

D.11 Removing Debt Between Affiliated Insurance Corporations and Pension Funds from Direct Investment

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Under the Balance of Payments and International Investment Position Manual, sixth edition (BPM6), direct investment (DI) excludes debt positions between selected types of affiliated financial corporations. The argument is that debt between these affiliated institutions typically corresponds to “normal banking-type business”, such that it should be excluded from direct investment so as not to distort the assessment of DI figures. Insurance corporations and pension funds (ICPFs) are excluded from this rule because their end goal goes beyond providing financial intermediation. This Guidance Note revisits the arguments to justify the exclusion of ICPFs debt positions and concludes that debt between ICPFs and their affiliated entities largely remains linked to the DI relationship. ICPFs’ debt activities have not evolved enough in nature since the last manual update to justify a change in treatment.²

SECTION I: THE ISSUE

BACKGROUND

1. **Should debt between affiliated insurance corporations and pension funds be excluded from direct investment (DI)?** Both the *Balance of Payments and International Investment Position Manual, sixth edition (BPM6)*³ and the OECD’s *Benchmark Definition of Foreign Direct Investment, fourth edition (BD4)* manuals, postulate that DI excludes debt positions between selected affiliated financial corporations. These inter-company debts “are taken to represent normal banking-type business, so that their very nature is quite different from that of other direct investment enterprises” (*BD4*, paragraph 184).
2. **To be more precise, the *BPM6* paragraph 6.28 states that “Debt between selected affiliated financial corporations is not classified as direct investment because it is not considered to be so strongly connected to the direct investment relationship.”** The selected financial corporations concerned are:
 - (a) deposit-taking corporations (both central banks and deposit-taking corporations other than the central bank);
 - (b) investment funds; and
 - (c) other financial intermediaries **except insurance corporations and pension funds.**⁴

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² The recommendations outlined in this GN were approved by the Committee via written consultation.

³ See *BPM6* paragraph 6.28. This rule is consistent with the OECD’s *BD4* manual (paragraph 184).

⁴ Other financial intermediaries except ICPFs consist of financial corporations that are engaged in providing financial services by incurring liabilities, in forms other than currency, deposits or close substitutes for deposits, on their own account for the purpose of acquiring financial assets. It is a feature of a financial intermediary that transactions on both sides of the balance sheet are carried out in open markets. (*BPM6*, paragraph 4.76; *MFSMCG*, paragraph 3.145)

All debt positions between the selected types of affiliated financial corporations are excluded from DI and are included in portfolio or other investment. Both affiliated parties (entities in a DI relationship) must be classified in one of the selected types of financial corporations, but they do not need to be of the same type.

3. **The *BD4* (paragraph 477) refers specifically to “financial intermediaries” as defined by the *System of National Accounts 2008 (2008 SNA)* to qualify both the creditor and the debtor of the debt to be excluded from DI:** *“All inter-company flows—with the exception of those pertaining to equity finance—between certain types of related financial intermediaries should be excluded from foreign direct investment (FDI) transactions and positions. Deposits and other amounts lent by a financial intermediary to its financial intermediary subsidiary or associate located abroad, as well as deposits and other borrowings between such companies, should be classified as ‘other investment’ rather than direct investment. A similar treatment applies to investment between fellow enterprises which are financial intermediaries. Debt securities between related financial intermediaries are classified as ‘portfolio investment.’”* The definition of the scope of enterprises included under “financial intermediary” in the *BD4* is in line with the *2008 SNA* and includes institutional units that incur liabilities on their own account to acquire financial assets by engaging in financial transactions on the market.

4. **The rationale for not considering debt positions between affiliated financial intermediaries as DI relates to the nature of the underlying debt, which is quite different from that of other affiliated firms.** Hence, in *BD4* paragraph 184, it is stated that: *“[...] debt positions between DI related financial intermediaries (such as commercial banks, savings institutions, credit unions, mutual funds or finance companies) are excluded from direct investment (though this exclusion does not apply if one of the parties is a holding company). The reason for this is that they are considered as ‘normal banking-type business’ transactions, so that their very nature is quite different from that of other direct investment enterprises. Consequently, it is felt that the inclusion of debt instruments between such related financial intermediaries would produce misleading results.”* In this regard, ICPFs are distinctly differentiated within other financial intermediaries, as indicated in the *BD4* box A.3.1.

5. **Intercompany lending has different implications for risk and vulnerability compared with debt between unrelated parties. In the case of debt between related selected financial intermediaries, this tends to be an important source of financing frequently used to meet liquidity constraints imposed by regulators or due to market conditions. It can be short-term by nature.** The *BPM5* (paragraph 372) and *BD3* (paragraph 40) excluded debt between affiliated financial intermediaries with the exception of permanent debt, defined as loan capital representing a permanent interest.

6. **The *BPM6* and *BD4* extended the exclusion of debt between financial intermediaries to permanent debt for practicality.** The *BD4* indicates in Annex 3, paragraph 2.1., that *“on conceptual grounds, permanent debt between selected related financial intermediaries would appear to qualify as direct investment. However, the Benchmark Definition recommends that, on grounds of practicality and statistical significance, it should instead be recorded as either portfolio investment or other investment, depending on the instrument.”* As indicated in the *BD4* paragraph 446: *“The concept of permanent debt was abandoned in the latest version of the Benchmark Definition so that all inter-company debt flows between related financial intermediaries are excluded from direct investment”*.

7. In both the *BPM6* and *BD4*, ICPFs are not defined as financial enterprises whose sole purpose is to serve as financial intermediaries and therefore their intercompany debt is to be included in DI flows and positions.⁵ According to the *BPM6*, paragraph 4.88, “Insurance corporations consist of incorporated, mutual, and other entities whose principal function is to provide life, accident, health, fire, or other forms of insurance to individual institutional units or groups of units or reinsurance services to other insurance corporations.” Also, according to paragraph 4.89, “Pension liabilities arise when members of households participate in a social insurance scheme that will provide income in retirement (and often benefits for death or disability). Such schemes may be organized by employers or by government; they also may be organized by insurance corporations on behalf of employees; or separate institutional units may be established to hold and manage the assets to be used to meet the pension obligations and to distribute the pensions. Pension schemes may be operated by a separately constituted pension fund or a fund that is part of the employer, or they may be unfunded. The pension fund subsector consists of only those social insurance pension funds that are institutional units separate from the units that create them.” These definitions are consistent with those provided in the 2008 SNA, paragraphs 4.115 and 4.116.

ISSUES FOR DISCUSSION

8. The following issues for discussion can be identified, taking into account that item (ii) and (iii) would be relevant only in case of a positive reply to (i):

- (i) Does debt between ICPF and affiliated entities conceptually meet criteria to be excluded from DI, similar to the “normal banking-type business” definition?
- (ii) In case of a positive reply to this question, would a change in methodology be feasible?
- (iii) Given the identified criteria, and the practical feasibility of such a change, what change in methodology would be needed for insurance corporations, for pension funds, and for all or some of the debt positions?

9. Concerning issue for discussion (i), it appears, based on the considerations above, that debt positions between insurance corporations and pension funds should be excluded from DI only if they would be misleading for the interpretation of the DI relationship. By definition, a DI relationship promotes stable and long-lasting economic links through direct access for investors in home countries to production units in host economies. It allows for the transfer of technology and know-how and has some impact on economic performance. The nature of debt between related selected financial intermediaries appears different. As indicated above, this debt is often used as a source of financing to meet liquidity constraints, and short-term by nature. This is why debt positions between DI related financial intermediaries are excluded from DI measurement and rather considered as “normal banking-type business.”

10. Nevertheless, the first basic issue to consider is whether the ICPF debt activities have evolved enough since the last Benchmark Definition to justify a change of concept. In France, for example, it does not appear to be the case, as reported DI outstanding amounts between affiliated

⁵ See the *BD4* Table A.3.1, which provides an overview of transactions/positions included in and excluded from FDI, as well as the *BD4* Box A.3.1 on the SNA classification of financial corporations.

insurance companies have not changed in recent years and have remained low, below 2 EUR billions. In addition, there are no pension funds in France. In Canada, inter-company debt outstanding amounts between affiliated insurance companies have also remained stable and at low levels, representing less than 10 percent of total foreign DI positions. Furthermore, overall inter-company debt amounts of pension funds have been insignificant or null in recent years.

11. **Should a change in methodology be considered, the *permanence* of debt positions could be taken as a criterion to assess if, in general, debt positions related to ICPF activities are to be excluded from DI.** For example, possible candidates for DI positions of ICPFs are loans and overall technical reserves, in particular whenever multinational insurance companies set up reinsurance entities abroad. Only non-permanent debt positions between financial intermediaries have once been excluded from DI, but this exclusion has been extended to all types of debt in the later edition of the OECD Benchmark Definition on grounds of practicality and due to the small amounts of permanent debt being recorded. One might still mention that the illiquid nature of life or non-life insurance technical reserves makes them very much “permanent”.

12. **Concerning issue for discussion (ii), on the feasibility of a potential change in methodology, it appears that such a change could raise practical issues.** As it is, according to the current standards, the breakdown by institutional sector for non-residents is not required in DI statistics.⁶ It may be difficult to obtain in practice as it may require identifying the counterpart institutional sector for respondents in surveys. As long as the debt between affiliated ICPFs is merged with other debts between affiliated parties in DI, there is no specific problem for the compilation of DI data including these debts. However, a change in methodology would require the identification of the institutional sector of the affiliated financial intermediaries in the reports provided by ICPFs. Furthermore, in case of a change in methodology limited to certain types of debt instruments, the identification of these types of debt instruments in the data may prove difficult. By contrast, leaving debt between affiliated ICPFs in DI is straightforward.

13. **Concerning issue for discussion (iii), on the need for a change in practice, it appears that further investigation would be needed to have a precise view of which debts would correspond to the criteria described above and can be measured in practice.** Any information on the following items would be interesting: the characteristics, the amounts and the volatility of debts between insurance corporations and affiliated insurance corporations or pension funds and between pension funds and affiliated insurance corporations or pension funds, for the different types of debts.

14. **Table 6.1 in the *BPM6* describes the links between financial assets classification and functional categories.** According to this table, among the “Insurance, pension, and standard guarantee schemes” (AF6), DI can principally take the form of Claims of pension funds on pension managers (AF64) and Provisions for calls under standardized guarantees (AF66). DI in the form of Nonlife insurance technical reserves (AF61) and Life insurance and annuity entitlements (AF62) are also possible but relatively uncommon cases, as indicated in the table notes. DI between affiliated insurance corporations and pension funds can also take the form of Debt securities (AF3), Loans (AF4) and Other accounts

⁶ The GN D.7 proposes to include the sectoral breakdown of DI in the standard components of the balance of payments and the IIP.

receivable/payable (AF8). DI between affiliated insurance corporations and pension funds in the form of currency and deposits (AF2) can be excluded.

SECTION II: OUTCOMES

15. **In the 2008 SNA, there is a brief mention related to the issue in paragraph 26.87: “Direct investment includes debt between the parties as well as equity except in the case of debt positions between related financial institutions.”** It is recommended to modify this paragraph in order to clarify which financial institutions are concerned.

SUMMARY OF DISCUSSIONS WITHIN THE DITT

16. **Twelve members of the DITT have shared their view on the guidance note. They unanimously support the proposed recommendation that the methodology should remain unchanged (i.e., that debt between affiliated insurance corporations and pension funds should remain in DI).** This view is also shared by all the co-authors of the guidance note. As it is, no member of the DITT reported any significant change in the debt positions between affiliated ICPFs since the last Benchmark Definition that could justify a change of concept and methodology.

17. **One member of the DITT stressed that “the problem of identification of the institutional sector of the affiliate (partially disclosed in paragraph 12 of the GN) remains unsolved even within the current framework.** If an affiliate has both features of financial intermediary and financial auxiliary (for instance, performs activities of both dealer and broker) then there’s no guidance on what (sub)sector should be assigned for this affiliate”. The authors of the guidance note consider that this issue is beyond its scope.

OUTCOMES OF THE WRITTEN CONSULTATION WITH THE COMMITTEE

18. **In line with the global consultation, and as recommended by the DITT, all Committee members unanimously supported maintaining the status quo with respect to the current methodological guidance for the treatment of debt positions between affiliated ICPFs.** Committee members argued that there is no evidence for significant developments that require a change from the status quo.

RECOMMENDATIONS

19. **It is recommended to keep the manuals unchanged,** as there is no evidence that debt of insurance and pension funds related to their activity as insurance and pension funds would distort the analysis of DI, as an inclusion of cross-border interbank loans in DI would.