IMF Committee on Balance of Payments Statistics

*BPM6* Update
Direct Investment Task Team (DITT)

APPROVED/FINAL VERSION

# D.3 Treatment of Collective Investment Institutions

## D.3 Treatment of Collective Investment Institutions[1]

The Balance of Payments and International Investment Position Manual, sixth edition *(BPM6), recommends that investments in and by collective investment institutions (CIIs) that meet the operational definition of direct investment (DI) be included in DI. CIIs cover a wide variety of undertakings in which the main focus of managers tends to vary from passive management of the investment portfolio to active management of the day-to-day operations and/or long-term strategy of the companies in which they invest. There is also the question of who is undertaking these investments: is it the fund managers or is it the individuals invested in the funds? This note discusses issues arising from the inclusion of CII in DI and offers several alternatives for recording investments in and by CIIs. Among all the proposals, the Committee members[2] supported Alternative 3.2, namely, to always treat investments in investment funds shares (F52) as portfolio investment while investments by investment funds may be recorded under DI or portfolio investment (PI) in accordance with the* BPM6 *current rules. There was unanimous support to include this exception to the definition of DI in* BPM7*.*

### SECTION I: THE ISSUE

#### BACKGROUND

1. **Current guidelines offer a clear prescription for measuring direct investment (DI) in and by collective investment institutions (CIIs).** Nevertheless, the guidelines also acknowledge the possibility of practical and conceptual difficulties with this treatment and characterize the suggested guidance as "debatable."[3]

2. **Paragraph 570 of the *OECD Benchmark Definition of Foreign Direct Investment*, *fourth edition 2008* (*BD4*) defines CIIs[4]** as "incorporated investment companies and investment trusts, as well as unincorporated undertakings (such as mutual funds or unit trusts), that invest in financial assets (mainly marketable securities and bank deposits) and/or nonfinancial assets using the funds collected from investors by means of issuing shares/units (other than equity)." The paragraph goes on to recommend that when an investor in one economy acquires at least 10 percent of the voting power in a CII in another economy, this investment should be regarded as DI. Similarly, when a CII owns at least 10 percent of the voting power of a nonresident entity, this relationship should also be considered as DI.

3. **The significance of CIIs in countries' DI statistics is difficult to quantify.** In a survey of WGIIS member countries conducted in May 2016, 12 countries indicated that they cover CIIs in their DI

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[2] The recommendations outlined in this GN were approved by the Committee in the February 2021 meeting and the *Summary of Discussions* of this meeting can be accessed here.

[3] Paragraph 593 of the *OECD Benchmark Definition of Foreign Direct Investment*, *fourth edition 2008* (*BD4*).

[4] The *BPM6* does not specifically define or refer to CIIs but rather refers to collective investment schemes.

statistics as direct investment enterprises, 17 countries did not, and three countries covered them only partially.[5]

4. **For the United States, international investment by CIIs that involve (directly or indirectly) a 10 percent or greater equity stake in an operating company are included in DI statistics.[6]** Likewise, 10 percent or greater nonresident equity stakes in CIIs that make such investments are treated as DI. The United States has not attempted to identify all CIIs in its outward DI universe but, based on exploratory research, it found that foreign affiliates of the largest U.S. private equity firms accounted for at least 2.3 percent of employment by all foreign affiliates, but it is a lower-bound estimate of the presence of CIIs in the U.S. direct investor universe (presentation by the United States at the November 2020 WGIIS meeting, (OECD, 2020)).

5. **In the European Union (EU) context, CIIs mostly refers to investment funds that are principally engaged in financial intermediation.** EU countries considered that DI relationship are only meaningful in closed-end funds, that is, funds where no additional shares are issued, and the fund itself won't redeem—buy back—shares. Closed-end funds were estimated as 0.6 percent of the total market capitalization of CIIs at end-2016 in the EU. Based on that outcome, EU countries exclude CIIs liabilities from their DI statistics, classifying them instead as portfolio investment. However, CIIs may be direct investors when the 10 percent rule on equity (SNA Financial Asset/Liability F51) applies, including the specific case of other equity investment (F519), including real estate.[7] For Luxembourg, CII assets classified as DI are a very small part of both aggregate balance sheet and external assets of CIIs.

6. **For Brazil, any relevant international investment in or by CIIs that conveys a voting interest of at least 10 percent by the investor is included in DI, although these investments have not been separately identified in the statistics.** This is in line with IMF's *Balance of Payments and International Investment Position Manual, sixth edition (BPM6)* guidance on standard components. The available source data for positions and transactions would nonetheless allow for separate identification of CIIs.

7. **For South Africa, national laws prohibit mutual funds from holding more than 10 percent of an unlisted company or more than 5 percent of a listed company.** Therefore, DI by mutual funds is essentially nonexistent. DI in CIIs is classified in portfolio investment, partly for practical reasons, including those mentioned for the EU, and partly for conceptual reasons, which are discussed below.

8. **There are conceptual and practical difficulties raised by this topic, which do not consistently point to a preferred solution.** Conceptually, it is not clear that the motivations and effects of DI by CIIs are consistent with those of traditional direct investors. An academic paper examining venture capital firms put it this way: "The cross-border expansion of venture capital firms presents an interesting case of internationalization, because they are at variance with both conventional portfolio and

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[5] https://qdd.oecd.org/data/FDI_Metadata_ComparativeTables/Q18+C_Q18_EXC.

[6] The term "equity stake" is used throughout this note to denote an equity stake that conveys a 10 percent voting interest. Many private equity firms have partnerships in their ownership structures. In partnerships, the notion that equity stakes convey voting rights does not apply. Limited partners are presumed to have equity stakes without voting rights, while general partners are presumed to have all of the voting rights with little or no equity stakes. An "operating company" is a business that is neither a CII nor a special purpose entity.

[7] See Annex IV for conceptual guidance from the EU.

DI models" (Guler and Guillén (2010): p. 185). A fundamental question is the extent to which the decision makers within the firm are concerned with managing the strategic and day-to-day operations of the individual businesses they own versus with managing their portfolio return.

9. **An exploratory study by the United States suggests that U.S. parents that are CIIs show little evidence of providing headquarters services to their foreign affiliates,** have a higher tendency to use financial leverage, and are less focused on the long-term growth of their affiliates (presentation by the United States at the November 2020 WGIIS meeting, (OECD, 2020)). On the other hand, even if these firms have motivations and strategies that differ in some respects from traditional direct investors, they can bring the kinds of benefits to economic growth and stability to their host countries that policymakers seek from DI. For example, the funding provided by certain CIIs might fill an important funding gap that is available to young, fast-growing, innovative businesses.[8] For a discussion of practical challenges for compilers, see Annex II.

ISSUES FOR DISCUSSION

10. **In order to address the conceptual and practical issues outlined above, three major alternatives, and three sub-alternatives have been identified for the treatment of CIIs.** All five alternatives are described below.

11. **In developing these alternatives, the authors sought to integrate the recommendations here with those in the guidance notes on the sectoral breakdown of direct investment (GN D.7) and nonbank financial intermediation (F.6), but this was not always easy to do.** See Annex III for details.

***A1. Alternative 1***

12. The **methodological and presentational status quo** is supported by current operational guidelines for measuring DI and in concept as well, to some extent. Operationally, DI is defined in the *BPM6* as based strictly on the 10 percent equity criteria (*BPM6*, paragraph 6.13). Conceptually, by virtue of these significant equity stakes, CII investors can influence the management of the companies in which they invest, whether or not they choose to do so. Therefore, there is no need to distinguish DI in or by CIIs from other DI.

***A2. Alternative 2***

13. The **methodological status quo** is supported by current operational guidelines for measuring DI but there are valid conceptual reasons for presenting separate statistics on DI in or by CIIs. Conceptually, it is not clear that the motivations of CIIs are like those of traditional direct investors. Whereas traditional direct investors tend to be concerned with managing the strategic and day-to-day operations of the individual businesses they own, CII direct investors tend to be more, or entirely, focused on managing their portfolio return. Therefore, **compilers** should be **encouraged to separately identify and present additional detail on DI in or by CIIs.**

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[8] These businesses are sometimes referred to as gazelles or unicorns. See, for example, Del Sorbo et al. (2018). The authors thank Sami Hamroush of the U.K. Department for International Trade for this insight.

*A3. Alternative 3*

14. **Given that the motivations of CIIs for acquiring 10 percent or greater equity stakes in businesses can differ, to varying extents, from those of traditional direct investors, there is justification for modifying the operational definition of DI to exclude certain investments in or by CIIs.** Nevertheless, from a conceptual perspective, the extent to which the owners of CIIs are concerned with managing the strategic and day-to-day operations of the individual businesses they own, arguably, varies by class of CII. Against this backdrop, we offer three sub-alternatives: A3.1, A3.2, and A3.3.

*A3.1. Alternative 3.1*

15. **The operational definition of DI should be changed to exclude investments in or by CIIs:** This alternative takes the most aggressive stance toward changing current standards to account for the non-traditional nature of 10 percent or greater equity stakes in or by CII. Conceptually, the motivations of investors in CIIs and CIIs for acquiring 10 percent or greater equity stakes in businesses often differ from those of traditional direct investors. Some CIIs hold more than 10 percent of foreign listed shares, which should, under Alternative 3.1 be re-classified to portfolio investment. From the DI enterprise side, the compiler should spot ex ante those particular CIIs investors and exclude them from their DI liability figures. Besides, some CIIs hold foreign land or real estate.[9] The *BPM6* paragraphs 4.34 to 4.39 details that those foreign assets should be recorded under DI – Equity and investment fund shares, as notional units. **This alternative may trigger an unwished amendment in the link between Financial Assets Classification and Functional Categories (*BPM6* table 6.1) if foreign land or real estate held by CIIs should be recorded under portfolio investment; otherwise could be reported under other investment.**

*A3.2. Alternative 3.2*

16. **Investments in investment funds shares (F52) will be considered always portfolio investment while investments by investment funds may qualify as DI in accordance with the *BPM6* current DI rules.** This alternative focuses on institutional sectors MMF (S.123) and non-MMF investment funds (S.124). This alternative offers a streamlining of CII's liabilities where investment shares/units are generally classified as portfolio investment. As such, it might also improve the comparability of CPIS and CDIS. The operational definition of DI would remain for the rest of CIIs. Conceptually, it could be argued that the collective legal nature of the investment funds, that is, more than one investor, suggests that no single foreign resident has a direct control on the investment strategy and day-to-day operations of the fund. Therefore, 10 percent or greater equity stakes in investment funds should be treated as portfolio investment. However, in the case of DI by investment funds, the fund as statistical unit should be viewed as the investor that takes investment decisions, suggesting the possibility of control over the strategic and day-to-day operations of the individual businesses it owns. Therefore, 10 percent or greater equity stakes held by investment funds in operating company abroad would be recorded as DI. This alternative is the current EU approach.

[9] Or even mobile equipment, ships, aircraft, gas and oil drilling rigs, etc. Nevertheless, the practical need for consistent recording of foreign land or real estate is mitigated by the fact that many compilers are not able to separate these investments, which are often a small share of total foreign holdings.

*A3.3. Alternative 3.3*

17. **Under this alternative, the operational definition of DI would remain only for private equity funds or real estate funds and should be changed to exclude investments in or by CIIs that are not private equity funds or real estate funds.** It questions the assumption, in Alternative 3.2 that CIIs owners of 10 percent or greater equity investments are individual investors rather than in some cases only managers of those CIIs and recommends consistently treating investments in and by CIIs. It recognizes the fact that control is unlikely to be exercised by the managers of all types of CIIs. It is likely that only private equity funds and, perhaps, real estate funds, tend to operate this way. Therefore, this alternative would record only the 10 percent or greater equity stakes held in private equity funds and real estate funds if the funds have a 10 percent or greater equity stake in operating companies as DI liabilities. Those assets would also be recorded as DI. (See Annex V for a discussion of the question of identification of the institutional unit in a private equity fund.) However, this proposed treatment may create some world asymmetries if the DI enterprise does not identify the investment fund as a private equity fund or a real estate fund and therefore consider the investment under portfolio investment. On the other hand, this issue is not unique to Alternative 3.3. There is a need for coordination of the collection of data on DI and on portfolio investment under any alternative. Additionally, the compiler of the country investing in the private equity fund should look through the investment of the fund and collect details of the companies where the fund is investing to identify if its investment in the CIIs qualifies as direct or portfolio investment. This alternative is similar to the current US approach.

## SECTION II: OUTCOMES

18. **The GN recommends to always treat investments in investment funds shares (F52) as portfolio investment while investments by investment funds may be recorded as DI or PI in accordance with the *BPM6* current rules (Alternative 3.2).** Alternative 3.2 was preferred on both conceptual and practical grounds relative to 3.1 and 3.3 within Alternative 3. Conceptually, the primary motivation of investments in CIIs is generally managing their portfolio rather than the strategic and day-to-day operations of the individual businesses that they own. Thus, this option does address the concerns about the inclusion of CIIs in DI. In addition, Alternative 3.2 respects the basic principle of institutional unit by not looking through the CII; that is, by not assuming the shareholders are the ones exercising the DI influence on the business enterprise. Finally, this alternative was preferred on practical grounds as it was viewed as easier to implement relative to Alternative 3.3.

19. **Include this exception to the definition of DI in the updated *BPM6* as well as the updated *BD4* to maintain consistency across manuals.** For example, this could be done by revising paragraph 6.11 that defines the direct investment enterprise. Alternatively, including the exception of CIIs in the discussion in section "B.2 Coverage if direct investment flows and positions" of Chapter 6 that describes in detail what should be included and what should be excluded from DI (e.g., coverage of debt between selected financial corporations). In *BD4*, paragraphs 30, 312, 321, 472, 473, and Annex 8 will need to be revised.

20. **Include additional clarification as part of the *BPM7 Compilation Guide* on practical implementation, the type of funds concerned, and their institutional sector classification.**

## OUTCOME OF THE DISCUSSION AT THE FEBRUARY 2021 COMMITTEE MEETING

21. **The IMF Committee on Balance of Payments Statistics agreed with the proposal to clarify the classification of investments in and by CIIs in the revised BPM.** Members' views were more split between Alternatives A3.2 and A3.3 with a slight majority supporting Alternative 3.2 (treating all investments—even over 10 percent—in CIIs as portfolio investment, while keeping investments by CIIs of over 10 percent in DI in accordance with *BPM6* standards) for the treatment of CIIs based on practical grounds. While recognizing that Alternative 3.3 responded better to the concerns about investments by CIIs not meeting the true definition of DI because private equity and real estate investors tend to be more active in the management of the businesses that they invest in, there were concerns about the practical challenges of differentiating the different types of funds, especially for non-resident CIIs. There was unanimous support to modify the operational definition of DI to include this exception in the *BPM7*. This version of the GN incorporates these discussions.

## REJECTED ALTERNATIVES

21. **Alternative 1** and **Alternative 2** were rejected because they do not recognize that the motivations of at least some classes of investment in or by CIIs are only weakly, or not at all, consistent with the distinguishing characteristics of DI described in paragraph 6.4 of the *BPM6*. **Alternative 3.1** was rejected because it seems to go too far in demanding strict adherence to those distinguishing characteristics. **Alternative 3.3** was rejected on both conceptual and practical grounds. While recognizing that this alternative responded better to the concerns about investments by CIIs not meeting the true definition of DI because private equity and real estate investors tend to be more active in the management of the businesses that they invest in, there were concerns about looking through the CII. There were also concerns about the practical challenges of differentiating the different types of funds, especially for non-resident CIIs. This would make it more difficult to implement than Alternative 3.2 and could lead to increased bilateral asymmetries if compilers on one side do not recognize the direct investor as a private equity or real estate fund.

## Annex I. Supplementary Information

### TITLE OF REFERENCED DOCUMENT

Del Sorbo, Maria, Vértesy Daniel, Damioli Giacomo (2018), *An EU-US Statistical Overview: Business Demography and Scaling up Comparisons*, European Commission, Joint Research Centre, Ispra, 2018.

European Central Bank (2017), *Manual on Investment Fund Statistics* (December 2017)

Guler, Isin, and Mauro F. Guillén (2010), *Institutions and the Internationalization of US Venture Capital Firms*, *Journal of International Business Studies* 41.2 (2010): 185–205.

OECD (2020), *Private Equity in the Outward Direct Investment Statistics of the United States: A Preliminary View*, presented by the United States at the WGIIS November 2020 meeting (reference “DAF/INV/STAT/WD(2020)3”), Virtual Meeting.

OECD (2016), *OECD Metadata Survey on BMD4: Metadata Tables*, presented at the WGIIS March 2017 meeting (reference “DAF/INV/STAT(2016)10/REV1/ADD1”), Paris.

## Annex II. Practical Challenges for Compilers

1. **The challenge of ensuring universe coverage.** Practically speaking, tracking and identifying CIIs can be difficult. They greatly outnumber traditional multinational enterprises. Based on the 2020 edition of Pratt's Guide to Private Equity and Venture Capital Sources, there are over 14,000 private equity firms worldwide. Based on data from the International Investment Funds Association, there are over 100,000 regulated open-end mutual funds worldwide.[10] In contrast, the 2020 World Investment Report from UNCTAD estimates that the top 5,000 MNEs account for most of global DI.

2. **In some countries CIIs are well identified and regulated while in other jurisdiction the borderline between investment funds and other financial institutions is not so well defined.** In addition, the number of hybrids as venture capital and private equity entities is growing making the life of the compiler much more difficult as they need additional information to identify them as CIIs. For example, the existence of day-to-day control over the assets in which the capital is invested will indicate that they are not CIIs.

3. **The challenge of ambiguous terminology.** For compilers, identifying CIIs in the DI universe is difficult, because it is an ambiguous term to many practitioners and therefore providing survey respondents with clear definitions of CIIs, especially their subclasses, can be difficult.[11] A starting point here may be the definitions offered in the European Central Bank's Manual on Investment Fund Statistics.

4. **The challenge of measuring ownership.** Investments by CIIs often using complex chains of ownership, including the use of master and feeder funds, which can make it difficult to identify the decision-making unit in the CII organization structure.[12] Also, in those lines of ownership, there can be differences between the level of equity control and the level of voting control. This complexity can make it difficult to determine the ultimate investing economy or the ultimate statistical unit within an economy. Looking through the investment of the fund and collecting details of the companies where the fund is investing would pose an additional heavy burden upon compilers and/or reporting entities. In addition, countries/compilers with limited capacity regarding staff and resources might be unable to cope with this requirement. Compilers may even face national or supranational statistical regulations prohibiting them from following investments to the entity within an economy that ultimately receives the funds.

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[10] See International Investment Funds Association, "Worldwide regulated open-fund assets and flows, first quarter 2020" (https://cdn.ymaws.com/iifa.ca/resource/collection/BD2DD483-21F4-4BA5-97D2-FFDD152D23ED/Worldwide_Regulated_Open-End_Fund_Assets_and_Flows_-_First_Quarter_2020.pdf). Number counts exclude funds of funds.

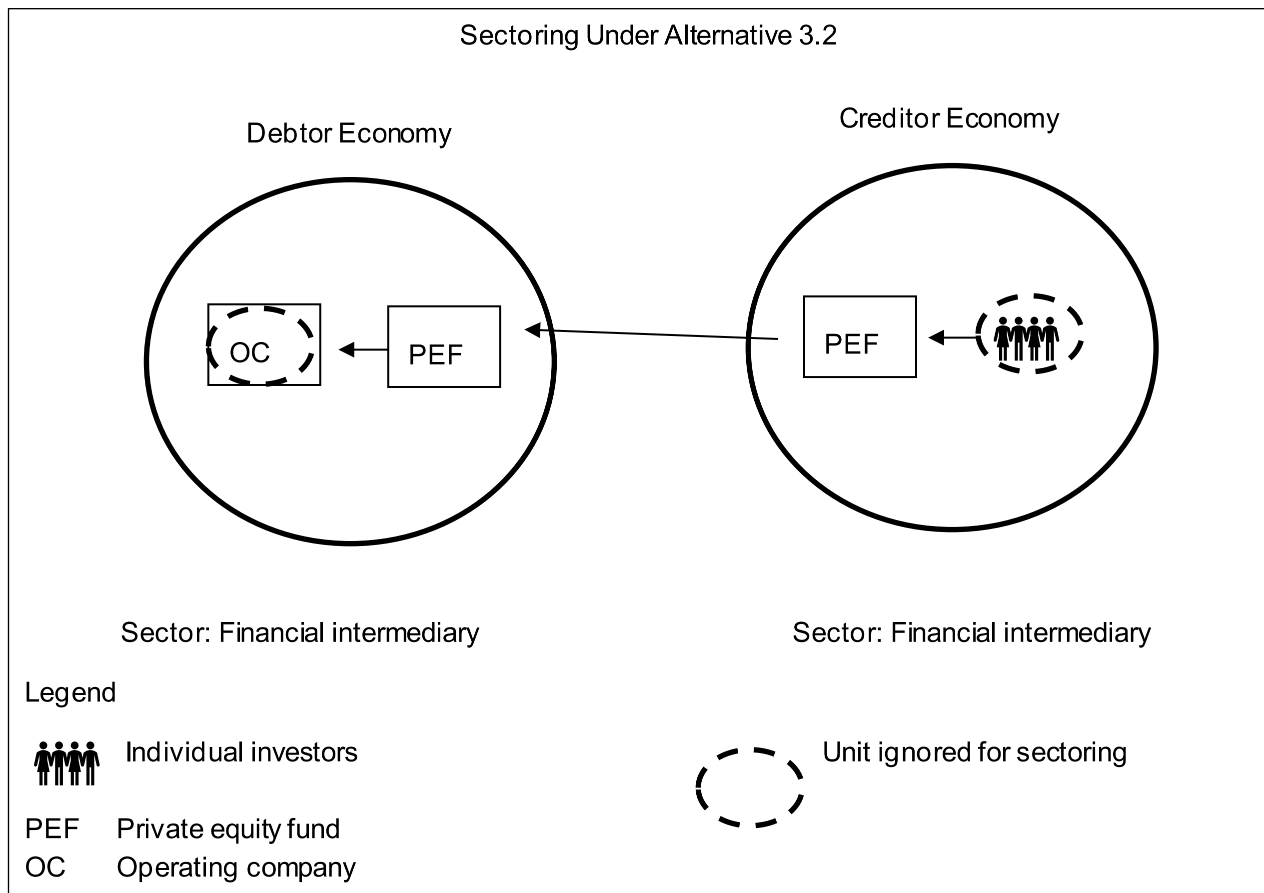
[11] For a typology of CIIs, see chapters 3–5 of European Central Bank (2017).

[12] For an explanation of master and feeder funds, see chapter 6 of European Central Bank (2017).

## Annex III. Sectoring

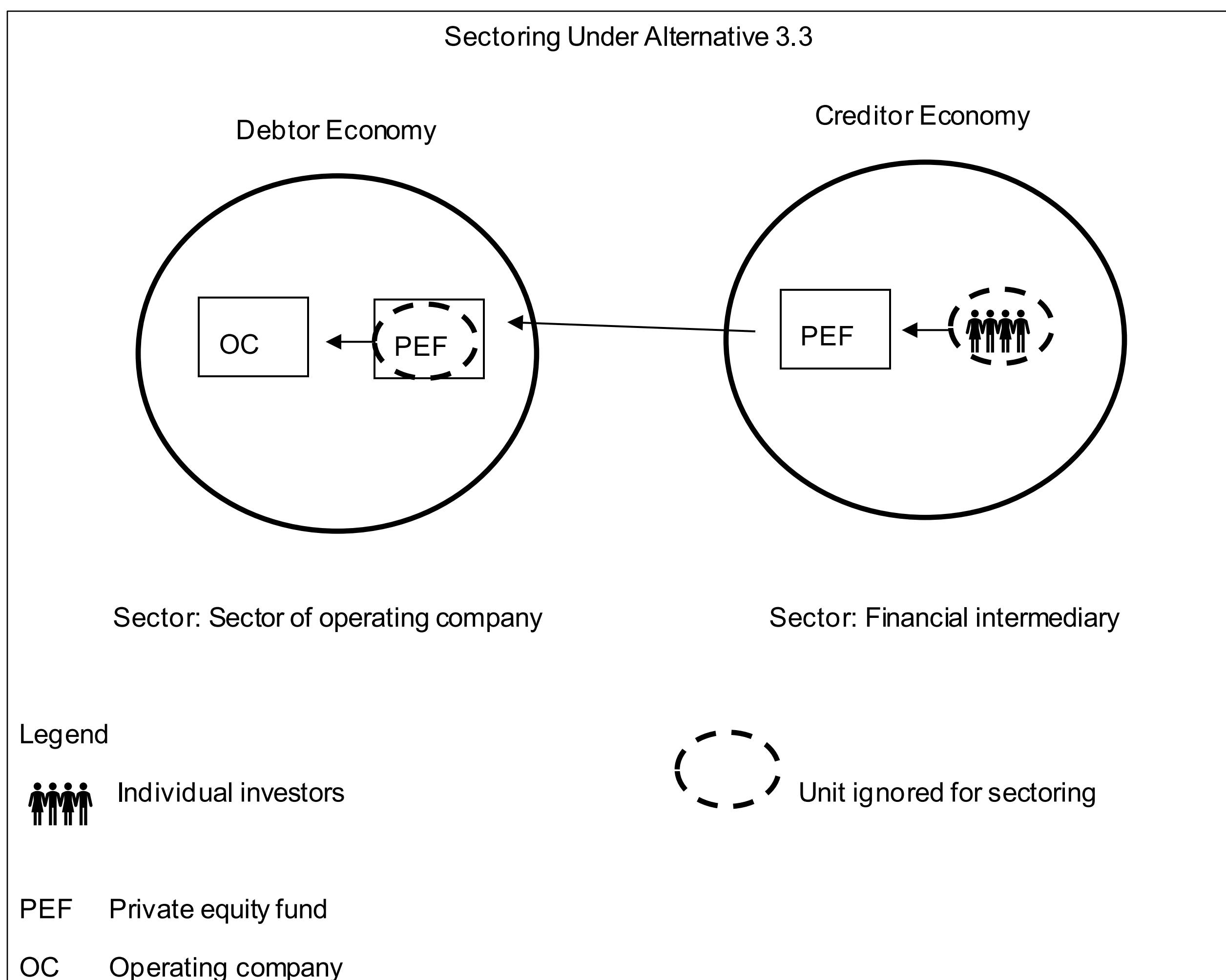
1. **The authors of this note sought to integrate the recommendations here with those in the guidance note on the sectoral breakdown of direct investment (GN D.7) and nonbank financial intermediation (F.6),** but this was not always easy to do. First, the recommended level of sectoral breakdown in those other notes is not nearly as detailed as would be needed to implement or illustrate the proposed guidance here. Second, CIIs could involve more than one institutional sectors, this note already identified investment funds (S124), other financial intermediaries (S125) and other financial auxiliaries (S126). Third, even if the necessary detail were available, its utility toward facilitating the recommendations here varies by alternative.

2. **The proponents of Alternative 3.2 believe that classification by sector upholds their proposal in both a conceptual and a practical sense.** Conceptually, Alternative 3.2 treats 10 percent or greater equity stakes in CIIs as portfolio investment based on the notion that these are "collective" investments so that even if the group of investors has an equity stake of that size, it is unlikely that any individual investor in the group does. It treats 10 percent or greater equity stakes by CIIs as direct investment based on the notion that the fund managers, rather than the individual fund participants who should be viewed as the investors. Practically, once the sector of the entity making or receiving the investment is identified and, in the case of assets, once the size of the equity stake is identified, it becomes easy to implement the suggested guidance of Alternative 3.2.




*Note:* This simple example is not meant to be detailed nor exhaustive, but only to roughly illustrate some of the possible sectoring differences between Alternative 3.2 and Alternative 3.3.

3. **Aligning the purposes of sectoring with the purposes of Alternative 3.3 is not as straightforward.** First, the proponents of Alternative 3.3 do not believe that identifying the sector of the entity making or receiving the investment is enough information. It is also necessary that the 10 percent or greater equity investments be in an operating company, rather than a holding company or another investment fund. This is because the conceptual basis of Alternative 3.3 is the intent of the investor to influence the strategy and/or day-to-day management of the target company. Second, and for the same reasons, proponents of Alternative 3.3 favor including in direct investment only classes of CIIs where there is at least some evidence of an intent to be an active business manager, namely, private equity funds and real estate funds. Third, even if sector detail were available for CIIs (and perhaps sub-sectors therein), on the liability side, if a foreign CII invested in a nonfinancial domestic business, the sector of the inward direct investment would provide no information about the role of foreign CIIs in supporting domestic investment.




*Note:* This simple example is not meant to be detailed nor exhaustive, but only to roughly illustrate some of the possible sectoring differences between Alternative 3.2 and Alternative 3.3.

## Annex IV. Conceptual Guidance from the European Union

For the European Union, discussions on the analytical meaning of DI in CIIs occurred in 2017 in the context of the Working group of External Statistics (WG ES). In the EU context, CIIs are exclusively investment funds which are principally engaged in financial intermediation. Their business is to issue investment fund shares or units, and, on their own account, to make investments primarily in financial assets and in nonfinancial assets (usually real estate). The conclusion was that a DI relationship could only be meaningful in closed-end funds, that is, funds where no additional shares are issued, and the fund itself won't redeem—buy back—shares; where the logic of control could be more easily established taking into account the usual reduced number of shareholders. On the contrary, in open-end funds, the investment policy is fixed in advance and hence the concept of control is rather blurred. Moreover, the 10 percent would be changing continuously what would make very difficult to track in practice and link the investment decision with the idea of getting influence or control in the fund. CIIs may also grant intragroup loans, which would also be classified as DI, unless granted to certain SNA financial institutional sectors—S122 to S125 (*BPM6* paragraph 6.28).

## Annex V. Identification of the Institutional Unit in a Private Equity Fund

Who should be treated as the resident institutional unit for investments by private equity funds? Some might argue that it should be the investors in the fund themselves because these funds are typically legally structured as partnerships. Others might argue that it should be the fund managers because the individual investors cede all decision-making regarding the portfolio composition and the day-to-day and strategic management of the target investments to the managers of the funds. In either case, it seems that a private equity firm should be considered a quasi-corporation, which is a separate institutional unit from its investor (*2008 SNA*, paragraph 4.42–4.46). By this argument, it seems that the collective unit, headed by the fund managers, should be considered the resident institutional unit for investment by private equity funds.