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Revision of the IMF Balance of Payments Manual: The Direct Investment Functional Category

Recommendations of the Direct Investment Technical Expert Group and Decisions of the IMF Committee on Balance of Payments Statistics

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REVISION OF THE IMF BALANCE OF PAYMENTS MANUAL: THE DIRECT INVESTMENT FUNCTIONAL CATEGORY

RECOMMENDATIONS OF THE DIRECT INVESTMENT TECHNICAL EXPERT GROUP AND DECISIONS OF THE IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

1. Most existing international statistical guidelines for the compilation of macroeconomic statistics were introduced in the early 1990s. In the light of changing economic conditions and user needs since that time, the international statistical community, represented by various high level groups, decided that a harmonized review of the various guidelines was required.

2. The *System of National Accounts, 1993* (*1993 SNA*), the IMF *Balance* of *Payments Manual,* fifth edition (*BPM5*), the *OECD Benchmark Definition of Foreign Direct Investment (Benchmark Definition),* and various other guidelines are being revised in coordination, and with the objective of complete consistency.

3. An IMF/OECD Direct Investment Technical Expert Group (DITEG) was established to make recommendations on the methodology of direct investment statistics for the harmonized revisions of the *BPM5* and *Benchmark Definition*.[1] DITEG submitted its recommendations for consideration by the IMF Committee on Balance of Payments Statistics (Committee) and the OECD *Workshop on International Investment Statistics (WIIS).* Details of the working arrangements are set out in Box 1. The conclusions of both groups were very similar. The summary of the Committee's decisions is attached in Annex 1.

4. The major feature of these decisions is that the existing guidelines on direct investment in the balance of payments and international investment position are, in the main, either unchanged or align even more closely with national accounting principles. However, the DITEG deliberations led to recommendations for new supplementary detail to assist in the economic analysis of direct investment.[2] This reflected evolving user requirements, for example in the context of globalization. Several areas of research work remain. Some additional user needs beyond the balance of payments, such as data by economic activity, will be described in the *Benchmark Definition.* DITEG's work, and further follow up, will also lead to improved clarity in the revised manual, as well as a significant amount of improved compilation guidance.

5. Among the most important areas that the Committee has decided will remain unchanged are:

- the 10 percent ownership threshold for establishing a direct investment relationship;

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[1] The fourth edition of the *Benchmark Definition* is scheduled to be published by the OECD by the end of 2006. This will be in advance of the release of the new balance of payments manual (BPM) by the end of 2008.

[2] In the new BPM, supplementary items are to be distinguished from standard components and will be options that may be considered by countries when a particular issue is of interest to analysts and policymakers.

- the market price principle for the measurement of direct investment equity stocks, which was reaffirmed and emphasized;[3]

- the resident status of Special Purpose Entities (SPEs)[4] in the economies in which they are registered or incorporated;

- the recognition of the Fully Consolidated System (FCS) as the ideal conceptual basis for delineating the scope of direct investment enterprises within the direct investment relationship;[5] and

- the retention of reinvested earnings as a transaction.[6]

6. Among the most important changes decided by the Committee are:

- to strictly apply the asset/liability principle, so that asset claims of direct investment enterprises on their direct investors are no longer netted against liabilities. Similarly, income flows are to be grossed up. Presently, the standards recommend that income payable and receivable between a direct investment enterprise and its direct investor be netted. This change improves alignment of the statistics with national accounting and balance of payments principles.

- to classify holding companies as institutional units in the financial corporations sector for purposes of the balance of payments and national accounts. This change is subject to a decision by the Advisory Expert Group on National Accounts (AEG) in January/February 2006. In those instances where such a holding company has subsidiaries in the same economy, compilers should consider also producing supplementary information with the group enterprise classified on the basis of the predominant activity of the "local" group to assist analysis of direct investment data.

- to no longer consider "permanent debt" between affiliated financial corporations as direct investment.

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[3] For unlisted enterprises, several alternatives (depending upon circumstances) were identified as acceptable proxies for market valuation.

[4] Includes Special Purpose Entities, Special Purpose Vehicles, brass plate companies, holding companies, and other similar entities that have minimal (or no) physical presence in the economy of their legal domicile.

[5] Two alternate measures, the "US Method" and the "EU Method" (or the "10/50 rule"), were deemed acceptable for approximating the FCS.

[6] The Committee, however, recommended that the treatment of reinvested earnings should be reviewed by an expert group that it considered should be set up to review the concept of income within the balance of payments and national accounting framework. This work would become part of the research agenda beyond the deadlines for completion of the new BPM and reviewed SNA.

Box 1. Working Arrangements for the Review of Direct Investment Methodological Issues for the Revision of the *BPM5* and the *Benchmark Definition*

The DITEG was created in 2004 as a joint IMF/OECD expert group to make recommendations on the methodology of direct investment statistics for the revision of the *BPM5* and the *Benchmark Definition*. DITEG held three meetings (June 2004 in Paris, December 2004 in Washington, D.C., and March 2005 in Paris) and has now been disbanded after conclusion of its work. DITEG was jointly chaired by the IMF and OECD and serviced by a joint IMF-OECD secretariat. Countries and international organizations that provided members to the DITEG were Australia, Belgium, Canada, Colombia, France, Hong Kong SAR, Japan, the Netherlands, Russian Federation, South Africa, Tunisia, United Kingdom, United States, ECB, Eurostat, IMF, OECD, and UNCTAD.

The coverage of DITEG's work program was based on a list of items identified by the Committee and the WIIS as issues for review and resolution. DITEG's conclusions and recommendations were submitted for consideration to the Committee and the WIIS. All issues and outcome papers are published on the IMF's external website at www.imf.org, as are the decisions of the Committee.

The Committee considered the recommendations of DITEG at its meetings in October 2004 and June/July 2005. WIIS deliberations were presented for information to the Committee. The conclusions of both groups were very similar, mainly due to the high level of expertise of their memberships and the close cooperation and the degree of transparency between the IMF and OECD staffs.

7. Also identified by the Committee were some areas for which more detail or clarification was required. First, while SPEs should be included in direct investment, it was decided that, where the size of their stocks and flows may be misleading for analysis of direct investment, the data should be reported as an "of which" item using national definitions. Attempts at developing an international definition of SPEs have been unsuccessful, but further work will be undertaken during the drafting of the *Benchmark Definition* to include criteria to identify SPEs and to provide guidance to national compilers. Second, it was decided that new breakdowns relating to mergers and acquisitions should be shown in the balance of payments as supplementary items. Further work on the development and harmonization of basic concepts and recording methods will be required. Third, it was recognized that definitions of mutual funds and similar organizations needed to be developed in order to clarify whether or not investment in or by these institutional units should be included or excluded from direct investment.

8. Looking ahead, the IMF staff will prepare in 2006 the first draft of the revised balance of payments manual. The first set of draft chapters will be posted on the IMF's external website by the end of 2006. Through 2007 and 2008, there will be country review, regional seminars, and redrafting that will result in the posting of a revised draft at the end of 2007 and a final draft, subject only to editing, by the end of 2008. Comments on the various drafts of the revised balance of payments manual, and its direct investment sections, will be encouraged and welcomed.

9. During 2006, the OECD Benchmark Advisory Group (BAG), which is a drafting group established by the OECD WIIS, will continue work on drafting the revised *Benchmark Definition.* The IMF staff will collaborate with the BAG. The IMF staff will work closely with the OECD staff and other relevant parties on the various unresolved issues with a view to bringing recommendations to the Committee and the WIIS.

DIRECT INVESTMENT[7]

DELIBERATIONS OF THE IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS (COMMITTEE), AS PART OF THE REVISION TO THE IMF'S *BALANCE OF PAYMENTS MANUAL*, FIFTH EDITION (*BPM5)*

Issue	***Outcome***	***Comments***
1. Valuation of:		
(i) direct investment equity: *whether the market price principle should be stressed, and, if so, how this should be applied to unquoted shares.*	(i) The Committee reaffirmed the market price principle and agreed to give it greater emphasis in the new balance of payments manual (BPM). For unquoted shares, several alternatives (depending on circumstances) were considered acceptable as proxies for market valuation. These included: recent transaction price; net asset value (with and without intangibles); capitalization ratio; and own funds at book value.	Unchanged for the basic principle. Improved compilation guidance.
(ii) branches: *whether intangible assets should be included in the value of a branch.*	(ii) The Committee agreed that, in principle, all assets of a branch should be included in determining value of the owner's equity.	Improved definition. Further aligned with System of National Accounts (SNA).
2. Definition of direct investment: 10 per cent threshold of voting power/equity ownership, employment		
(i) Whether the 10 percent threshold of voting power/equity ownership should be changed to 20 percent (in line with international accounting standards) and whether employment should be used as a criterion to determine whether there was "real" direct investment.	(i) The Committee decided to retain 10 percent equity ownership as the threshold for establishing the direct investment relationship. The Committee decided not to use employment as a criterion for determining "real" direct investment.	Unchanged.

[7] The Committee also examined two other issues that are important for direct investment analysis but would most likely fall outside the scope of the standard components and supplementary items that will be covered in the revised balance of payments manual. The first issue related to principles for classification of direct investment data by industry: these will be spelled out in the revised *OECD Benchmark Definition of Foreign Direct Investment.* The second issue related to the development of supplemental position and income statistics (i.e. "economic measures" rather than "financial measures") as a part of globalization statistics in recognition of additional user needs; those measures could be described in revised *Benchmark Definition* if the work was sufficient advanced. The Committee noted that the work should proceed in parallel with the work on UBO/UBA that is mentioned under issues #8 and #11 in this table.

Issue	*Outcome*	*Comments*
(ii) Whether to adopt the same terminology with regard to subsidiary, affiliate, branch, and unincorporated enterprise as in the 1993 SNA.	(ii) The Committee agreed that the new BPM should adopt same terminology as the SNA.	Clarification and coordination with SNA.
3. Indirect investment—Fully Consolidated System (FCS), "US Method," or the "EU Method"	The Committee confirmed that the FCS represents the ideal conceptual basis for delineating the scope of direct investment enterprises within the direct investment relationship. Both the "US Method" and the "EU Method" (or the "10/50 rule") were deemed acceptable alternates for the FCS.	Ideal conceptual basis unchanged. Enhanced compilation guidance, and with the "EU Method" adopted as an extra alternate system.
4. Mergers and acquisitions	The Committee agreed that new breakdowns relating to mergers and acquisitions should be shown in the BPM as supplementary items.	New supplementary detail.
5. Reinvested earnings: (i) as affecting national saving (ii) of indirectly owned direct investment enterprises	 (i) The Committee agreed to retain current treatment in the new BPM but recommended the creation of an expert group to review the concept of *income* in the balance of payments and national accounts. The group would not be expected to report until after the new BPM and the reviewed SNA are published, and so its work would become part of the research agenda beyond these deadlines. (ii) The Committee clarified how reinvested earnings should be aggregated along a chain of indirectly owned enterprises.	 Unchanged for present revision. Improved compilation guidance.
6. Bring together all direct investment issues (stocks, flows, income, and other activities between affiliates) in an appendix to the new BPM	The Committee agreed that such a presentation should be described in an appendix and adopted on a supplementary basis in the BPM.	New supplementary detail in BPM.
7. Directional principle and reverse investment	The Committee decided that direct investment positions, financial transactions, and income should be presented on a gross basis, under assets, liabilities, receivables, and payables (rather than including reverse investment flows on a net basis). The Committee agreed to retain reverse investment (i.e., investment	Changed and aligned with SNA principles. Unchanged.

Issue	*Outcome*	*Comments*
	by a direct investment enterprise in its direct investor, even when the reverse equity holding is less then 10 per cent) as direct investment.	
8. Special Purpose Entities (SPEs), shell companies, holding companies, offshore enterprises (units, sectorization, residence, transactions)	The Committee agreed that SPEs, shell companies, etc., are resident in the economy in which they are legally domiciled.	Unchanged.
	The Committee agreed that holding companies, in institutional sector classifications for the balance of payments and national accounts, should be classified in the financial corporations sector and that compilers should consider also the production of supplementary direct investment data classified by the sector of the enterprise group resident in the same economy.	Subject to decisions of the Advisory Expert Group on National Accounts (AEG).
	The Committee concluded that further consultation is required to address whether non-equity transactions and positions between a "conduit" SPE and a related nonfinancial entity should continue to be included in direct investment. This issue, which may lead to a change that affects only the borderline between direct investment and other functional categories, is under consultation among direct investment experts.	Further consultation required.
	The Committee agreed that, to enhance the analytic usefulness of data on direct investment, data on "SPEs" be shown on a supplementary basis, using national definitions, for countries where these entities are important and where the size of direct investment transactions and stocks might otherwise be misleading.	New supplementary detail.
	The Committee agreed that users' requests concerning more information on SPEs should be provided, by making use of standard principles within the BOP framework, while noting that no	

Issue	*Outcome*	*Comments*
	single solution to SPE operations would be appropriate in all cases.	
	The Committee noted a need to explore ways of determining the main characteristics of SPEs, which can be used by countries in isolating SPEs transactions and positions.	Further work and coordination required.
	The Committee agreed that supplementary positions and income data on a Ultimate Beneficial Owner (UBO)/Ultimate Beneficiary Affiliate (UBA) basis be generated outside the core accounts of the BOP.	New supplementary detail. Further work and coordination required.
9. Rules for identification of branches	The Committee endorsed the view that the existing criteria (including the one-year rule, flexibly applied) should be applied to determine whether a branch is a separate institutional unit. The Committee emphasized that the absence of an income statement and a statement of assets and liabilities would make the collection of data for a branch very difficult.	Unchanged.
10. Country identification (UBO/UBA and immediate host/investing country)	(i) The Committee recognized that, for country and sector analysis, the immediate host/investing country concept should be the principle for identifying host and home countries for the core accounts.	Unchanged in the core accounts.
	(ii) The Committee recognized that supplementary information on the UBO/UBA basis would be valuable for analysis of direct investment positions and income outside the core accounts. See also issue #8.	New supplementary detail. Further work and coordination required.
11. Geographic classification principles (debtor/creditor or transactor principle)	The Committee agreed that the debtor/creditor principle should be primary, while recognizing that there may be practical reasons for using the transactor principle.	Clarification.
12. Round tripping *Round tripping refers to the channeling by direct investors of local funds and the subsequent return of these funds to the local economy in the form of direct investment.*	The Committee confirmed that round tripping should be included in direct investment, with separate supplementary breakdowns included in the BPM presentation. This decision could be partly affected by the results of the consultation described under issue #8.	Unchanged in principle. New supplementary detail.

13. Permanent debt between affiliated financial corporations (other than insurance corporations and pension funds)	The Committee agreed that, on conceptual grounds, permanent debt represents direct investment but that, on grounds of practicality and statistical significance, should be recorded as either portfolio investment or other investment, depending on the instrument.	Changed.
14. Land and buildings owned by non-residents	The Committee agreed that, subject to the outcome of considerations of the issue by the Canberra II group, at its meeting in September 2005: - the treatment of long-term leases of land and buildings, and, by extension, other natural resources, by nonresidents needs to be clarified in the new BPM; - where an effective change of ownership takes place (comparable to a finance lease) that a notional resident entity be created, in the same manner as with an outright purchase of land and buildings, and other natural resources; - such an acquisition by a notional entity represents an equity investment.	Subject to decisions of the AEG on relevant Canberra II group proposals.
15. Use of maturity and full instrument split for direct investment	The Committee decided that an instrument breakdown of direct investment that is consistent with the SNA instrument breakdown, and a maturity split, should be included in the supplementary items, with compilation priority being given to the instrument split.	Alignment with SNA for instruments. New supplementary detail on maturity.
16. Multi-territorial enterprises and areas of joint sovereignty	The Committee agreed that the current treatment in *BPM5* be generalized to all enterprises where identification of separate units in different economies is not possible. For joint sovereignty zones, the Committee agreed that guidance should be provided in the new manual, but flexibility should be allowed.	Clarification. Improved compilation guidance.
17. Define terms more clearly	The Committee agreed.	Clarification. Further work required in drafting.
18. Transactions/positions between banks and affiliated (financial and nonfinancial) entities	The Committee agreed to continue the present exclusion from direct investment of non-equity transactions and positions between	Unchanged.

	affiliated financial corporations (other than insurance corporations and pension funds). In addition, see decisions regarding permanent debt (issue #13) and consultations regarding conduit SPE activities (under #8).	
19. Banking activities: *payments by a branch to its nonresident head office that result in a zero balance in the branch's income account*	The Committee agreed that such payments should be treated as income, and not to try to separate any other elements (such as service payments).	Clarification.
20. Shipping companies: *should recording transactions/positions under direct investment related to shipping companies be further clarified in the BPM?*	The Committee agreed.	Unchanged in principle. Further work and coordination required to improve compilation guidance.
21. Natural resource exploration and construction: *should existing rules in determining the residency of enterprises operating in construction and natural resource exploration be preserved?*	The Committee agreed.	Unchanged.
22. Other capital (focusing on short-term instruments): *that all other capital transactions and stocks, both long-term and short-term, between direct investment related enterprises should be included in direct investment and not in other investment (other than the specific exceptions mentioned in #8, #12, and #15) and thus to keep the existing treatment unchanged*	The Committee agreed to retain present treatment.	Unchanged.
23. Inter-company transactions and amounts outstanding with fellow companies (i) Should they be included in direct investment? (ii) If yes, is the asset/liability principle the most appropriate treatment for the transactions between fellow companies?	 (i) The Committee agreed (ii) The Committee agreed	 Unchanged. Clarification in BPM.
24. Valuation of real estate (i) Encourage the use of real estate price indexes (despite their methodological heterogeneity among countries)	 (i) The Committee agreed.	 Improved compilation guidance.

rather than a more general price index to calculate the market value of real estate stocks (ii) Reject the use of acquisition cost in the same purpose	 (ii) The Committee agreed.	 Improved compilation guidance.
25. Collective investment schemes (units, sectorization, residence, transactions) (i) When hedge funds, private investment funds, and distressed funds have equity ownership in a nonresident entity of 10 percent or more, should such relationships be considered direct investment, or should there be some exceptions to the "10 percent" rule? (ii) Should feeder funds be treated as direct investors in their nonresident master funds if they hold 10 percent or more of the equity in the master? (iii) If equity investment by retail mutual funds in a nonresident entity meets or exceeds 10 percent of equity on issue, should the relationship be regarded as direct investment? (iv) How can these funds be identified?	 (i) The Committee decided to treat investment in, and investment by, hedge funds, private investment funds, and distressed funds as direct investment if the standard 10 percent threshold is met. (ii), (iii) and (iv) The Committee had divided views on the appropriateness of applying the 10 percent rule to investment in and by retail mutual funds and master/feeder funds. The Committee noted that it is necessary to have a definition in order to apply an exception and that further work needed to be done on this issue, in conjunction with other groups that may be examining this topic.	 Clarification. Affects the borderline between direct investment and other functional categories of investment. Unresolved clarification. Further work and coordination required.
26. Accounting methods and international accounting standards.	This item provided information on various issues relating to direct investment that could affect direct investment recording.	