BOPCOM-06/26

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Direct Investment—Debt Between Affiliated Financial Intermediaries

Prepared by the Statistics Department
International Monetary Fund

1. Background

1. Debt between affiliated financial intermediaries can include very large and fluctuating values. This debt is not considered to be connected to the direct investment relationship, because it reflects normal financial intermediation operations. As a result, a special treatment is adopted for debt between affiliated financial intermediaries.

2. *BPM5* Treatment

2. This issue is dealt with in *BPM5* as follows:

> 372. 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. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, under portfolio investment or other investment. The stock of foreign assets and liabilities of banks and other financial intermediaries (international investment position) should be treated in a parallel manner.

3. Comment: Despite its wording, it is understood that this paragraph was intended to cover debt between affiliated financial intermediaries, rather than transactions between financial intermediaries. This is because a transaction between two affiliated enterprises involving a debt instrument issued by an unrelated third party would not be classified as direct investment under any circumstances.

3. Additional elaboration by the Committee

4. Paragraph 372 was elaborated by the Committee (see http://www.imf.org/external/np/sta/di/fditran.htm):

> Following discussions with the OECD WFS and the ECB WGBP&ER, the Committee at its October 2001 meeting reached the following decisions on the recommended treatment of transactions with affiliated financial intermediaries.
>
> The *BPM5* definition of the scope of enterprises included under "banks and other financial intermediaries such as security dealers" should be clarified as being equivalent to the following *1993 SNA* financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. As a

result, SPEs principally engaged in financial intermediation for a group of related enterprises would be encompassed in that definition.

The implications of the above clarification are that financial (and investment income) transactions 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; or (3) financial auxiliaries would be excluded from FDI except for transactions in the form of equity capital or permanent debt.

Financial transactions between units that are not financial intermediaries and affiliated financial SPEs abroad should be recorded under FDI.

It is important to note that this last recommendation overturns the practice described in the *BOP Textbook*, which excludes from the FDI data transactions between nonfinancial FDI enterprises and affiliated SPEs with the sole purpose of financial intermediation. The effect of the recommendation is that there will no longer be any difference in the treatment of SPEs that have the sole purpose of financial intermediation and SPEs that have the primary purpose of financial intermediation—the FDI data are to include both (i) transactions between nonfinancial FDI enterprises and affiliated SPEs with the ***sole purpose*** of financial intermediation, and (ii) transactions between nonfinancial FDI enterprises and affiliated SPEs with the ***primary purpose*** of financial intermediation.

The Committee also agreed that, in light of concerns expressed by some members of the OECD and ECB groups, the decision about the inclusion in the FDI data of financial transactions between units that are not financial intermediaries and affiliated financial SPEs abroad would be re-examined in the context of the next revision of the *Balance of Payments Manual.* In the meantime, countries that exclude such transactions from the direct investment data are encouraged to explain their practices and if possible to publish memorandum items to facilitate international comparability.

5. Comment: "Financial intermediaries" as a term for this treatment could more accurately be replaced by "selected financial corporations" because the treatment covers financial auxiliaries (which are not intermediaries) and does not cover insurance and pensions schemes (which are intermediaries).

4. Instrument coverage

6. Table 1 shows the current proposal before the AEG for the financial instruments classification. In terms of the proposed financial instruments classification, debt comprises F.2, F.3, F.4, F.6, and F.8. (As discussed in BOPCOM-06/28, the SDR part of F.1 is also considered to be a debt instrument, but it does not arise in direct investment cases. Financial derivatives are excluded from direct investment in all cases.)

7. In the light of the Committee's decision in 2005 on this issue, the draft *International Accounts Manual* and *Benchmark Definition* drop the qualification of "permanent" debt. As background to *BPM5* and the supporting documents offer no further specification of "permanent" and it has been a source of uncertainty.

Table 1—Proposed Financial Instruments Classification
as at September 26, 2006

Financial asset (transaction)	SNA code (transaction)
Monetary gold and special drawing rights (SDRs)	**F.1**
Monetary gold	
Special drawing rights	
Currency and deposits	**F.2**
Currency	
Transferable deposits	
Interbank positions♦	
Other transferable deposits	
Other deposits	
Debt securities *	**F.3**
Short-term	
Long-term	
Loans	**F.4**
Short-term	
Long-term	
Equity and investment fund shares **	**F.5**
Equity	
Listed shares♦♦	
Unlisted shares♦♦	
Other equity	
Investment fund shares/units*	
Money market fund shares/units	
Other investment fund shares/units	
Insurance, pension and standardised guarantee schemes♦♦	**F.6**
Non-life insurance technical provisions	
Life insurance and annuity entitlements♦♦	
Pension entitlements	
Provisions for calls under standardised guarantees	
Financial derivatives and employee stock options	**F.7**
Financial derivatives	
Options	
Forwards***	
Employee stock options	
Other accounts receivable / payable	**F.8**
Trade credit and advances	
Other	
Memorandum item:	
Direct foreign investment	
Equity	
Loans	
Debt securities	
Trade credit and advances	
Other accounts receivable/payable—other	

* The listed/unlisted split is relevant for debt securities and investment funds also.
** Reinvested earnings can exist under any of these.
*** Credit default swaps to cover for guarantees are included within this item.
♦ Still subject to discussion over separate identification.
♦♦ Still subject to discussion over precise terminology.

5. Institutional coverage

8. Table 2 shows the current proposal before the AEG and ISWGNA for the financial subsectors. In terms of the proposed classification, the existing special case for debt between affiliated financial intermediaries applies for Subsectors 2, 3, 4, 5, 6, and 7 (as shown in Table 2 below). That is, it covers all financial subsectors except central banks, insurance companies, and pension funds.

9. Both the debtor and creditor in the debt relationship must be in one of the subsectors, however they need not be in the same subsector.

10. Under this treatment, if a holding corporation[1] is classified as other financial institution (subsector 7 in Table 2), then any debt positions with other affiliated financial intermediaries would be excluded from direct investment. However, if a holding corporation were classified as a nonfinancial enterprise, or insurance company, or pension scheme, then all debt positions with affiliated enterprises would be included in direct investment.

Table 2—Proposed Financial Subsector Classification
as at September 26, 2006

1 Central bank, as now

2. Other deposit-taking corporations

3. Money market funds (MMF)

4. Investment funds, other than MMF

5. Other financial intermediaries except ICPF

6. Financial auxiliaries

7. Other financial institutions, except ICPF. This would include corporate or quasicorporate money lenders and may include some SPVs and holding companies.

8. Insurance companies (IC)

9 Pension funds (PF)

(The revised *SNA* will provide detailed definitions of these sectors.)

[1] Holding corporation is used here to mean a company that holds or directs subsidiaries, as in the *1993 SNA*. However, a more narrow definition has been adopted by the AEG.

(The treatment of equity and investment fund share positions between affiliated money market funds and other investment funds is discussed in BOPCOM-06/27.)

Questions for the Committee

- *Does the Committee agree to continue the special case for debt between affiliated financial enterprises?*

- *Is the definition of debt for the purposes of this treatment suitable?*

- *Does the Committee agree that the financial enterprises covered by the special treatment for debt between affiliated financial enterprises should be as set out in paragraph 8?*

- *Should the special treatment for debt between affiliated financial enterprises be extended to any cases where only one party is an affiliated financial enterprise?*

- *Does the Committee have any views on whether debt positions between affiliated holding companies should be excluded from direct investment?*