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# Issues on Direct Investment Requiring Decisions by the IMF Committee on Balance of Payments Statistics for the Updating of the Fifth Edition of the *Balance of Payments Manual*

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# ISSUES ON DIRECT INVESTMENT REQUIRING DECISIONS BY THE IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS FOR THE UPDATING OF THE FIFTH EDITION OF THE *BALANCE OF PAYMENTS MANUAL*

This paper brings to the attention of the IMF Committee on Balance of Payments Statistics several issues for decision on direct investment that remain unresolved in the updating of both the fifth edition of the *Balance of Payments Manual (BPM5)* and the third edition of the *OECD Benchmark Definition of Foreign Direct Investment (BD3)*.

## 1. 10 percent voting power

At its meeting in 2004, the Committee decided that the current threshold of ownership of 10 percent of the voting power or ordinary shares in an entity by a nonresident should be retained. However, while, in most instances, there is no conflict between the level of ownership of voting power and ordinary shares, there may be circumstances where these two measures are in conflict. For example, A may own 8 percent of the shares in B (a resident enterprise in another economy) but has 12 percent of the voting power. As the concept of direct investment is built on the premise that the direct investor (DI) is able to influence the operations of the entity in which he/she/it has invested, it would seem appropriate for voting power to be the determining variable in such circumstances. The Workshop on International Investment Statistics (WIIS) has agreed with this proposal.

Of particular note are “golden shares”. These give the holder a significant voice in the entity (often including the right of veto), ensuring that other investors cannot establish control with a majority stake, even though the actual holding, as a percentage of total shares on issue, may be very small. Golden shares are usually held by governments in their privatized government business enterprises, which are mostly not across borders, but, it is possible that holdings of golden shares may be held across borders, and may not be limited to governments as the holders. Therefore, as golden shares provide the holder with a significant degree of influence over the operations of the entity in which the golden shares are held, it seems appropriate that the holder of any golden shares should be considered a direct investor.

Having said that, however, for income items, it is proposed that the recommended approach should be to use the actual entitlement of the distribution for dividends, and that the same weighting be used for reinvested earnings.

*Questions for the Committee*

1. *Does the Committee agree that, for determining whether a direct investment relationship exists, where the levels of ownership of ordinary shares and voting power are different, that the determining variable should be whether the investor holds at least 10 percent of the voting power in an entity resident in another economy?*

2. *Does the Committee agree that where an investor holds a "golden share" in a nonresident entity, and that golden share represents a significant degree of influence, including the right of veto, that the holder of the golden share be regarded as a direct investor, regardless of the proportion of shares held?*

3. *Does the Committee agree that, where the proportion of a direct investor's share ownership and voting power in a direct investment enterprise differ, that, for purposes of the calculation income, the proportion of shares owned should determine the share of dividends and the allocation of reinvested earnings payable to the direct investor?*

## 2. Lasting influence

In *BPM5* and *BD3*, one of the criteria for determining whether a nonresident investor is a direct investor is that the investment be, or is intended to be, "lasting", which is taken to be one year or more. Through such an investment, it is assumed that the investor may exercise influence on the operations of the enterprise. However, while most direct investors may have the intention of having an influence over several years, even indefinitely, there may be instances where an investor has no such intention, but where the investment is undertaken to gain influence. In such a situation, the investment might be considered to be direct investment, nonetheless. In other words, is the exercising of influence the critical criterion, regardless of the length of time the investor holds the investment, or is there a requirement that the holding needs to be for a period of a year or more as well?

Short-term holding in order to gain influence could arise from a variety of situations. One is "greenmailing", where an investor acquires 10 percent or more of the voting power in an enterprise with a view to forcing the entity's board to adopt a particular course of action (such as the divestment of a particular asset, or to undertake a particular change in management philosophy, or to accept (or reject) a takeover offer). The greenmailer may have no intention or interest in holding the investment for a year but the holding may be very influential. Another instance may arise with corporate buy-outs. In this instance, a private equity group or a small group of investors, acting together, may take an enterprise private, put into effect a radical change in the enterprise (restructuring debt, selling off assets, reducing the payroll, changing the enterprise's product mix, paying themselves very large "dividends") and then publicly listing the remodeled enterprise, or selling it on to another group of investors (or the managers). Many instances of this type of restructuring likely require that the investor(s) retain ownership for several years, but there may be cases where the investors find fairly soon after acquisition that their original expectations cannot be met and sell out, or, if the restructuring is not overly complicated that it can be undertaken within a year, allowing for a quick on-sale, or for other reasons. Indeed, there is little way of knowing *a priori* what an investor's intentions are.

In all these instances, the investors are acquiring their investment with the intention of exercising some influence on the operations of the enterprise, regardless of the length of time they plan on holding the investment. That being the case, it could be argued that the investment meets the meaning of the direct investment. Even if there is no lasting holding, the influence will have a lasting effect.

That having been said, there may be instances where the ownership of shares (taken as a proxy of voting power) oscillates round 10 percent over several periods. In the *Financial Stability Indicators Guide*, it is suggested that, in such situations, a rule-of-thumb might be that, where an entity's holdings remain above the 10 percent threshold for two consecutive quarters, that that be taken as evidence that a direct investment relationship exists.

*Question for the Committee*

*4. What are the Committee's views with regard to situations where a direct investor may not have the intention of having a lasting investment in a direct investment enterprise? Is the exercising of influence the critical criterion, regardless of the length of time the investor holds the investment?*

*5. What are the Committee's views about the treatment of an investor whose share of voting power oscillates around the 10 percent the threshold? Should the rule-of-thumb be adopted of treating an investor as a direct investor where, in such a situation, the threshold is exceeded in two consecutive quarters?*

## 3. Reverse investment

*Reverse investment* is the investment by a direct investment enterprise (DIE) in its direct investor (DI). That is, where a DIE owns less than 10 percent (often zero) of the ordinary shares (voting power) in its DI but has provided funds to the DI, these funds are regarded as *reverse investment*. In *BPM5*, such reverse investment is netted against the funds provided by the DI (either under *direct investment abroad* or under *direct investment in the reporting economy*) but, for the new manual, the Committee decided to adopt the "strict asset and liability" approach, so that assets and liability transactions and positions are recorded gross (see Table 1). However, for presentational purposes, it was decided to show the following breakdown as it is considered that each relationship is analytically different, that is, the DI's investment in its DIE is different from a DIE's investment in its DI, which are both different in nature from investments by affiliated enterprises in other affiliated enterprises, in which they have little or no voting power.

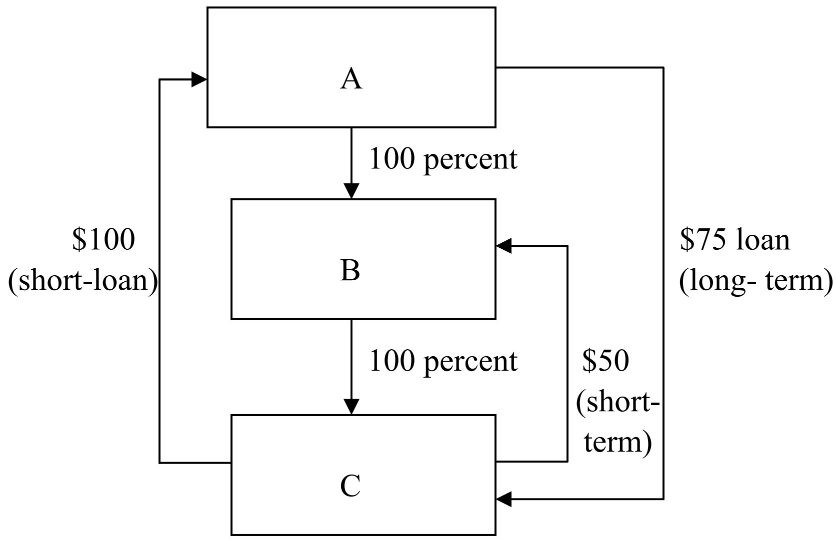
**Table 1 Foreign Direct investment presentation: transactions**

| **Assets** | **Liabilities** |
|---|---|
| **Direct investment abroad** | **Direct investment in reporting economy** |
| *By direct investors in direct investment enterprises* | *Of direct investment enterprises to direct investor* |
| **A1** Equity | **L1** Equity |
| **A2** Reinvestment of earnings | **L2** Reinvestment of earnings |
| **A3** Debt instruments | **L3** Debt instruments |
| | |
| *Reverse investment: By direct investment enterprises in direct investor* | *Reverse investment: Of direct investors to direct investment enterprises* |
| **A4** Equity | **L4** Equity |
| **A5** Debt instruments | **L5** Debt instruments |
| | |
| *By direct investment enterprises in other affiliated enterprises* | *Of direct investment enterprises to other affiliated enterprises* |
| **A6** Equity | **L6** Equity |
| **A7** Debt instruments | **L7** Debt instruments |

In this situation, however, the question has arisen as to whether reverse investment involves only a direct relationship or whether it can also include indirect relationships.

For example, in Diagram 1, A, B, and C are each in different economies; A owns 100 percent of B, which in turn owns 100 percent of C. C makes short-term loans to B, for $50, and to A, for $100, while A makes a long-term loan to C for $75. In these situations, while it is clear that C has a reverse investment with B, as B is the direct DI of C, it is not clear whether C's investment in A is reverse investment or whether it should be classified in Table 1 to *Assets: by direct investment enterprises in other affiliated enterprises,* for C, and as *Liabilities: of direct investment enterprises to other affiliated enterprises,* for A*?*

Diagram 1




If C's loan to A is treated as reverse investment, it follows that A's loan to C should be treated as *Assets: by direct investors in direct investment enterprises* (for A) and as *Liabilities: Of direct investment enterprises to direct investor* (for C). If C's loan to A is treated as investment in other affiliated enterprises, then it would appear that A's loan to C should be treated in the same way. As C is a DIE of A (as defined under the Framework of Direct Investment Relationships), it would appear to follow that A's loan to C should be treated as *Assets: by direct investors in direct investment enterprises*, and C's loan to A as *Reverse investment: by direct investment enterprises in direct investor*. There may be, however, considerable practical problems to this treatment which may make it inappropriate to treat C's loan to A as reverse investment.

*Question for the Committee*

*6. Does the Committee consider that reverse investment should (i) only involve the provision of funds between a direct investment enterprise and its immediate direct investor, or (ii) should it also include the provision of funding to indirect direct investors as well?*

## 4. Exclusion of retail mutual funds and/or master-feeder funds from direct investment

At its meeting in 2005, the Committee discussed, but was unable to reach a conclusion, as to whether, in the context of direct investment relationships, (i) retail mutual funds could be either DIs or DIEs, and (ii) master-feeder funds (or funds of funds) should be exempted from the standard 10 percent threshold to determine whether a direct investment relationship exists. (During the same discussion, the Committee concluded that investment in, and investment by, hedge funds, distressed funds, and private equity funds should be treated as direct investment when the threshold of 10 percent is reached.)

*Retail mutual funds*

For retail mutual funds, as to whether or not they can be DIs, the question centers on:

- what is the current treatment. While *BPM5* states that mutual funds are included in portfolio investment, it is not clear whether that is intended to trump the threshold of 10 percent

- whether, by the very nature of these funds as passive investors, investment is not acquired with a view to exercising influence, and that to include such an investment as *direct investment* would further erode the meaning of that concept; or,

- whether, regardless of the point above, it is unhelpful to have additional exemptions to the 10 percent threshold.

It might be noted that pension funds may also acquire more than 10 percent of an entity, whether to exercise influence or not, and that should retail mutual funds be excepted from the 10 percent threshold, there may be a logic to extend that exemption of pension funds as well.

As to whether retail mutual funds can be DIEs, the issue centers on:

- whether a putative DI would acquire a holding of 10 percent of the voting power in a retail mutual fund in order to influence its operations, and, if not, whether treating such investment as direct investment would represent a meaningful interpretation of that concept; or

- whether it is unhelpful to have an additional exception to the 10 percent threshold.

If retail mutual funds are to be exempted from the direct investment threshold of 10 percent of the voting power, a definition is required as to what such a fund is, so that it can be identified. The ECB has proposed a definition of "investment funds"

> *Investment funds are collective investment undertakings investing in financial and/or non-financial assets with the sole objective of investing capital raised from the public by issuing shares or units. Some funds may be open to certain investors only. Investment funds include undertakings whose shares/units are, at the request of the holders, repurchased or redeemed directly or indirectly out of the undertaking's assets, and undertakings with a fixed share capital, where investors entering or leaving the fund must buy or sell existing shares. Investment funds may be constituted: (i) under the law of contract (as common funds managed by management companies), or (ii) under trust law (as unit trusts), or (iii) under a statute (as investment companies), or (iv) otherwise with similar effect.*[1]

This definition does not differentiate between retail investment funds and other types. No other definition has been developed.

*Master-feeder funds*

In regard to whether feeder funds (in a master-feeder fund relationship) can be DIs in their master funds, the situation is somewhat different. In a master-feeder fund (or fund of funds) relationship, the roles of the investor and investment enterprise are reversed in that, while it is the feeder funds that place funds with the master (and thereby may acquire 10 percent or more of the master fund's equity on issue), it is the manager of the master fund that exercises control of the relationship. Accordingly, it may make more sense to except master-feeder relationships from the standard 10 percent threshold. However, in practice, it may prove difficult for compilers to identify where a master-feeder relationship exists, and so it may be less ambiguous and easier to implement if the 10 percent threshold applied.

*Questions for the Committee*

*7. Does the Committee consider that the threshold of 10 percent for establishing a direct investment relationship should apply for both investment in and investment by retail mutual funds?*

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[1] (***Classification and terminology of financial assets and liabilities in the 1993 SNA Rev. I*** Paper presented at the fourth meeting of the Advisory Expert Group on National Accounts (AEG) at the European Central Bank in Frankfurt am Main (30 January to 8 February 2006).

*8. If the Committee considers that retail mutual funds should never be treated as either DIs or DIEs, what are the Committee’s views as to (i) whether this exemption from direct investment should also apply to pension funds; and (ii) the definition needed to ensure international comparability?*

*9. Does the Committee consider that the threshold of 10 percent for establishing a direct investment relationship should (i) apply for feeder funds in their master fund, or (ii) should such relationships be treated as portfolio investment in all instances?*

## 5. Technical reserves of captive insurance companies

In the standard instrument classifications, technical reserves of insurance companies (to be renamed "insurance company provisions" in the new *System of National Accounts* and the new balance of payments manual) are a separate instrument. They are liabilities of the insurance companies to their policyholders for outstanding (known and unknown) claims, as well as for events that have yet to occur. As a result, these reserves are not part of shareholders' funds, and are excluded from direct investment.

For captive insurance companies, however, the owners and the insured are the same. Captive insurance companies are set up by a large multinational enterprise (MNE) as self-insuring units. They are often set up in another jurisdiction (typically in small economies with international financial centers). The captives are provided with working capital to set up a portfolio of investments that are intended to be used to cover claims made against the parent MNE. In view of the fact that the DIs of these captives are also the insured, it may be appropriate to treat the captives' insurance technical reserves as part of direct investment.

*Question for the Committee*

*10. Does the Committee agree that insurance technical reserves of captive insurance companies should be included in direct investment?*

## 6. Non-profit institutions serving households

Non-profit institutions serving households (NPISHs) are defined in the *Monetary and Financial Statistics Manual, 2000* (para. 114) as

> *"The NPISH sector comprises a subset of nonprofit institutions. NPISHs are mainly engaged in providing goods and services to households or the community at large free of charge or at prices that are not economically significant (and thus are classified as nonmarket producers), except those that are controlled and mainly financed by government units. NPISHs are mainly financed from contributions, subscriptions from members, or earnings on real or financial assets. NPISHs consist mainly of associations such as trade unions, professional or learned societies, consumers' associations; political parties (except in single-party states in which the political party is included in general government); churches and religious societies (including those financed by government); social, cultural, recreational, and sports clubs; and organizations that provide goods and services for philanthropic purposes rather than for the units that control them."*

NPISHs may have long-term operations in many different countries. Much (often all) of the financing of these operations is provided by the parent NPISH or other related parts of the NPISH's global operations. However, as the modus operandum of NPISHs is to provide non-market services to households, their activities are quite different from those of market producers. As direct investment is a business concept, based on market production, it may be inappropriate to treat the funds provided from the parent or other related part of the NPISH's global operations as direct investment. However, if an NPISH invests in a nonresident market producer, then the standard rules to determine whether or not it is a direct investor should apply.

*Question for the Committee*

*11. Does the Committee agree that all funding by NPISHs to their activities abroad should be excluded from direct investment?*

*12. Does the Committee agree that, if an NPISH invests in a nonresident market producer, then the standard rules to determine whether or not it is a direct investor should apply (i.e., the 10 percent threshold)?*

## 7. Goods and services in-kind

In *BPM5* and *BD3*, the treatment of the counterpart entry in the financial account of the provision of goods and services provided in-kind by an entity in a direct investment relationship to a related entity is not spelt out. The practice has been to treat such transactions as injections of equity, in the absence of any other indication. Such a treatment would cover the provision of goods and services in-kind by a DI to its DIE. Included would be the provision of goods and services in-kind to notional DIEs, such as for land holdings. However, where a DIE provides goods or services in-kind to its DI, it may be more appropriate to treat the transaction as a withdrawal of equity by the DI from the DIE, rather than an injection of capital by the DIE in its DI. Similarly, if an affiliated enterprise were to provide a good or service in-kind to another affiliated enterprise, in which it has no equity holding, the underlying meaning is that the DI has withdrawn equity from one affiliate and injected it in the other[2]. However, this treatment is likely to be difficult to implement, in which case, it may be more appropriate to adopt a convention that the transaction represents an injection of equity by one affiliate in the other.

If the goods provided are for processing, and the processing service is provided in-kind, the principles would be the same. Thus, for example, if the processor were a DIE, and the contractor the DI, it should be recorded as a withdrawal of equity by the DI from the DIE.

The value of the goods provided in-kind would depend on whether or not they undergo an effective change of ownership. If an effective change of ownership occurs, the injection of the equity should equal the value of the asset acquired (e.g., if capital equipment, the present value of the future stream of services produced by the good). If an effective change of ownership does not occur, that is, the goods are provided on the basis of an operational lease, the value of the equity injection should equal the rental service charge for the period(s) the good is being used. For services, the value is market equivalent of the service consumed during the period.

*Question for the Committee*

*13. Does the Committee agree that, in the absence of any other indication, the counterpart financial account transaction to the provision of goods and services in-kind by:*

*(i) a DI in its DIE should be treated as an injection of equity?*

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[2] These principles are essentially the same as those articulated in Chapter 10, para. 10.87, on the treatment of transfer pricing. It might be noted that similar situations may arise as payments of dividend in lieu of cash. The distinction between income and withdrawal of capital is an area that the future income working group will examine.

*(ii) a DIE in its DI as a withdrawal of equity by the DI in the DIE?*

*(iii) an affiliated enterprise to another affiliated enterprise in which it has no equity holding as a withdrawal of equity by the direct investor from DIE and an injection of equity into the other, as the appropriate conceptual basis, but, given the probably difficulties in implementing the concept, that it be treated as the acquisition of equity by the provider of the goods or services in the affiliated enterprise, by convention?*