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**The Effects of Including SPEs on BOP and FDI Statistics**

**Prepared by  
De Nederlandsche Bank**



## The effects of including SPEs on BoP and FDI statistics

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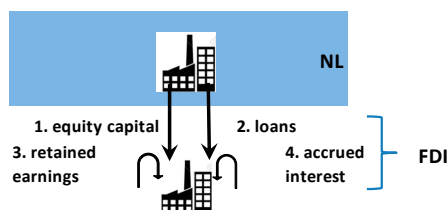
### **Introduction**

The past decades have seen an explosive increase in international capital flows. This was not only reflected in an increase in transaction volumes on financial markets, but also in growing amounts of foreign direct investment (FDI). The internationalisation of the business sector, by cross-border takeovers of businesses, reinvestment of profits and loans between group entities based all over the world, took on great proportions (Fig.1).

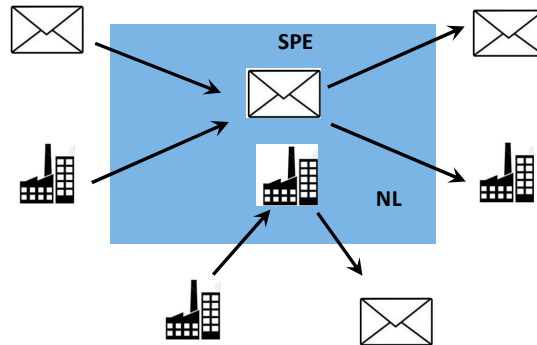
As a result of this expansion of multinational enterprises (MNEs) intra-group transactions have become increasingly complex. Capital from a range of sources often flows to multiple destinations via group entities based in several countries. In countries like the Netherlands, so-called Special Purpose Entities (SPEs) play an increasingly important role in this regard. SPEs are often referred to as brass plate or mailbox companies as they are companies with very few staff or little production and are merely used as financial turntables by foreign MNEs (Figure 2).

Although direct investments by or in Dutch SPEs, for instance, are hardly indicative of the relative appeal of enterprises or the investment climate in the Netherlands, or of the foreign expansion by Dutch MNEs, SPEs obviously need to be included in external statistics like those of the IMF, whose aim is to paint a complete and consistent picture of capital flows between countries throughout the world. However, including them may look easier said than done, as SPEs have next to no physical substance, which makes them rather intangible. That is why this paper describes how to take account of this type of institution, drawing on experience gained in the Netherlands. A brief discussion of the relevance of SPEs to balance of payment and FDI statistics in section 1 is followed by a section dealing with the collection and compilation of statistics including SPEs (section 2). Section 3 deals with the interpretability of balance of payments (BoP) and FDI statistics including and excluding SPEs. Section 4 briefly addresses the comparability of Dutch statistics including SPE figures with their mirror images in other countries, which is followed by conclusions.

**Figure 1 Globalization of the business sector by FDI**



**Figure 2 The increased relevance of Special Purpose Entities**



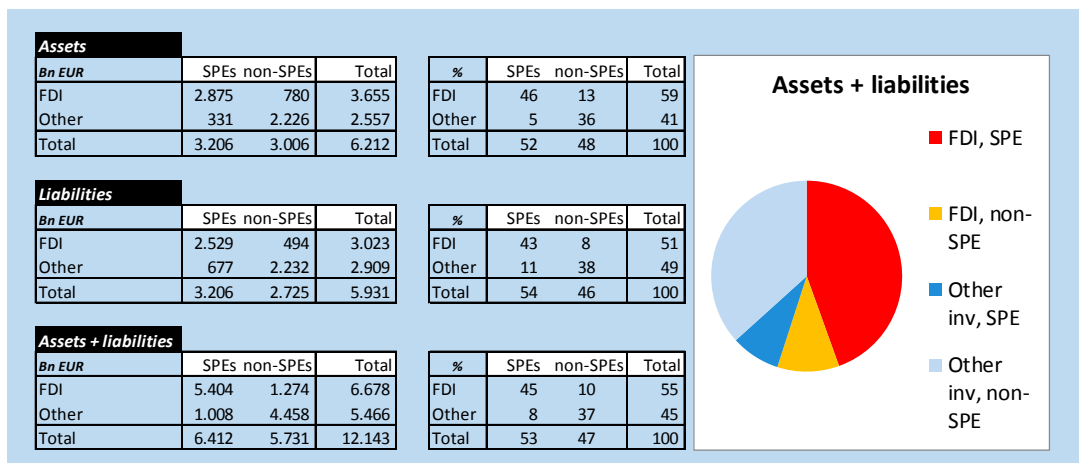
## 1 The relevance of SPEs to BoP and FDI statistics of the Netherlands

### 1.1 Major impact of SPEs on foreign assets and liabilities

The Netherlands has significant foreign assets and liabilities relative to its GDP. At the end of 2012, they stood at EUR 6,200 and EUR 5,900 billion, respectively, including SPEs, approximating ten times GDP in 2012 (fig. 3). However, the ensuing *net* position of some EUR 300 billion was not accounted for by SPEs but by non-SPEs. SPEs use to be strongly represented in assets and liabilities – at the end of 2012 they had a share of more than half of the totals – but these positions as well as the corresponding transactions mostly offset each other, the principal business of Dutch SPEs being to channel capital between MNE group members outside the Netherlands.

Most of the assets and liabilities of SPEs concern foreign direct investment. At end-2012 FDI assets of the Netherlands totalled at almost EUR 3,700 billion, 80% of which was attributable to SPEs.

**Figure 3 Composition of Dutch foreign assets and liabilities at end-2012**



The share of SPEs in the balance of FDI liabilities of more than EUR 3,000 billion was even larger, standing at approximately 85%. At end-2012 the contribution of SPEs to the net FDI position was some EUR 350 billion. This amount consisted largely of intra-group loans. End-2012 SPEs had outstanding loans of no less than EUR 900 billion with foreign group companies, versus liabilities of EUR 675 billion.

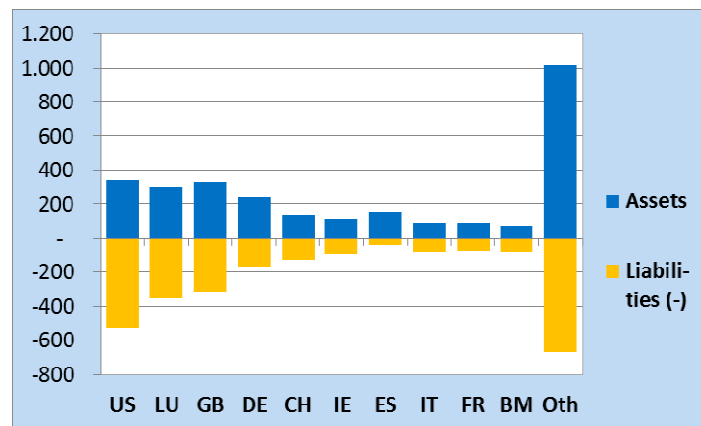
These amounts dwarf the FDI positions of non-SPEs. To the extent that non-SPEs contribute to Dutch net FDI positions, this is mainly due to considerable capital participations of large multinational companies like Royal Dutch Shell, Unilever, Philips, Heineken etc.

### 1.2 Breakdown by country dominated by a few big countries

Given that approximately 80% to 85% of FDI positions relate to SPEs, these institutions also have a large impact on the breakdown of FDI by country. Three countries together account for approximately 40% of all assets and liabilities of SPEs: the United States, Luxembourg and the United Kingdom. At end-2012 these countries accounted for 48% of all liabilities and 34% of the assets of SPEs. In other words, they are countries of origin more often than they are countries of destination (Fig. 4).

It is not surprising to find countries like the US and the UK in the top ten of positions, in view of the size of their economies and the presence of financial centres within their borders. Luxembourg's share is large because it acts as a financial turntable, just like the Netherlands. Some other countries or groups of countries hosting many SPEs are also strongly represented in the top ten. On average, assets held by SPEs in “Other countries” exceeded their liabilities to those countries. The net positions with BRIC countries, southern European countries and developing countries, especially, have seen strong increases in recent years.

**Figure 4 FDI positions of SPEs by country, end-2012 (billion EUR)**



## 2 *Collection and compilation of data on SPEs*

### 2.1 Brief historical overview

The collection of data about SPE-like institutions in the Netherlands started in the years after the Second World War. At the time, DNB had imposed limitations on international transactions that could reduce the effectiveness of monetary policy. DNB made an exception for subsidiaries of foreign multinational companies that were based in the Netherlands solely to channel capital (today we would refer to them as SPEs, but that term did not become fashionable until the 1970s). Reports about their activities by banks (about transactions that they settled for these institutions) and by the institutions themselves (about transactions settled otherwise) were initially only used by DNB to check whether the activities of these institutions were monetary neutral in foreign exchange terms.

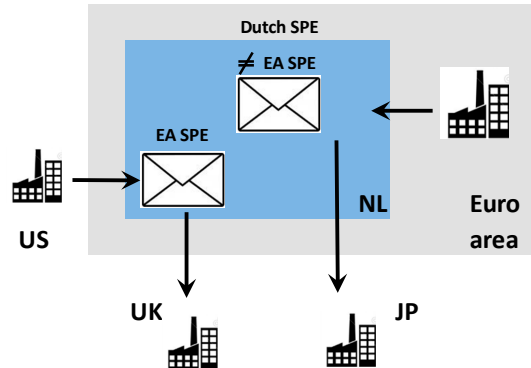
After the limitations had been lifted, DNB continued to distinguish this type of financial turntables, which were henceforth labelled SPEs (*Bijzondere financiële instellingen*) if their assets and liabilities were mainly foreign. Any small *net* balance of inflows and outflows of capital was now to be included in the balance of payments as a change in 'other cross-border liabilities'. This would remain the case until 2005, when DNB started publishing balance of payments and international investment (IIP) statistics excluding SPEs as well as BoP/IIP statistics including SPEs on a *gross* basis.

The largest SPEs were now required to report all their foreign transactions on a monthly basis using (electronic) survey forms<sup>1</sup>. Now, collecting information on SPEs actually served not just a national but also a European goal, given that meanwhile the ECB had been founded, which also needed data about the capital outflows and inflows through Dutch SPEs, as these could be members of a German MNE, for instance. From a euro area (EA) perspective, of course, these Dutch entities are not necessarily SPEs (Fig. 5). For the same reason – i.e. enabling the compilation of European figures – DNB provided figures both including and excluding SPEs to Eurostat. By contrast, DNB continued to provide SPE-free balance of payments figures and FDI figures to the IMF, the OECD and UNCTAD.

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<sup>1</sup> In 2003, DNB replaced cash flow reports of banks by a direct reporting system for SPEs and most other sectors in the economy.

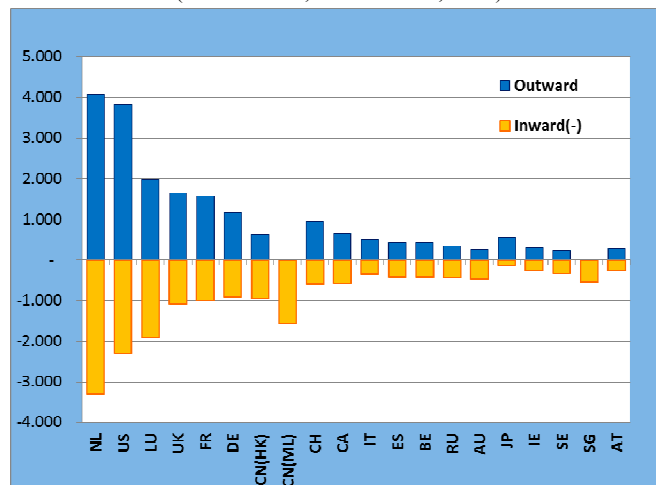
**Figure 5 – Dutch SPEs not necessarily European SPEs**



The information provided to the IMF changed when the Netherlands started to participate in the Coordinated Direct Investment Survey. DNB subscribed to the importance of bilateral symmetries - from a check-on-quality perspective - which the IMF considered to be important in achieving a consistent global picture. Figures provided to the IMF to compile the CDIS (as well as the CPIS, for that matter) therefore included SPEs. The CDIS soon highlighted the Netherlands as one of the most important FDI countries in the world (Fig. 6). This was mainly due to the inclusion of SPEs. Notwithstanding the inclusion of SPEs, DNB continued to also ask the attention for statistics excluding SPEs, as it had done in the context of the OECD, when working on the new Benchmark Definition of Foreign Direct Investment, 4th edition (BD4): SPEs should be observed, but in economic analyses of BoP/IIP/FDI figures they should rather be kept separate to avoid a misinterpretation of those figures as a result of inflation (see section 3).

**Figure 6 Ranking of FDI positions by country, average 2009-2011**

(Billion dollar; source: CDIS, IMF )

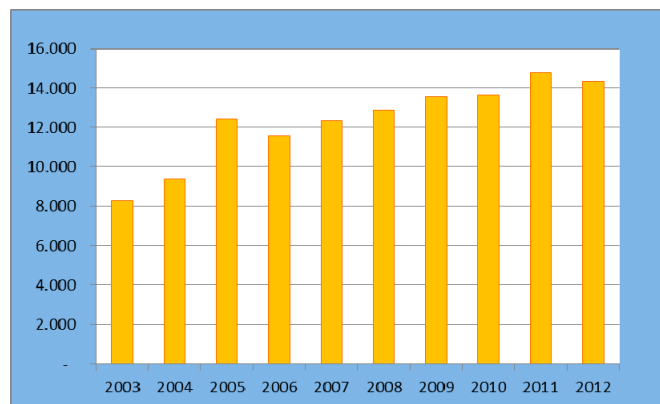


## 2.2 Maintenance of the population of SPE reporters – recent developments

The large amounts contributed by the SPEs to the Dutch FDI statistics reflect the ever increasing number of SPEs established in the Netherlands. Between 2003 and 2012, their number increased by 75% to over 14,000 (Fig. 7). Over these years, total foreign assets rose above EUR 3,000 billion, well over five times Dutch GDP. While some SPEs are very large, there are also thousands of smaller SPEs. This asymmetric distribution made it possible in 2003, at the time of the transition to direct reporting (footnote 3), to limit the number of monthly SPE reporters by a “cutting of the tail”, and to monitor the rest using a two-yearly benchmark survey of all foreign and domestic balance sheet items. At the time, a number of 700 reporting SPEs turned out to be sufficient to cover 90% to 95% of the foreign assets and liabilities. Until the next benchmark survey positions of reporting-exempted SPEs were used to gross up the foreign positions of SPEs that did report.

Over the past decade, the number of SPE's reporting on a monthly basis has doubled, resulting in an increase in DNB's workload. That is why DNB has again looked for ways of limiting the number of reporters, this time by distinguishing a middle group of SPEs, divided into a few subgroups (strata based on balance sheet totals and major IIP items reported in benchmark surveys), from which samples will be taken.

**Figure 7 – Increasing numbers of Dutch SPEs**



Complicating factors in administering and monitoring the SPE population are the changeable nature of the balance sheet of SPEs and changes in clusters of Dutch entities belonging to the same MNE (SPEs may easily come and go). The character of an individual entity can change over time, as its focus shifts from domestic production activities to channelling capital or vice versa. This is also important for Statistics Netherlands (CBS), which, like DNB, wants to be able to single out SPEs to enable a proper interpretation of national figures – in particular in the National Accounts (SPEs are included in other financial institutions).



Hence, DNB and Statistics Netherlands work closely together in distinguishing between SPEs and, for instance, non-financial corporations. Since 2012, in order to limit revisions, the population is refreshed *annually* on the basis of benchmark surveys among all known SPEs.

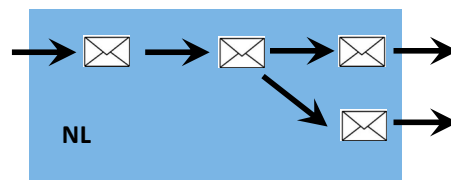
New SPEs are traced in several ways. In this regard an important role is played by trust offices, which must inform DNB on new SPEs, as must any other new SPE not represented by a trust office. Other sources of information to trace new SPEs include the registers of the Chambers of Commerce, annual reports of enterprises, news items, reports on major take-overs and so on. Once a (legal) obligation to report is imposed, a system of sanctions is in place to enhance compliance with it.

Since 2010, DNB and Statistics Netherlands use a jointly developed decision tree to single out SPEs. Criteria used for SPE classification include the country where an MNE's top management is based (in the Netherlands or abroad), the share of foreign assets and liabilities in balance sheet totals, the number of employees and the production volume. This decision tree elaborates on the general criteria developed in the context of BD4.

### 2.3 Borderline cases

While the SPE criteria like in BD4 are now generally applied, difficult cases continue to occur, making arbitrary choices sometimes unavoidable. Take, for instance, the condition that most assets or liabilities should be foreign. In practice, this condition will not always be met, even though the SPE nature of an entity looks obvious (Fig. 8). BD4 addresses this issue by recommending that identification of SPEs should not just involve an assessment of individual entities but also of clusters and chains of entities. One of the examples in BD4 is about capital flowing through a country via a *chain* of domestic entities specifically established for that purpose. The first link in such a chain has no foreign assets, while the last link has no foreign liabilities. So strictly speaking, neither individual entity would qualify as an SPE, but combined they do.

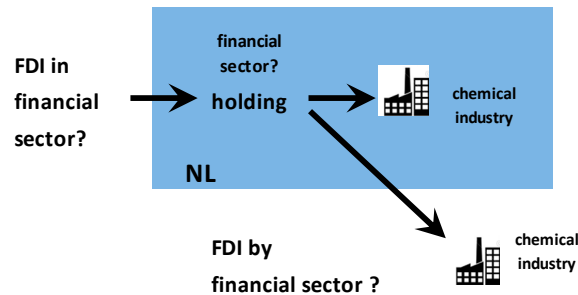
**Figure 8 SPEs with domestic assets or liabilities**



The identification of SPEs is an important but sometimes difficult task for DNB and Statistics Netherlands. For instance, a recurring question is how to best deal with hybrid entities like entities with large capital flows but only a limited number of employees. Should such an entity be counted as an SPE to avoid inflation of national FDI figures, or as a non-financial corporation

because of the persons working there? Decisions are made on a case-by-case basis and subsequently incorporated in the decision tree so that it covers a growing variety of special cases. Another issue, not just related to SPEs but also to non-SPEs, concerns the classification of entities by industry. If a foreign chemical group invests in a Dutch operating company through a Dutch holding company, should the Dutch holding really be considered as part of the “holding” industry (NACE code 6420)? Strictly speaking, all direct investment in the Netherlands *via the holding company* should, in that case, be included in investments in the *financial* sector (Fig. 9). When analysing direct investment figures, however, one might consider this to be a distortion of the genuine direct investments in the financial sector and an underestimation of the investments in the Dutch chemical industry.

**Figure 9 Problems with the classification by industry**

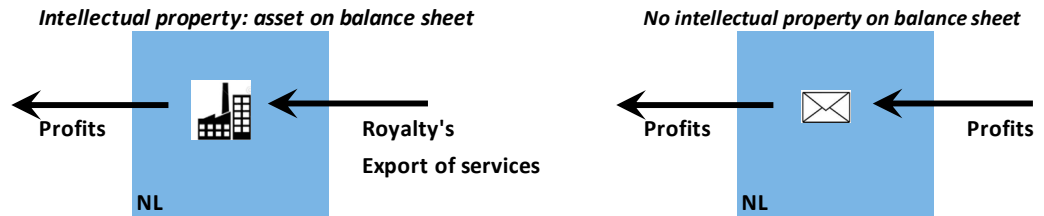


As regards SPEs in deliveries to Eurostat and the OECD, according to current Dutch practice, direct investments *in* SPEs are included under the holding companies industry and direct investments *by* SPEs are included under the industry of the group to which they belong.

Regarding non-SPEs, there is no such distinction. Here, both the assets and liabilities of an empty holding company - a local top-level entity from which share capital is distributed - are usually included under the industry of the operating companies below that holding company. The classification of holding companies is thus aligned with the treatment of such entities by Statistics Netherlands, with which DNB cooperates when compiling the balance of payments and national accounts.

An entirely different example of a difficult case concerns entities that channel export receipts from royalties and licences as dividend to their foreign parent company (approximately EUR 10 to 15 billion in recent years). For a long time, such entities used to be treated as SPEs. But recently it was decided to treat such entities as non-financial corporations if the underlying income-generating rights (the intellectual property) are on their balance sheet, in accordance with ESA2010 (Fig. 10; left hand side). Otherwise they are classified as SPEs (right hand side).

**Figure 10 Treatment of royalty's depending on intellectual property**



It should be noted that one effect of treating this type of entity as a non-SPE is that as the case requires, its income may have to be included in export income, which can have a significant impact on GDP. The impact on national income, however, is neutral as the income belongs to the non-resident parent of the SPE.

Another unusual case DNB once came across concerned a Dutch subsidiary of a foreign multinational, which had an offshore drilling rig in South America on its balance sheet, funded by the foreign parent. The drilling rig could not be treated as FDI, because it is not a financial asset. Consequently, the (financial) SPE criteria could not be applied and the entity could not be treated as an SPE. To enable the application nevertheless, so that various lease or oil revenues and profit transfers could be allocated to an *SPE*, it was then decided to count the value of the drilling rig as a direct investment, so that now both liabilities *and assets* could count as foreign.

### **3 SPEs and the interpretability of BoP and FDI figures**

#### **3.1 Inflation of figures due to the pass-through of capital**

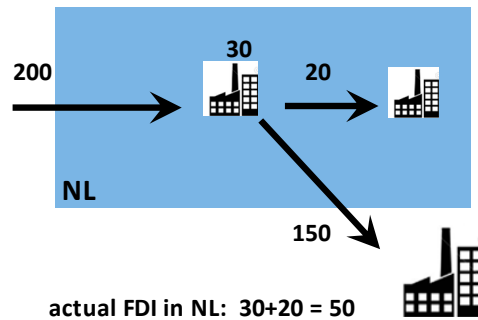
SPEs have hardly any impact on *net* figures like the current account surplus or the net IIP. SPEs withhold only a small part of income in order to pay for services in the Netherlands, by trust offices etc. This being said, SPEs do seriously affect *gross* figures, i.e. assets and liabilities, which should rather not be netted as they use to be driven by different factors that have nothing to do with each other. So even though an analysis of *net* figures may not be hampered by SPEs, in an analysis of *gross* figures SPEs cannot be ignored. This holds as much in the Netherlands as in other SPE countries, in particular in analyses of FDI.

Traditionally, direct investment statistics about a country aim to provide insight into the amounts by which enterprises from that country increase their interests in other countries and vice versa. Once a direct investment relationship has been established through the acquisition or establishment of a foreign enterprise (a 'greenfield' investment), intra-group loans, intra-group accounts at treasuries, etc. are also classified as direct investments, given that a subsidiary can also use intra-group *borrowings* to expand local activities. The same applies to the reinvestment of profits that a subsidiary is not required to distribute to its parent company. *Theoretically*

speaking, all these types of direct investment abroad can be indicative of the extent to which enterprises expand their activities in other countries or transfer activities to those countries. Likewise, incoming investment in a country could theoretically be an indication of the appeal of that country to foreign multinationals.

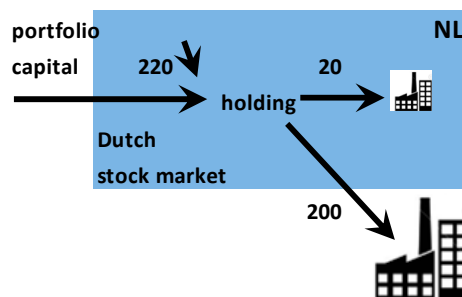
*In practice*, there are various factors complicating the interpretation of the figures. The pass-through of funds via SPEs is one of the most important ones. Non-SPEs can be another factor, given that they too can invest inflowing amounts not only in the local economy, but to a large extent abroad as well. In the Netherlands, many foreign multinationals have operating companies that themselves own foreign operating companies and have direct investments in other types of subsidiaries (Fig. 11).

**Figure 11 Incoming FDI sometimes large compared to activities of local enterprise**



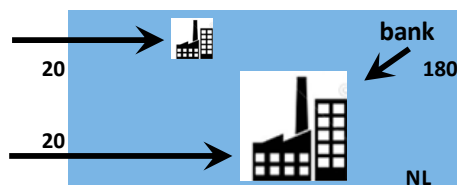
Another factor affecting direct investment abroad from the Netherlands is the presence of – in many cases listed – head offices of multinationals, to which the Dutch tax climate is as relevant as the economic climate. The appeal of the Netherlands to multinationals is enhanced by its large number of tax treaties with other countries, the local knowledge in that field, and the ability to obtain clear advance tax rulings from the Dutch tax authority. The presence in the Netherlands of large multinationals like Royal Dutch Shell, and the fact that all share capital is redistributed and invested from the Netherlands, together, are responsible for high direct investment positions abroad (Fig. 12).

**Figure 12 FDI abroad not always proportional to activities of direct investor**



As a consequence of the above factors, direct investment from a country is mostly not in proportion to the size of the local enterprises making those investments. Incidentally, the same holds for the enterprises invested in, because they can raise finance not only from the parent company, but also locally and thus represent much more activity than is reflected by the inflow of FDI capital (Fig. 13). Overall, direct investment between two countries, as it is currently measured, should not be overestimated as an indicator of the economic intertwinement between those countries.

**Figure 13 Incoming FDI sometimes small compared to activities of local enterprise**



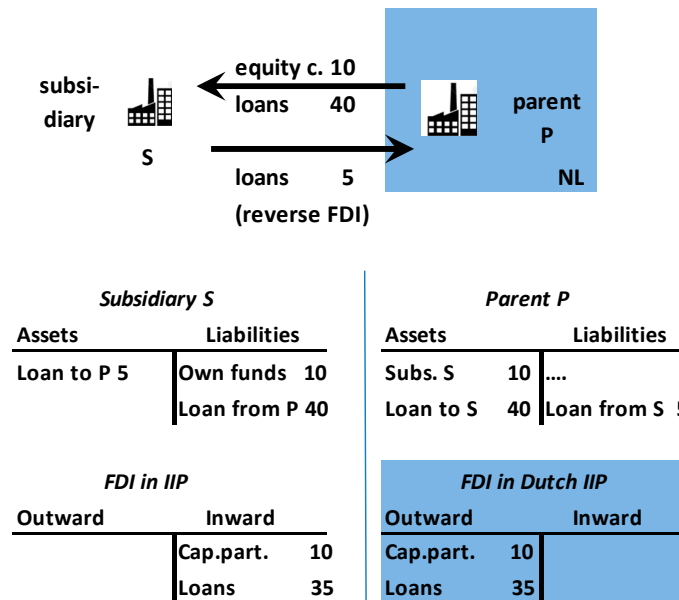
### 3.2 Problems due to capital flowing uphill and the directional principle

Another phenomenon complicating the interpretation of figures is that of capital flowing uphill. Through the years, enterprises have increasingly financed themselves through foreign subsidiaries in financial centres raising capital from the markets by issuing bonds or by taking out bank loans. This phenomenon also pushes up direct investment figures, both in the countries of the subsidiaries and in countries of their parents. As a consequence of this type of uphill (or bottom-up or homeward) financing –“genuine” FDI from countries harbouring many finance companies is overestimated. After all, uphill outflows towards a parent company do not necessarily point at foreign expansion by local enterprises and an increased *economic* intertwinement of countries.

Compilers of the IMF Balance of Payments Manual were aware of reverse investments at an early stage. The 'directional principle' acknowledged that a parent company may not just extend loans *to* its foreign subsidiary, but may also borrow *from* that subsidiary. Up to the fifth balance of payments manual, the directional principle prescribed that only the *net* amount of

outgoing and incoming equity capital and loans be counted as direct investments in the balance of payments statistics, under *outward* investments in the parent's country and under *inward* investments in the subsidiary's country. The classification of the net amounts thus corresponded with the direction of equity capital held (by parent companies in their subsidiaries; Fig. 14).

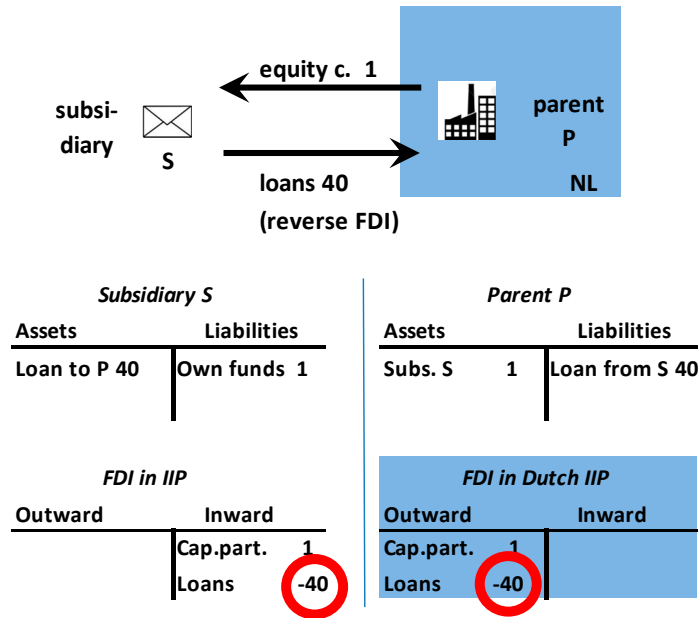
**Figure 14 Reverse investment**



The fifth manual did not yet require netting of loans between fellow companies. The idea to net these too, according to an extended directional principle (XDP; see hereafter), was elaborated during the preparation of BD4 and BPM6. As the XDP concerned only FDI, to which the IMF had now devoted its own statistic, the CDIS, the IMF decided to introduce the XDP in the CDIS while simultaneously abandoning the directional principle from the balance of payments and the IIP. In Europe, a similar distinction between FDI and BoP statistics was made by Eurostat.

The directional principle was now relevant for FDI statistics only, but meanwhile some had started doubting whether it was still effective and useful anyway. Originally, it had helped to avoid inflation of FDI figures by aiming in particular at net outward and inward amounts lent by parents to their subsidiaries. At the time of the first manuals, capital flows from parent companies to their subsidiaries may often have exceeded reverse flows, so that net loans to subsidiaries remained positive. However, over the years reverse capital flows and parents *borrowing* net amounts have become more commonplace (Fig. 15).

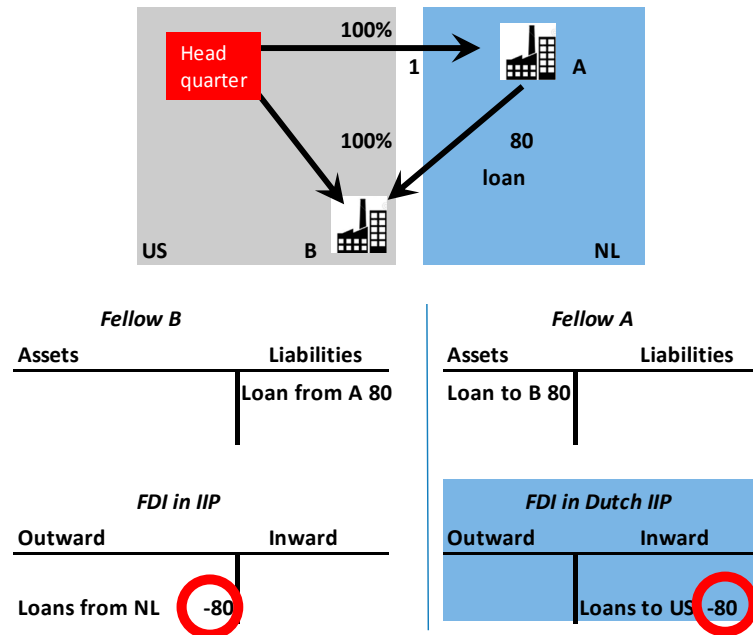
Figure 15 Negative FDI positions



Netting increasingly resulted in negative amounts that could still be explained as a result of rules in the manuals, but not interpreted anymore as activities (by the parent) aimed at expanding abroad. In the country of the parent company, negative amounts result in an *underestimation* of *outward* flows. In the same way, a reverse problem may occur in the country of the subsidiaries: a misinterpretation of outgoing loans as either a withdrawal of capital (by the foreign parent; negative inward FDI) or an expansion of local enterprises (increase in assets). This may particularly affect the direct investment figures of countries harbouring many SPEs, since they are often established with the stated purpose of financing their foreign parent companies.

As a result, the directional principle seems to have become less effective over the years. Nevertheless, when preparing for BPM6 en BD4 it was still envisaged that netting would help to address yet another problem: the inflation of figures not by capital flowing *vertically* between group entities, but by *horizontal* flows between fellow companies (e.g. from Fellow 1 in the US via Ireland to Fellow 2 in Germany). In the OECD, for instance, there was a long discussion on how best to deal with the increased complexity of direct investment networks. This resulted in an expansion of the directional principle, the *extended directional principle* (XDP), based on which loans between fellow companies could now be netted. BD4 recommends that a net balance of outstanding loans with foreign fellow companies is classified as *outward* or *inward* depending on whether the local entity belongs to a domestic or a foreign multinational. For instance, BD4 recommends to treat loans to foreign fellow companies belonging to the same multinational enterprise as *negative borrowings* (Fig. 16).

**Figure 16 Treatment of loans between fellow enterprises**



Some countries that had helped develop the new manuals held the view that the XDP did not remedy the problems of possible distortions, but could even exacerbate them. That is why a Technical Expert Group on the Extended Directional Principle was established in Europe in 2009, chaired by the ECB, with representatives of the central banks of some Member States and of the ECB and Eurostat. This group prepared a report that took stock of the problems. Views differed on the way forward, but it was clear that with some countries already engaged in implementing the new manuals, it would not be possible anyway to revise the manuals in a way that would be acceptable to all countries while also accommodating fast implementation. In any case, the ECB decided to stick to assets and liabilities.

### 3.3 Outstanding issues

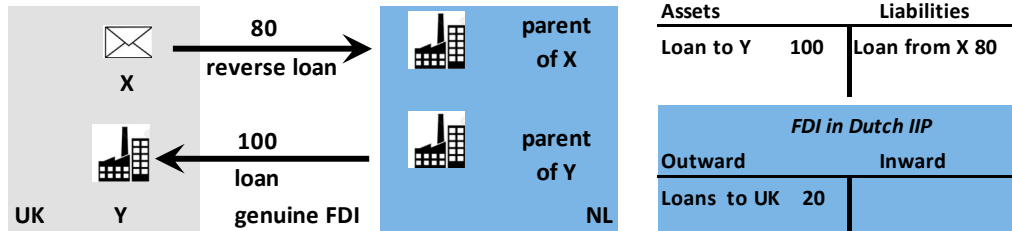
DNB has always been concerned that the extension of the directional principle has not made FDI statistics easier to interpret or better usable from an economic analysis point of view. The principle has disadvantages that remain unresolved. It already had pros and cons before it was extended to fellow enterprises.

Thanks to the principle, certain transactions may be rightly separated off from incoming direct investments – think of loans taken out by a Dutch multinational with a UK subsidiary. Such incoming loans do not reflect British willingness to invest in the Netherlands or increasing economic intertwinement between the UK and the Netherlands. Under the directional principle, they rightly do not count as inward FDI (Fig 17; upper arrow). But at the same time the directional principle instead prescribes the subtraction of such loans from outgoing investments in



the UK – which *may well be genuine* investments, made by *entirely different* Dutch companies intending to expand and grow in the UK (Fig. 17; lower arrow).

**Figure 17 Apples and pears in outward FDI**



Such netting therefore underestimates a country's investment abroad – in our example, by the Netherlands in the UK. Indeed, without the directional principle, inward FDI would have been overestimated, by the same amount. But after the application of this principle the percentage error will in many cases be larger (Box 1). This applies equally to transactions and to the associated positions.

**Box 1 – How the directional principle turns overstatements into understatements**

A simple example may make clear why the directional principle may turn one problem into another (see also the diagram on the next page). Assume a country's FDI assets are 200 and its liabilities are 100. If both are overestimated by - say - one-third, the respective "genuine" positions are 150 and 75. The overstatements by 50 and 25 might be labelled that way because they represent reverse loans, for instance, that do not reflect economic integration.

Now, application of the directional principle implies that the amounts of 50 and 25 are *rightly* excluded from assets and liabilities (step 1). Unfortunately, the story doesn't end here. The next step (2) is to subtract the amounts of 50 and 25 from liabilities and assets respectively. As a result, the inward figure, for instance, decreases by a higher amount than one would wish. It already went down from 100 to 75 (a correct adjustment for non-genuine FDI), but now an additional amount of 50 is subtracted because of non-genuine *assets*. Thus, the inward figure ends up at 25. This is 67% less than the genuine amount one would like to see (75). The underestimation is now even bigger than the original overestimation (by 33%). On the assets side, something similar happens. An overestimation by 50 is reversed into a (smaller) underestimation by 25. Indeed, this might be called an improvement, but the results are clearly mixed.

In short: where assets vis-à-vis a country considerably exceed liabilities, a useful adjustment of overestimated assets may well be accompanied by an even larger underestimation of liabilities.

**Ctd on p. 17**

**Box 1 (Ctd)**

<i>Dutch IIP before dir.principle</i>			
<i>Assets</i>		<i>Liabilities</i>	
genuine FDI	150	genuine FDI	75
"non-genuine"	50	"non-genuine"	25
<b>total</b>	<b>200</b>	<b>total</b>	<b>100</b>

**overstatement 33%** (left)      **overstatement 33%** (right)

<i>Step 1: exclude reverse loans</i>			
<i>Assets</i>		<i>Liabilities</i>	
genuine FDI	150	genuine FDI	75
<b>total</b>	<b>150</b>	<b>total</b>	<b>75</b>

**overstatement 0%** (left)      **overstatement 0%** (right)

<i>Step 2: subtract 50 from liabilities, 25 from assets</i>			
<i>Outward</i>		<i>Inward</i>	
FDI (BD4)	125	FDI (BD4)	25
	(=150-25)		(=75-50)
<b>total</b>	<b>125</b>	<b>total</b>	<b>25</b>

**understatement 17%** (left)      **understatement 67%** (right)

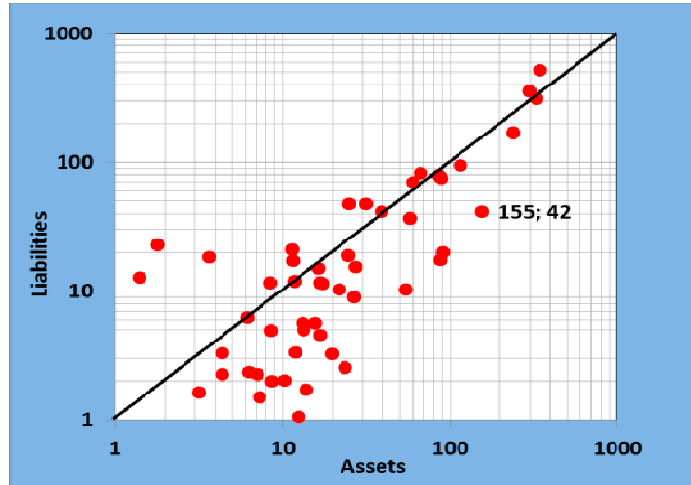
The distortions depend on the size of assets and liabilities and the degree of ‘overestimation’. The probability of increasing distortions – with overestimations being replaced by even larger underestimations – quickly becomes substantial where assets and liabilities differ rather strongly, as in the case of the Netherlands. In 2012, total incoming and outgoing loans added up to some EUR 1,200 billion and EUR 900 billion, respectively. Even though the ratio between these assets and liabilities is not especially high, positions vis-à-vis individual countries may differ (far) more (Fig.18), with the proportional risk that the XDP may lead to stronger rather than weaker distortions (see, for instance, the point indicating assets of EUR 155 billion and liabilities of EUR 42 billion).

A problem is also that in geographical breakdowns of FDI, the most frequently used presentation of FDI figures, the level of distortion may differ from one country to the next. Consequently, it seems difficult to maintain that figures in international comparisons and classifications by country, as in UNCTAD, IMF and OECD publications, have become easier to interpret since the introduction of the XDP. For countries like the Netherlands, that harbour many SPEs, the problems are likely to be even larger than for others, not just because they dominate

Dutch FDI statistics, but also because many SPEs are financing companies, which transfer considerable amounts to their parent and fellow companies.

**Figure 18 Intra-group loans of SPEs, foreign assets and liabilities end-2012**

(billion EUR; each dot represents a country with assets > 1 bn EUR)

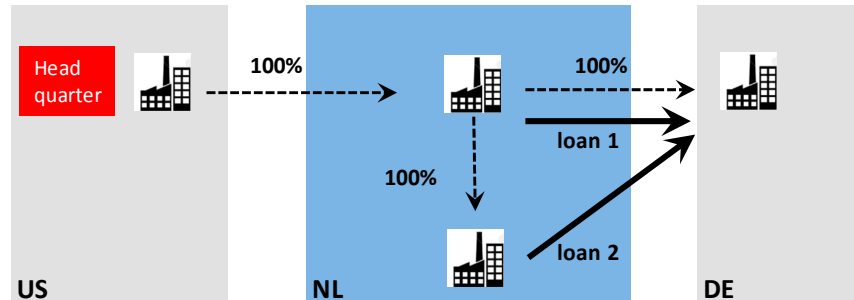


Even where there is no reason to keep certain amounts out of FDI statistics, complying with the XDP and its breakdown by parents, subsidiaries and fellow companies may still lead to a reclassification that is less than self-evident to the analytical mind. If, for instance, a Dutch subsidiary of a US company has a subsidiary of its own in Germany to which it extends a loan, this counts as outward FDI (Fig. 19a; loan 1). However, if the same Dutch company instructs its local, Dutch subsidiary to provide the loan – the German company is now a *fellow* – then under the XDP this will enter the statistics under inward FDI, as being a withdrawal of German capital (Fig. 19a; loan 2).

This may easily put XDP users of statistics on the wrong foot as the inward (headline) figure wrongly suggests a declining appetite of German enterprises for Dutch ones. However, if both the Dutch company and its local subsidiary are treated as one enterprise group, it no longer matters which member of the local group actually provides the loan (Fig. 19b), as in both cases the foreign counterpart is a subsidiary of the local enterprise group. The outcome of the XDP clearly also depends on the definition of statistical units.

**Figure 18 The sensitivity of outward/inward figures to the statistical unit under the XDP**

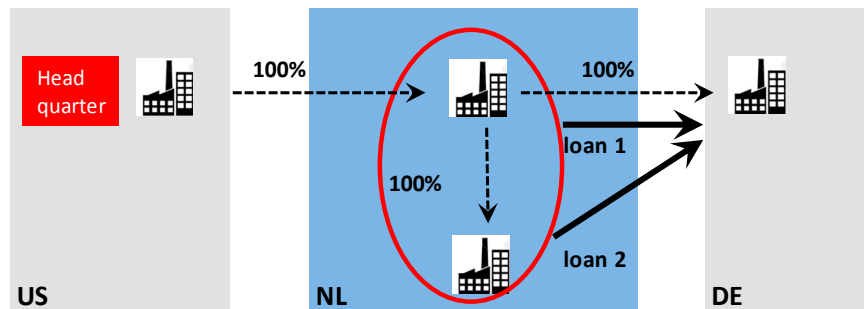
*a. Statistical unit = legal entity*



**loan 1: outward**

**loan 2: negative inward**

*b. Statistical unit = group of entities*



**loan 1: outward**

**loan 2: outward**

### 3.4 Better statistics through new concepts

Given the increasing complexity of FDI statistics, DNB would welcome initiatives in international settings in the next few years aiming to enlarge the usability of FDI statistics through the use of more appropriate concepts, by way of follow-up after the efforts already made by the IMF and the OECD in the past decade. One of the principal items on the research agenda, in DNB's view, would have to be a way to deal - to the extent possible - with the progressive blurring between, on the one hand, such as 'real' investments by mergers and acquisitions, indicating increasing economic intertwinement between companies and countries, and on the other the purely financial flows and positions that may or may not reflect economic intertwinement.

One topic to be investigated might for instance be whether in future the users of, say, CDIS figures might not be better served with two separate headline figures instead of the current

single one based on netting. While the one headline figure would be entirely financial, and suitable for the analysis of cross-border intra-group assets and liabilities, the other, more economic in nature, would better meet user interests in the realm of economic activity and economic relations between companies and countries.

The declining usability of current FDI figures for the latter purpose may be partly due to the fact they have over the years come to include components that understandably cannot be ignored in the BoP or IIP, but are less appreciated in an analysis of direct investments. Think of reverse loans that may lead to negative investments by one country in another. That a balance of payments should add up goes without saying, but the compilers of FDI statistics should be allowed more freedom to select and arrange building blocks into a few clear-cut indicators.

### 3.5 Experimenting in the Netherlands

In the view of DNB exploring new concepts more closely meeting user needs could be a promising avenue. From discussions over the directional principle it has already become clear that there is ample room for improvement. DNB has so far not produced statistics based on such new concepts, but it has already been toying with some ideas. Figure 20 below may serve as an illustration of the possibility to distinguish two types of FDI.

**Figure 20 Tentative alternative presentation of FDI figures (investment abroad)**

Direct investment (analytical presentation)		Resident is SPE	Resident is non-SPE	Total FDI
<b>A</b>	<b>Total investment abroad - Gross assets</b>			<b>Headline figure 1</b>
	Capital participations			
	<i>Purchases/sales of equity</i>			
	<i>Reinvestment of earnings</i>			
	Other investment (e.g. intercompany loans)			
<b>B</b>	<b>Assets in counterpart offset by liabilities to same counterpart</b>			
	Capital participations			
	Other investment (e.g. intercompany loans)			
<b>C = A - B</b>	<b>Net investment abroad before further adjustments</b>			
<b>E</b>	<b>Assets funding foreign homebases</b>			
<b>F</b>	<b>Investment with a pass-through character *)</b>			
	<i>Decided about by Dutch multinational enterprises</i>			
	<i>Decided about by foreign multinational enterprises</i>			
<b>G = C - E - F</b>	<b>Investment abroad after adjustment ("genuine FDI")</b>			<b>Headline figure 2</b>
	<i>Decided about by Dutch multinational enterprises</i>			
	<i>Decided about by foreign multinational enterprises</i>			

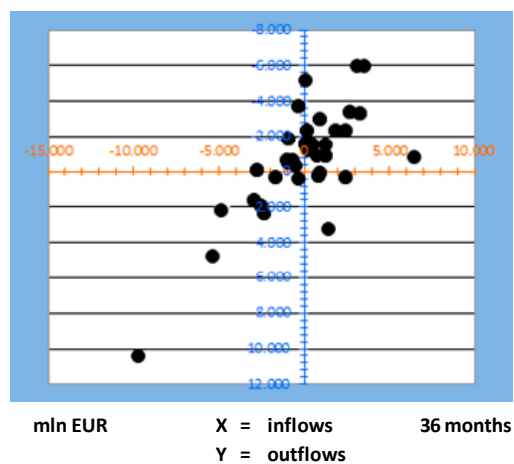
\*) To the extent it can be identified by statistical methods or characteristics of the reporter (SPEs)

One possible new and useful concept might be *homeward financing*, by which we mean amounts that Dutch MNEs borrow from their foreign subsidiaries (or, conversely, loans granted by Dutch-

based subsidiaries to group members in the country where the headquarters are based). Such loans, granted, for instance, by a subsidiary in London to its Dutch parent, may be included in newly conceived presentations in different ways. They could, of course, be presented as a separate item. Alternatively one could show them to the extent they cannot be netted with loans *by* the Dutch parent *to* the subsidiary in the UK. This latter condition at least helps to avoid negative loans at the enterprise level.<sup>2</sup>

The table distinguishes between SPEs and non-SPEs, but as mentioned above, non-SPEs may also channel funds whose inclusion in direct investment is debatable. This is why DNB is contemplating ways to trace pass-through capital also by statistical means, for instance by analysing all cross-border transactions of *individual enterprises* during a sufficiently large number of months. Correlations between capital inflows and outflows, both intra-group and otherwise, could point at a funding or pass-through role on the basis of which one could consider to treat certain flows of an entity as “non-genuine” FDI (Fig. 21 shows an example of this correlation, that might help to find enterprises whose FDI flows could be adjusted this way). Pass-through capital identified in this manner – to appear in memo item F in the table – should ideally be able to be separated out, because the idea is to identify not pass-through entities but the underlying phenomenon. As some arbitrariness in such an approach is unavoidable, it is of course considered to be suitable only in national publications of Dutch FDI statistics.

**Figure 21 Tracing pass-through capital via individual non-SPEs**



In addition to aggregate tables (like Fig. 20) DNB plans to publish, like other countries, direct investment figures broken down by ultimate controlling parent (UCP), an addition generally perceived as useful and already implemented by some countries. It should be noted that

<sup>2</sup> If for instance, the subsidiary in the UK lends 100 to its top parent in the Netherlands, and the parent lends 40 to its subsidiary, the two options would be: 1. Show the gross flow uphill (100) as homeward financing and consider 40 to be genuine FDI abroad, 2. Show the net flow uphill (60) as homeward financing.

separating off SPE-related figures, as in Figure 20, does not mean that they might not contain interesting information. BD4 suggests, for instance, to use micro data on SPEs to construct inflow-outflow matrices showing linkages between countries of (immediate) origin and destination. DNB has already developed a matrix that shows where capital coming from Egypt, for instance, flows to via Dutch SPEs.

The section that follows discusses another problem FDI statistics users may run up against: the mismatch between figures and their mirror counterparts. It will be explained that the risk of this happening may likewise increase if one of the countries in the comparison is home to a large number of SPEs.

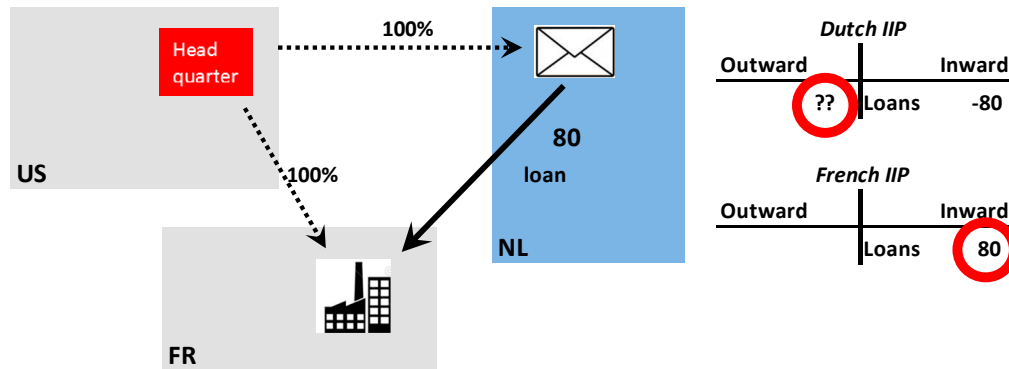
#### **4 *Bilateral comparability of direct investment figures and valuation issues***

##### **4.1 Asymmetries**

One of the key objectives in drawing up the CDIS was to provide a consistent overall image of outward and inward direct investments of IMF member countries. It goes without saying that to achieve bilateral symmetry in such a *global* picture, as an important check on quality, countries such as the Netherlands contribute figures including SPEs, even though at a *national* level such figures are not thought to offer a useful indicator of, for instance, the propensity among foreign enterprises to expand or contract their activities in the Netherlands.

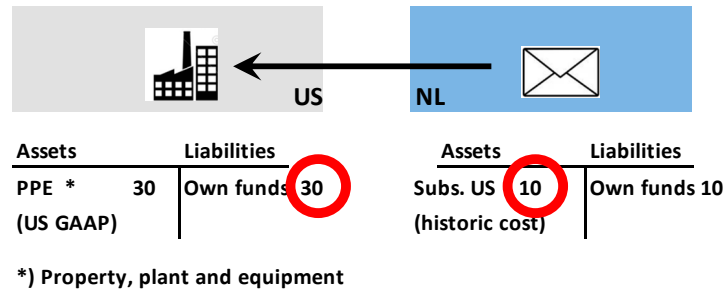
Given the sizeable direct investments by and in Dutch SPEs, their inclusion can only benefit the bilateral comparability of FDI statistics. Yet differences may persist, as under the XDP differences between countries that both use this principle *by definition* can no longer be excluded. This is because under the XDP transactions or positions between (for instance) two fellow companies may have to be classified as inward in both countries involved (in one country with a plus and in the other with a minus sign). This is the case if both enterprises are established outside the country where the group headquarters reside (the UCP's home country; Figure 22). Users would expect a (positive) inward figure of 80 in France to match with a (positive) outward figure of 80 in the Netherlands, not with a negative figure (-80).

**Figure 22 Undesirable asymmetries inherent to the XDP**



Another type of asymmetry may arise when a capital participation by a parent in its subsidiary (the own funds of the subsidiary) is valued differently by the two entities. This is another issue that one might call highly relevant to users who really want to understand what is meant by “equity capital” or “capital participations” in FDI statistics. It may occur especially if a parent in the Netherlands, for instance, does not know the current value of its subsidiary in the US (say 30) and can only value it at *historic cost*, that is, the nominal amount for which the subsidiary was once, possibly long ago, bought from the previous owner (say 10; Fig.23).

**Figure 23 Same capital participation valued differently by parent and subsidiary**



While not in line with the manuals of the IMF or the OECD – they expect/recommend the best possible *current* value to be assigned – it is nevertheless common practice among SPEs in the Netherlands to report ‘historic cost’ to DNB. SPEs or their representatives (typically trust offices) are usually unable to retrieve the actual/current value of their foreign subsidiaries, for instance from the foreign parents of the SPEs. Incidentally, this holds not just for SPEs but obviously for *all* companies (with foreign parents) that themselves do not know the current value of their foreign subsidiaries.



Like in the example above, a Dutch SPE may report a historic cost price that is unrelated to the book value used by its American subsidiary. Apart from this discrepancy it should be noted that usually *both* amounts (the one in the books of the parent and the one in the books of the subsidiary) differ from the actual (fair) value of the subsidiary:

- The Dutch SPE may have paid a (historic cost) price including goodwill that has never been realized by its subsidiary in the US. Conversely, the subsidiary may have substantially increased in value - and reported this higher value to its compiler - as profits and reinvestments far outstripped the historic cost (as in Figure 23, for instance).
- The American subsidiary too may have reported about its own funds a value other than the net asset value (i.e. the difference between its assets and loans). The net asset value may turn out higher or lower, depending on how the subsidiary values its assets.

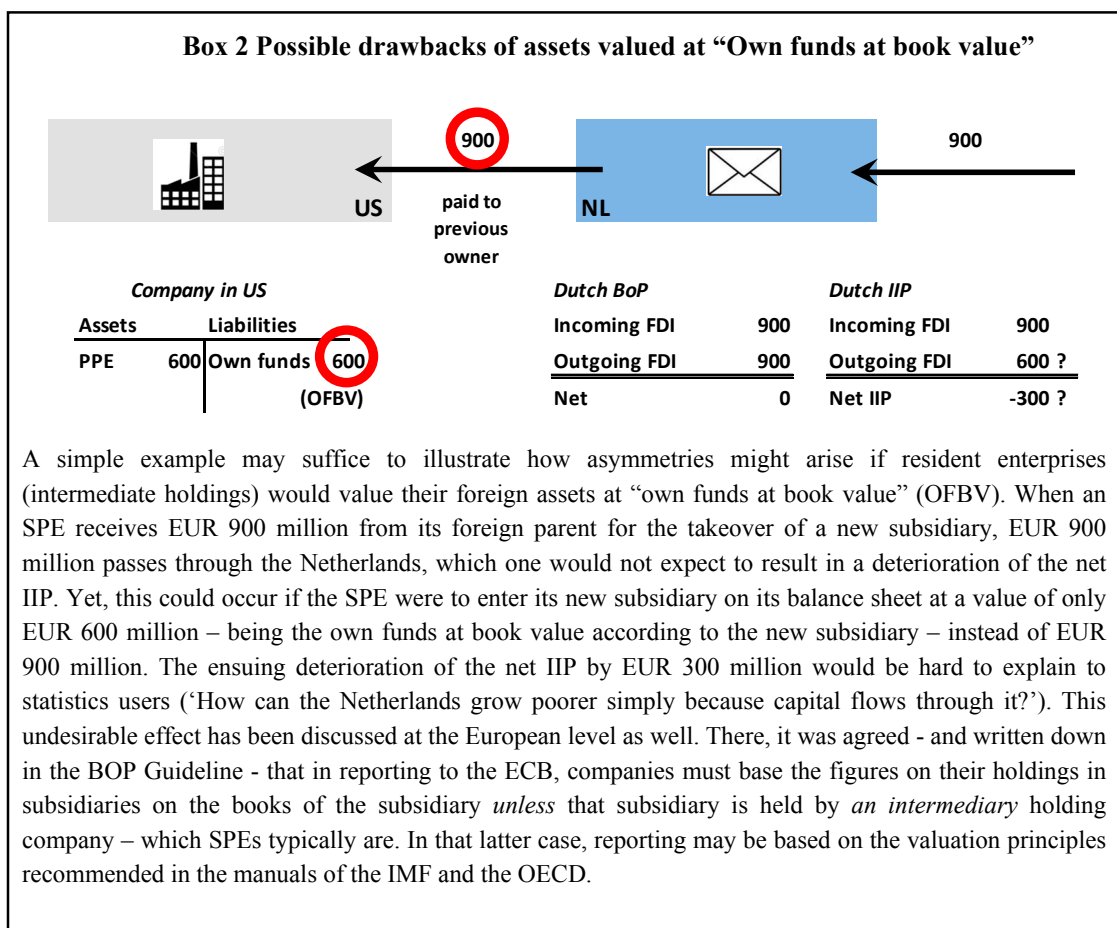
According to FDI manuals (BD4, CDIS) such differences should not have to occur, if only all parties (companies and compilers) adopted the recommendation to base the value of foreign subsidiaries on the net asset value reported in the subsidiary's own books. Yet, as already mentioned, the difficulty for intermediate holding companies like SPEs is precisely their inability, in most cases, to retrieve this amount.

The way DNB deals with this situation can be described as “making the best of it”. Each parent company in the Netherlands is asked to report to DNB *the net asset value* of its subsidiaries, as calculated by the Dutch parent. Only if the parent is not capable to do so, it may fall back to historic cost. The reason for DNB to prefer the net asset value is that this value, contrary to historic cost prices, may change over time due to reinvestments of earnings by the foreign subsidiaries.<sup>3</sup>

Incidentally, if SPEs were to copy figures from the books of their subsidiaries in reporting to DNB (which in practice they don't and aren't able to), this would lead to yet another interpretation problem: an adverse effect on the net IIP that users would not understand given the fact that SPEs use *foreign* capital to finance the purchase of *foreign* subsidiaries, as reflected by equal inflows and outflows of capital (Box 2).

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<sup>3</sup> There is only one drawback to this. When a Dutch parent company calculates for DNB the net asset value of its foreign subsidiary, it looks at the assets and liabilities of the subsidiary only, meaning that it does not take into account the *goodwill* that it has *also* paid for the subsidiary. As a result, the calculated net asset value of the subsidiary may be lower than the price (possibly recently) paid for it. In the Dutch IIP, which should reconcile with flows, any discrepancies related to goodwill are taken care of - in the period of the takeover - by means of “other changes”.



#### 4.2 Estimating market values from book values

It may be clear from the above how difficult it can sometimes be to compile FDI statistics strictly as the manuals recommend. In some cases, resorting to estimations is inevitable. Let us conclude with an example.

The recommendation to report direct investment positions at fair value (market value) has already been mentioned. Yet to do so is almost a mission impossible, if only because companies or units of companies are not traded on a day-to-day basis. Daily market valuations are available only for listed companies – not for individual parts of multinational enterprises, such as foreign subsidiaries. Yet in order to still provide users of FDI statistics with an approximate valuation of cross-border capital interests, as the manuals recommend, DNB has, like other countries, developed its own method to estimate quarterly market values for capital participations (own funds) from the book values as reported to DNB (Box 3).

### Box 3 Estimating market values from book values of capital participations

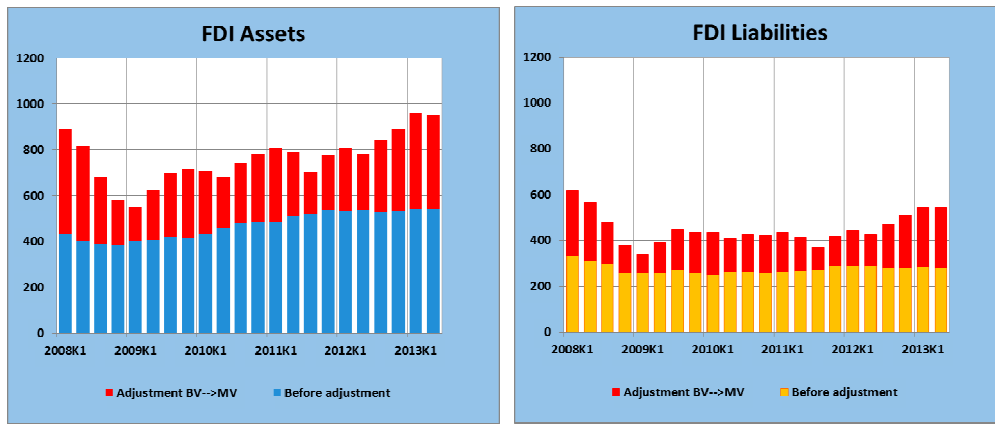
In a slightly simplified form, the method to estimate the market value of capital participations – which has so far been applied to non-SPEs – consists of the following three steps. First, a ratio is computed for every AEX-listed company between its market value (number of outstanding shares times listed share price) and the own funds at book value as reported in the company's own quarterly statements. An unweighted average of these ratios is then used to estimate a 'market value' for non-listed companies, on the basis of the latest known 'own funds'. For Dutch subsidiaries of foreign companies the outcome equals the market value of incoming capital participations. Next, the gap between the (estimated) market value and the book value, the so-termed value gap, is allocated to domestic and foreign parts of the group in proportion to their contribution to the quarterly earnings of the group. Finally, the foreign part of the gap is added to the book value of *outgoing capital participations* (as reported to DNB). The sum equals their market value.

The same method may also be applied to capital participations of SPEs, because the market value of SPEs may be computed in the same manner from their own funds (i.e. incoming capital participations), through multiplication by the aforementioned ratio. Next, the difference between the market and book values of incoming capital participations can be used to calculate the current market value of outgoing capital participations. In the case of SPEs, this is done by simply adding the *entire* value gap to the reported (book) value of outward capital participations: since SPEs make no profits domestically, the domestic part of the value gap comes to nil.

Market valuation of capital interests would not affect the net external position of SPEs. At end-2012, the market value of SPEs' outgoing capital participations would have come out at some EUR 5,000 billion (2½ times the book value of roughly EUR 2,000 billion). The market value of incoming capital participations too would exceed the book value (by some EUR 3,000 billion).

Although the method in Box 3 is surrounded by some uncertainties, estimations for non-SPEs across the 2008–2012 period indicate that the market value of direct investment usually is considerably higher than the book value. Movements in the balance of adjustments to FDI assets and liabilities followed the Amsterdam AEX index, since in the Netherlands the FDI assets of non-SPEs strongly exceed their liabilities (Fig. 24). Such figures are a reminder of how important it is, in compiling direct investment statistics, to take account of the substantial weight of SPEs and the resulting impact they have on the interpretability of these statistics, depending among other things of the valuation of their assets and liabilities.

**Figure 24 –Market and book value of capital participations of non-SPEs (bn EUR)**



### *Conclusions*

- In countries such as the Netherlands, balance of payments and FDI statistics are strongly influenced by the presence of SPEs. As from 2014 (i.e. once BPM6 will be implemented) DNB will therefore provide *figures including SPE data* to international institutions. For the sake of international comparability (with countries assumed to also include SPEs) these will be the official figures for the Netherlands, after many years in which figures excluding SPEs were reported to IMF and others. Meanwhile, for analytical purposes DNB will continue to publish national statistics excluding SPEs.
- DNB intends to break down FDI figures in the BoP and IIP by parent, subsidiary and fellow enterprises, in line with BPM6, so that all FDI amounts continue to be taken on board, including those of SPEs. However, in the Netherlands, certain statistical units cannot have fellow companies. This is because DNB regards the enterprise group as the statistical unit, in order to maintain compatibility with figures compiled by Statistics Netherlands (CBS). By definition, a group of enterprises with a Dutch-resident UCP cannot have fellow companies. This does not preclude, however, any bilateral comparison of assets and liabilities for the sake of quality enhancement.
- FDI statistics have become statistics in their own right. Nevertheless, FDI building blocks in the CDIS continue to be reshuffled under the XDP as if the net outcome must be neutral, as it used to be in the BoP and the IIP. Whereas in BoP and IIP statistics assets and liabilities are no longer subject to reshuffling, in FDI statistics they are still adjusted by *equal amounts*, even if they may be driven by totally different and unrelated factors at home and abroad. For such practice there is no rationale. Compilers should use the freedom they have to include or omit FDI components from the BoP or IIP, allowing them to construct more meaningful headline figures and indicators. In doing so, they

should better also stop trying to describe *two phenomena*, the economic and financial intertwinement of countries, by just *one single figure*. A better approach might be to construct two separate headline figures as indicators for *financial* phenomena on the one hand and *economic* phenomena on the other.

- DNB subscribes to the importance of the CDIS as an instrument to improve the quality of FDI figures. Bilateral comparability of FDI figures would be helpful in this respect, yet it is limited by the extended directional principle (under which it is no longer true that every inward figure needs to have an outward counterpart). From a compiler and user point of view it would therefore be advisable to give a more prominent place in the CDIS to (gross) *assets and liabilities*, rather than to (netted) outward and inward figures. Incidentally, such a shift in emphasis - to total assets and liabilities by country - might be a reason for some countries not yet participating in the CDIS to start doing so.
- From an economic analysis perspective, however, it remains desirable to explore ways of adjusting assets and liabilities so as to *make FDI figures easier to interpret* by users. With the introduction of BD4, country-level figures in particular have not become any easier to interpret – which holds especially for countries harbouring many SPEs. Valuation issues too should be (better) brought under the attention of users of FDI statistics. DNB does not intend to publish national FDI statistics on an XDP basis in the near future, but is researching new presentations of FDI figures and for the next few years would be prepared to continue doing so in collaboration with others.