market price only to transactions in financial assets.
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 4, #28, #29

MERGERS & ACQUISITIONS, GREENFILED INVESTMENTS AND EXTENSION OF CAPITAL

Prepared by
Canada
OECD
May & November 2004
Direct investment flows have been very heavily influenced by large international mergers and acquisitions in recent years. For example in the year 2000 in Canada, the net change from transactions associated with cross border mergers and acquisitions accounted for 70% of Canadian Direct Investment Abroad and 65% of Foreign Direct Investment in Canada. While 2000 had by far the largest contribution, the averages over the last 10 years were 30% and 33% respectively.

The size of merger and acquisition activity led to the compilation of separate data on the impact of these transactions so that direct investment data are presented separately for these one time transactions. The press release for the Canadian Balance of Payments regularly refers to these data in explaining direct investment flows. These references are very often picked up and expanded on by the economic press and other analysts in their own analytical and interpretative articles.

Most of the value of M&As are in a small number of large transactions. The importance of these transactions to the overall quality of the data, for direct investment and other classes of investment, requires special operational attention. As such, the development of a separate class for merger and acquisition data can be seen as benefiting analysis and also acting as a quality assurance measure.

Note that by definition the net change from merger and acquisition transactions and net change from reinvested earning would be mutually exclusive. Taking these two ‘of which’ classes out of total net change in direct investment from transactions would leave an ‘Other’ class that would comprise primarily the net change from the infusion and withdrawal of direct investment capital from direct investment enterprises.

These infusions and withdrawals cover many different types of transactions. Some of which are the basis for other topics of discussion such as round tripping, extensions of capital and the treatment of flows through SPEs.

I. Current international standards for the statistical treatment of the issue

The OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition) and the IMF’s Balance of Payments Manual do not provide for the separate delineation of flows associated with merger and acquisition activity from other direct investment flows.

This paper was initially prepared for the June 2004 meeting of DITEG. It is identical to the version included in document DAFFE/IME/STAT(2004)19/REV1.
II. Concerns/shortcomings of the current treatment

74. The nature of the transactions associated with mergers and acquisitions are quite different from other direct investment transactions. In general these transactions do not provide any new financing for the firms involved but rather represent a realignment of the portfolios of investors. The resulting firm may benefit in a number of ways from the merger or acquisition but the initial transactions are generally associated with changes in ownership of assets only.

75. Current classification does not call for these very large and specialized transactions to be isolated from other transactions for analysis.

76. Some countries as such as Canada provide information on the values of FDI that are associated with mergers and acquisitions. However, as there is no guidance in the manuals on this issue, the definition and coverage of these data across countries is likely inconsistent. For a discussion of definitions of mergers and acquisitions please refer to the note by the OECD.

77. While the documentation on what is included in the merger and acquisition series in Canada is incomplete, in practice the series would include examples of all of the cases defined in the Annex to the OECD issues note on this subject. On the inward investment, any transaction that would qualify as a direct investment flow and resulted form merger and acquisition activity would be included. For outward direct investment, the merger and acquisition series are based on the ultimate destination of the investment activity. That is, in cases where a Canadian resident company channeled funds through a special purpose entity in country B on route to acquire a company in Country C, this would be included in the direct investment data under the merger and acquisition sub-heading.

78. Another case of interest is that where a wholly owned Canadian subsidiary of a direct investor is used as the conduit by its parent to acquire a firm in a third country. In such cases it is often the case that the parent will provide all or part of the capital needed to acquire the third party. In this case, however, as there was already a direct investment relationship between the parent and the Canadian subsidiary, the capital moving from the parent to the subsidiary would not be considered an M&A investment. The outflow to the third country to acquire the target company would be included in our M&A data.

79. In addition, there are private commercial data sources such as Dealogic that report on values of mergers and acquisitions. These are not directly associated with the balance of payments data or foreign direct investment data and often have much broader definitions and coverage. These data may include the total value of assets of the firm or firms involved which may be quite different from the cross border flows that are considered for direct investment and the balance of payments.

III. Possible alternative treatments

80. There seem to be two options, first to add an ‘of which mergers and acquisitions’ split as part of the standard direct investment presentation for asset and liabilities and secondly to have this as supplemental information. While the first option would encourage the most uniformity across countries, there may be few mergers and acquisition in smaller countries in any given time period and thus confidentiality considerations may often result in suppression.

81. In the case of the Canadian data on mergers and acquisition, confidentiality concerns are one reason that only aggregate data have been released. There has been no release of data by country or industry.
82. The provision of supplemental classes for mergers and acquisitions would allow the provision of guidance on the standard definition and treatment while allowing countries to determine the analytical relevance for their own situation.

83. Possibly a third option would be to have the OECD adopt the mergers and acquisitions class as a required element in the Benchmark Definition but the IMF include it as supplemental information. Since the definition of the merger and acquisition component does not affect the overall definition of direct investment, this would allow for a common definition of FDI and M&As while not forcing smaller IMF members to provide these data.

IV. Points for discussion

(1) Do DITEG members feel that guidance should be provided on the creation of an 'of which mergers and acquisitions' class should be added to the OECD Benchmark Definition and the IMF’s Balance of Payments Manual?

(2) If DITEG members consider that an 'of which mergers and acquisitions' class should added should it be a supplementary classification or an additional breakdown in the official classification?

(3) Do DITEG members have comments on cases raises in the Canadian context?
1. Mergers and Acquisitions (M&As), Greenfield investments and Extension of Capacity

2. Current international standards for the treatment of M&As

1. IMF Balance of Payments Manual, 5th edition (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition) do not provide recommendations to distinguish different types of direct investment. FDI can be in three forms:

   (i) Cross-border mergers and acquisitions: the combination of two or more companies belonging to the same legal entity (or not) to achieve strategic and financial objectives. Companies involved in the operation may come from different economic sectors.

   (ii) Greenfield investments: creation of a subsidiary from scratch by one of more non-resident investors;

   (iii) Extension of capacity: increase in the capital (conversely divestment) of established direct investment enterprises.

3. Concerns/shortcomings of the current recommendation

2. Main shortcomings and concerns are related to the absence of recommendations and international standards to classify the statistics by type of FDI:

   (a) Analytical shortcoming considering the significant share of M&As in FDI activity worldwide. The impact of M&As on home and host economies differs from the impact of other types of investments, in particular of greenfield investments.

   (b) There is no agreed coverage and definitions of M&As, greenfield investments and extension of capacity.

   (c) There are no (or very few) data by type of direct investment consistent with official FDI statistic.

   (d) Lack of guidance for recording individual transactions and their classification by type of FDI.

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18. This document was initially prepared for the June 2004 meeting of DITEG [see DAFFE/IME/STAT(2004)19/REV1]. It was revised to include greenfield investments and extension of capacity.

19. See also an issues paper prepared by Canada on M&As.
3.1 Rationale and analytical relevance of statistics by type of FDI

3. M&As account for a very large share of FDI. Initially significant in the United States, M&As have become a wide-spread feature of European and emerging economies. As the barriers to trade and investment were lifted and global economic integration grew, the international dimension of M&As has developed dramatically in the corporate restructuring of enterprises, including the improvement of performance, meeting financial requirements, etc. Restructuring can be conducted in several phases, starting at the national level followed by cross-border operations.

4. Companies go cross-border to access the most competitive and efficient markets. There are various other favourable factors which attract business: convergence of consumer needs and preferences; better opportunities to recover costs generated by research and development (R&D); availability of capital and the financial innovations providing additional financing facilities; new opportunities as a result of privatisation of state-owned enterprises. However, the opening of markets (cross-border) added a higher risk factor for business failures as the players may not master the conditions as well as they could have done for domestic operations.

5. The business strategy of the company designs the objectives of M&As. For example, the acquirer may have a strategy for the improvement of the productivity of the target company through efficiency gains. In other cases, the acquirer may have a strategy for diversifying its activities in unrelated business to minimise its risk exposure rather than creating profits for shareholders. Generally, the main motivation of M&A is the improvement of profits and efficiency through a new business combination. The immediate objective is the growth and expansion of the company with regard to its assets, shares and market share. The ultimate objective is the maximisation of profits and the achievement of sustainable competitive advantages.

6. Most common strategic motivations of M&As are: (i) to achieve growth by opening up to market opportunities as compared to small domestic markets; (ii) to access raw material, innovations, technology, cheap and efficient labour, etc.; (iii) to benefit from exclusive advantages such as company reputation, its brand or design, production, management, etc.; (iv) to manage risk by diversifying products and markets, by reducing dependence to local expertise, to avoid prohibitive policy and/or regulation in home country, to escape economic instability, etc.; (v) to take opportunities which offer favourable conditions; (vi) to respond to clients’ needs with services from overseas subsidiaries, such as banking and accounting.

7. M&As can generate economic gains by business expansion. They allow (i) the transmission of complementary skills, such as management or technical skills; (ii) increased “market power” and access to new market segments; (iii) economies of scale (particularly in manufacturing sector), i.e. lowering the costs through the production of larger volumes; (iv) to improve the use of capital equipment as result of an increase in the specialisation of labour and management; (v) to obtain more rapidly a good reputation and a critical size on the market, which will require more time and resources for a new company.

8. As far as financial aspects are concerned, M&A transactions may facilitate the consolidation of asset management and provide better means and reputation to access to financial markets. Large companies are considered as less subject to risk which may have a favourable impact on the cost of borrowing of the firm.

9. There may be tax incentives to conduct M&As. Taxation can have a significant role in the structuring of the M&A operation once a deal has been identified. It is useful for a firm to focus on specific

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20 Market share: The total number of units of a product (or their value in a given currency) expressed as a percentage of the total number of units sold by all competitors in a given market.
fiscal aspects of the transaction to be able to identify cost advantages and the possibility to minimise the liabilities.

10. In the absence of appropriate statistics, greenfield investments, are in general considered by analysts, for practical reasons, as direct investment which is not in the form of M&As. Greenfield investments imply the creation of new subsidiaries (new direct investment enterprises) in the host economies. The economic impact of greenfield investments may be different, in particular for the host economy, than the impact of M&As (e.g. for job creations). Although many factors determine investment decisions, greenfield investments are mostly targeted to less competitive markets and more frequently in developing or transition economies.

11. The extension of capacity of direct investment enterprises are at times confused with greenfield investments, while in both cases the underlying concept relates to the creation of new or additional capital stocks. Reinvested earnings also represent an extension of the capacity of the enterprise (as opposed to divestments).

3.2 Data availability and coverage

12. There are only a very few OECD countries which include M&A statistics within their official data collection and dissemination. Most of M&A data are compiled by private commercial data sources which have the merit for providing usually very timely data with a wide coverage. However, the underlying purpose of for compiling these statistics is not to analyse the FDI activity. They complement business statistics and relate to the overall capital of enterprises rather than the transactions which qualify as either domestic or cross-border operations. Therefore, these data cannot be used as a part of FDI statistics but could be used for reference by national compilers.

13. Statistics on greenfield investment and extension of capacity are not generally compiled by most OECD countries although some estimates may be available for analytical purposes. Clear definitions and a description of the concepts and the coverage are not available. One of the difficulties in the measurement of greenfield investments is the time element, i.e. for how long a direct investment should be considered as greenfield investment. Some have indicated that an investment will cease to be classified as greenfield 4 to 5 years after the initial investment. However, there are no agreed standards on this and other related items.

14. OECD Secretariat published in “Recent trends and developments” (2002) detailed M&A data along with FDI statistics. Presenting such data in the same article evoked the criticism of certain national experts of FDI statistics even if the article cautioned the reader to the incompatibility of two sets of data (FDI and M&As). On the other hand, the article received ample solicitation from the public, demonstrating its support in favour of including M&A analysis when discussing FDI developments.

15. M&A is a generic term covering various types of business combinations. All existing statistics, private and /or official, do not necessarily relate to the same categories. Annex 2 includes a preliminary glossary for the consideration of experts.

21. The United Kingdom is one of the rare countries falling into this category. A background document “Mergers &Acquisitions: Mini-review, 2003” describes these statistics and provides very useful information.

22. See Annex 3 for the description provided in the OECD. International Investment Perspectives – 2002.
4. Alternative treatment

4.1 A new proposal for FDI statistics

16. The proposal is to expand FDI statistics to classify by type of FDI:
   (i) Cross-border M&As;
   (ii) Greenfield investments;
   (iii) Extension of capacity of established direct investment enterprises.

17. The proposal relates to:
   (i) Financial flows; i.e. cross-border M&As, greenfield investments and extension of capacity as a sub-category of total FDI capital flows (the proposal does not relate to FDI income and to FDI position data);
   (ii) Breakdown by partner country;
   (iii) Breakdown by industry.

18. It is necessary to establish a list of types of business combinations including definitions and descriptions. The terms mergers, acquisitions, consolidations and take-overs are usually used interchangeably. Differences between these forms of business combinations lie mostly in the legal nature of the resulting entity.

19. Recording cross-border M&A involves, for many operations, more than one component of the balance of payments and all the transactions are not always necessarily either domestic or cross-border. Recommendations should provide clear guidance to compilers (see example in Annex 1).

20. More and more M&As are arranged by exchange of securities as opposed to cash payments, a feature most common in big operations. For example, the ex-owners of the acquired company (direct investment enterprise) become shareholders of the acquiring company (direct investor). Recording such operations may be complicated for complex operations. The reader is referred to a background document prepared by Banque de France which discusses payment by exchange of securities.

5. Questions for discussion

(1) DITEG is invited to discuss the possible extension of FDI statistics to provide additional breakdown by type of FDI, namely cross-border M&As, greenfield investments and extension of the capital of established enterprises.

(2) What are the comments of the experts on the experience of the United Kingdom M&A statistics described in a dedicated background document?

(3) What are the comments of experts regarding the definitions in Annex 2: glossary?

(4) Do experts agree with the proposal for the statistical treatment described above under “4. Alternative treatment”? Do they agree with the treatment described by the background document by France on the exchange of securities?

(5) If it is recommended that breakdowns by M&As, greenfield investments and extension of capacity be a part of the official statistics, DITEG is invited to make specific proposal for the preparation of a comprehensive documentation, for IMF Balance of Payments Manual and the OECD Benchmark Definition of Foreign Direct Investment definitions.

23 Background document by Banque de France: “The treatment of M&As in direct investment statistics: the case of M&As involving an exchange of securities”.
Supplementary information:

Annex 1 – An example for recording M&As

An example

Case of a cross-border merger where Company B [resident of New Zealand] becomes a subsidiary of Company A [resident of the United Kingdom]

Acquiring company: Company A
Target company: Company B
The overall cost of the operation for Company A is $190 m:
- $150 m.[market value] to purchase the shares of Company B
- $40 m for other expenses including a premium for shareholders
To finance this operation Company A will increase its capital by issuing new equity and bonds on the international market for $190 m
- $180 m. of new equities of which $165 m will be set aside for the shareholders of Company B [as payment for $150 m plus $15 m premium] and $15 m for other foreign investors.
- $10 m of bond of which $6 m will be on international markets and $4 m on the domestic market.
Company A will own all the shares of Company B;
The shareholders of Company B become shareholders of Company A but their holdings represent less than 10% of the shares of Company A.
Remaining equity [$15 m] is purchased by French and Japanese investors, $5 m and $10 m respectively;

The statistical recording in the balance of payments (In US$ million)

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<th>Balance of payments of United Kingdom</th>
<th>Balance of payments of New Zealand</th>
<th>Balance of payments of Japan</th>
<th>Balance of payments of France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct investment abroad</td>
<td>-165</td>
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<tr>
<td>Direct investment from abroad</td>
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<tr>
<td>Portfolio investment in foreign securities</td>
<td>-165</td>
<td>-10</td>
<td>-5</td>
<td></td>
</tr>
<tr>
<td>Foreign portfolio investment in domestic securities</td>
<td>165+10+5+6(*)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(*) $180 m in equity securities and $6 m in international bond issues. $4 m domestic bond issues are not accounted for in the balance of payments but will be included in the flow of funds of the United Kingdom.
Annex 2 – Glossary

An acquisition is a business transaction between unrelated parties based on terms established by the market where each company acts in its own interest. The acquiring company purchases the assets and liabilities of the target company. The shareholders of the target company can no longer claim any ownership. In some cases, the target company becomes a subsidiary or part of a subsidiary of the acquiring company;

(i) A take-over is a form of acquisition where the acquiring firm is much larger than the target company. The term is sometimes used to designate hostile transactions.

(ii) A reverse take-over refers to an operation where the target company is bigger than the acquiring company. However, mergers of equals (in size or belonging to the same sector of activity) may also result in a hostile take-over.

Divestment refers to the selling of the parts of a company due to various reasons: a subsidiary or a part of a company may no longer be performing well in comparison to its competitors; a subsidiary or a part may be performing well but may not be well positioned within the industry to remain competitive and meet long-term objectives; strategic priorities of a company to remain competitive may change over time and lead to divestment; loss of managerial control or ineffective management; too much diversification may create difficulties thus lead the parent company to reduce the diversification of its activities; the parent company may have financial difficulties and may need to raise cash; a divestment may be realised as a defence against a hostile take-over.

Corporate divestment can be conducted in different ways.

(i) Corporate sell-off: in most cases buyers are other companies.

(ii) Corporate spin-offs: the divested part of the company is floated on a stock exchange. The newly floated company is separately valued on the stock exchange and is an independent company. The shares in the newly listed company are distributed to the shareholders of the parent company who thereafter own shares of two companies rather than one. Through such an operation they increase the flexibility of their portfolio decisions.

(iii) Equity carve-out is a partial divestment; it is similar to corporate-spin off but the parent retains the majority control. This form has the advantage of raising cash for the divestor.

(iv) Management buy-outs (MBO) and buy-ins (MBI): Sometimes the buyer is the manager of the company that is being sold off. In the case of an MBI, a private company is bought by the management.

A merger is the combination of two or more companies to share resources in order to achieve common objectives. A merger implies that, as a result of the operation, only one entity will survive. There are three types of mergers: statutory mergers, subsidiary merger and consolidation.

(i) Statutory merger relates to the business combination where the merged (or target) company will cease to exist. The acquiring company will assume the assets and liabilities of the merged company. In most cases, the owners of merged companies remain the joint owners of the combined company.

(ii) Subsidiary merger relates to an operation where the acquired company will become a subsidiary of the parent company. In a reverse subsidiary merger, a subsidiary of the acquiring company will be merged into the target company.
Consolidation is a type of merger which refers to a business combination whereby two or more companies join to form an entirely new company. All companies involved in the merger cease to exist and their shareholders become shareholders of the new company. The terms consolidation and mergers are frequently used interchangeably. However, the distinction between the two is usually in reference to the size of the combining companies. Consolidation relates to an operation where the combining firms have similar sizes while mergers imply significant differences.

Mergers are usually referred to as horizontal, vertical or conglomerate mergers.

(a) A horizontal merger occurs when two competitors combine, i.e. two companies having the same activity (e.g. two companies in defence industry). Such a combination may result in an increased market power for the merged company and, consequently, may be opposed by antitrust regulators.

(b) A vertical merger is the combination of two companies with complementary activities such those having a buyer-seller relationship (e.g. an operation between a pharmaceutical company and a company which specialises in the distribution of pharmaceutical products).

(c) A conglomerate merger relates to all the other types of transactions, i.e. when two companies do not have a specific relationship and are usually in different lines of business (e.g. a tobacco company merging with a food company).

Strategic alliances are arrangements or agreements under which two or more firms co-operate with a view to achieving commercial objectives. As an alternative to M&As failures, companies have explored other business combinations. However, the objectives of strategic alliances and M&As are different. Strategic alliances are not outright acquisitions and their forms can vary between simple agreements between firms up to the creation of separate and legal entities.

A joint venture is a well know form of strategic alliance which involves two or more companies with legally distinct structures investing in an entity and, consequently, participating in its management. Motivations for such alliances are cost reductions, sharing technology, product developments, market access or access to capital. If strategic alliances are properly structured, they can be less costly than acquisitions. The underlying assumption is that if two or more companies pool their resources, joint objectives can be achieved more easily and more economically.

Strategic alliances can be terminated much more easily than M&As considering structural and legal commitments. However, the success of strategic alliances is not estimated to produce as successful results as expected.
Annex 3 – Extracts from International Investment Perspectives, 2002, OECD

M&A Data: Sources and Definitions

The mergers and acquisitions data used in this article were made available for the purpose of this article by the global investment banking analysis company Dealogic on the basis of their M&A Global Database. The definitions applied to the data collection are the following:

**Inclusion criteria:**

1) **Acquisitions, mergers and disposals.** All transactions are included, of both public and private companies. Included are public offers; open market purchases; stock swaps; going-private deals; reverse takeovers; share placements; recapitalisations; and buy-outs.

2) **Acquisitions of assets.** Asset purchases are covered and include business divisions and operations; restaurants, pubs, hotels, casinos and other leisure industry assets; shopping centres; newspapers and periodicals; airports and ports; telephone, cellular and wireless licenses; pharmaceutical distribution rights; and hospitals, nursing homes and other medical care facilities.

3) **Stake purchases.** All stake purchases of 5 per cent or above in both public and private companies are covered wherever possible. The acquisition or disposal of lower stakes may also be included where the stake purchased or sold is considered to be of strategic importance.

4) **Spin-offs, split-offs and equity carve-outs.** Demergers including privatisations are covered.

5) **Share buy-backs.** Share buy-backs are included or excluded according to the following criteria. Public tender offers and buy-backs as divestments are covered; likewise buy-backs employed as a defensive technique are covered. Other buy-back programmes are included if they are for the repurchase of stakes greater than 10 per cent or, lastly, if the value of the programme is greater than USD 50 million.

6) **Joint ventures.** Strategically important joint ventures are covered. Transactions where existing assets or businesses are being acquired by, or merged into, a joint venture will be included. As a rule, the creation of new companies to pursue joint venture interests is not covered.

**Exclusion criteria:**

1) **Alliances or agreements.** Strategic alliances (not identified as joint ventures); distribution, contract and customer purchase agreements; and leases are not considered for inclusion. Likewise purchases by companies of products manufactured by another company are not considered.

2) **Financial instruments.** The following instruments are not included in the database: options, rights, warrants, debt instruments (e.g. subordinated notes), private placements other than private equity transactions, and loans. Placements of shares, whether primary or secondary, are not included unless they meet the criteria for divestments or privatisations.

3) **Patents and copyrights.**

4) **Restructurings.** Transactions considered as the merger of one company’s wholly owned subsidiaries are classified as a restructuring exercise, and as such are not included.

Additional information, as well as commercial access to Dealogic’s comprehensive databases, can be obtained from the website [www.dealogic.com](http://www.dealogic.com).
REFERENCES


Changing patterns of industrial globalisation: cross-border mergers and acquisitions, OECD, 1999


*Benchmark Definition of foreign Direct Investment, 3rd edition*, OECD, 1996
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 21

VARIOUS SPECIAL CASES: BANKING ACTIVITIES, NATURAL RESOURCES EXPLORATION, CONSTRUCTION, SHIPPING

Prepared by
Belgium
Greece

November 2004
1. Current international guidelines for the statistical treatment of the issue

21. The Balance of Payments Manual, 5th edition (BPM5) states in its paragraph 37, that transactions between affiliated banks can only be considered as direct investment transactions when they are related to equity capital and permanent debt.

22. Transactions of another nature must be classified in the appropriate functional component of the balance of payments regrouping the instruments concerned.

23. The transactions between banks and affiliated non-financial enterprises are qualified as direct investment transactions in application of the general rules defined in chapter XVIII of BPM5.

24. The OECD Benchmark states the same rule in paragraph 61 and precises in its paragraphs 39 and 40 that, exception made of flows between affiliated banks, inter-company flows should be "encompassed within the scope of foreign direct investment transactions" and that "...inter-company flows between affiliated entities involved in these activities (also banking activities) be excluded from direct investment".

25. There was an agreement given in 2001 by the IMF BOPCOM and the OECD WIIS to broaden the coverage of the original rule that excludes transactions, other than equity capital and permanent debt, between affiliated banks and between financial intermediaries from the FDI transactions. As a result, the transactions of this kind between entities of the 3 following sub sectors of the financial corporation sector as defined by the SNA93:

- S122 other depository corporations;
- S123 other financial intermediaries;
- S124 financial auxiliaries.

are excluded from FDI transactions

26. This provision aimed to clarify the methodology mainly for SPE's principally engaged in financial intermediary transactions.

24 This approach is proposed in paragraph 5.27 of the annotated outline for the revision of the Balance of Payments Manual, 5th edition (April 2004).
27. Their transactions, as those of banks, would be excluded from FDI transactions only when made with a counterpart of one of the 3 above mentioned sectors.

2. Concern/shortcomings of the current treatment

28. The distinction made in the treatment of transactions other than in equity capital and permanent debt in function of the counterpart - affiliated banks (or as in the annotated manual "affiliated financial intermediaries") or affiliated non-financial enterprises - implies a correct identification of the activity sector of this counterpart.

29. One may suppose that for both the BOP compiler and the respondent, such an identification would be difficult; for the BOP compiler it would even imply to expand the data collection procedures in order to dispose of the necessary information and thus to increase the burden for the respondent.

30. Also the inclusion of pure banking activities (i.e. loans and deposits) within FDI transactions may appear hard to be justified in an economic way.

31. First the aim of the banking activities is to bring together in a secured way different counterparties in the market: the borrowers and the lenders. When an affiliated enterprise borrows from the related bank, the latter is funded by the market and is only channelling the funds from the market to the borrower; the result is the same as when the borrower addresses himself directly to the market.

32. In general financial transactions between affiliated enterprises exist because they are related; if the relation would not exist, the transaction would not happen. Considering a bank, the financial transactions mostly exist because it is a bank even with affiliated enterprises. One may say there is a higher level of independence between the transaction and the specific relation between the bank and the affiliated enterprises.

33. The above mentioned problem, regarding the identification of the counterpart, may be tackled in different ways by several countries resulting in bilateral asymmetries.

3. Possible alternative treatments

34. There are 3 alternatives to considered, all of them modifying the scope of the transactions (and positions) to be included in FDI transactions (and positions).

(i) The first option is to extend the definition of FDI transactions to all transactions between affiliated banks, so that also loans and deposits between affiliated banks would be included in FDI transactions. This approach gives the priority to the conformity to the general definition of FDI above the economic rational.

- The advantage is the simplicity of treatment where no distinction has to be made in function of the quality of the counterpart;

- This approach does not however take into account the specificities of the transactions between banks where liquidity management is essential, and could justify another treatment.\(^{25}\)

\(^{25}\) See § 5.27 of the annotated outline for the revision of BPM5 (April 2004).
(ii) The second option consists into the full exclusion of all transactions other than those related to equity capital and permanent debt between banks and affiliated enterprises, whatever their nature, from the FDI transactions. This approach favours the economic rational of banking transactions. It will reduce the scope of FDI transactions.

- This option has the same advantage of simplicity as the first one.
- This approach classes all the transactions between banks and affiliated enterprises as pure banking transactions, where the FDI relationships do not interfere.

(iii) The third option is a deviation from the first one and consists in a differentiated treatment regarding the status of the bank within a group of related enterprises.

- Indeed we could distinguish the situation of what can be called as a "captive bank" from the one of a bank that is simply part, as any other affiliated entity, of a group.
- In the case of a "captive bank", the transactions between the other affiliated enterprises and the "captive bank" will be determined by the membership of the same group, thus by the fact FDI relationships exist. The resulting transactions between the "captive bank" and the affiliated enterprises, whatever their nature, could then be regarded as FDI transactions.
- In the second case, the transactions between the bank and the affiliated enterprises, whatever their nature, will not necessarily be the result of the existing FDI relationships and both the bank for its liquidity management and the affiliated enterprises for their financial management will behave as any other non related bank or enterprise. Those transactions could thus be considered as non FDI transactions.

➢ This approach introduces an economic dimension in the rational of the treatment of the transactions.

➢ The degree of complexity to apply the rule is higher and implies to have some knowledge of the precise status of a bank, member of a group of related enterprises.

4. Points for discussion

(1) Do the DITEG members consider that the treatment of transactions of banks with affiliated banks and other non-financial enterprises as presently proposed in the IMF BPM5 and in the OECD Benchmark Definition should be retained?

(2) Do the DITEG members consider that the transactions of banks need to be treated in another way than these of the other financial intermediaries (sectors S.123 and S.124)?

(3) If DITEG members consider that the transactions of the banks should be treated differently, which option should they favour:

- all transactions with all affiliated enterprises, whatever their nature, be treated as FDI transactions;

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• all transactions with all affiliated enterprises, whatever their nature, be treated as non FDI transactions, exception made of equity capital and permanent debt;

• introduction of the concept of "captive bank" of which all transactions with all affiliated enterprises, whatever their nature, be treated as FDI transactions; the transactions of ordinary related banks be treated as non FDI transactions, exception made of equity capital and permanent debt.

Reference

- IMF Chapter XVIII Balance of Payments Manual 5th edition 1993
- OECD Benchmark for FDI 3d edition 1996 chapter III, 5 and VI, 1
- System of National Accounts 1993 chapter IV
IMF/OECD – DITEG: ISSUES PAPER #21
VARIOUS SPECIAL CASES: SHIPPING

Prepared by Andreas Karapappas
Statistics Department, Bank of Greece,
November 2004

I. Current international guidelines for the statistical treatment of shipping companies’ activities

35. The international activities of shipping companies are recorded in the balance of payments mainly under the transport services. However the usual practice for such companies to establish ‘branches’ or ‘operating offices’ to a number of countries as well as to be registered for flying flags of convenience for their vessels makes difficult to determine the residency (i.e. the country) to whom and to which country the activities of the shipping company would be allocated to. Furthermore, such a worldwide establishment of branches/offices raises the question of how these should be treated. A clear-cut answer has not yet been provided by the Balance of Payments Manual, 5th edition, (BPM5) or the Benchmark definition of FDI, 3rd edition, (BD3).

36. In chapter IV (Resident unit of an economy) under the section of “Units operating mobile equipment” paragraph § 81 points out to the problem of residency that “For ships flying flag of convenience, it is often difficult to determine the residence of the operating enterprise. There are may be complex arrangements involving ownership, mode of operation and chartering of such ships. In addition, the country of registry differs, in most instances, from the operator’s (or owner’s) country of residence. Nevertheless, in principle, the shipping activity is attributed to the country of residence of the operating enterprise.”

37. With regard to the FDI issue, BPM5 (Chapter XVIII-direct investment) devotes a section to “Other Special Cases of Direct Investment Enterprises” (§378 to $383) in which there is no any special reference to FDI in shipping companies and its treatment. However again in chapter IV (Resident unit of an economy) there is a short remark that “If an enterprise establishes, for tax or other consideration, a branch (direct investment) in another country to manage the operation, the operation is attributed to the resident (branch) operating in that country.”(§81).

38. There is more discussion and exploration of shipping companies’ activities in the Balance of Payments Compilation Guide (BPCG) where paragraphs 442 – 450 deal with the “Treatment of the operations of mobile equipment”. There, in §442 is stated clearly that “the key to correct treatment of

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26. The views expressed are those of the author and do not necessarily represent the views of the Bank of Greece
this (shipping) equipment lies in determining the residency of the operator of the equipment” and § 449 considers a further complication that arise when “the operating enterprise may be registered in two or more countries as a result of special legislation”. The solution suggested is twofold. The first solution establishes an FDI relationship (not clearly stated in the text) since it suggests “the country where the head office of the enterprise is located could be considered the operator’s office and the other countries could be consider shareholders in the operation” while the second solution suggests that “the earnings, expenses, assets and other activities of the operator could be split between the countries in proportion to shares held in the operating enterprise” without recording an FDI relationship.

39. Finally in chapter XVI (Compiling BoP financial account and IIP) in BPCG there is a section covering the “Nonoperating Direct Investment Enterprise”(§ 705 – 707) where does everything but names Special Purpose Entities since for the first time brass plate companies are defined “as those to register ownership of shipping vessels or to raise capital through the issuance of securities”(§ 705) and goes on in § 706 to specify that such nonoperating companies “may register in a country but for all practical purposes have no operational presence in that economy. ….That is the companies do not carry out production, have no employees and do not pay taxes… Brass plate companies may pay a fee to register in a host country and may share an office or directors with similar enterprises. However books or accounts may be maintained elsewhere and, thus, be invaluable to the host country compiler”.

40. In BD3, in chapter VI “special entities” there is section 3 which is devoted to “shipping companies”. Within that section (§ 64 pp23) is reaffirmed the complexity of arrangements involved in shipping companies operations by repeating more or less § 81 and § 82 of the BPM5.

41. An interesting remark is made in Annex 3 where SPEs are covered. Specifically, when other types of SPEs are discussed it is mentioned that although it is not usual to associate SPEs with manufacturing or other operating activities “some companies that appear to be merchandising, insurance or other financial or shipping companies are really SPEs. In these case the statistician has to determine the center of their economic activities. For instance, if a Canadian company incorporates a subsidiary shipping company in Singapore, flies a flag of convenience of another country and directs the activities from Belgium, to which country should Canadian direct investment abroad be attributed? “

42. Finally in BD3 there is a reference about the followed practices by most countries where it is stated “ Many countries try to allocate ships involved in international trade to the country of residency of the owner regardless of the country under whose flag the ship is registered. Other countries allocate the ship to the country of the ship’s operator if different from that of the owner “(pp 23)

II. Concerns/shortcoming of the current treatment

43. There seems to be no clear guidance about if ,when and what type of FDI relationships are established when shipping companies are involved.

44. From the treatment of this issue by BMP5 and BD3 , they are mainly concerned with the problem of determining the residency of the actual operator of the vessel so that to determine the country to which operations (shipping services) would be allocated to. There is no clear guidance about the treatment of the management offices (call them branches) established by the ship owner. Should such offices be considered as FDI? How then should we record freight receipts flows between owner and its office?

45. It is true that the ultimate beneficial in the cases of shipping companies’ branches and management offices is the ship owner. Such ‘branches” are merely intermediate offices for freight
collection and manage the employment for ships. Given that the ship owner and its country of residency could be easily determined, a solution would be to generalize the practiced followed so far i.e. to allocate ships involved in international trade to the country of residency of the owner regardless of the branches and flag of convenience they are flying.

III. Points for discussion

(1) Given, as presented above, the complexity of shipping company’s residency and the nature of shipping ‘branches’ activities, does DITEG consider that there might be no ground for direct investment in the operations of shipping companies?

(2) If not, does DITEG consider the shipping management offices as branches or as a special case of SPEs (brass plate)?

(3) If branches/offices are considered as direct investment enterprises (branch or SPE), how should the transactions between owner and branch/office be recorded when such flows involve direct transfer of freight receipts to the owner. Under FDI other capital or under services/transport? In the former case shall we miss the receipts from transport services, which ultimately accrue to the owner?

(4) Should we keep following the current practice that is to allocate all shipping activities (freight, loans etc) to the country of the ship owner?

(5) Which one of the two solutions provided in the BPCG (§ 449) is considered the appropriate one in case where the operating enterprise (branch/office) is registered in two countries?

References


OECD Benchmark Definition of Foreign Direct Investment. Third edition, 1996, OECD.
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 22

OTHER CAPITAL (FOCUSING ON SHORT-TERM INSTRUMENTS)

Prepared by the Netherlands

November 2004
Introduction
46. Due to the liberalisation of the capital and money markets, multinational enterprises are nowadays much more involved in funding activities than 10 years ago. More and more, so-called in-house banks perform the activities of banks for the entire group, such as raising funds and transfer money to all group entities.

47. One of the objectives of in-house banking is “liquidity efficiency”: funds are transferred between group entities as efficient as possible in order to create the highest return on the funds raised. In addition, in-house banks are involved in cash management/pooling such as netting arrangements in which all intra-group accounts are netted everyday amongst the group entities. Other typical short-term intercompany banking transactions are call loans, zero balancing and overnight deposits.

48. The channelling of money through the company has led to an increase of the other capital component of Foreign Direct Investment (FDI), both on a gross and net basis, especially in the form of short-term capital (loans and intra-group accounts) which can give users a distorted picture of the actual FDI. The question can be raised whether all these transactions (or positions) are real FDI? Do these flows/positions have a ‘FDI character’, i.e. related to lasting interest and/or the company’s strategy? More in general, should all transactions/positions between companies in a FDI relationship be included in FDI?

49. This issue paper explores these questions and goes back to the fundamental question: what should FDI measure?

1. Current treatment
50. According to BPM5, the Benchmark Definition and the Annotated Outline, all transactions within a FDI relationship should be classified under FDI once the FDI relationship has been established. All transactions not concerning equity capital or reinvested earnings should be treated as ‘other capital’ (except for certain transactions involving affiliated banks, affiliated financial intermediaries and SPEs which serve as a financial intermediary, see issue papers #9 and #11).

51. For instance, BPM 5, §370 states: ‘Other direct investment capital (or intercompany debt transactions) covers the borrowing and lending of funds—including debt securities and suppliers’ credits—between direct investors and subsidiaries, branches, and associates. The borrowing and lending are reflected in intercompany claims and liabilities (receivables and payables), respectively. Both loans to
subsidiaries from direct investors and loans from subsidiaries to direct investors are included. In contrast to the treatment of other investment, no distinction is made between short- and long-term investment.  

52. In addition, the ‘OECD recommends that short-term loans and trade credit be included as there is often no clear distinction between short-term finance such as a loan repayable on demand but never repaid and long-term finance.’ (Benchmark, §23)

2. Concerns/shortcomings of the current treatment

53. The current treatment does not give any insight in the different types of other capital FDI. Because the current figures may mislead users and may give a distorted picture of FDI, it is important to give users insight in the other capital transactions and positions; what is ‘real’ FDI and what is part of the in-house banking activities of the company? Should the flows of in-house banks be included in FDI or should the flows be included in Other Investment? Are the activities of in-house banks FDI or not?

54. The main question is whether all transactions in ‘other capital’ have a FDI character. An example: All intra-group accounts of group entities with the parent company are ‘pooled’ on a daily basis by the bank. The next day, the money is being transferred back to the intra-group accounts. This process is known as cash pooling. A result of these daily flows is that the gross figures of intra-group accounts can change dramatically on a monthly basis. Although these flows are booked in FDI due to their intercompany nature, these flows may be considered as non-FDI as it lacks a real (lasting) investment character.

55. A similar argument holds for short-term loans or overnight deposits. These loans and deposits blow up both the monthly gross and net figures. The net balance of these flows is dependent on the amount outstanding at the end of the month. For example, suppose that the net balance of short term loans is EUR + 1 bn end-January and EUR – 0.5 bn end-February. Does this decreased balance lead to less real FDI in a particular country in February than in January, when on 1 March the balance may be EUR + 0.3 bn?

56. In general, do short-term transactions such as short-term loans and overnight deposits have a lasting interest character and/or do they relate to the company’s strategy? In our opinion, the answer to this question is ‘no’. The FDI nature of long-term intercompany debt is more evident than short-term intercompany debt because long-term intercompany debt is more often real, actual investment in the subsidiary (or associate) and therefore more ‘lasting’ and strategy-related. However, sometimes long-term loans are routed through a specific country by a so-called Special Purpose Entity (SPE). In that case, one can seriously question the ‘real’ nature of the investment.

57. Alongside, the question can be raised whether transactions involving SPEs should be included in FDI – both transactions in equity and other capital. Should funding and on-lending activities be included in FDI? In general, are these types of activities FDI? Can a company distinguish between transactions that should and should not be included in FDI? Certain transactions of resident MFIs and OFIs with non-resident MFIs or OFIs should already be reported as Other Investment and not as FDI.

58. Economically speaking, transactions of SPEs give a misleading picture of the FDI figures of a country because these transactions have no influence on the economy in which the SPE is a resident. These

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27 According to the ESA (5.22), long-term investment is investment with an original maturity of > 1 year and short-term investment is investment with an original maturity ≤ 1 year.

28 ‘flows’ or ‘transactions’ may also be read as ‘positions’/‘stocks’

29 This question is also raised in issue paper #11 and will therefore be discussed briefly in this paper.
types of transactions blow up the FDI figures even though there is no investment made in the economy involved.

59. To illustrate the influence of other capital on the gross and net flows, please refer to Table 1 below. To highlight one year: of total FDI outward gross outflows in 2003, 85% is other capital. For inflows, the share of other capital in FDI is even higher: 91%. For FDI inward, the percentages are as follows: 90% for inflows and 95% for outflows.

**Table 1 Influence of FDI other capital on gross and net FDI flows (EUR billions)**

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<td>Total other capital outward</td>
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<td>Total FDI outward</td>
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<td>240</td>
<td>221</td>
<td>298</td>
<td>356</td>
<td>428</td>
<td>533</td>
<td>1.201</td>
<td>1.932</td>
<td>1.395</td>
<td>1.193</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflows</td>
<td>218</td>
<td>198</td>
<td>270</td>
<td>318</td>
<td>366</td>
<td>418</td>
<td>1.012</td>
<td>1.725</td>
<td>1.254</td>
<td>1.085</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total FDI outward</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other capital inward</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflows</td>
<td>18</td>
<td>20</td>
<td>17</td>
<td>19</td>
<td>34</td>
<td>67</td>
<td>102</td>
<td>117</td>
<td>130</td>
<td>659</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outflows</td>
<td>14</td>
<td>12</td>
<td>14</td>
<td>19</td>
<td>21</td>
<td>48</td>
<td>63</td>
<td>70</td>
<td>98</td>
<td>624</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total other capital inward</td>
<td>4</td>
<td>8</td>
<td>3</td>
<td>0</td>
<td>13</td>
<td>19</td>
<td>39</td>
<td>47</td>
<td>32</td>
<td>35</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total FDI inward</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflows</td>
<td>33</td>
<td>38</td>
<td>37</td>
<td>51</td>
<td>92</td>
<td>120</td>
<td>232</td>
<td>300</td>
<td>294</td>
<td>732</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outflows</td>
<td>18</td>
<td>20</td>
<td>19</td>
<td>23</td>
<td>43</td>
<td>62</td>
<td>87</td>
<td>118</td>
<td>210</td>
<td>657</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total FDI inward</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Balance of Payments of the Netherlands

60. In Table 2, the 2003 figures are divided into long-term (> 1 year) and short-term (≤ 1 year) FDI-other capital to illustrate the impact on the FDI figures of both categories. The table shows that about 70% of the gross flows is short-term.

**Table 2 Division between short-term and long-term FDI other capital (EUR billions)**

<table>
<thead>
<tr>
<th>OUTWARD</th>
<th>Outflows</th>
<th>Inflows</th>
<th>Total outgoing</th>
<th></th>
<th></th>
<th>INWARD</th>
<th>Outflows</th>
<th>Inflows</th>
<th>Total inward</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term other capital</td>
<td>-262</td>
<td>226</td>
<td>-36</td>
<td></td>
<td></td>
<td>Long-term other capital</td>
<td>-178</td>
<td>213</td>
<td>35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term other capital</td>
<td>-752</td>
<td>761</td>
<td>9</td>
<td></td>
<td></td>
<td>Short-term other capital</td>
<td>-446</td>
<td>446</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>-1.014</td>
<td>987</td>
<td>-27</td>
<td></td>
<td></td>
<td>Total</td>
<td>-624</td>
<td>659</td>
<td>35</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Balance of Payments of the Netherlands
3. Possible alternative treatments

61. It is recognized that not all countries have problems with large amounts of short-term flows, though countries with large multinationals and a large amount of SPEs and OFIs often do. There are some possible treatments for the treatment of FDI short-term other capital which attempt to deal with the overstatement of short-term other capital. Some possible treatments of intercompany debt:

(i) To retain all flows within FDI with no separation between short-term and long-term flows (current practice).

(ii) To retain all flows within FDI with a separation of short-term and long-term flows. The AO also gives consideration to this treatment in paragraph 5.28[30]; however, this is only limited to debt instruments.

(iii) All short-term other capital transactions should be included in Other Investment (if needed, including an “of which” category for transactions between affiliated enterprises) whereas long-term transactions would remain in FDI-other capital.

(iv) All FDI-other capital transactions, whether long-term or short-term should be included in Other Investment, including an “of which” category for transactions between affiliated enterprises, so FDI according to the current definition is still identifiable.

(v) Only direct lending and borrowing between a parent company and its subsidiaries or associates should be included in FDI. Indirect inter-company lending and borrowing (for instance, between sister companies) would then be included in Other Investment.

All alternative treatments, including their advantages and disadvantages, are given in the next table:

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30 AO, paragraph 5.28: ‘Consideration will be given to breaking down “debt instruments” into long term and short term, in view of interest in assessing potential vulnerability associated with direct investment. However, the limitations could be noted, as in BPM5 para. 339.’ Paragraph 339 of BPM states: ‘In the categories of direct investment, portfolio investment, and reserve assets, long- and short-term investment are not formally distinguished. For direct investment, such a distinction is not made because it is essentially determined by arbitrary enterprise decisions and because of the fact that there is no meaningful analytic distinction between the two maturities for intercompany flows.’
Table 3 All alternative treatments to deal with FDI other capital

<table>
<thead>
<tr>
<th>Long-term FDI other capital</th>
<th>Short-term FDI other capital</th>
<th>Split?</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 FDI – other capital</td>
<td>FDI – other capital</td>
<td>No</td>
<td>- No change to the current treatment</td>
<td>- Analytical problem other capital: the overstatement of both gross and net short-term flows is accepted</td>
</tr>
<tr>
<td>2 FDI – other capital</td>
<td>FDI – other capital</td>
<td>Yes, between long-term and short-term FDI</td>
<td>- Differentiation between short-term and long-term gives insight in type of transaction or position. Therefore the AO also considers this option but only for debt instruments.</td>
<td>- Higher reporting burden - Compilation of back data</td>
</tr>
<tr>
<td>3 In FDI – other capital</td>
<td>In Other Investment – other investment, short-term</td>
<td>Possibly in Other Investment - an “of which” category for transactions / positions between affiliated enterprises</td>
<td>- No disturbance in FDI, clearer view on short-term capital - The counterparty of the transactions or positions is not important for classification of other capital short-term flows/stocks - Users could still re-build back series if the “of which” category were to be considered</td>
<td>- Higher reporting burden - Compilation of back data (if no additional split were to be approved)</td>
</tr>
<tr>
<td>4 In Other Investment – other investment, long-term</td>
<td>In Other Investment – other investment, short-term</td>
<td>Possibly within Other Investment - an “of which” category for transactions / positions between affiliated enterprises</td>
<td>- No disturbance in FDI - The counterparty of the transactions is not important anymore for classification for all other capital flows/stocks - Users could still re-build back series if the “of which” category were to be considered</td>
<td>- FDI will decrease immensely - FDI is only limited to equity capital - Compilation of back data (if no additional split were to be approved)</td>
</tr>
<tr>
<td>5 In FDI only when it involves flows/stocks between a parent and subsidiary or associate (direct)</td>
<td>In FDI only when it involves flows/stocks between a parent and subsidiary or associate (direct)</td>
<td>No</td>
<td>- No disturbance in FDI by financial vehicles’ activities (such as conduits) because most lending and borrowing involves indirect relations and these will be excluded from FDI - Relates to the application of the directional principle as described in BPM5 which also involves direct links only</td>
<td>- Does not fit the treatment of FDI-equity capital which involves all FDI entities, direct and indirect - The counterparty of the flows/positions is important for classification of other capital flows/stocks. This counterparty may be unknown</td>
</tr>
</tbody>
</table>
Two marginal notes on both possible treatments 3 and 4:

- Some companies fund their branches through intra-group accounts (short-term capital). Once the branch is fully operational, the branch is transformed into a legal entity and the intra-group account is being converted into equity capital. Thus, the short-term transaction in the form of an intra-group account is eventually being transformed in real FDI.

- Roll-over loans will be included in Other Investment as well.

A marginal note on possible treatment 5:

- This treatment attempts to exclude transactions involving SPEs which do not function as holding companies (such as conduits) and should be read in relation with issue paper #11 on financial SPEs.

4. Points for discussion

(1) Do DITEG members think that short-term transactions such as cash pooling, overnight deposits, etc have a character of a lasting interest and/or are related to the company’s strategy?

(2) Do DITEG members think that the flows of in-house banks should be included in FDI or that the flows should be included in Other Investment? More in general, are the activities of in-house banks FDI or not?

(3) Do DITEG members think that funding and on-lending activities by SPEs and OFIs should be included in FDI? Are such transactions by these companies FDI? Can a certain type of company distinguish between different types of short-term or long-term transactions?

(4) Do DITEG members agree that, in light of the first point for discussion, intercompany short-term transactions should not be included in FDI?

(5) Which option proposed in table 3 has the preference of the DITEG members and why? Should a different treatment be selected for different types of capital (short/long-term), i.e. solution 3 suggested in the paper?

References


IMF Annotated Outline (2004), paragraph 5.28

OECD Benchmark Definition (1996), paragraph 23

European System of Accounts (1995), paragraph 5.22
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 11(I)

SPES: INCLUSION OF DIRECT INVESTMENT TRANSACTIONS BETWEEN NON-FINANCIAL DIE AND AFFILIATED FINANCIAL SPES

Prepared by ECB

November 2004
The widespread practice of establishing special purpose entities (SPEs) in financial (often offshore) centres generates numerous statistical problems that have been analysed in several issues papers considered by both DITEG and BOPTEG. This paper focuses on the specific problems generated by conduits (as described in BOPTEG # 9) whose main (most often only) activity is borrowing funds from international (non-affiliated) investors. Such proceeds are subsequently channelled to the (financial or non-financial) parent company. From a more general perspective, the paper also considers the possible extension of recommendations aimed at solving these problems to the intra-group financial activities of banks and other financial corporations (i.e. not only to such financial SPEs). As in the case of most issues considered by DITEG, at the core of this topic lies the definition of what FDI statistics should measure and the concept of direct investment itself. This paper does not tackle statistical distortions linked to the existence and operation of holding companies. Such issues were already discussed at length by both DITEG and BOPTEG in their respective meetings.

I. Current international standards for the statistical treatment of the issue

Paragraph 372 of the 5th edition of the Balance of Payments Manual (BPM5) states that “Intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers)—including SPEs with the sole purpose of serving as financial intermediaries—recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, fixed assets.” Paragraph 39 of the OECD Benchmark Definition of Foreign Direct Investment (BMD3) establishes similar exceptions to the classification of certain transactions/positions under direct investment.

Following discussions with the OECD Working Party on Financial Statistics and the ECB Working Group on Balance of Payments and External Reserves, the IMF Committee on Balance of Payments Statistics (the Committee), decided at its October 2001 meeting to revise the BPM5 methodology by making the following clarifications:

- The definition of enterprises to be included under “banks and other financial intermediaries” is the equivalent of the following SNA93 financial corporations sub-sectors: other depository

This paper has benefited from comments provided by the members of the ESCB Working Group on External Statistics and other compilers in the European Union. The views expressed in this Paper are those of the author and do not necessarily represent those of the European Central Bank.
corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries.

- SPEs **principally** engaged in financial intermediation for a group of related enterprises, not just SPEs with the **sole purpose** of financial intermediation, are encompassed in the definition of enterprises to be included under banks and other financial intermediaries.

- Financial (and investment income) transactions [positions] between two affiliated enterprises that are part of (1) other depository corporations (other than the central bank); (2) other financial intermediaries, except insurance corporations and pension funds; and (3) financial auxiliaries, would be excluded from FDI except for transactions/positions in the form of equity capital or permanent debt.

- Financial [and income] transactions [positions] between units that are not financial intermediaries and affiliated SPEs abroad [resident in another economy] should be recorded under FDI.

(These decisions were promulgated in May 2002 in the document  **Recommended Treatment of Selected Direct Investment Transactions**.

65. The expansion of the definition of “affiliated banks and affiliated financial intermediaries” was agreed by the OECD Workshop on International Investment Statistics (WIIS) and the ESCB Statistics Committee (STC). However, in light of concerns expressed by some members of the OECD and ECB groups, the Committee decided that the decision to include in the FDI data financial transactions/positions between units that are not financial intermediaries and affiliated SPEs abroad would be re-examined in the revision of **BPM5**.

**II. Concerns/shortcomings of the current treatment**

66. Several papers presented to the BOPCOM\(^{32}\) drew attention to transactions associated with the activity of conduits and financial vehicles, which are often excluded from direct investment so as to avoid statistical distortions.\(^{33}\)

67. Three main problems linked to the treatment prescribed by current standards (namely, the recording of these flows and stocks under direct investment) may be highlighted: (i) it may hamper the economic interpretation of FDI statistics; (ii) FDI statistics may frequently show a negative balance; and (iii) attempts to overcome these problems may usually end up with an increasing level of global asymmetries.

(i) Genuine FDI intercompany loans are closely linked to the investment strategy and the economic activity of the multinational group. Financial flows lent or borrowed by these types of affiliated SPEs do not seemingly fit with the motivation of direct investment activities. Foreign investors are well aware of the fact that the financial instruments issued by such conduits in offshore territories are ultimately guaranteed by the parent company, which is thus getting financing from abroad under market conditions (rather than at privileged conditions, which would be more typical of genuine FDI lending activities). Furthermore, \(^{32}\) See related bibliography at the end of this document.

\(^{33}\) For example, BOPCOM-02/35 described the case of financial vehicles incorporated in the Netherlands Antilles that serve their US non financial mother company as a veil to raise debt funds on international financial markets at more convenient conditions. Such cases are excluded from FDI in US statistics.
due to the significant size of the funds channelled through these conduits, their consideration under direct investment usually blur the interpretation of FDI figures.

(ii) Due to their specific structure, such conduits typically operate with a fairly limited volume of own funds provided by the parent company. Therefore, direct investment stocks may easily turn negative. 34

(iii) Finally, the solutions to the above-mentioned problems that have been adopted by several countries (namely excluding from direct investment the loans granted to resident parent companies by conduits located in financial/offshore centres) could create bilateral asymmetries with the counterpart financial/offshore territories.

68. Reflecting these concerns and the decision of the Committee to revisit the issue, paragraph 5.27(b) of the Balance of Payments Manual Annotated Outline (AO) indicates that “Debt between special purpose entities (SPEs) that have the primary function of financial intermediation and affiliated nonfinancial enterprises. The possible exclusion of these flows from direct investment will be reviewed in the light of whether such flows are considered to be predominantly oriented to the direct investment relationship or not.”. The AO also asks for views on (i) how debt between SPEs that have the primary function of financial intermediation and affiliated nonfinancial enterprises should be classified, and (ii) the meaning of “SPEs that undertake financial intermediation”.

III. Possible alternative treatments

69. As suggested by the AO, a possible solution to the problem could be the exclusion from direct investment of transactions (other than those in equity capital and permanent debt) between special purpose entities (SPEs) that have the primary function of financial intermediation and affiliated nonfinancial enterprises.

70. Such a solution would overcome the three typical problems associated with these cases as depicted in the previous section. The classification of financing flows and stocks between conduits and financial vehicles and their (non-financial) parent companies under “other” or “portfolio” investment seem to better coincide with the underlying concepts. This treatment would be equivalent to applying a “passing-through” treatment to these SPEs, whereby the parent company would be considered to directly establish a portfolio/other investment relation with the non-resident non-affiliated investors. This treatment seems to be more meaningful from an analytical viewpoint since it better reflects the true relationship between the lender(s) and the ultimate borrower(s).

71. Nevertheless, this solution entails a significant difficulty, which is the need to identify in a very precise way this type of institutions so as to exclude any transactions/positions not involving equity capital or permanent debt vis-à-vis affiliated companies from direct investment. Otherwise, the risk of bilateral asymmetries would be very high.

72. For a number of compilers of external statistics in the European Union, a pure fund raising entity is more an exception than the general rule. According to their experience, these entities may also perform sub-holding and other financing activities like lending-through (i.e. intermediating between two non-financial counterparts of the group). Furthermore, the SPE activities can change over time and they might be rarely restricted to a single type of operation (for example they may also have subsidiaries or they may...

34 Some compilers in the European Union suggested the possibility to analyse this problem in the framework of reverse investments and considering the application of the directional principle as proposed in the annotated outline of the Balance of Payments Manual.
be involved in refinancing debtors, etc.). Other EU compilers were rather of the opinion that the bulk of the activities of the conduits analysed in this paper is restricted to raising funds for the mother company and this rarely changes over time. According to these compilers, this conduits’ operative does not coincide with what users understand as FDI other capital, i.e. financing under non-market conditions.

73. An alternative option could be considered, namely to exclude from direct investment all transactions/positions (except equity capital and permanent debt) in which at least one of the counterparts is a financial corporation as defined in SNA 93, i.e. depository corporations other than central banks; other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. This proposal would unify the treatment applied to all financial transactions/positions of financial corporations vis-à-vis affiliated enterprises, which would be considered as part of their normal business.

74. The main advantages of this second proposal would be as follows:

- **Simplicity.** – it just requires an appropriate sectorisation of the companies involved.\(^{35}\)

- **Lower risk of asymmetries.** – since it would not require separate identification of specific companies (such as conduits or financial vehicles), bilateral asymmetries resulting from diverging interpretations of the same case would be less likely.

75. Those financial intermediaries whose purpose is not merely serving the mother company usually do not operate only as an “execution branch” but rather stand on their own. In the typical case of a bank lending/borrowing money to/from affiliated enterprises, such transactions often take place under the same conditions as their normal business. Therefore, they may rather be classified as portfolio or “other” investment.

76. In order to distinguish between activities undertaken by the intermediary in favour of the parent company and their day-to-day business, case-by-case considerations may arise. Such a treatment may be costly and asymmetry-prone and may, in turn, not add much value for economic analysis.

77. One consequence of this proposal that should be borne in mind is that loans between non-financial affiliates routed through a financial company within the group would no longer appear as direct investment. The direct consequence would be that the coverage of FDI statistics would result reduced. Additionally, any changes to the current treatment will necessarily imply breaks in time series.\(^{36}\)

78. The ECB Working Group on External Statistics (WG-ES) considered a preliminary version of this paper at its meeting on 3 and 4 November 2004. The WG-ES unanimously favoured the second option over the first one, though some members raised awareness on the risk of excluding “genuine” FDI financing from FDI statistics. The WG-ES noted the need to also find a satisfactory solution to other

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35 A difficulty may be the need to gather information on the economic sector of activity of the non-resident counterparts so as to exclude from FDI all debt corresponding to (resident or non-resident) financial corporations. However, such a need is also implicit in the exclusions prescribed by international standards at present. In the European Union, uniform classifications such as NACE ensures a perfect identification of financial corporations at a reasonable cost.

36 One possible way out would be the publication of memorandum items that allowed the reconstruction of back series. The dissemination of memorandum items that aimed at reconciling “BPM5” and “BPM6” standards could prove beneficial also for a better economic understanding of the nature and relevance of intra-group financial transactions. For instance, some EU compilers suggested the possibility to create new entries in portfolio and other investment (or equivalent memorandum items), concerning 'portfolio / other investment between affiliated enterprises'.
problems of the FDI equity capital component linked to the existence of other types of SPEs, namely holding companies (to be discussed under item 9 of the DITEG terms of reference). The group was of the view that additional efforts in FDI are necessary to further develop the concept of FDI (what we try to measure); in particular, users may have manifold interests, and FDI statistics may not meet all users’ demands at once. Given the need to preserve homogeneity in the principles applied within the overall b.o.p. and i.i.p. framework, some of those additional needs will necessarily have to be accommodated through satellite accounts.

79. A third option would be to retain the methodology promulgated in 2002, and in instances where national compilers consider that the recommended treatment would result in misleading statistics, to identify in a separate memorandum item the transactions between non-financial direct investment enterprises and affiliated financial intermediaries.  

IV. Points for discussion

(1) Do DITEG members consider that the three drawbacks of the current treatment identified in paragraph 0 justify the need to consider changes to the current standards?

(2) If the answer to the previous question is yes, the views of DITEG are sought on which of the two options presented in this paper would be more plausible on both conceptual and practical grounds:

(i) Exclusion from direct investment (in addition to current exceptions) of transactions and positions (excluding those in equity capital and permanent debt) between conduits/financial vehicles located in financial or offshore centres and affiliated companies; or

(ii) Exclusion from direct investment all transactions/positions (except those in equity capital and permanent debt) in which one of the counterparts is included in one of the following SNA93 financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries.

(3) If the answer to Question 1 above is No, do DITEG members consider that the issues raised in paragraph 6 above could be addressed by the use of a separate memorandum item showing the transactions [positions] between non-financial direct investment enterprises and affiliated financial intermediaries, including SPEs primarily engaged in financial intermediation for a group of related enterprises in those instances where national compilers consider that the direct investment statistics have been distorted by the inclusion of these transactions?

37 Current practices, as reflected in the results of the 2003 Survey of the Implementation of International Methodological Standards for Direct Investment (SIMSDI), and comments to the AO are shown in Annex 1.
References


OECD (1996), Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition,
Annex 1: results of the 2003 Survey of the Implementation of International Methodological Standards for Direct Investment (SIMSDI) and comments to the AO

1. The preliminary results of the 2003 SIMSDI (for the 54 of the 61 countries that participated in the 2001 SIMSDI update for which information is available) indicate that the overwhelming majority include in their direct investment data transactions and positions between nonfinancial direct investment enterprises and affiliated financial intermediaries, including SPEs primarily engaged in financial intermediation for a group of related enterprises:

   (a) 90 percent of the countries for which these transactions are applicable include income transactions in their inward transactions data and 92 percent in their outward transactions data; 92 percent include equity capital transactions in their inward transactions data and 94 percent in their outward transactions data.

   (b) Somewhat smaller numbers include other capital transactions: 77 percent for both the inward and outward transactions data.  

   (c) The figures for the position data indicate a similar pattern (94 percent for both the inward and outward data on reinvested earnings, 92 percent for the inward position data on equity capital, and 90 percent for the outward data, and 80 percent for the inward data on other capital, and 82 percent for the outward position data).

2. The comments on the first question raised in the AO, namely, how debt between SPEs that have the primary function of financial intermediation and affiliated nonfinancial enterprises should be classified, were as follows.  

<table>
<thead>
<tr>
<th>Total responses</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct investment</td>
<td>1</td>
</tr>
<tr>
<td>Other investment</td>
<td>1</td>
</tr>
</tbody>
</table>

38 The majority of countries that exclude other capital transactions are European (Iceland, Lithuania, Luxembourg, the Netherlands, Norway, Poland (outward data only), Spain, and Turkey). Non-European countries that exclude other capital transactions are Bolivia (inward data only), El Salvador, Japan, Mexico, and the Philippines.

39 No comments were received on the second question raised in the AO, namely, the meaning of “SPEs that undertake financial intermediation”
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 12(I)

COUNTRY IDENTIFICATION (ULTIMATE BENEFICIAL OWNER/ULTIMATE DESTINATION AND IMMEDIATE HOST/INVESTING COUNTRY)

Prepared by
United States
Eurostat

November 2004
80. The OECD Benchmark Definition of Direct Investment notes that analysis of direct investment may require classification of the data by country on two bases: 1) by ultimate host country/ultimate investing country, and 2) by immediate host country/immediate investing country. Of these two, the preferred basis for classification for most direct investment statistics, according to the Benchmark Definition, is immediate host country/immediate investing country. Specifically, the Benchmark Definition recommends that direct investment balance of payments flows be classified only by immediate host/immediate investing country and that the stock of direct investment net assets and direct investment earnings also be classified primarily on this basis. Although the Benchmark Definition recognizes that classification by ultimate host country/ultimate investing country can be useful, it notes that for outward investment “recording earnings on the basis of the ultimate host country would appear more appropriate in the case of operating data of affiliates, for those countries that collect such data.” For inward investment, the Benchmark Definition points out that the share of earnings and net assets attributable to the ultimate parent company will not normally be known because the host country does not know the percentage share holdings in the various intermediary companies between the direct investment enterprise and the company that ultimately owns it.

81. In accordance with the Benchmark Definition, the standard presentation by the United States of the direct investment position and of balance of payments flows is based on data classified by immediate host country/immediate investing country. The United States also collects extensive data on the operations of direct investment enterprises and, for these data, the country of ultimate host country/ultimate investor country is the principal basis for classification. The remainder of this paper discusses how the United States uses ultimate investor classifications in the inward investment data on the operations of direct investment enterprises.

82. The data on the operations of inward direct investment enterprises are collected in order to be able to monitor, assess the impact of, and guide U.S. policy on foreign direct investment in the United States. For these purposes, the country that ultimately owns or controls a direct investment enterprise and, therefore, derives the benefits from owning or controlling the enterprise, is considered most important. To adequately evaluate many of the issues of concern to policymakers and researchers pertaining to direct investment, information on the ultimate owner is essential. For example, an understanding of the ramifications of technology transfer associated with a direct investment partly depends on knowledge of

40. The data on the operations of direct investment enterprises, which are collected in mandatory surveys, include such items as balance sheets and income statements, sales of goods and services, employment and employee compensation, U.S. trade in goods, research and development expenditures, taxes, and external financial position.
the country of the ultimate investor because the ultimate investor infrequently the source for transfers of
technology to or the recipient of technology transfers from the direct investment enterprise. The country of
the immediate investor often irrelevant, particularly if, as is often the case, the immediate investor serves
only as a conduit for financing and income flows.

83. The United States refers to the ultimate investor as the “ultimate beneficial owner” (UBO), the
immediate owner as the “foreign parent,” and the direct investment enterprises the “U.S. affiliate.” Using
the U.S. terminology, the UBO is defined as that person, proceeding up the U.S. affiliate’s ownership chain
beginning with and including the foreign parent, that is not owned more than 50 percent by another person.
The foreign parent is the first person outside the United States in the U.S. affiliate’s ownership chain that
has a direct investment in the U.S. affiliate. If the foreign parent is not owned more than 50 percent by
another person, the foreign parent and UBO are the same. Unlike the foreign parent, the UBO may be
either a U.S. person or a foreign person (though most are foreign). Both the UBO and foreign parent are
“persons,” where person is broadly defined to include any corporation, individual, branch, partnership,
association, associated group, estate, trust, or other organization and any government.

84. The United States collects UBO information in mandatory annual and benchmark survey
reports filed by U.S. affiliates. The definitions discussed above are provided on the survey forms, and the
U.S. affiliate is required to provide information on the country and industry of its UBO based on those
definitions. The United States does not collect information on the UBO’s percent ownership share in the
U.S. affiliate or on intermediary companies between the foreign parent and the UBO. The United States
believes its method of collecting the information yields accurate information on the country and industry of
the UBO. For the majority of cases, there is little evidence that the absence of information on the UBO’s
ownership interest in the U.S. affiliate or of information on intermediary companies has affected the
quality of the information provided.

85. Although information on intermediary companies between the foreign parent and the UBO could
be useful in answering some research and policy questions, the information is not collected by the United
States because of concerns about the difficulty of obtaining the information and about the burden that
would be imposed on survey respondents. Also, it is not clear how information on the often complex
structures of intermediary companies would be tabulated if it were collected. Ownership chains can involve
a number of tiers—a single UBO’s ownership chain might involve companies in several countries before
reaching the U.S. affiliate—and the chains can vary significantly from company to company. Presenting
such complex and varying information in a meaningful way would be problematic.

86. In collecting the UBO information, the primary goal is to obtain accurate information on the
country and industry of the UBO; information pertaining to the identity of the UBO itself (such as its
name) is of secondary importance. The United States recognizes that a UBO that is an individual (or group
of individuals) may prefer not to be specifically identified and, in such cases, the U.S. affiliate is not
required to report the name of its UBO. A similar situation that might affect reporting arises if the UBO
does not want to make requested information available to the U.S. affiliate for inclusion in a survey report.
Because of concerns about such situations, the first U.S. surveys that obtained UBO information permitted
the UBO itself to directly supply the requested information. However, the early surveys indicated that this
was not a significant issue, and the United States no longer provides instructions on its survey forms
regarding direct reporting of information by a UBO.

87. Although the United States obtains information on the industry of UBO in addition to the
country, its use of the industry classifications is limited. Most tables that disaggregate the operations data
by industry are based on data classified by industry of the U.S. affiliate; only a few are classified by
industry of UBO. The industry classifications obtained for UBO’s are much less detailed than those for
U.S. affiliates. In the 2002 benchmark survey, UBO’s were assigned to 1 of 32 broad categories while
U.S. affiliates were assigned to 1 of almost 200 industry classifications (the attachment lists the 2002 UBO industry categories). In the case of UBO’s that are business enterprises, the classifications are assigned based on the UBO’s worldwide consolidated activities, including the activities of the U.S. and foreign entities in the ownership chain below it.41 The industry classification of the UBO can and often does differ from that of the foreign parent. (Classifications can differ even in cases where the UBO and the foreign parent are the same company.) This difference occurs because the industry classification of the foreign parent reflects only the activities of the parent and the foreign parent consists only of the first person outside the United States in the U.S. affiliate’s ownership chain; all other affiliated foreign or U.S. persons are excluded. UBO’s that are not business enterprises are classified based on the type of entity—for example as individuals, estates, or trusts. When the United States first began collecting UBO information, the industry was assigned based on the activities of the UBO itself rather than on its worldwide activities. Many UBO’s are holding companies, and tabulations based on the information collected in the early surveys tended to classify a substantial portion of the data as holding companies. Because of this problem, beginning with the 1987 benchmark survey of foreign direct investment in the United States the basis for assigning industry classifications was changed to the UBO’s worldwide activities.

88. A U.S. affiliate may have more than one foreign parent and, therefore, may also have more than one UBO. In such cases, U.S affiliates are required to identify the UBO for each foreign parent ownership chain. (An affiliate could have two foreign parents if, for example, one parent has a 30 percent ownership interest in the affiliate and another has a 70 percent interest.) In tabulations that present data by country of UBO, data for U.S. affiliates with more than one UBO are assigned to the country of the UBO in the ownership chain of the foreign parent with the largest ownership interest.

89. UBO information was first collected in the 1980 benchmark survey of foreign direct investment in the United States. In addition to the data for 1980, the benchmark survey information was used to identify the UBO’s of U.S. affiliates that reported in annual surveys covering 1977-79. Since 1980, all annual and benchmark surveys have collected UBO information, and published reports with tabulations of data classified by country and industry of UBO are available for each of the years 1977-2002.

90. Almost all of the tables that present the operations data disaggregated by country are based on data classified by country of UBO. However, a few tables provide data classified by country of foreign parent (that is, by country of the immediate investor). Comparisons of data from the 2002 benchmark survey of foreign direct investment in the United States indicate that distributions based on data classified by country of UBO differ significantly from distributions based on the data classified by country of foreign parent. For example, when distributed by country of UBO, totals for the United Kingdom, Italy, and Hong Kong are substantially higher than those shown when data are distributed by country of foreign parent (see the attached table). For other countries—most notably, Switzerland, the Netherlands, Ireland, and some Caribbean countries—totals shown when data are distributed by country of foreign parent are substantially higher than those shown when distributed by country of UBO. Another difference is that values are shown for the United States in the data distributed by country of UBO.

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41. UBO’s that are not business enterprises are classified based on the type of entity—for example as individuals, estates, or trusts. When the United States first began collecting UBO information, the industry was assigned based on the activities of the UBO itself rather than on its worldwide activities. Many UBO’s are holding companies, and tabulations based on the information collected in the early surveys tended to classify a substantial portion of the data as holding companies. Because of this problem, beginning with the 1987 benchmark survey of foreign direct investment in the United States the basis for assigning industry classifications was changed to the UBO’s worldwide activities.
In addition to the operations data, the United States publishes a limited amount of data on the inward direct investment position and on direct investment balance of payments income classified by country of UBO; these data are available for the years 1987-2003. In order to tabulate the direct investment position and income data by country of UBO, the UBO information collected in the annual and benchmark surveys is linked to information on balance of payments transactions and positions obtained in quarterly direct investment surveys. In the tabulations of the data, values shown for the direct investment position and income are not prorated to reflect the UBO’s percent ownership share in its U.S. affiliate because, as noted earlier, this information is not obtained in the U.S. surveys. Also in the tabulations, values associated with U.S. affiliates with more than one UBO are assigned to the country of the UBO in the ownership chain of the foreign parent with the largest ownership interest.

Questions for discussion:

(1) Do DITEG members have comments on the UBO concept as used by the United States?

(2) Do DITEG members have comments on the methods used by the United States to obtain UBO information?

(3) Should the benchmark definition recommend that information on the ultimate investor be collected by host countries?

(4) Do DITEG members agree that it is not necessary to collect information on the ultimate investor’s percent ownership interest in the direct investment enterprise or on intermediary companies between the immediate and ultimate investing companies?
ATTACHMENT

UBO Industry Categories Used in the 2002 Benchmark Survey of Foreign Direct Investment in the United States

01 Government and government-owned or -sponsored enterprise, or quasi-government organization or agency
02 Pension fund — Government run
03 Pension fund — Privately run
04 Estate, trust, or non-profit organization
05 Individual

Private business enterprise, investment organization, or group engaged in:

06 Insurance
07 Agriculture, forestry, fishing, and hunting
08 Mining
09 Construction
10 Transportation and warehousing
11 Utilities
12 Wholesale and retail trade
13 Banking, including bank holding companies
14 Holding companies, excluding bank holding companies
15 Other finance
16 Real estate
17 Information
18 Professional, scientific, and technical services
19 Other services

Manufacturing, including fabricating, assembling, and processing of goods:

20 Food
21 Beverages and tobacco products
22 Pharmaceuticals and medicine
23 Other chemicals
24 Non-metallic mineral products
25 Primary and fabricated metal products
26 Computer and electronic products
27 Machinery manufacturing
28 Electrical equipment, appliances, and components
29 Motor vehicles and parts
30 Other transportation equipment
31 Other manufacturing
32 Petroleum manufacturing, including integrated petroleum and petroleum refining without extraction
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<th>Sales (in $ millions)</th>
<th>Value added (in $ millions)</th>
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Note: This report gives employment data for the year 2003. The data may not be comparable to other years.

The data source is the United Nations Conference on Trade and Development (UNCTAD).
IMF/OECD – DITEG: ISSUES PAPER 12(I)
COUNTRY IDENTIFICATION
(ULTIMATE BENEFICIAL OWNER/ULTIMATE DESTINATION AND IMMEDIATE HOST/INVESTING COUNTRY)

Prepared by Paolo Passerini,
Eurostat, Unit C-4, November 2004

I. Current international standards for the statistical treatment of the issue

92. The BPM5 treats regional allocation principles in §§481-498. BPM5 discusses the distinction between the transaction principle and the debtor/creditor principle. In both cases reference is made to the immediate host/investing country of the transactor or debtor/creditor, respectively. Financial flows may be geographically allocated either on the basis of the transaction principle or on the basis of the debtor/creditor principle (§482). International investment position data are to be allocated on the basis of the debtor/creditor principle (§484).

93. The OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition) also recommends that direct investment flows, income and stocks be allocated to the country of the immediate host/investing country (§§46-47).

94. The Benchmark Definition, however, suggests that the stocks of direct investment net assets be also compiled in respect of the ultimate host or controlling country (§45).

II. Concerns/shortcomings of the current treatment

95. The Benchmark Definition does not give definitions of the ultimate host or controlling country.

96. A less important concern is that the reference to “net assets” is not completely clear about the components of FDI stocks to be compiled in respect of the ultimate host or controlling country.

97. There is a widespread interest among users in knowing more than the immediate host/investing country. Investors frequently use entities located in offshore centres or SPEs to channel FDI funds, while users are also interested in knowing about the ultimate country of control or destination. Data available in some EU Member States for inward stocks compiled in respect to the ultimate controlling country, when compared to data according to the immediate investing country, show that the impact of the reallocation may be substantial.

III. Possible alternative treatments

98. In practical applications, the reclassification of inward stocks by ultimate controlling country is more developed than the reclassification of outward stocks by ultimate host country (see also point 10 below). The rest of this paper therefore considers mainly the case of inward FDI stocks. After a preliminary distinction on the concept of control, a definition for the ultimate controlling country is proposed and the case of other capital stocks is discussed.

42 See chapter 7 of the report of the Eurostat/ECB Task Force on FDI (Eurostat/ECB, 2004). Data for inward FDI stocks according to the ultimate controlling country were provided by Austria, Denmark and Germany.
99. Given the interest of users in this subject, it is proposed that, for inward stocks at least, the
‘suggestion’ given in §45 of the Benchmark Definition be strengthen and transformed into a
‘recommendation’.

100. However, supplementary definitions seem needed to overcome the concerns mentioned above
regarding the definition of ultimate controlling country and the identification of the components of FDI
stocks to be reallocated.

101. The case of outward stocks by ultimate host country is treated more concisely and in less detail.
Information on outward FDI stocks by ultimate host country is until now collected, according to table 12 in
IMF-OECD (2003, p.79), only by Denmark, Estonia and Luxembourg\textsuperscript{43}. A tentative definition for the
ultimate host country is proposed in §15. If a general definition is agreed, more analysis would be needed,
at least for the case of multiple ultimate host countries. A discussion of the other capital component is
similarly not provided here for outward stocks.

**Inward stocks by ultimate controlling country**

102. Considering the case of inward stocks, it should be preliminary observed that the concept of
control\textsuperscript{44} may in general be interpreted as referring to the direct investment enterprise as a whole, or to any
given position of inward FDI held by an immediate direct investor\textsuperscript{45} (there can be more than one immediate
direct investor for the same direct investment enterprise, or the enterprise may be nationally controlled).
The second interpretation is equivalent to referring control to the immediate direct investor itself.

103. The two concepts obviously give different results in cases such as: i) there is more than one
foreign owner above 10% in a direct investment enterprise, one of which controls the enterprise; ii) there is
one or more foreign owners below 50% and the direct investment enterprise is controlled by a resident
entity.

104. In statistics such as those on ‘operating data of foreign affiliates’ (also called FATS), the concept
of control is actually referred to the enterprise as a whole.

105. It seems however that the second interpretation (namely, to refer control to the immediate direct
investor) is the correct one in the context of the FDI methodology. Paragraph 43 of the Benchmark
Definition refers to the stock of net assets due to the immediate investing country, reanalysed by country of
ultimate control.

106. Several arguments in favour of the second interpretation can be given. First, FDI statistics
measure lasting interest, which obviously does not necessarily imply control on the enterprise. Secondly,
in ‘operating data’, variables such as turnover or employment are allocated 100% to the controlling

\textsuperscript{43} According to the same source, however, Estonia and Luxembourg do not disseminate data by ultimate host
country.

\textsuperscript{44} In the Benchmark Definition control is not explicitly defined. However, it can be said that the definition of
subsidiary in §14 of the Benchmark Definition gives a definition of control in the sense that A is controlled
(directly or indirectly) by B if A is a subsidiary (or a branch) of B. §14 makes reference to the majority
ownership criterion and to other forms of control.

\textsuperscript{45} The qualification “immediate” may be redundant, but is kept in the rest of this paper for clarity to indicate the
first non resident entity directly holding an inward FDI position. The immediate investing country is the
country of residency of the immediate direct investor. Incidentally, while checking the definition of direct
investor in chapter XVIII of BPM5, it was noticed that §359 refers to the direct investor as a “resident
etity”; which is not the case for inward FDI.
country. FDI positions refer instead to the capital stock of the direct investment enterprise only in proportion to the share held by the immediate direct investor. Thirdly, if control was referred to the direct investment enterprise, for all resident associate companies the “ultimate controlling country” would be the compiling country. Finally, for subsidiaries, there would be the additional question of how to allocate minority shares (above 10%) held by a direct investor other than the one controlling the subsidiary.

107. On the other hand, the main argument in favour of the first interpretation seems to refer to the fact that for compilers it would be easier to obtain information on the ultimate controlling country of the enterprise than on that of the immediate direct investor. Collecting data for the ultimate controlling country of the immediate direct investor (when this is not the same as for the direct investment enterprise) may be difficult and may result in statistics of lower quality.

108. To sum up this part, main intermediate conclusions are:

(i) in the framework of the present FDI methodology, for determining the ultimate controlling country of inward FDI stocks, control is to be referred to the immediate direct investor, not to the resident direct investment enterprise;

(ii) point i) implies that for a given resident direct investment enterprise there may be more than one ultimate controlling entity and, if they reside in different countries, more than one ultimate controlling country.

109. Having clarified these points, the following definition of ultimate controlling country is proposed:

The ultimate controlling country is the country of residency of the first person (proceeding up the chain beginning with and including the immediate direct investor) that controls the immediate direct investor and is not controlled by another person.

110. Regarding the identification of components of FDI stocks to be re-allocated according to the ultimate country of control criterion, two points seem to deserve consideration by the DITEG:

(i) the meaning of “net assets” needs clarification.

It may be preferable to speak of net liabilities for inward stocks and net assets for outward stocks. ‘Net’ in both cases seems to refer to the case of reverse investment below 10%.

(ii) should the reallocation concern only the equity capital and reinvested earnings component or also the other capital component of FDI liabilities?

111. During the discussion at the EU Task force on FDI (Eurostat/ECB, 2004) it emerged that the interpretation of the methodology differs among compilers. Some compilers consider also the other capital component and some do not.

112. It seems however to be no difficulty in including also the other capital component if (as proposed above) the reallocation by country of ultimate control is referred to the immediate direct investor. Stocks of other capital can be reallocated applying the same principles as for the equity capital and reinvested earnings component.
Outward stocks by ultimate host country

113. Regarding outward stocks, the problem of defining the ultimate host country may be considered in a symmetric way with respect to the case of inward stocks by ultimate controlling country. That is to say, net assets invested in the immediate direct investment enterprise are reallocated to the country where the immediate direct investment enterprise ultimately holds FDI stocks.

114. The following definition of “ultimate host country” is proposed:

The ultimate host country is the country of residency of the first affiliate (proceeding down the chain beginning with and including the immediate direct investment enterprise) that is controlled by the immediate direct investment enterprise and does not control any other affiliate.

115. Clearly, the immediate direct investment enterprise may hold different chains of control ending up in different ultimate host countries. A criterion for breaking down net assets (invested in the immediate direct investment enterprise) among the different destinations is not proposed at this stage. Given the potential complexity of the reallocation, one possible option could be to recommend a reallocation by ultimate host country only for cases in which the immediate direct investment enterprise is a holding company and/or an SPE.

IV. Points for discussion

(1) Do DITEG members agree that the Benchmark Definition should recommend allocation of FDI inward stocks by ultimate controlling country?

(2) Do DITEG members agree with the definition of ultimate controlling country proposed in §12?

(3) Do DITEG members agree that the reallocation by ultimate controlling country should refer to both equity capital and reinvested earning and other capital inward stocks?

(4) Do DITEG members agree that the reallocation by ultimate controlling country should refer to net liabilities, i.e. liabilities to the immediate direct investor minus assets below 10% possibly held by the direct investment enterprise in the capital of the immediate direct investor?

(5) Do DITEG members agree with the definition of ultimate host country proposed in §15?

(6) Do DITEG members agree that §359 of BPM5 needs redrafting in the part where it says that the direct investor is a resident entity (see footnote 3)?
References


*Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996*


IMF-OECD (2003), *Foreign Direct Investment Statistics – How countries measure FDI.*
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 13

ROUND TRIPPING

Prepared by
Hong Kong, China

September 2004
IMF/OECD – DITEG: ISSUES PAPER #13
ROUND TRIPPING

Prepared by Census and Statistics Department,
Hong Kong, China, September 2004

I. Current international standards for the statistical treatment of the issue

116. The term “round tripping” is not explicitly discussed in the BPM5 and OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition). It is defined in the Annotated Outline (AO) for the revision of BPM5 as the channelling by direct investors of local funds to SPEs abroad and the subsequent return of the funds to the local economy in the form of direct investment.

117. Para. 365 of the BPM5 and para. 39 of the Benchmark Definition state that SPEs be included as direct investment enterprises if they meet the criteria of direct investment, except for SPEs with a sole purpose of serving in a financial intermediary capacity. Although SPEs, typically set up in offshore financial centres or tax haven economies, may have different structures or purposes, they are an integral part of the structure of the direct investment network. As such, round tripping funds flowed within the direct investment network are currently recorded as FDI transactions on a gross basis, i.e. as direct investment abroad for the local funds channelled to SPEs abroad, and as direct investment in the reporting economy for the subsequent return of the funds to the local economy.

II. Concerns/shortcomings of the current treatment

118. FDI inflow to some economies has increased significantly in the past several years. A share of the total FDI inflow to these economies is expected to be of the nature of round tripping funds, given that in those economies, investment incentives are available to foreign investors but not domestic ones. In addition to tax and fiscal advantages that are provided to foreign investors, there are other incentives for round tripping, such as safety and risk management of capital, accessing better financial services, etc. Some elaborations on these incentives are given below:

(a) Tax and fiscal advantages

Some economies provide preferential policies to attract foreign direct investment, including low taxation, favourable land use rights, convenient administrative support, etc. Since it is not always easy for local enterprises to find foreign investors who are willing to invest in them, they may firstly channel capital abroad which is then disguised as foreign capital for local investment to take advantage of the preferential treatments only available to foreign investors.

(46) For instance, 40% of total FDI inflow to Hong Kong between 1998 and 2002 was related to round tripping.
(b) Property right protection

Infrastructure for property right protection in some economies is not well established. Therefore, the enterprises in these economies may have the motivation to park their wealth in affiliated enterprises set up in overseas economies having better legal and institutional settings for property right protection. Besides, some investors may prefer to keep their identities anonymous by investing through companies set up in offshore financial centres. Capital will then be brought back to the host economies in the form of FDI if there are profitable investment opportunities.

(c) Expectations on exchange control and exchange rate

Some economies have control on capital account and exchange rate. Expectations on changes in exchange control and exchange rate may generate round tripping for larger flexibility in foreign exchange management.

(d) Accessing better financial services

Financial markets of some economies are not well developed. Enterprises of these economies have to access overseas financial markets for obtaining better financial services, such as listing of companies in overseas stock markets. The funds raised will be brought back to the host economies in the form of FDI. Round tripping may occur as part of this process.

119. Although the current treatment of recording of round tripping funds under FDI is in conformity with recommendations of the BPM5 and Benchmark Definition, some argue that these round tripping funds lead to an overstatement of the true magnitude of FDI. In order to better reflect the ability of these economies to attract FDI other than round tripping, and to enhance international comparability, it is useful to compile a supplementary set of FDI statistics that excludes round tripping funds.

120. While a general description of round tripping activity is given in the AO, more specific guidelines are needed in the next BoP manual for both compilers and users to better understand the activity, given that it is often difficult to follow closely the intricate enterprise structure of direct investment network and the funds flowing within the network.

121. From the perspective of the host economy, the following two types of FDI flows are considered as round tripping:

(a) domestic investment disguised as foreign investment through non-resident SPE, e.g. in Figure 1(a), Company A in the host economy provides FDI funds to a non-resident SPE (Company B) for investing back in Company C in the host economy.

(b) channelling of FDI funds through local SPE, e.g. in Figure 1(b), Company A’ in economy X channels FDI funds to Company C’ in the same economy through a SPE in the host economy (Company B’).
122. Since this round tripping of capital funds usually have little economic significance to the host economy, it is useful to exclude them for the purpose of compiling a supplementary set of FDI statistics for the host economy to better reflect its ability in attracting FDI.

123. To compile the supplementary set of FDI statistics for the host economy, one basic approach is to identify and ascertain the true round tripping nature of FDI funds received from and provided by companies in the host economy. For instance, in case of Figure 1(a), Company C can be asked to confirm whether the FDI funds received from Company B are in fact local funds provided by another company in the host economy, i.e. Company A. Moreover, Company A can be asked to confirm whether the FDI funds provided to Company B would be, and at what time, channelled back to another company in the host economy, i.e. Company C. For the case of Figure 1(b), Company B’ can be asked to confirm whether the FDI funds received from Company A’ in economy X would be, and at what time, channelled back to Company C’ in economy X.

124. Nevertheless, it is difficult to ascertain the true nature of round tripping funds simply by surveying the companies. Because of the inherent underlying incentives for round tripping (e.g. to disguise the capital flows for taking advantage of preferential treatments only available to foreign investors), some companies actually involved in round tripping activities may not be willing to disclose the true nature of FDI flows. For the type of round tripping shown in Figure 1(b), there may be an additional difficulty in trying to contact and obtain information from Company B’ since it is a SPE (e.g. a brass-plate company).

III. Possible alternative treatments

125. To overcome the inherent difficulties of directly obtaining comprehensive information from companies on the true round tripping nature of FDI funds, compilers can consider identifying some recognisable structures of direct investment groups to assist in the compilation of round tripping statistics. Since it may be difficult to follow closely a complicated group structure and the funds flowing within the group, focus of the survey work could firstly be placed on those relatively simple group structures that are seen to be conducive to round tripping. For most economies, this approach would end up capturing most of the round tripping flows, while enhancing the effectiveness of the survey apparatus as the main tool for data collection. An example of a simple group structure that is conducive to round tripping is shown in Figure 2.
In Figure 2, Companies A, B and C are members of a direct investment group, where Companies A and C are residents of the same host economy, and Company B is a non-resident SPE. This simple group structure will be conducive to round tripping if the following two conditions are met:

(a) Company B is wholly-owned by Company A (i.e. the 100% arrow shown in the diagram);
and
(b) Company B does not own any company other than Company C.

Under this simple structure of direct investment group, it is likely that FDI funds received by Company C from Company B are in fact provided by Company A, i.e. round tripping. The two conditions given above preclude the possibility that the funds received by Company C are in fact provided by other direct investors or direct investment enterprises of Company B.

Of course, it is possible for Company B to borrow funds from unaffiliated companies and channel the funds to Company C in the form of FDI. It is therefore essential to find out from Company C about the source of FDI funds provided by Company B, i.e. whether the funds come from Company A, or are borrowed from other companies. For the purpose of compiling round tripping statistics, in the event that Company C fails to further clarify and ascertain the nature and source of FDI funds provided by Company B, given the structure of this direct investment group, it can be imputed that the funds are actually provided by Company A, i.e. round tripping.

Time of recording

In Figure 2, it is obvious that Company A may provide capital funds to Company B at a time different from that when the funds are channelled back from Company B to Company C. At the time when funds flow out from Company A to the SPE abroad, one cannot be certain that they will actually flow back to the host economy, notwithstanding the obvious intention behind and the likelihood. It is therefore reasonable to consider these funds as round tripping funds only when they actually flow back to the host economy. Only at the time when this round tripping nature of the funds is ascertained, both outflow and inflow of round tripping funds can be recorded (i.e. at the time when the funds flow back to the host economy).
130. If the flows of funds in opposite directions (outflow and inflow) in a round tripping activity take place in two different reference periods, say the outflow occurs in period $t - 1$ and the inflow of the same amount occurs in period $t$, an outflow will need to be imputed and recorded together with the inflow in period $t$, given the rule of recording stated above.

131. There is a major limitation for this rule of recording. In compiling the supplementary set of FDI statistics that excludes round tripping funds, it is possible that, for a given reference period, the total FDI outflow to a particular economy is smaller than the imputed outflow of round tripping funds to that economy, giving a negative FDI outflow to that economy after excluding round tripping funds. This will be difficult to interpret. Selecting a longer reference period (e.g. one year) and adopting a broader geographical breakdown (e.g. a region) will reduce the chance of recording such a negative outflow of FDI other than round tripping.

**Treatment of different flows in opposite directions**

132. The definition of round tripping implies that the total sizes of the flows of funds in opposite directions (outflow and then inflow) in round tripping should be identical. In practice, for a given reference period, it is possible that they are different.

133. For the case shown in Figure 2, the outflow of $x$ may be greater than, equal to, or even smaller than the inflow of $y$ for a reference period. Since funds flowing out to the SPE abroad will only be considered as round tripping funds when they actually flow back to the host economy, $y$ should be taken as the size of the recorded round tripping funds in both directions. Even if $x$ is greater than $y$, only $y$ will be recorded as round tripping in the reference period, and the residual (i.e. $x - y$) would be taken as returning to the host economy in a later period. On the other hand, if $x$ is smaller than $y$, the gap (i.e. $y - x$) would be taken as having been provided to Company B by Company A in an earlier period.

**Direct investment components of round tripping funds**

134. Round tripping funds may cover any components of direct investment capital, namely, equity capital, reinvested earning, or other capital. It is possible that the components of direct investment capital are different for the opposite flows in round tripping. For instance, Company A may provide other capital to Company B which in turn uses the funds to increase its holdings of equity capital of Company C.

**Other structures of direct investment groups conducive to round tripping**

135. The simple group structure shown in Figure 2 can be easily extended to cover other more complicated group structures that are conducive to round tripping and are useful for identifying potential round tripping activities in survey work for the purpose of compiling round tripping statistics. Two examples of these structures are given in Figures 3 and 4 below.
In survey work, for a structure of direct investment group to be seen as conducive to round tripping (such as that shown in Figure 3 or 4), the ownership structure of the group should be set up in a way that preclude the possibility that funds received by Company C are in fact provided by other direct investors or direct investment enterprises of Company B3. For the purpose of compiling round tripping statistics, in the event that Company C fails to further clarify and ascertain the nature and source of FDI funds provided by Company B3, it can still be imputed that the funds are actually provided by Company A, i.e. round tripping.

Remark: n% is the threshold signifying a direct investment relationship.
IV. Points for discussion

(1) Should both types of round tripping (i.e. domestic investment disguised as foreign investment through non-resident SPEs, and channelling of FDI funds through local SPEs) be excluded in compiling the supplementary set of FDI statistics for the host economy?

(2) In compiling the supplementary statistics of FDI other than round tripping, should survey work be focused only on those structures of direct investment groups that are seen to be conducive to round tripping, given that it is difficult to directly obtain from most companies comprehensive information on the true round tripping nature of FDI funds?

(3) Is the suggested rule of recording for round tripping funds appropriate? Is there any method to overcome the limitation of the possibility of recording negative FDI outflow to an economy after excluding round tripping?

(4) Should round tripping funds cover all components of direct investment capital? Is it appropriate to allow the recording of different components of direct investment capital for the opposite FDI flows (outflow and inflow) in round tripping?

(5) Are there other structures of direct investment groups that are also seen to be conducive to round tripping?

References


*Benchmark Definition of Foreign Direct Investment*, third edition, OECD, 1996

*Annotated Outline for the Revision of BPM5*, IMF, April 2004
ISSUES PAPER (DITEG) # 14

PERMANENT DEBT

Prepared by
Japan
IMF

November 2004
IMF/OECD – DITEG: ISSUES PAPER #14
PERMANENT DEBT

Prepared by the Bank of Japan
November 2004

1. Current international standards for the treatment of the direct investment item

137. The statistical definition of permanent debt is not clearly defined in the IMF Balance of Payments Manual, fifth edition (BPM5) or the OECD Benchmark Definition of Foreign Direct Investment, third edition (BD3). Current international standards for the treatment of capital transactions associated with permanent debt with financial affiliates under Direct Investment are as follows;

(a) “Inter-company transactions between affiliated banks and affiliated financial intermediaries recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity investment or, in the case of branches, fixed assets. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as, appropriate, under portfolio investment or other investment” (BPM5, paragraph 372).

(b) The BD3 says that inter-company flows between affiliated entities involved in these activities be excluded from direct investments (BD3, paragraph 40), and that direct investment for banks be restricted to transactions in share capital of its subsidiaries and in permanent debt (defined as representing a permanent interest in the subsidiaries), or in the case of branches, invested in fixed assets (BD3, paragraph 61).

2. Concerns of the current treatment

138. The paragraph 372 of the BPM5 and paragraph 61 of the BD3 only defines permanent debt as “loan capital representing a permanent interest”, and there are no detailed criteria to be regarded as permanent debt. Thus, the definition and classifications of permanent debt differs across countries. That is, some countries record capital transactions with affiliated banks or affiliated financial intermediaries under Direct Investment, and others classify them under Portfolio Investment or Other Investment. It would result in bilateral asymmetries and international discrepancies where counterpart countries adopt different classifications. Furthermore, under the current treatment of permanent debt, FDI statistics might not adequately reflect the business reality of capital transactions with financial affiliates.

The views expressed in this paper are those of the authors and do not necessary reflect those of the Bank of Japan
3. Possible alternative treatments

139. As we proceed with our discussions on permanent debt in the balance of payments, it should be noted that:

(a) most funds (whether from equity capital, retained earnings, or long-/short-term debt capital) that a financial affiliate receives, is used for its banking-business or asset management, except for some of the initial equity capital provided to establish the financial affiliate, and

(b) the BPM5 says that “for Direct Investment such a distinction (long- and short-term) is not made because it is essentially determined by arbitrary enterprise decisions and because of the fact that there is no meaningful analytic distinction between the two maturities for intercompany flows” (BPM5, paragraph 339).

140. In line with above features, a possible alternative treatment is;

To drop the description of treatment of permanent debt in the upcoming manual. Thus any debt transactions with financial affiliates would be classified into Portfolio Investment or Other Investment as usual banking business, regardless of the percentage of ownership or the original maturity.

4. Points for discussion

(1) Do DITEG members consider that it is appropriate to elaborate on the statistical definition of “permanent debt”?

(2) Do DITEG members consider that it is appropriate to continue to include capital transactions associated with permanent debt with financial affiliates under Direct Investment?

(3) Do DITEG members consider that it is appropriate to include reverse investment (collection of funds from financial affiliates abroad to direct investors) of permanent debt under Direct Investment?

5. Supplementary information

According to the “Foreign Direct Investment Statistics: How Countries Measure FDI 2001”, of the 33 (outward) and 37 (inward) of 61 countries/regions surveyed record transactions between affiliated banks in their FDI statistics, and of the 32 (outward) and 38 (inward) of 61 countries/regions do transactions between affiliated financial intermediaries under Direct Investment.

6. Annex of the most relevant documents


48. As for Japan’s case, there is a significant volume in cross-border capital transactions associated with permanent debt (permanent loans or perpetual bonds) to enhance a bank’s BIS ratio. Such transactions include “collection of funds from financial affiliates abroad to direct investors (reverse investment)” as well as “capital injections to financial affiliates abroad from direct investors”.
I. Current international standards for the statistical treatment of the issue

141. The fifth edition of the IMF Balance of Payments Manual (BPM5) indicates that “intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g. security dealers)—including [Special Purpose Entities] SPEs with the sole purpose of serving as financial intermediaries—recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share) capital, or in the case of branches, fixed assets. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries as classified, as appropriate, under portfolio investment or other investment.” (Paragraph 372.)

142. The third edition of the OECD Benchmark Definition of Foreign Direct Investment (BD3) states that “in the case of banks, all intercompany flows – with the exception of those considered to represent permanent debt or equities – with related affiliates should not be counted as direct investment. Similar considerations apply to financial intermediaries... and to SPEs whose sole purpose is to serve as financial intermediaries. OECD recommends that intercompany flows between affiliated entities involved in these activities be excluded from direct investment. (Paragraph 40.) Although the BD3 defines permanent debt simply as “representing a permanent interest” (paragraph 61), a footnote indicates that “[Bank of International Settlements] BIS “second-tier” capital might be a useful indication for compilers regarding what represents permanent debt.”

143. The Balance of Payments Textbook (BOP Textbook) (paragraphs 542-544) specifically excludes from the direct investment data all non-equity/permanent debt transactions between a nonfinancial enterprise and an affiliated SPE with the sole purpose of financial intermediation, and specifically includes such transactions between a nonfinancial enterprise and an affiliated SPE with the primary purpose of financial intermediation.

144. These statements have caused confusion in the past, for a number of reasons:

(a) The BPM5 text could be interpreted as applying only to those transactions between affiliated banks and between affiliated financial intermediaries, and not to transactions between affiliated banks and affiliated financial intermediaries.

(b) The BD3 text which refers to intercompany flows with related affiliates could be interpreted as referring to all related enterprises, including nonfinancial enterprises, and not just to those that are banks or financial intermediaries.
Neither the BPM5 or the BD3, or the BOP Textbook were clear about what exactly was meant by financial intermediaries.

There seemed to be little justification for the differing treatment of SPEs with the sole purpose of financial intermediation and those with the primary purpose of financial intermediation, given that there is essentially no economic difference between the two types of SPEs.

As a result, following discussions with the relevant working groups at the OECD and the ECB, at its October 2001 meeting the IMF’s Committee on Balance of Payments Statistics (the Committee) amended the treatment recommended in the international manuals. The decision affecting the treatment of permanent debt, which was promulgated in May 2002 in the document Recommended Treatment of Selected Direct Investment Transactions, was as follows: “The BPM5 definition of the scope of enterprises included under "banks and other financial intermediaries such as security dealers" should be clarified as being equivalent to the following SNA93 financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. As a result, SPEs principally engaged in financial intermediation for a group of related enterprises would be encompassed in that definition.

- The implications of the above clarification are that financial (and investment income) transactions between two affiliated enterprises that are part of (1) other depository corporations (other than the central bank); (2) other financial intermediaries, except insurance corporations and pension funds; or (3) financial auxiliaries would be excluded from FDI except for transactions in the form of equity capital or permanent debt.

- Financial transactions between units that are not financial intermediaries and affiliated financial SPEs abroad should be recorded under FDI.”

The statement promulgating this decision emphasized that the effect of the last recommendation is that there is no longer be any difference between the treatment of SPEs that have the sole purpose of financial intermediation and the treatment of SPEs that have the primary purpose of financial intermediation.

II. Concerns/shortcomings of the current treatment

The argument has been made that there is little economic difference between permanent debt, which the present methodology specifies should be included in the direct investment data, and other types of debt and liabilities related to usual banking and financial intermediation activities, which are to be excluded from the direct investment data, in that ultimately, the funds are all fungible. 49

Concerns have been expressed about the difficulty of implementing the recommended treatment, with the result that many countries do not include permanent debt in their data on other capital.

The vagueness of the definition of permanent debt has also raised concerns, not least because it can lead to asymmetries in the bilateral data. To address this issue, the 2003 SIMSDI questionnaire asked

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49 See the paper prepared by the US Bureau of Economic Analysis for the 2002 meeting of the IMF Committee on the Balance of Payments Statistics, Exploring the Borderline between Direct Investment and Other Types of Investment: The U.S. Treatment.
respondent countries to provide the definition of permanent debt that they use in their direct investment data, with the aim of determining the extent to which there is consensus about what countries view as being permanent debt.

150. The IMF’s Annotated Outline for the Revision of the Balance of Payments Manual, Fifth Edition (AO) stated that the definition of permanent debt and the possible exclusion of all debt between affiliated financial intermediaries will be considered in the revision of BPM5, and asked whether permanent debt between affiliated financial intermediaries should be excluded from direct investment, and whether, and how, the definition of permanent debt should be expanded.

III. Possible alternative treatments

151. There are two options:

(a) To retain the existing methodology for the treatment of permanent debt, as clarified in the decision of the Committee promulgated in 2002, and to amend the manuals to provide a more detailed definition of permanent debt.

(b) To amend the present methodology by removing permanent debt between affiliated banks and between affiliated financial intermediaries from the direct investment data and instead classifying it under Portfolio Investment or Other Investment as appropriate.

152. The comments on the questions raised in the AO, namely, (i) Should this exception [to transactions between units in a direct investment relationship] be extended to [permanent] debt? (ii) Alternatively, should “permanent debt” be defined further, and if so, how? (Paragraph 5.27), show support for retaining the present methodology of including in the direct investment data permanent debt between affiliated financial intermediaries.

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153. The preliminary results of the 2003 Survey on the Implementation of Methodological Standards for Direct Investment (SIMSDI) also tend to support option (a). Those results indicate that the number of countries that include permanent debt in their direct investment data has improved in recent years. Of the 86 countries for which the issue is applicable, 56 (or almost two thirds) now include permanent debt between affiliated banks, and 46 include permanent debt between affiliated financial intermediaries.

154. The 2003 SIMSDI results also support the need for further defining permanent debt and indicate that the precise definition being used varies across countries, with the most common definition being “subordinated loans”. Of the 29 countries that had provided this information at the time of writing, 15

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50 At the time of writing, 22 respondent countries had indicated that they did not compile data on the other capital component of direct investment, and the 2003 SIMSDI questionnaire responses for 5 OECD countries and 3 non-OECD countries had not been received.

51 This compares with the results of the 1997 SIMSDI, when half the countries included permanent debt between affiliated banks, and one third of the countries included permanent debt between affiliated financial intermediaries.
defined permanent debt as being “subordinated loans” or “subordinated debt” 52, including 2 countries that had an additional criterion of a maturity of 5 years or more. Five countries used definitions similar to those given in the BPM5 and BD3 of “debt involving a permanent or lasting interest” 53, 4 countries used the definition of “perpetual debt or debt with no fixed maturity” 54, 1 country defined permanent debt as being “both subordinated loans and perpetual debt”, 3 countries defined permanent debt as being “debt that is part of the equity capital”, and the remaining 2 countries defined it as being all “long-term loans between affiliated banks and between affiliated financial intermediaries”.

IV. Points for discussion

(1) Do the DITEG members consider that the existing methodology for the treatment of permanent debt, as clarified in the decision of the Committee promulgated in 2002, should be retained?

(2) If so, do the DITEG members consider that the definition of permanent debt should be amended to clarify the meaning of “permanent or lasting interest”?

(3) If so, which, if any, of the following definitions do the DITEG members prefer:

(a) “Debt that represents a permanent or lasting interest, in the form of subordinated debt” or

(b) “Debt that represents a permanent or lasting interest, in the form of subordinated debt and perpetual debt” or

(c) Debt that represents a permanent or lasting interest, in the form of subordinated debt and perpetual debt, that also has the purpose of acting as equity”?

(4) If the DITEG members do not prefer any of the definitions cited in (3) above, what should the amended definition of permanent debt be?

(5) If the answer to 1 above if “No”, do DITEG members consider that the present methodology should be amended by removing permanent debt between affiliated banks and between affiliated financial intermediaries from the direct investment data and instead classifying it under Portfolio Investment or Other Investment, as appropriate, in the balance of payments statistics?

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52 Including Australia, Croatia, Estonia, Germany, Hungary, Ireland, Luxembourg, Norway, Portugal, Russia, Slovenia, Spain, and Switzerland.

53 Including Kazakhstan, Kuwait, Lebanon, and Thailand.

54 Including Finland, Hong Kong SAR, and the United Kingdom.
References


IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 15

LAND AND BUILDING OWNED BY NON-RESIDENTS

Prepared by the IMF

November 2004
IMF/OECD – DITEG: ISSUES PAPER #15
LAND AND BUILDING OWNED BY NON-RESIDENTS ON A LONG-TERM LEASEHOLD BASIS

Prepared by Maire Montanjees
Statistics Department, IMF,
November 2004

I. Current international standards for the statistical treatment of the issue

155. The fifth edition of the IMF Balance of Payments Manual (BPM5) states that in instances of ownership of land and buildings by a nonresident, “the owner is treated as if he has transferred his ownership to a notional institutional unit that is actually resident in the country. The notional unit is treated as being owned and controlled by the nonresident owners—much as a quasi-corporation is owned and controlled by its owner.” (paragraph 64). Although not specifically stated in the BPM5, the IMF Balance of Payments Textbook (BOP Textbook) indicates that “The relationship between the nonresident legal owner of the land and the notional entity is a direct investment relationship.” (Paragraph 550.) BPM5 also makes it clear that “private, nonbusiness real estate investment (e.g. holiday and other residences owned by nonresidents for personal use...) is, in principle, included in direct investment.” (Paragraph 382.)

156. The third edition of the OECD Benchmark Definition of Foreign Direct Investment (BD3), indicates that the direct investment data should cover “Land, structures (except those structures owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident. Holiday and second homes owned by nonresidents are therefore regarded as part of direct investment...” (Paragraph 10.)

157. Although neither the BPM5 or BD3 indicate the component of direct investment under which land and buildings are to be classified, the IMF Balance of Payments Compilation Guide specifies that purchases and sales of land and buildings by nonresidents are to be classified under the equity capital component of direct investment (Table 16.2, page 158), as does the BOP Textbook (paragraph 551).

II. Concerns/shortcomings of the current treatment

158. The fact that neither the BPM5 or BD3 specifically state that land and buildings purchased/owned by nonresidents on a long-term leasehold basis, as opposed to land and buildings purchased/owned outright on a free-hold basis, are to be included in the direct investment data has caused some confusion amongst compilers.

159. The manuals also do not address the issues of whether the data should cover only leases that are long-term, and if so, the precise definition of those “long-term” leases.

160. In response to these concerns the Annotated Outline for the Revision of BPM5 (AO) proposes that the treatment of land and buildings indicated in the present manuals will also be applied to long-term leases.
of immovable assets on the basis that long-term leases approximate ownership. The AO also asks for views on whether this proposed treatment is considered to be appropriate, and if so, whether the definition of “long-term” should be one year or whether it should be a longer period. (Paragraph 4.24.)

III. Possible alternative treatments

161. There are three possible options:

(a) To expand the text in the manuals to make it clear that (i) purchases/ownership of land and buildings by nonresidents on a long-term leasehold basis are to be included in the direct investment data, (ii) the definition of long-term leases should be consistent with that used for other debt instruments, namely, “leases with a duration of one year or more”, and (iii) purchases/ownership of land and buildings by nonresidents on a long-term leasehold basis are to be classified under equity capital, together with land and buildings owned outright by nonresidents.

(b) To amend the current methodology to make a distinction between land and buildings owned outright by nonresidents and those owned on a leasehold basis, with the former being classified under the equity capital component of direct investment, and the latter being classified under the other capital component of direct investment, as is the present practice of a few countries.

(c) To amend the current methodology to make a distinction between land and buildings owned outright by nonresidents and those owned on a leasehold basis, with the former being classified under the equity capital component of direct investment, and the latter being excluded from the direct investment data, and instead classified under the Other Investment category in the balance of payments statistics, as is the present practice of several countries.

162. The preliminary results of the 2003 Survey of the Implementation of International Methodological Standards for Direct Investment (SIMSDI) indicate that a significant number of countries already apply the classification and definition proposed in 9(a) above. Of the 56 respondent countries\(^{55}\) for which purchases of land and buildings on long-term leases are applicable:

(a) 21 countries\(^{56}\) include the land and buildings purchased/owned by nonresidents on long-term leases in their direct investment data.

(b) All of the 21 countries classified these transactions/positions as equity capital, together with the data on outright purchases/ownership of land and buildings by nonresidents.

(c) Of the 14 countries that provided information on the definition of “long-term leases” used for their data, 2 countries made no distinction between land and buildings owned outright by nonresidents and those owned on a leasehold arrangement, and all but 2 of the remaining 12 countries used the standard definition for long-term debt, namely leases with a duration of one year or more.\(^{57}\)

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\(^{55}\) At time of writing, the issue was not applicable for 52 countries and the 2003 SIMSDI questionnaire responses for 5 OECD countries and 3 non-OECD countries had not been received.

\(^{56}\) These countries comprise 4 OECD countries, Mexico, Spain, the United Kingdom, and the United States), and 17 non-OECD countries, including Malaysia, Pakistan, Russia, Singapore, and Tunisia.

\(^{57}\) Costa Rica defines long-term leases for the purchase of land and buildings by non-residents as being those with a duration of 10 years or more, or leases that includes an option to buy. Pakistan defines long-term leases for the purchase of land and buildings by non-residents as being 99 years.
163. The 2003 SIMSDI questionnaire does not address the reasons why the remaining 35 countries do not include purchases/ownership of land and buildings by nonresidents on long-term leases in their direct investment data.

164. The comments on the questions raised in the AO (Is the proposed treatment for long-term leases of land suitable? If so, what is the definition of “long-term”? Is it one year, as in other cases or something longer?) also support the proposal in 9(a) above.

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<td>• 1 year (4); 3 years (1); 3-5 years (1); 30-50 years (1); long, at country’s discretion (1).</td>
<td></td>
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<tr>
<td>Other</td>
<td>1</td>
</tr>
<tr>
<td>• If yes, longer than 1 year.</td>
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IV. Points for discussion

(1) Do DITEG members consider that the revisions to BPM5 and BD3 should clarify that (i) land and buildings purchased/owned by non-residents on a long-term leasehold basis are to be included in the direct investment data, (ii) the definition of long-term leases should be consistent with that used for other debt instruments, namely, “leases with a duration of one year or more”, and (iii) land and buildings purchased/owned by non-residents on a long-term leasehold basis are to be classified under equity capital, together with land and buildings owned outright by non-residents? or

(2) Do DITEG members consider that the methodology should be amended to make a distinction between land and buildings owned outright by non-residents and those owned on a long-term leasehold basis, with the former being classified under the equity capital component of direct investment, and the latter being classified under the other capital component of direct investment? or

(3) Do DITEG members consider that the methodology should be amended to make a distinction between land and buildings owned outright by non-residents and those owned on a long-term leasehold basis, with the former being classified under the equity capital component of direct investment, and the latter being excluded from the direct investment data, and instead classified under the Other Investment category of the balance of payments statistics?

References


ISSUES PAPER (DITEG) # 16

USE OF MATURITY AND FULL INSTRUMENT SPLIT FOR DIRECT INVESTMENT

Prepared by the IMF

November 2004
IMF/OECD – DITEG: ISSUES PAPER #16
USE OF MATURITY AND INSTRUMENT SPLIT FOR DIRECT INVESTMENT

Prepared by John Joisce
Statistics Department, IMF

November 2004

1. Current international standards

165. The current international standards for balance of payments statistics recommend that the direct investment instrument be split into “equity capital”, “reinvested earnings” and “other capital.” For the international investment position (IIP), only a breakdown into “equity capital and reinvested earnings” and “other capital” is recommended (i.e. “reinvested earnings” is combined with “equity capital” in the IIP). No maturity split is recommended. **BPM5** suggests (para. 339) that a split between “long-term capital” and “short-term capital” is not meaningful as investment decisions are made on an arbitrary basis by the enterprise involved and that there is no meaningful analytic distinction between the two maturities for inter-company flows.\(^{58}\)

2. Concerns/shortcomings of the current treatment

166. One of the goals of the BPM5 and the 1993 System of National Accounts (1993 SNA) was the creation of an integrated framework of statistics, ensuring, to the maximum extent possible, that the two frameworks were compatible. That goal was achieved to a very large extent but there are some areas where integration remains problematic. One of those is the linking of “other capital” in direct investment to the financial account and balance sheet of the “rest of the world” in the **1993 SNA**, because it is not broken down by instrument or maturity.

167. In addition, there is growing interest in obtaining more detail of “other capital” for analysis of cross-border financial positions flows, such as for trade credit.

3. Possible alternative treatments

168. In order for compilers of the national accounts’ financial account and balance sheets to be able to compile their data more easily, it would be useful for an instrument breakdown to be obtained, (that is, a breakdown showing (i) securities other than shares (i.e., debt securities), (ii) loans, (iii) accounts receivable/payable (further broken down into “trade credit and advances” and “other”), and (iv) other. It is proposed that this breakdown would be encouraged on a supplementary basis for countries where debt instruments other than loans are an important financing instrument. For all of these instruments, a long-term/short-term distinction would also be useful to fit the requirements of the national accounts, as the national accounts financial account has a similar split. However, for the reasons indicated in para. 339 of **BPM5**, it might not be meaningful or feasible to compile such a split, especially for loans.

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\(^{58}\) “Short term” is defined as up to and including one year and “long term” as more than one year.
169. The encouraged information would be for both transactions and positions. However, if transactions breakdowns were to prove too difficult to collect, data on a positions basis would still be very useful supplementary information.

170. Repeating the concerns raised in BPM5 may be necessary as the points raised are probably still relevant.

4. Responses to Annotated Outline

171. Paragraph 5.28: Should debt in direct investment be broken down between long-term and short-term components, and into the underlying instruments, to permit reconciliation with the 1993 SNA financial account and balance sheets?

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5. Questions/points for discussion

(1) Do the members of DITEG have a view about the desirability and practicality of collecting, on a supplementary basis, a breakdown of “other capital” in direct investment into the instrument classification (viz, debt securities, loans, accounts receivable/payable, and other) of the 1993 SNA, in order to assist the integration of the balance of payments financial account and IIP with the financial account and balance sheet of the 1993 SNA and for analytical reasons?

(2) Do members of DITEG feel that obtaining an additional instrument breakdown of accounts receivable/payable (i.e., “trade credit and advances” and “other”) on a supplementary basis, is desirable and practical?

(3) Do members of DITEG feel that a short-term/long-term breakdown for debt securities is achievable? Do they feel that it would be meaningful and feasible to make such a breakdown for loans and accounts receivable/payable (or trade credits)? Or do they feel that the issues raised in BPM5 about the arbitrariness of a short-term/long-term distinction is still appropriate, especially with regard to loans?

(4) Do members of DITEG feel that a breakdown of “other capital” positions data would be easier to obtain than transactions?

Annex of the most relevant documents

Annotated outline Paras. 5.28

BPM5 paras. 339 and 370.

1993 SNA Table 11.3a
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 17
[ BOPTEG ISSUES PAPER 6A ]
MULTITERRITORY ENTERPRISES

Prepared by Australia

May 2004
IMF/OECD – DITEG: ISSUES PAPER #17
MULTI-TERRITORY ENTERPRISES (AND JOINT TERRITORIES)

Prepared by International Financial Accounts Branch
Australian Bureau of Statistics, May 2004

Introduction

172. BPM5 and proposed revisions have raised the issue of multi-territory enterprises. This paper looks at the various cases raised and concludes that there is no need for special treatment for such enterprises as, with a little digging, the structure can be determined and the constituent companies treated in the normal way according to existing standards. A related but separate issue is that of joint territories. The ABS has had to decide on the statistical treatment of an area over which Australia has joint jurisdiction with neighboring East Timor. This case and the treatment decided upon are described in order to highlight the need for guidance in the standards and to share the ABS's experience.

Current international standards for the treatment of the issue

Multi-territory enterprises

173. BPM5 contains an example of an enterprise which consists of a corporation that is registered in two or more countries through special legislation by the participating governments. The Draft Annotated Outline of the new BPM describes a more general case of a multi-territory enterprise as a single enterprise that is run as a seamless entity across several economic territories, so that separate branches cannot be identified.

174. The issue of assigning residency to a multi-territory enterprise is addressed in BPM5 for an enterprise that operates mobile equipment in several jurisdictions, including ships, aircraft and railways. The manual proposes two ways to treat these enterprises. The first option states that "all of the corporation's transactions may be allocated to the countries of registry in proportion to the amounts of financial capital that the countries have contributed or in proportion to their shares in the equity of the corporation". The second option is to treat the corporation as a resident of the country where its headquarters are located. Corporation premises in other countries would be treated as foreign branches and classified as residents of the countries where they are located. The first method is preferred, however both are claimed to be consistent with the general principals of the BPM5 and the SNA93.

175. BPM5 contains recommendations on the treatment of regional central banks. In determining the residence of regional central banks, the recommendation is to treat the national office in each member country as an institutional unit separate from its headquarters. Each national office is therefore to be treated as a resident of the country where it is located, and the financial assets and liabilities of the regional central bank should be allocated in proportion to the claims that such offices have over the bank's collective assets.

59 Document initially prepared for BOPTEG.
Joint territories

176. SNA/BPM5 provide guidelines for the partition of the globe into economic territories, the identification of institutional units, the determination of the relationship between an economic territory and a unit known as residence and the allocation of units to institutional sectors and industries. Economic territories, with few exceptions, coincide with national territories. However, there are some territories where more than one national government has jurisdiction. The standards do not give any guidance on the treatment of these territories.

Concerns/shortcomings of the current treatment

Multi-territory enterprises

177. The case of companies which can operate throughout Europe is raised as an example of a multi-territory enterprise whose treatment is problematic under the current standards.

178. Other examples put forward are those of hydro-electricity schemes on border rivers, and pipelines, bridges and tunnels which cross borders. Because these are located in two or more economic territories, their treatment is considered problematic.

179. The recommendations on the treatment of regional central banks appear sound and require no alternative.

Joint territories

180. The standards do not give any guidance on the treatment of these territories.

Possible alternative treatments

181. In many decades of collecting and compiling BOP and IIP data in a very open economy, with strong links to Asia, the Americas and Europe, a high level of foreign ownership of companies and a high incidence of complex international business arrangements, the ABS has not encountered a multi-territory enterprise that fits the DAO description. While many companies coordinate activities and even more enter into complex arrangements such as dual listings and the issue of stapled securities in order to appear highly integrated, in every case it has been possible to follow the normal SNA/BPM process of identifying institutional units, determining their residence and allocating them to institutional sectors and industries. The appearance of being multi-territorial has been constructed more as a public relations activity than anything else, and the companies are incorporated in a particular country and have branches and subsidiaries in other countries the same as any other company. Unless it can be established that such enterprises exist and need special treatment, references to multi-territory enterprises need not be included in the standards.

182. In the case of companies which can operate throughout Europe, on the information available it would appear that it is possible to identify and allocate the units in the normal manner. Should the European Union achieve the level of integration needed for a company to operate seamlessly within its borders, the Union should be considered one economic territory, as are the federations of Switzerland, the United States, Russia and Australia.

183. In the case of hydro-electricity schemes on border rivers, and pipelines, bridges and tunnels which cross borders, while these are split physically between two or more economic territories, the current standards contain ample guidance for the process of identifying institutional units, determining their
residence and allocating them to institutional sectors and industries. It should be noted that residence does not depend on ownership, so ownership criteria should not be used to determine residence.

184. If problems are encountered in determining the residence of units which have links with more than one economic territory, the nature of the problems needs to be taken into account in reinforcing the guidelines for determining residence as part of the current revision.

185. The recommendations on the treatment of regional central banks appear sound and require no alternative.

186. While the current standards can deal with companies with activities in more than one territory, there is a need for alternative views of groups of companies, for instance the view provided by grouping companies in global groups rather than groups restricted to companies in the same economic territory. The development of these alternative views should be pursued through globalisation and related research.

**Joint territories**

187. The ABS has had to deal with recording economic activity in a territory which is under the joint jurisdiction of two sovereign states, East Timor and Australia. A description of this treatment is provided here to highlight the considerations needed in dealing with joint territories.

188. The Timor Sea has been the subject of competing claims between East Timor and Australia concerning the location of the boundary between the two countries. In 2003 East Timor and Australia entered into an arrangement, The Timor Sea Treaty, which provides the basis for the development of the major oil and gas deposits in the Timor Sea in an area called the Joint Petroleum Development Area (JPDA). The JPDA is an area of joint jurisdiction between Australia and East Timor. The Treaty states that exploration and production activity in the JPDA is to be administered by an authority, the Designated Authority, established by the Australian and East Timorese governments. Title to all petroleum produced in the JPDA is to be shared by East Timor and Australia, whereby 90% belongs to East Timor and 10% to Australia. Taxation and royalty flows to each government are determined on the basis of these shares.

189. The construction of infrastructure for the extraction and processing of petroleum has proceeded in the JPDA. Production began at the beginning of 2004.

190. To determine the economic territory to which the JPDA belongs, there are two possible interpretations. The first interpretation is to treat the JPDA as being outside the economic territory of any country as no one country has exclusive jurisdiction. If the JPDA is considered in this way, then activity in the area would be assigned to the economic territory to which the unit undertaking the activity has the closest economic links, in this case Australia or East Timor. The alternative interpretation is that the intention of the SNA/BPM requirement to divide the world into economic territories is to prevent duplication of recording of economic activity and this can be achieved by either defining territories which are the exclusive territory of one country or territories which are the territory of more than one country to the exclusion of all other countries. Under this interpretation, given that the JPDA is subject to the jurisdiction of both Australia and East Timor, it can be considered to be the economic territory of both countries. This is the treatment that has been adopted in Australia's economic statistics.

191. As jurisdiction is shared equally between Australia and East Timor, economic activity in the area should be allocated 50% to Australia and 50% to East Timor. The option of allocating the economic activity by units operating in the JPDA according to the split of the flows such as royalties and tax, namely 90% to East Timor and 10% to Australia, was considered, but it was decided that the jurisdiction is independent of the flow of benefits such as royalties and taxes. Under a previous arrangement with Indonesia, these flows would have been split 50/50. A change in the political situation caused a change in
the split from 50/50 to 90/10. Should another activity, such as fishing, occur in the JPDA, the share of flows may be different. However, both countries maintain a claim over 100% of the territory and the Treaty arrangements are pragmatic compromises to allow economic activity to proceed.

192. The units which will be extracting petroleum in the Bayu Undan Gas Recycle Project are part of an unincorporated joint venture (UJV) set up to produce in the JPDA. The ABS is of the view that the Bayu Undan unit is made up of quasi-corporations producing petroleum in the JPDA. Because these units are operating in the JPDA, an economic territory equally shared between Australia and East Timor, all economic activity undertaken by these units should be attributed 50% to Australia and 50% to East Timor. In practice, this is achieved by treating all units operating within the area as consisting of two nominal entities - one with residence in the economic territory of East Timor and one with residence in the economic territory of Australia. The allocation of related flows such as rent (royalties) and tax are done in proportions determined by the production sharing contract, that is 90% to East Timor and 10% to Australia.

193. This treatment is difficult to implement. Petroleum will go directly from the JPDA to its markets in Asia and the Americas. It will not cross a customs frontier, so exports will need to be collected by other means. Equipment and supplies sent from Australia will be recorded by customs as exports, so 50% of these will need to be subtracted for BOP purposes. Activity, such as the provision of services by Australian companies, may or may not be included in statistical reports by Australian companies when they are asked to report their Australian activities. Each statistical collection feeding into the national accounts needs to be scrutinised separately, with the most likely outcomes being that 100% is being reported, in which case 50% needs to be subtracted, or none is being reported (it is not seen as being Australian activity), in which case data need to be obtained elsewhere. There is a need to liaise with the East Timor statistical agency in order to avoid duplication and omissions.

194. Arriving at this treatment was not easy, and many alternative treatments, taking into account the legal and economic arrangements, were considered. However, after extensive discussion within the ABS and consultation with key users of economic statistics, it was agreed that the treatment described in this paper was the most appropriate.

195. There is a need for SNA/BPM to provide guidance on the principles to be applied in such cases, with clarification of the nature of economic territory, namely whether it is meant to be the exclusive territory of one country or if it can be the territory of more than one country to the exclusion of all other countries. The ABS believes that the latter interpretation is necessary to cater for situations such as that in the Timor Sea.

Note:
The treaty arrangements between Australia and East Timor referred to in this paper reflect the understanding of the ABS of the Treaty's statistical implications and are presented to place the statistical treatment described in context. Readers requiring authoritative information on the Treaty should seek advice from the Australian Government Attorney-General's Department.

Questions/points for discussion

(1) Do BOPTEG members agree that there is no need to modify the standards to address the issue of multi-territory enterprises?

(2) Are members aware of any joint territories and how are they treated?

(3) Do members agree that guidance should be provided on the treatment of joint territories?

(4) Do members believe that the ABS treatment provides a basis for addressing the issue of joint territories?
Supplementary information


IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 23

INTERCOMPANY TRANSACTIONS AND AMOUNTS OUTSTANDING WITH FELLOW SUBSIDIARIES

Prepared by Italy
November 2004
**IMF/OECD – DITEG: ISSUES PAPER #23**

**INTER-COMPANY TRANSACTIONS AND AMOUNTS OUTSTANDING WITH FELLOW SUBSIDIARIES**

*Prepared by Valeria Pellegrini and Maurizio Iannaccone, Statistics Department, Ufficio Italiano dei Cambi (Italy)*

*November 2004*

**Introduction**

196. The relationships between fellow enterprises make an exception in the context of FDI because in these cases direct investment links are established, notwithstanding no participations in the equity capital exceeding 10% exist between the involved companies. In fact, according to the FCS, all the BOP transactions and the outstanding amounts between companies sharing the same direct investors should be classified as direct investments. The aim of this paper is to highlight some critical issues concerning definitions and rules for recording flows/positions between fellow companies. In the final part of the paper some key issues are proposed for discussion at the DITEG.

I. **Current international standards for the statistical treatment of the issue**

197. The Benchmark Definition summarises the FCS (fig 1) in paragraph 4.16 as follows: “...Thus direct investment statistics based on the Fully Consolidated System would cover A,B,C,D,E,F,H,J,K,L.”

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**Fig. 1**

- **Company N**
  - 60% Company A
  - 10% Company D
  - 30% Company F
  - 60% Company H
  - 70% Company K
  - 55% Company B
  - 60% Company E
  - 25% Company G
  - 30% Company J
  - 70% Branch L
  - 12% Company C
198. This sentence can be interpreted as follows:

all transactions between:

(1) associates of N (for example D and F, or C and J….)
(2) associates and subsidiaries/branches of N (for example D and A or J and K)
(3) subsidiaries and branches of N (for example A and H or B and K)

should be considered as direct investments. This interpretation seems to be confirmed by the BPM5 par.368 in Chapter XVIII and by the Compilation guide par. 689 in Chapter XVI and the Balance of Payments textbook par. 517 in Chapter IX.

199. In case 1 and 2, the fellow companies may belong to different groups. They share the same direct investors but do not necessarily share the same mother company and the same harmonised group policy.

200. In case 3, the fellow companies belong to the same group and are controlled by the same mother company. In this case a harmonised policy within the group influences the behaviour of both fellow companies.

II. Shortcomings of the current definitions

201. The Benchmark Definition deals specifically with transactions between fellow companies in par. 5.40 a) “Amounts outstanding with fellow subsidiaries”. Both the title and the contents of this paragraph seems to be referred to subsidiaries (case 3) and seems to exclude case 1 and 2. “Inward and outward direct investment enterprises may have loans or balances due to or from fellow subsidiaries and branches – that is companies and their branches which have the same ultimate parent as the direct investment enterprise….” “OECD recommends that these amounts be included in direct investment and allocated to the country of the fellow subsidiaries or branch or of the indirectly controlled direct investment enterprises as appropriate”. The term “fellow subsidiary” is also used in annex 4 of the Benchmark Definition dealing with the same subject, and it seems to be too restrictive, it can be misinterpreted.

202. Many terms are generally used to address fellow companies (fellow subsidiaries, sister company, siblings, cousin, related companies) in manuals and documents. In order to allow a better comprehension of the subject the same consistent terminology should be adopted across the board.

III. Concerns/Conceptual background and geographical allocation

203. Any FDI relationship is characterised by the existence of two well identified subjects: the direct investor and the direct investment enterprise. Sticking to this conceptual framework, the relationship between fellow companies in the context of FDI can be interpreted following two alternative approaches. In order to explain these different approaches the example proposed in fig. n.2 can be analysed. The company A is a direct investor for both companies B and C. Company B does not have participation exceeding 10% of the equity capital of company C. Similarly company C does not have participation exceeding 10% of the equity capital of company B. Companies B and C are fellow companies and are considered to have a direct investment relationship.
204. According to the first approach, direct investor and direct investment enterprise are identified on a transaction by transaction basis. The direct investor is the subject (company B in the example) which is increasing its asset vis-à-vis the fellow company and the direct investment enterprise is the subject (company C in the example) which is increasing its liability vis-à-vis the fellow company. Summing up, fellow companies may play an alternative role either as direct investor or as direct investment enterprise, depending on the specific transaction. Consequently, the BOP recording follows the assets/liabilities principle, which is recommended by the Benchmark Definition against the directional one. This approach introduces an exception in the context of FDI because, in these cases, direct investment relations are established without direct investment in equity capital and lasting interest.

205. According to the second approach and referring to the example above, company A is considered the effective direct investor which channels its transaction through company B, in order to change its assets vis-à-vis company C. Companies B and C have no lasting interests in each other and consequently they can only be direct investment enterprises of company A. This interpretation perfectly tallies with the basic philosophy of the directional principle underlying FDI methodology. In annex 4 of the Benchmark Definition, an alternative method based on the directional principle for recording transactions between fellow companies is proposed. With reference to the proposed example, the alternative method implies that the loan granted by company B is considered an asset vis-à-vis the direct investor (company A). Company A, on its turn, records a liability vis-à-vis the affiliate company B and an asset vis-à-vis the affiliate company C.

206. Generally speaking, a single conceptual framework justifying the inclusion of all transactions between fellow companies has not been precisely identified. As a consequence is not fully clear what should be the analytical value of the inclusion of these transactions in FDI.

207. In the framework of the second approach, fig. 3 and 4 show two examples which raise some problematic issues. In figure n.3 company B (UK) is an associate of company A (IT) and it is controlled by company D (US). As a consequence, company A and company B belong to different groups. According to the FCS, the loan granted by company B to company C (FR) should be treated as if it were made on behalf of company A. This treatment could originate misleading interpretations. In fact company D is the mother company of company B and defines the strategy policy of the group company B belongs to. The
direct investment relationship between company A and company B is effectively established and even though it is a necessary condition, it is not sufficient to assume that the provision of capital to company C through company B is made on behalf of company A.

Fig. 3

![Diagram of investment relationships between A, B, C, and D.]

In fig. n 4 companies B (UK) and C (FR) are both associates of both company A (IT) and company D (US). In case company B grants a loan to company C, it cannot be determined which of the two companies (company A or company D or both) is supposed to increase its assets in company C.

Fig. 4

![Diagram of investment relationships between A, B, C, and D showing the loan.]
209. With reference to this example, the alternative method proposed in annex 4 of the Benchmark Definition might create some discrepancies. In fact, according to this method, the assets of the enterprise B vis-à-vis company C should be recorded as an asset vis-à-vis the direct investor. In the example above there is no single direct investor for company B and company C. Therefore is not clear how the loan should be allocated. In fact:

- UK and FR may allocate the loan granted/received as an asset/liability vis-à-vis IT or US or both direct investors and

- IT and US may both record the loan as a liability vis-à-vis the UK direct investment enterprise and an asset vis-à-vis the FR direct investment enterprise.

This recording method, applied to this example, may generate asymmetries and double counting.

210. On the contrary, the recommended method based on the asset/liabilities principle does not pose any practical problem in recording data, due to the fact that only UK and FR have to record under FDI the loan transaction.

211. On the basis of the problematic issues raised in the proposed example we can make the following considerations.

The basic idea of the directional principle can only be applied to transactions between subsidiaries and branches belonging to the same group and sharing the same mother company. In this case the actual direct investor can always be identified as the company controlling both the fellow companies. When the directional approach is applied to transactions involving fellow associates discrepancies can be envisaged. As a consequence, the directional approach would be theoretically consistent with a revised FCS in which transactions between fellow associates are not included.

212. Even though from a conceptual point of view the directional approach seems to be the more satisfactory, it should be recognised that from a practical point of view a correct application of the directional principle would require a full knowledge of the group structure. Consequently asymmetries between countries may easily occur.

23.1 Whenever transactions between associates are involved, implying that a single mother company does not necessarily exist, the assets/liabilities approach appears to be the only applicable one. From the practical point of view the assets/liabilities principle is the easiest to implement and it reduces the risk of asymmetries between countries. Nevertheless, it should be recognised that the application of the assets/liabilities principle for transaction between fellow companies generally does not provide enough elements to correctly interpret this kind of transactions included in FDI.

213. Therefore, the conceptual rationale for the inclusion of these transactions in FDI has not yet been fully clarified.

IV. Points for discussion

(1) Do the DITEG members agree that reviewing and harmonising the terminology and definitions addressing the fellow companies/subsidiaries is needed?

(2) Do the DITEG members agree that the conceptual rationale for the inclusion of transactions between fellow companies/subsidiaries should be better clarified?
(3) Do the DITEG members believe that the current recommended treatment of the transactions between fellow subsidiaries following the asset/liability principle is the most appropriate? Alternatively, do the DITEG members believe that the alternative method based on the directional principle should be recommended?

(4) Do the DITEG members believe that transactions between fellow associates should not be included in FDI statistics? If not, do the DITEG members believe that the alternative method proposed in Annex 4 of the Benchmark Definition does fit also in the treatment of transaction between fellow associates?

References

- BPM5 (Paras 359-375 371-372)
- Balance of Payments Textbook, IMF (Paras. 529, 531-533)
- FDI Task force Report, ECB/Eurostat (paras 40-44)
- Background paper #7A "Compilation of Direct investment statistics for Ireland - Selected topics" Prepared by CSO Ireland
- Diteg Issue papers #7 and 8 "Reverse investment and directional principle" prepared by IMF
- Background paper Issue 7 "The Application of the Directional Principle" prepared by Dutch Nederlandsche Bank
- Draft Annotated Outline, IMF (paras 5.16-5.20)
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 24

DIRECT INVESTMENT STOCKS (FINANCIAL VERSUS ECONOMIC MEASUREMENT)

Prepared by Belgium

November 2004
214. Data related to foreign direct investment can be considered on one hand as part of the balance of payments or of the international investment position, on the other hand as feeding an autonomous statistic on both flows and stocks.

215. The two sets of statistics need to be consistent which each other and therefore must rest on the same conceptual basis.

216. Nevertheless, FDI statistics due to their aim to provide information useful for analytical purposes and political purposes must also be considered from another point of view. This process requires an enlargement of the outputs such as break-downs by economic activity, break-down by type of investment i.e. M&A, greenfield ...

217. Also the interest for the phenomenon of globalisation of the economy and recent developments in the field of measuring this evolution influence on the way FDI statistics are used and analysed. This new field of analysis focus on the economic impact of affiliated enterprises located in another economy than the one of the parent enterprises and by priority on the impact of subsidiaries and branches. Therefore, it aims to treat data directly related to these affiliates. FDI statisticians may not ignore the approach followed in the elaboration of some statistics on globalisation, because those statistics mostly refer to a "presence abroad" of a domestic entity that is controlled by the latter. That means that FDI relationships are the building-blocks on which these statistics are made. Considering the relation between the 2 areas, FDI statistics must in one way or another be comparable to the statistics on globalisation allowing to confront the activity indicators regarding the subsidiaries and branches with the financial related indicators.

218. In this prospect it may be wondered if, for stocks measurement, supplementary practices cannot be developed in order to favour not only a cohesion with BoP and IIP statistics, but also with the new field of statistics regarding the globalisation.


219. In the 5th edition of the Balance of Payments Manual (BPM5), FDI stocks statistics are part of the International Investment Position (IIP). The IIP is defined in chapter XXIII of BPM5.

220. The conceptual framework of the IIP is similar to the one of the balance of payments, as stated in chapter II of BPM5. This similarity makes that for FDI stocks, the methodology, the concepts and the definitions are the same as for FDI flows in the balance of payments and are defined in chapter XVIII of BPM5.
221. Moreover, BPM5 emphasises the cohesion between the balance of payments and the IIP in its chapter II and its chapter XXIII.

222. The OECD Benchmark definition of FDI aims to provide the framework and standards for the production of FDI statistics considered as a tool for economic analysis and policy making. In that prospect it distinguishes clearly flows from stocks, although the major concepts are identical and described in chapter II of the Benchmark.

223. In chapter III, dedicated to the valuation of FDI stocks and flows, the Benchmark gives an inventory of the components for both the stocks statistics and the flows statistics.

224. The OECD Benchmark states in its paragraph 22 that FDI stocks data of subsidiaries, associates or branches should be measured using the fraction attributable to the direct investor of "... market value or the written-down book value of the company's fixed assets and the market value or book value of its security holdings and other assets, less its liabilities and provisions ..." or " ...market value... of the concern's fixed assets, and the market value... of its investments and current assets, excluding amounts due from the direct investor".

225. Further, in its paragraph 27, the OECD Benchmark recommends even to require the information on all assets of the affiliated enterprises or at least the total value of a selection of their assets.

226. The frequent reference made to the availability and use of consolidated accounts (in a bookkeeping meaning) in paragraph 18 and paragraphs 72 to 74 of the OECD Benchmark nevertheless can lead to the conclusion that the accountancy approach of consolidation fulfils the statistical needs for stocks statistics. Such a conclusion appears to be fully correct in the framework of the BoP and IIP and allows a perfect reconciliation between flows statistics and stocks statistics in that framework.

2. Concerns/shortcomings of the current treatment

227. The major concern is that there is a lack of clarity on the way stocks of FDI should be compiled in the framework of autonomous FDI statistics.

228. As a component of the IIP, FDI data as already mentioned must be consistent with the BoP, meaning that the variation of the FDI stocks components in the IIP must reflect, besides the currency exchange rates changes and the prices changes, the changes due to the transactions as registered in the balance of payments.

229. This approach, if used in FDI statistics considered as autonomous statistics, would provide what one may call a "financial" measurement of the FDI stocks.

230. This measurement does not provide immediate information on the "penetration" of domestic enterprises in foreign economies and does not allow to identify neither the country of investment nor the activity sector in which the investment is made.

231. Furthermore, it does not allow to compare the investment income in a proper way with the overall volume of direct investment abroad.

232. Finally, such a measurement does not give the detailed information by affiliated enterprise and as a result cannot be reconciled with statistics on globalisation or on FATS.
3. **POSSIBLE ALTERNATIVE TREATMENT**

233. The proposal made in the present issue paper is not an alternative to an existent methodology but much more a supplementary approach of FDI stocks statistics that should be considered for the future.

234. This measurement of FDI, one may call the "economic measurement" of FDI, would aim to get a picture of the global "presence" abroad under the form of affiliated enterprises and of the "financial" weight of each direct investment enterprise. Also the investment income, including "reinvested earnings", would then be identifiable by individual affiliated enterprise.

235. To allow such a reconciliation, and as a consequence, to reinforce the analytical interest of FDI stocks statistics, FDI statistics need to reflect the necessary financial data, defined as significant for direct investment statistics, of each entity being a direct investment enterprise. This process would also aim to produce such statistics, including the FDI income, for each country where direct investment enterprises would be located.

236. The set of "financial" data obtained in this way could then be confronted and even reconciled with other statistics on globalisation and with FATS, as well as with other statistics on enterprises activities.

237. As a result, the supplementary statistics would consist into compiling the elements of information identified to measure FDI stocks as defined in paragraph 22 of the present Benchmark definition, or applying an adjusted definition, by individual affiliated enterprise.

238. The total "economic" FDI stocks should be by consequence equal to the sum of all the concerned data compiled individually.

239. The data would be allocated for the fraction that can be attributed to the direct investor regarding his percentage of ownership.

240. The allocation of the FDI data by country of investment would also be possible as well as an allocation of reinvested earnings by country where they are originating from, unlike the recommendation of paragraph 45 (for stocks statistics) of the OECD Benchmark Definition.

241. Keeping in mind that those FDI stocks statistics would be coherent with globalisation statistics and FATS, their coverage could be limited to the affiliated enterprises controlled by the investor(s). It would mean that only affiliated enterprises where the investor(s) own(s) more than 50 % of the ordinary shares or voting power, or the equivalent, such as subsidiaries and branches, would be concerned.

4. **POINTS FOR DISCUSSIONS**

   (1) **Do the DITEG members agree there is a need to consider FDI statistics as autonomous statistics besides the approach as a component of BOP and IIP ?**

   (2) **If this need is accepted, do the DITEG members agree that the basic concepts and definition remain similar in both fields of statistics ?**

   (3) **Considering the autonomous FDI statistics, do the DITEG members agree with the proposed procedure :**

138
• **FDI stocks statistics should also be produced by adding up the individual FDI data by affiliated enterprise.**

• **the geographical allocation of FDI stocks statistics should refer to the country of localisation of the affiliated enterprise; the same rule should prevail for the related reinvested earnings.**

(4) Which of the two coverages do the DITEG members favour :

• **restricting the FDI stocks statistics to the affiliated enterprises under control,**

• **expanding the FDI statistics to the whole population of affiliated enterprises.**

References


- OECD, Benchmark for FDI 3d edition 1996, chapters III and VII


- OECD Handbook on Economic Globalisation Indicators 2004 preliminary version chapters 1 to 3

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 25

VALUATION OF REAL ESTATE

Prepared by France

October 2004
1. Current international standards

242. The current international standards for balance of payments statistics recommend that all of the components of the international investment position (IIP) be measured at market value, with reference to observable market prices. For real estate, the stock data can be estimated by using a perpetual inventory approach based on the use of price indexes, which may be produced by the compiling country's statistical agency. Such indexes may be available too from organisations involved in the real estate industry.

2. Concerns/shortcomings of the current treatment

243. We can first notice that the use of price indexes produced by organisations involved in the real estate industry is not very easy to implement. But the main shortcoming of this approach is the heterogeneity of such indexes. There is no homogeneous methodology at a global level for the production of price index for real estate. According to the countries, the available indexes reflect the prices of old housing or new housing or both of them; the office prices may or not be included; the indexes can be calculated for the whole country, or for some regions, or for big cities only. In short, the market value measurement of the outward stocks in real estate cannot be homogeneous, because it uses a mix of very different national indexes; and this measurement cannot be homogeneous either with the market value calculated for the inward stocks (which uses the index of the reporting country, probably based on a different methodology).

3. Possible alternative treatments

244. A possible solution could be the use of a price index which is less specific to the real estate, but more homogeneous among countries (and easier to collect for compilers). It could be for example the price deflator for gross domestic product.

245. However, the shortcoming of such a treatment is that its result is significantly different from a measurement based on a real estate price index. The price deflator for gross domestic product do not reflect the crisis in the real estate sector of the beginning of the 90s, and do not reflect either the current increase in housing prices. The table 1 shows the difference for France between the alternative treatments:
Table 1: Difference between the alternative treatments in measuring the market value for real estate stocks (at the end of 2002)

<table>
<thead>
<tr>
<th></th>
<th>Book value in bn €</th>
<th>Price deflator for GDP</th>
<th>Real estate price indexes</th>
<th>Ratio market value / book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>French real estate stock abroad</td>
<td>8,4</td>
<td>14,8</td>
<td>18,5</td>
<td>1,76 2,20</td>
</tr>
<tr>
<td>Foreign real estate stock in France</td>
<td>35,7</td>
<td>51,0</td>
<td>71,7</td>
<td>1,43 2,01</td>
</tr>
</tbody>
</table>

4. Questions/points for discussion

(1) Do the members of DITEG have a view about the possibility of improving the homogeneity and the availability of national real estate price indexes?

(2) If it is not possible to improve the use of real estate indexes, do members of DITEG agree with the use of an alternative index (such as the price deflator for gross domestic product) to calculate the market value of real estate stock, even if the result may not reflect the evolution of the real estate markets?

(3) Do members of DITEG agree to allow the exceptional use of book value to calculate the real estate stock in order to take into account the difficulties encountered in calculating market value?

Annex of the most relevant documents

BPM5 paras. 467.

Compilation Guide paras. 718 to 722.
IMF/OECD – DITEG: ISSUES PAPER #27
PRINCIPLES FOR CLASSIFICATION BY INDUSTRY (ACCORDING TO THE DIRECT INVESTOR OR DIRECT INVESTMENT ENTERPRISE)

Prepared by Paolo Passerini
Eurostat, Unit C-4, November 2004

I. Current international standards for the statistical treatment of the issue

246. The BPM5 does not refer to the industrial classification of FDI statistics. The OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition) treats the classification of FDI by industry in paragraphs 48-51, under the title “Industry sector classification”.

247. The Benchmark Definition recommends that, where feasible, the direct investment enterprise be analysed both by its industrial activity in the host country and by the activity of its direct investor.

248. The Benchmark Definition recommends that countries should as a minimum provide an industrial analysis which corresponds to the nine major divisions in the United Nations International Standard Industrial Classification (ISIC).

249. Concerning the activity of the direct investor, the Benchmark Definition recommends that the economic activity should be the main activity of the direct investor and all its subsidiaries and related companies in its country of residence.

250. For the activity of the direct investment enterprise, the recommendation of the Benchmark Definition is more articulated:

(i) when unconsolidated data exist for directly and indirectly owned direct investment enterprises, the activity should be the main activity of each enterprise for which data are available;

(ii) when only consolidated data are available, the activity should be the main activity of the direct investment enterprise and all its subsidiaries and related companies.

251. However, paragraph 117 of the Benchmark Definition says that holding companies are considered financial corporations even though the investments that they hold is in other industries.

II. Concerns/shortcomings of the current treatment

252. The use of the term “sector” (“Industry sector classification”) can create confusion with the classification by institutional sectors.

253. The reference to the ISIC nine major divisions appears to be incorrect. In the ISIC, the highest level of the structure is called section, while the division is the second level in the hierarchy of the
structure. In the present version of the ISIC (Rev. 3.1) there are 17 sections (from A to Q) and 99 divisions\(^{60}\).

254. The recommendation to record, where feasible, the activity of both the direct investment enterprise and of its direct investor covers all possible cases. However, in practice, the majority of compilers record the activity of the resident entity (direct investment enterprise, for inward FDI; direct investor, for outward FDI)\(^{61}\). As it is said in IMF-OECD (2003, p. 20), this can create difficulties for bilateral comparisons when the activity of the direct investment enterprise is different from the activity of the direct investor.

255. Concerning holding companies, differently from paragraph 117 of the Benchmark Definition, ISIC Rev. 3.1 gives two possibilities:

(i) class 6599, *Other financial intermediation n.e.c.* (included in section J - Financial intermediation), contains the activity of financial holding companies;

(ii) class 7414, *Business and management consultancy activities* (included in section K - Real estate, renting and business activities) contains the activity of management holding companies.

### III. Possible alternative treatments

256. To avoid confusion with the breakdown by institutional sector, it is advisable to change the title to something like “industrial activity classification”.

257. Alternative possible treatments in respect to the concerns mentioned in points 8-10 are proposed below.

**Content of the list of activities to be recommended**

258. Reference could be made to “current ISIC sections”, as a minimum requirement. Some sections can be excluded, because they are not relevant for FDI: section P (Activities of private households as employers and undifferentiated production activities of private households) and section Q (Extraterritorial organizations and bodies).

259. A supplementary, more specific, list of ISIC activities could be proposed for FDI statistics. For services, a possible reference is the classification ICFA (ISIC Categories for Foreign Affiliates) contained in the Manual on statistics of international trade in services (2002, p. 64).

**Classification according to the activity of the direct investor or of the direct investment enterprise**

260. It is suggested that, as a second priority (after the double classification recommended by paragraph 48 of the Benchmark Definition), the methodology recommend to record the activity of the direct investment enterprise for both inward and outward FDI.

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\(^{60}\) See the following website: [http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17&Lg=1](http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17&Lg=1). A revision of the ISIC is presently under discussion at the United Nations.

\(^{61}\) See pages 20-21 in IMF-OECD (2003), and table 14 in Appendix I of the same publication.
Classification of holding companies by activity

261. It is proposed that:

(i) if a holding company owns no enterprise resident in the same country, the holding company is included in class 6599 (Other financial intermediation n.e.c), in section J (Financial intermediation). This proposal is consistent with Outcome paper # 9 and 10 of BOPTEG;

(ii) if a holding company owns enterprises resident in the same country, and a main activity of the resident group can be determined, the holding company is classed in the main activity of the group;

(iii) if a holding company owns enterprises resident in the same country, and a main activity of the resident group cannot be determined, the holding company is included in class 7414 (Business and management consultancy activities), in section K (Real estate, renting and business activities);

IV. Points for discussion

(1) Do DITEG members agree that the Benchmark Definition should refer to the “industrial activity classification”, rather than to the “industry sector classification”?

(2) Do DITEG members agree that the Benchmark Definition should refer to “current ISIC sections” as a minimum requirement for the classification by industrial activity?

(3) Do DITEG members agree that a supplementary classification by industrial activity specific for FDI statistics should be recommended in the Benchmark Definition?

(4) Do DITEG members agree that, as a second priority, the Benchmark Definition should recommend to record the activity of the direct investment enterprise for both inward and outward FDI?

(5) Do DITEG members agree with the classification by industrial activity proposed in point 16 for holding companies?

References

Benchmark Definition of Foreign Direct Investment (Benchmark Definition), third edition, OECD, 1996
IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 30

MUTUAL FUNDS

Prepared by Japan

November 2004
1. Current international standards for the treatment of the direct investment item

Mutual funds are not clearly defined in the IMF *Balance of Payments Manual, fifth edition* (*BPM5*) or the OECD *Benchmark Definition of Direct Investment, third edition* (*BD3*). Related descriptions are as follows:

(a) “Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise” (*BPM5*, paragraph 359).

“The benefits that direct investors expect to derive from a voice in management are different from those anticipated by portfolio investors having no significant influence over the operations of enterprise. Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects, which may be affected by short-term developments in financial markets” (*BPM5*, paragraph 361).

“A direct investment enterprise is defined in this Manual as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power or the equivalent” (*BPM5*, paragraph 362).

“Mutual funds and investment trusts also are included” (*BPM5*, paragraph 388<Portfolio Investment>).

(b) *BD3*, paragraphs 5, 7 and 109

2. Concerns of the current treatment

According to the above descriptions shown in the *BPM5* and the *BD3*, mutual funds could be classified in two ways. Thus the way of classifying these funds might differ across countries, and result in bilateral asymmetries and international discrepancies where counterpart countries apply another way of classification. Two criteria for classifying mutual funds are as follows:

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62 The views expressed in this paper are those of the authors and do not necessarily reflect those of the Bank of Japan.
(a) 10 percent criterion; investment in/from mutual funds is recorded as equity capital of Direct Investment, if the percentage of ownership is 10 percent or more.

(b) Actual control criterion; investment in/from mutual funds is recorded as equity capital of Direct Investment, regardless of the percentage of ownership.

3. Possible alternative treatments

264. According to the distinguishing features of Direct Investment, i.e. significant influence of direct investors on management, it is desirable to classify investment in/from mutual funds as equity investment of Portfolio Investment, not as equity capital of Direct Investment, regardless of the percentage of ownership.

265. However, the way of classifying specific types of mutual funds needs to be examined further. They are hedge funds, distressed funds, and feeder/master arrangements.

4. Points for discussion

266. Do DITEG members consider that it is appropriate to classify mutual funds and hedge funds into Portfolio Investment, regardless of the percentage of ownership?

267. Do DITEG members consider that it is appropriate to classify distressed funds and feeder/master funds into Direct Investment as an exception of above treatment, if the percentage of ownership is 10 percent or more?

5. Supplementary information

NA

6. Annex of the most relevant documents

IMF [2001], Mutual Funds and “Fund of Funds”: Portfolio Investment or Direct Investment?, BOPCOM-01/22

R. Kozlow [2002], Exploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment, BOPCOM-02/35

Bank of Japan [2002], The Treatment of Corporate-type Mutual Funds, BOPCOM-02/36

R. Kozlow [2003], Investment Companies: What are they, and Where Should they be Classified in the International Economic Account?, BOPCOM-03/22

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63 Investors generally invest in hedge funds to obtain investment returns in a short-term asset management, not a lasting interest based on the control or management, and thus these funds could be regarded as de-fact Portfolio Investment.

64 As for distressed funds, investors are willing to participate in the control or management of the enterprise for a specified period, in order to redevelop or enhance the enterprise value. Their controlling or managing attitudes in a long-term relationship are features of Direct Investment.

65 In many cases, feeder/master funds are set up in different jurisdictions as different legal structures to acquire preferential treatments related to taxation or securities regulations in the process of asset-management, thus result in a certain amount of cross-border transactions. Since a common fund manager is delegated to set up these arrangements and make investment decisions on behalf of investors (the purpose of investors is to gain a short-term interest by investing in portfolios through feeder/master funds), it could be seen that these is a direct investment relationship among feeder/master funds.