Investment screening in times of COVID – and beyond

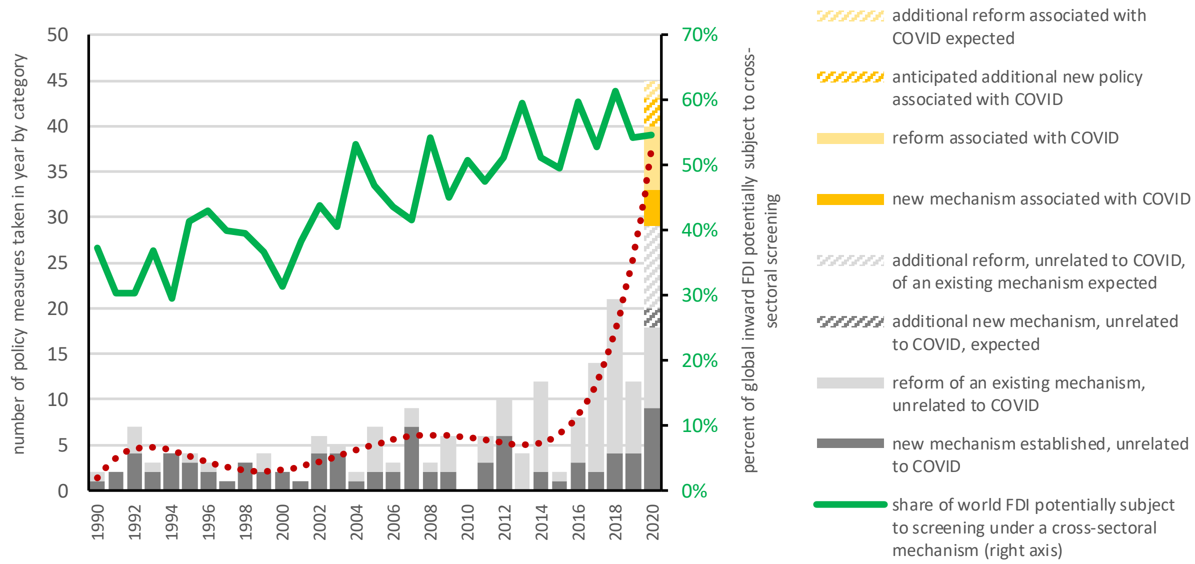
23 June 2020

The economic upheaval resulting from the COVID-19 pandemic has led many governments to enhance their foreign investment screening mechanisms or introduce new ones. Investment screening was already enjoying a heyday before the COVID-19 crisis – the pandemic is accelerating, rather than triggering this trend. The accumulation of the two waves of new measures may bring about transformational change to investment screening policy practice and to the way governments and societies view the benefits and risks associated with foreign investment.

Foreign direct investment (FDI) is widely considered as beneficial for host and home economies and for the enterprises that carry out the investments. It can, for example, enhance growth and innovation in host countries, contribute to creating quality jobs and developing human capital, raise living standards and help spread good practices in management and with regard to responsible business conduct.

The opportunities presented by international investment occasionally bring risks, including for the essential security interests of host countries. Governments are taking these risks increasingly seriously, and an ever growing number of countries are introducing mechanisms that allow for an upfront review of certain investment proposals to manage these risks. Reform efforts in this area have accelerated significantly since 2016. Health-related concerns and the particular economic situation that has resulted from the COVID-19 pandemic have given a further boost to this trend (Figure 1).

Figure 1. Introduction and reform of acquisition- and ownership-related policies to safeguard essential security interests (1990 to 2020)



Note: Data covers the 62 economies that participate in the OECD-hosted Freedom of Investment Roundtable. A new mechanism or reform is "associated with COVID-19" if the government has explicitly justified its introduction, at least in part, with the pandemic or its fallout. Projections by the OECD Secretariat are based on public government statements.

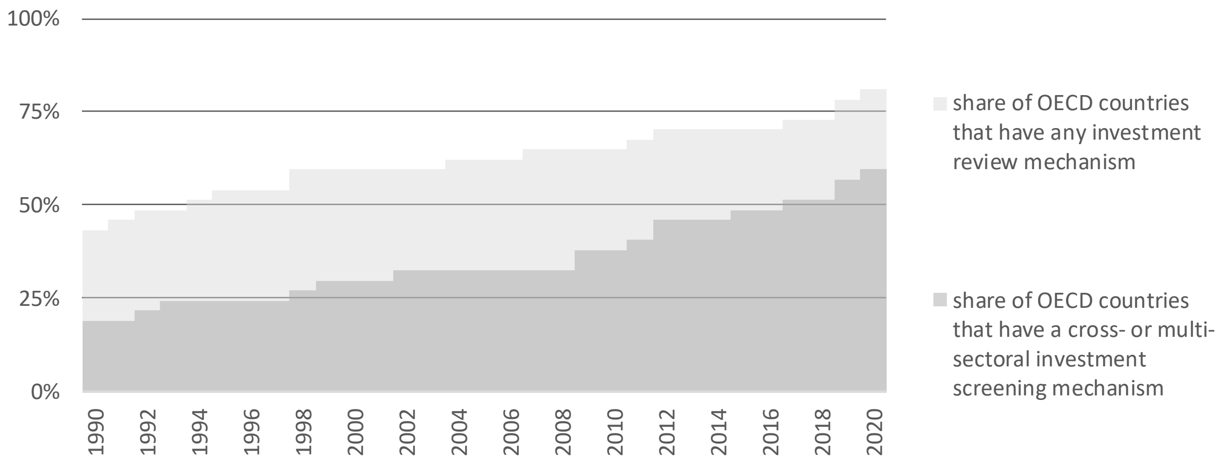
This note sets out the developments in this policy area prior to the COVID-19 pandemic and how the pandemic shaped and amplified these developments. It also seeks to anticipate the future of FDI screening policy once the exceptional circumstances have abated.

Risks associated with foreign investment have become more serious – or are being taken more seriously

Investment screening mechanisms have existed for a long time. The introduction of such rules, which allow governments to scrutinise individual investment proposals for their potential impact on essential security interests, can be traced back to the 1960s in some countries. Until very recently however, many countries did not have investment screening mechanisms in place, and were instead relying on single-sector authorisation requirements or similar mechanisms at most. For many years, few countries had legislated in this area – introduced new mechanisms or reformed existing ones – until policymaking activity surged considerably in and after 2016 (see the red trend-line in Figure 1).

Only since 2018 have more than half of the 37 OECD countries had a cross- or multi-sectoral investment screening mechanism in place, compared to less than a third a decade earlier (Figure 2). This reform drive continues. In the first half of 2020, France, Japan and the United States brought reforms into force that are unrelated to the COVID-19 pandemic. Additional countries, including Austria, Czech Republic, Finland, Germany, Italy, Korea, Lithuania, the Netherlands, New Zealand and the United States, are preparing or have recently adopted new policies or reforms that are unrelated to the pandemic. Denmark, Sweden and the United Kingdom have officially announced reforms, and Ireland was consulting on the merits of introducing an FDI screening mechanism in May 2020.

Figure 2. Evolution over time of the presence of investment screening mechanisms in OECD countries, 1990-2020



Note: Cross- or multi-sectoral screening mechanisms include arrangements that cover all sectors of the economy or a significant number of individually listed sectors.

Beyond the quantitative change associated with the greater number of mechanisms in this area, qualitative changes have significantly transformed policy practice in many advanced economies in the past five years. Most mechanisms now allow for intervention in a much broader section of the economy. Combined with the lowering of trigger thresholds, a much larger number of transactions are now potentially subject to scrutiny. Rules have become more detailed and sophisticated and are geared towards routine applications. Implementation practice has also changed in many countries, with more confident and frequent use of the instruments. Greater depth of regulation and transparency about policy practice are further indicators of a transformational change that has emerged over the past decade in many countries and that has deepened markedly from 2016 onwards.

COVID is prompting broader and additional mechanisms, and bringing them more swiftly

The exceptional economic situation caused by the COVID-19 pandemic has further accelerated policymaking in this area as documented by several reforms and temporary adjustments of existing policies. In some countries this acceleration was further boosted by a European Commission Communication issued in March 2020. Australia, France, Hungary, and Italy have made explicitly temporary adjustments that lower trigger thresholds or apply more stringent rules to a broader range of transactions than was previously the case. In addition, France, Germany, Japan and Spain have made permanent changes to their investment screening mechanisms in response to the new situation. Slovenia has introduced a new review mechanism, motivated explicitly, at least in part, by the arrival of the pandemic. Germany, the Netherlands, New Zealand and the United Kingdom have fast-tracked reforms of their policies that had been initiated before the crisis hit. Poland had legislation for additional mechanisms pending in mid-June 2020 that, according to official statements, was at least partly motivated by pandemic-related factors.

Policy attention to this matter is high in emerging economies, too. India and Romania have made explicitly justified recent adjustments with the pandemic or its fallout. The People's Republic of China and the Russian Federation passed reforms in the first half of 2020. Further reforms are imminent or under consideration in Brazil, the People's Republic of China, the Russian Federation, Ukraine, and Viet Nam, for example.

Adjustments to investment screening mechanisms that can be directly associated with COVID-19 fall into one of two groups corresponding to specific concerns and intentions:

- Reforms that add assets to the scope of screening mechanisms that are crucial for the *pandemic response* (health-related industry sectors and associated supply chains) or that specifically strengthen controls in these areas; and
- Measures that introduce or enhance FDI screening mechanisms across the board to prevent acquisitions in *any* sector where assets suffer from temporary financial stress and value distortions under the exceptional economic conditions associated with the pandemic.

These seemingly similar policy responses reveal some commonalities, but also some structurally different considerations.

Watching over assets essential for the pandemic response and related supply chains

Reforms that focus on assets that are essential for the pandemic response result from the understanding that production capacity and availability in this area are an essential security interest of societies. Advanced economies have been spared epidemics over the past decades and have not experienced supply chain vulnerabilities in health-related industries, so these assets were often not included in lists of FDI screening mechanisms. The experience of unforeseen shortages in this sector has led governments to swiftly remedy this omission. Several countries have either added these assets to lists on sectors in which investment screening applies or moved to apply tighter procedural rules that countries apply to investments in particularly sensitive sectors.

Some countries' investment screening mechanisms apply economy-wide and do not distinguish between sectors for their application. This explains why many countries did not take any measures to ensure that health-related industries were under the scope of their mechanisms. Table 1 provides an overview of measures that selected countries have taken – or did not need to take – to ensure that their FDI screening mechanisms apply to health-related industries.

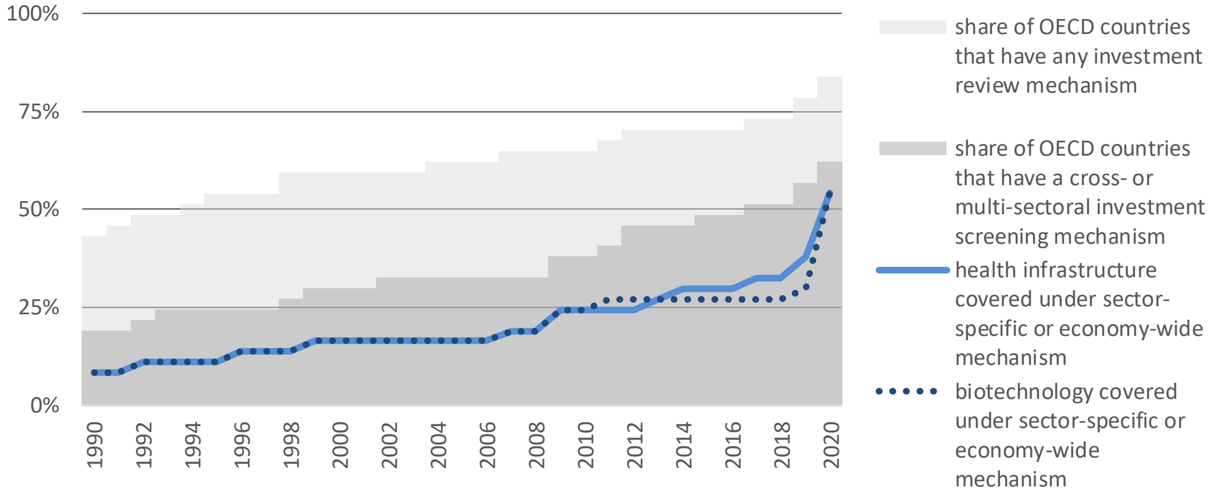
Table 1. Policy measures in selected OECD countries to ensure health-related industries are under the scope of FDI screening mechanisms

health-related sector added to sector list [B = biotechnologies; I = critical health infrastructure]	reclassification of health-related sector under stricter regime [B = biotechnologies; I = critical health infrastructure]	entirely new mechanism – that covers health-related industries – introduced	sector-list had contained health-related industries prior to the pandemic	FDI screening does not use sectors as criterion
France (B) Italy° (B/I) Austria* (B/I)	Germany Spain (B/I) Japan* (certain B companies)	Czech Republic* (B/I) Hungary° (B/I) Slovenia° (B/I) Poland* (B/I)	Austria (I) France (I) Hungary (I) Korea (B) Latvia (I)	Australia Canada Finland Germany Iceland New Zealand■ United States

Note: Lists include OECD countries and are up to date as of 12 June 2020. Only changes that official statements or the legislation itself associate with the COVID-19 pandemic are included. Country names with "*" indicate legislation or rules that had not yet come into effect on 12 June 2020 but were expected to become operational shortly thereafter. "°"indicates changes that were identified as temporary, and "■" indicates a new mechanism in this category. More detailed descriptions of individual countries' mechanisms as of and up to 15 May 2020 are available in *Acquisition- and ownership-related policies to safeguard essential security interests*, OECD Secretariat research note, May 2020.

As a result of the policy adjustments that have been observed in OECD Members since March 2020, critical health infrastructure is now or will very soon be subject to screening in 20 OECD countries that screen inward FDI for security reasons, up from 14 just a few months ago. Acquisitions of biotechnologies or medical devices companies are also now or very soon subject to investment screening in 20 OECD countries that screen inward FDI for security reasons, up from 11 countries before the pandemic (Figure 3).

Figure 3. Evolution of coverage of health-related sectors by investment screening mechanisms in OECD countries, 1990-2020



Preventing unwanted acquisitions under extraordinary economic conditions

Several countries have adjusted their investment screening mechanisms as the economic disruption resulting from the pandemic and subsequent containment efforts has led to severe financial stress for many companies and to erratic or unusually low enterprise valuations. These policy adjustments typically apply economy-wide or reach well beyond assets that are related to the pandemic response. Where such adjustments have been made, they have been explicitly temporary with defined end-dates or time-horizons that refer to specific events or situations.

Among the countries that have taken such measures are Australia (trigger threshold temporarily lowered to zero for all investors), France (approval temporarily required for acquisitions of 10% interest instead of 25%), Hungary (lower and additional trigger thresholds apply temporarily), Italy (more exigent rules temporarily apply to EU and EEA investors) and New Zealand (transactions that are not normally reviewable are temporarily reviewable).

Many countries are choosing a different course of action than in the 2008 crisis

The current tightening of control over inward investment in response to the severe economic disruption differs markedly from the stance that countries took during and just after the global financial crisis of 2008/2009. Then, as now, company valuations had plummeted and economic prospects were uncertain. Both crises affected countries to different degrees, providing companies from countries less impacted with opportunities to acquire companies in countries more impacted. But in 2008/2009, unlike responses unfolding today, many countries chose to open further to foreign capital. The outcome of this stance was mostly positive, at least for many enterprises.

The investment policy response is markedly different this time around. Why? Why are so many governments choosing such a different path in the face of the deep economic disruption caused by this second crisis only a decade later?

No definite answer can be given at this time, but three possible explanations may shed light on the starkly different choices that countries are making today. And all three have probably contributed in varying degrees in different countries to why the crisis response this time is so different from the response chosen a decade ago:

- The economic crisis in 2008 was linked primarily to financial causes including overleveraging, overvaluations and unsustainable corporate debt. A financial solution, and new capital in particular, was able to remedy these problems, with the exit of unviable enterprises part of the solution. The current crisis is rooted in exogenous causes that threaten viable companies, do so potentially only temporarily. The COVID-19 crisis has led to a situation comparable to a market dysfunction where a temporary "suspension of trading" could be part of the solution; this would not have been a solution in 2008/2009.
- State-owned enterprises (SOEs) have taken on a more dominant role as international investors and play a much more prominent role as foreign investors than they did in 2008/2009. SOEs, particularly foreign SOEs, are viewed with suspicion as they may have non-economic motives and their explicit or implicit state-backing may secure them advantages unavailable to most privately-owned enterprises. Resulting foreign state-influence over the assets under acquisition may also shed a different light on implications for essential security interests of a proposed acquisition. The advantages that SOEs may enjoy, such as privileged access to financing, may be amplified in a situation of severe market distortions; tighter scrutiny of transactions involving SOEs may correspond to the associated higher security implication of SOE investments.

  Several countries have indeed expressed these specific concerns about investments by companies owned, controlled or linked to foreign governments in the exceptional economic context: New Zealand and Spain have introduced stricter scrutiny as part of their COVID-related adjustments of FDI screening mechanisms; Hungary and Slovenia have reaffirmed that state-ownership of an acquirer during this time is an additional risk factor; and Canada, Japan and New Zealand, where SOEs have attracted a greater level of concern outside the current context, have specifically reaffirmed their stance in this regard. The share of OECD countries that single out state-owned acquirers in the context of FDI screening has grown from eight to fourteen since the beginning of 2020.
- Finally, government perceptions of the benefits and risks associated with international investment may have changed over the past decade, thus provoking a different reaction to a somewhat similar scenario. While governments continue to emphasise their openness to FDI and will rely on FDI for the recovery phase as they did after the crisis of 2008/2009, they have become more selective with respect to the FDI they welcome.

  Several indicators suggest such a change in many governments' stance. The introduction and expansion of FDI screening mechanisms in an ever growing number of jurisdictions since 2016 and the shortening intervals at which rules are further enhanced suggest that potential risks associated with foreign investment are now firmly on governments' minds, much more prominently than they were a decade ago.

  This trend towards a more selective approach to FDI is accompanied by a fairly consistent metamorphosis of government discourse on FDI screening. Until around 2016, this sort of screening was framed as an exceptional tool in a rigorously open investment environment. Language then became subtly but steadily more assertive language such as the "end of naivety" reciprocity considerations, and "strategic" enterprises – rather than "sensitive" ones – entered the discourse. The advent of the COVID-19 pandemic has also resulted in hitherto unseen vocabulary appearing in this area of policymaking as governments have started mentioning "unwanted" investment, "opportunistic acquisitions" and "predatory acquisitions". Whereas foreign investment was previously associated with opportunities, it is now occasionally associated with sell-offs and the loss of critical assets and technology.

Barely three months have passed since governments took the first measures in response to the COVID-19 pandemic. How the three factors explain best the reaction of different governments can only be assessed more accurately at a later point in time. The retrospective assessment will also be informed by the course of action that governments decide to take. For example: Will temporary measures be unwound, and when? Will FDI screening mechanisms continue to become more stringent even as the crisis abates?

These decisions will depend on how governments weigh the opportunities and risks associated with international investment as they confront the economic crisis that results from the COVID-19 pandemic.

For decades, government perceptions of the benefits of international investment has led them to progressively open their economies to foreign capital, and where policies to manage risks for host country recipient countries existed, they were guided by principles set out in the Recommendation of the Council on Guidelines for Recipient Country Investment Policies relating to National Security (2009). The stance of openness to foreign investment continues to hold. International investment helped economies recover from the global financial crisis of 2008/2009. It could play the same role now if governments seize its opportunities while managing the risks.

Contact

Ana NOVIK (✉ ana.novik@oecd.org)

Joachim POHL (✉ joachim.pohl@oecd.org)

Nicolas ROSSELOT (✉ nicolas.rosselot@oecd.org)