BOPCOM-05/53A

Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005

SPEs and Nonfinancial DIEs

I. DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)
II. OUTCOME PAPER (DITEG) # 11-B

April 8, 2005

1. **Topic: SPEs: Inclusion in direct investment of transactions between non-financial DIE and affiliated financial SPE**

2. **Issues: See DITEG Issue Paper # 11 by the ECB (December 2004); Background document by the ECB (February 2005); Background document by the OECD (February 2005); Background document by the Netherlands (DNB - March 2005)**

3. **Recommendations:**

(i) DITEG confirmed the opinion expressed in previous meetings with regard to the fact that an internationally agreed definition of SPEs seems hardly achievable in the time set for updating BPM5 and the Benchmark Definition. This was reinforced by the background paper presented by the OECD, which showed a very large number of heterogeneous country practices and non-existence of any legal or other definition in most OECD countries. Therefore, the group was supportive to providing solutions to users' requests spelled out in the letter by the Chairman of the OECD Investment Committee by making use of standard principles consistent with the overall b.o.p. / i.i.p. framework, as opposed to developing any ad-hoc treatment addressed to a specific type of companies (i.e. SPEs), which is not separately identified in international statistical standards at present.

(ii) DITEG concurred with the view that a single solution could not address all problems related to the operations of SPEs. In particular, the group agreed with the three statistical problems identified by the ECB paper in the field of FDI:

- *First problem*: countries which are hosts of SPEs register a large volume of gross (inward and outward) flows and stocks due to the operations of SPE holding companies;

- *Second problem*: investor and investee countries are losing information on the final destination / ultimate origin of direct investment relationships passing through SPEs located in third countries; and

- *Third problem*: a number of distortions are registered in relation to FDI other capital flows and stocks due to the existence of conduits and SPVs raising funds in offshore centres for their direct investors.

(iii) With regard to the first problem, there was a wide range of views among the group, some supportive to leaving methodology unchanged, some supportive to isolating the operations of resident SPE holding companies as part of the standard components of the b.o.p. and i.i.p., and some supportive to presenting this information in supplementary

presentations of FDI statistics. However, the impossibility to achieve an internationally agreed definition of SPEs (see (i) above) suggests that other possibilities should be explored. In that context, the possibility of isolating holding companies' transactions / positions (even if indistinguishably comprising both SPE and non-SPE holding companies) as part of the sector breakdown of the b.o.p. / i.i.p. - as suggested by BOPTEG outcome paper #9B – was considered by some as an approach which could be a more promising and feasible way out in this context (see also DITEG outcome paper #27).

(iv) Concerning the second problem, DITEG agreed with the proposal in the ECB paper that it should be resolved outside the scope of the core accounts, in particular via supplementary presentations of FDI statistics based on concepts other than the general b.o.p./i.i.p. standard ones. Since such concepts would have much to be with the identification of ultimate beneficial owners and affiliates, it was agreed to link their resolution to discussions related to these topics (see DITEG outcome paper # 12).

(v) Regarding the third problem, DITEG recognized that, on theoretical grounds, exclusions from FDI should be limited to financial SPEs borrowing funds from outside the group and lending to the direct investor, as suggested by the annotated outline of the forthcoming Balance of Payments Manual. On pragmatic grounds though, it was recognized that an accurate identification of the population of SPEs that would be subject to this exclusion would be hardly feasible (see DITEG outcome paper # 11); additionally, the difficulty to establish a perfect correspondence between origin and destination of each individual flow / stock (with a view to determining which of the loans provided by such SPEs would originate from outside the group) was also considered hardly realistic. Therefore, as an alternative it was proposed to exclude from FDI those reverse investments (other than equity capital and permanent debt) in which the lender is a financial affiliate providing funds to its (financial or non-financial) direct investor. While it was recognized that there was still some risk of excluding some transactions / positions which could be deemed to correspond to genuine FDI relations (FDI classified according to ultimate destination), it was concluded that the bulk of those excluded would not comply with the definition of FDI and, therefore, the quality, in particular the value for analysis, of FDI flows and stocks would significantly improve.

(vi) Finally, DITEG also expressed preference for maintaining the existing exclusion from FDI in the present standards, i.e. financing flows or stocks other than equity capital and permanent debt[1] in which both lender and borrower affiliated enterprises have a financial nature would be recorded under portfolio or other investment (instead of under FDI).

(vii) DITEG did not reach a consensus and was not in a position to determine the methodology in response to the request of the OECD Investment Committee to include in the *Benchmark Definition* recommendations to isolate "genuine FDI further broken down by partner country and by industry classification." As the balance of payments does not address specifically bilateral data issues, DITEG recommended to defer the

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1. See also outcome papers #14 Permanent Debt and #21 Banking.

discussion to Benchmark Advisory Group of the OECD Workshop on International Investment Statistics.

4. Rejected Alternatives:

(i) The group rejected the proposal of the Netherlands to net out under inward direct investment all flows/stocks in which the resident company is not the ultimate beneficial owner. Among the reasons given, several members mentioned inconsistency with the reformulation of the directional principle as supported by DITEG, incompatibility with the general principle of recording gross assets and liabilities, serious consistency problems between inward and outward FDI which would prevent bilateral comparisons amongst countries, etc. In general, it was deemed that the proposal would create as many problems as it would solve. However, the group was of the view that some of the ideas contained in the paper could find proper accommodation in supplementary presentations of FDI statistics and suggested further work in that direction.

5. Questions for the IMF Committee on Balance of Payments (the Committee) and the OECD Workshop in International Investment Statistics (WIIS)

(i) Do the Committee and the WIIS agree that solutions to users' requests concerning SPEs should be provided by making use of standard principles consistent with the overall b.o.p. / i.i.p. framework?

(ii) Do the Committee and the WIIS agree that a single solution could not address all problems related to the operations of SPEs?

(iii) If yes, do the Committee and the WIIS agree with the three main statistical problems in the field of FDI identified by DITEG, namely (1) large volume of gross (inward and outward) flows and stocks due to the operations of SPE holding companies in countries which are SPE hosts; (2) loss of information on the final destination / ultimate origin of direct investments passing through SPEs located in third countries; and (3) how to record financial flows / stocks due to the existence of conduits and SPVs raising funds in offshore centres for their direct investors.

(iv) In relation to the first problem, do the Committee and the WIIS agree that the possibility of isolating holding companies' transactions / positions (even if indistinguishably comprising both SPE and non-SPE holding companies) as part of the sector breakdown of the b.o.p. / i.i.p. could be worth considering?

(v) In relation to the second problem, do the Committee and the WIIS agree that it should be resolved outside the scope of the core accounts and in particular via supplementary presentations of FDI statistics based on, inter alia, UBO/UBA principles?

(vi) In relation to the third problem, do the Committee and the WIIS agree that the most practical solution is to exclude from FDI those reverse investments (other than equity capital and permanent debt) in which the lender is a financial affiliate providing funds to its (financial or non-financial) direct investor?

(vii) Do the Committee and the WIIS agree to disregard the proposal to net out under inward direct investment all flows/stocks in which the resident company is not the ultimate beneficial owner? Do both committees agree that the proposal could perhaps be given further consideration in developing supplementary presentations of FDI statistics?

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUE PAPER 11

INCLUSION IN DIRECT INVESTMENT OF TRANSACTIONS BETWEEN FINANCIAL SPEs AND AFFILIATED (NON-FINANCIAL) COMPANIES

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[1] 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.

1. 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

2. 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.

3. 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 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.*

4. 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

5. Several papers presented to the BOPCOM[2] 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. [3]

6. 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, 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.[4]

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[2] See related bibliography at the end of this document.

[3] 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.

[4] 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.

(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.

7. 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

8. 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 non financial enterprises*.

9. 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).

10. 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.

11. 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

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.

12. 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.

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

- *Simplicity.* – it just requires an appropriate sectorisation of the companies involved.[5]
- *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.

14. 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.

15. 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.

16. 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.[6]

17. 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

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[5] 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.

[6] 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'.

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 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.

18. 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 nonfinancial direct investment enterprises and affiliated financial intermediaries. [7]

IV. Points for discussion

1. Do DITEG members consider that the three drawbacks of the current treatment identified in paragraph 6 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 nonfinancial direct investment enterprises and affiliated financial intermediaries, including SPEs primarily engaged in financial intermediation for a group of related

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[7] 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.

[10] 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.

enterprises in those instances where national compilers consider that the direct investment statistics have been distorted by the inclusion of these transactions?

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Annex 1: Results of the 2003 Survey of the Implementation of International Methodological Standards for Direct Investment (SIMSDI) and comments on the AO

1. The preliminary results of the 2003 SIMSD (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. [10]

(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. [11]

Total responses	2	
Direct investment	1	
Other investment	1	

[11] No comments were received on the second question raised in the *AO*, namely, the meaning of “SPEs that undertake financial intermediation”