

**Fourteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Tokyo, Japan, October 24-26, 2001**

Clarification of Foreign Direct Investment Recommendations

**Prepared by Ayse Bertrand
Organisation for Economic Co-operation and Development**

CLARIFICATION OF FOREIGN DIRECT INVESTMENT RECOMMENDATIONS

1. At its meeting on 8-9 November 2000, the OECD Working Party on Financial Statistics considered a document by the IMF providing clarifications with regard to the following foreign direct investment recommendations.

1. Transactions with affiliated financial intermediaries;
2. Payments associated with the acquisition of a right to undertake direct investment;
3. Shut down of a foreign direct investment enterprise set up for natural resources exploration.

Annex 1 of the present document includes the full text that was circulated for discussion.

2. *The Working Party confirmed its agreement with the text concerning points 2 and 3 but postponed its decision on point 1 to a later discussion. At the OECD Workshop on Foreign Direct Investment Statistics (June 2001), Delegations supported the views expressed by the IMF on the transactions with affiliated financial intermediaries and indicated that national compilers will try to apply these recommendations despite some practical difficulties. However, Delegations also suggested that, in the long-term, it would be useful and even necessary to review all the aspects of financial institutions.*

3. In 1999 a provisional decision¹ was taken by the IMF Committee on Balance of Payments Statistics to classify financial derivatives presently classified under “direct investment” and “reserve assets” as separate sub-components of those categories. It was also agreed that this provisional decision will be made final following discussions and recommendations in other international fora and the discussions with national experts.

4. The proposal was submitted to national experts at the OECD Workshop on Foreign Direct Investment Statistics (June 2001) for their approval (see Annex 2). *Delegations agreed that, in theory, financial derivatives should be excluded from foreign direct investment statistics.* In practice some countries may include financial derivatives under the “other capital” component of foreign direct investment due to difficulties in identifying them separately.

1. See *Financial Derivatives; A Supplement to the Fifth Edition (1993) of the Balance of Payments Manual*, IMF, 2000.

ANNEX 1

CLARIFICATIONS OF FOREIGN DIRECT INVESTMENT RECOMMENDATIONS

(by the IMF)

I. Introduction

5. In May 1997, after consulting with the IMF Committee on Balance of Payments Statistics (Committee) and the OECD Working Party on Financial Statistics (WFS), the IMF and OECD launched the *Survey of Implementation of International Methodological Standards for Direct Investment* (SIMSDI). The SIMSDI results were used to determine the extent to which countries have adopted the recommendations on foreign direct investment (FDI) statistics in the fifth edition of the *IMF Balance of Payments Manual (BPM5)* and the third edition of the OECD's *Benchmark Definition of Foreign Direct Investment (Benchmark)*. The SIMSDI report on the outcomes of the survey is posted on the Fund's Internet site for the Committee.

6. As a follow-up to the 1997 *Survey of Implementation of International Methodological Standards for Direct Investment* (SIMSDI), the OECD organised, in March 1999, the FDI Workshop of the WFS to review the treatment of a number of FDI transactions where there are practical measurement problems. The participants at the Workshop highlighted (1) the difficulties in properly measuring reinvested earnings and in recording transactions of indirectly owned direct investment enterprises and (2) the differing interpretations, by the participating countries, of the international statistical guidelines for recording transactions with affiliated banks and special purpose entities (SPEs).

7. In addition, at the September 1998 OECD Technical Meeting on Collecting and Reporting FDI Statistics in the Commonwealth of Independent States, it was disclosed that compilers employed different practices for recording transactions associated with investment in natural resources. In many instances, these differences arose because the international statistical guidelines did not provide sufficient guidance on the treatment of investment in the area of natural resources exploration and extraction.

8. It is against this background that this paper includes a discussion of the IMF/OECD direct investment recommendations that are related to the classification of (1) transactions with affiliated financial intermediaries, (2) fees for permission to undertake some types of investment, and (3) the adjustments associated with the shutdown of a direct investment enterprise set up for natural resources exploration.

II. Transactions with affiliated financial intermediaries

9. In *BPM5*, transactions to be recorded in FDI “comprise not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated”². However, it is unclear to many compilers whether direct investment transactions should encompass *other capital* transactions between banks and non bank affiliated enterprises or between other non bank financial

2. *BPM5*, paragraph 359.

intermediaries and non financial intermediary affiliated enterprises. In addition, there seems to be some confusion in the coverage of *other financial intermediaries*.

10. The recommendation in the *BPM5* is that, *intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers) - including SPEs with the sole purpose of serving as financial intermediaries - recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment...*³. In both the *BPM5* and the *Benchmark*, the recommendations for recording intercompany transactions between affiliated financial intermediaries in FDI statistics are that such transactions are limited to those associated with equity investment and permanent debt.

11. The *BPM5* does not recommend excluding from FDI statistics *other capital*⁴ transactions between financial intermediaries and affiliated enterprises not principally engaged in financial intermediation. In the *BPM5*, the recommendation is that only *other capital* transactions between affiliated financial intermediaries (including banks) are not reported under FDI. Similarly, in the *Benchmark*, the recommendations are to exclude, from FDI, *other capital* transactions only for “*certain flows between affiliated banks, affiliated financial intermediaries (e.g., security dealers), and Special Purpose Entities (SPEs) with the sole purpose of serving as financial intermediaries*”⁵. Thus, all financial transactions between a financial intermediary and an affiliated enterprise that is not a financial intermediary should be recorded under FDI.

12. However, in the *BPM5* and the *Benchmark*, the coverage of enterprises included under “*other financial intermediaries such as security dealers*”⁶ remains unclear. In addition, as a result of continuous evolution and innovation in financial markets, the boundary between financial intermediation and many of the services that are auxiliary to financial intermediation has become blurred. Few enterprises have a “*sole purpose of serving in a financial intermediary capacity*”⁷. In the *System of National Accounts 1993* (SNA93), the definition of the financial corporations sector consists of “*corporations or quasi-corporations principally engaged in financial intermediation or in auxiliary financial activities which are closely related to financial intermediation*”⁸. This sector includes the central bank; other depository corporations; other financial intermediaries, except insurance corporations and pension funds; financial auxiliaries; and insurance corporations and pension funds⁹.

13. With a view to clarifying the *BPM5* recommendations, it is proposed to better define the scope of enterprises included under banks and “*other financial intermediaries such as security dealers*”. The

3. *BPM5*, paragraph 372. A previous reference to FDI transactions of financial intermediaries and special purpose entities (SPEs) is included in paragraph 365. However, in that paragraph readers are explicitly referred to paragraph 372 for an explanation of the recommendation.

4. For the purpose of this discussion, *other capital* transactions are defined to include those financial transactions that are not associated with *equity capital* or permanent debt. Transactions in financial derivatives between affiliated financial intermediaries are to be included in the new functional category *financial derivatives* in the financial account.

5. *Benchmark*, paragraph 39.

6. *BPM5*, paragraph 365 and 372.

7. *BPM5*, paragraph 365 and 372; *Benchmark*, paragraph 39, 40c and 62.

8. *SNA93*, paragraph 4.77.

9. For a complete definition of the scope of enterprises included in the sector, refer to chapter 4.D of the *SNA93, The financial corporations sector and its sub-sectors*.

proposition is to redefine banks and other financial intermediaries as “enterprises principally engaged in providing financial intermediation services or services auxiliary to financial intermediation”¹⁰ with a view to including those corporations and quasi-corporations that are grouped, in the *SNA93*, into the following financial corporations sub-sectors:

1. other depository corporations (other than the central bank);
2. other financial intermediaries, except insurance corporations and pension funds; and
3. financial auxiliaries.

This proposition does not include insurance corporations and pension funds in the definition of financial intermediaries because of the *BPM5* recommendation to treat the transactions of affiliated insurance corporations in the same manner as transactions of affiliated industrial and commercial enterprises, except for those transactions that are concerned with the technical reserves of insurance corporations¹¹.

14. The treatment of *other capital* transactions of SPEs acting as financial intermediaries requires special attention as the structure of multinational enterprises (MNEs) is becoming more and more complex. Many MNEs set-up SPEs that are principally engaged in providing financial intermediation services for the related group of enterprises. Such SPEs would be grouped into the financial corporations’ sub-sector “other financial intermediaries, except insurance corporations and pension funds” of the *SNA93*¹². In the instances where SPEs are principally engaged in financial intermediation “(e.g., [administration,] management of foreign exchange risk, facilitation of financing of investments), SPEs are an integral part of the structure of the direct investment network as are, for the most part, SPE transactions with other members of the group”¹³. In accordance with the previously quoted *BPM5* recommendation, the *Benchmark* recommends that “transactions between SPEs and other members of a multinational group should be reflected in the [FDI] statistics”¹⁴.

15. Thus, the recommendation of the *BPM5* is that intragroup transactions of SPEs principally engaged in financial intermediation for the group of related enterprises should be recorded under FDI. This recommendation is included in paragraph 373 of *BPM5*. The only exception to the rule applies to *other capital* transactions between affiliated financial intermediaries - including SPEs with the sole purpose of serving as financial intermediaries - which are to be excluded from FDI.

16. Previous clarifications to the *BPM5* recommendation concerning transactions of financial SPEs are found in paragraphs 542-544 of the 1996 IMF *Balance of Payments Textbook* and paragraph 86 of the 1996 IMF *Co-ordinated Portfolio Investment Survey Guide*. These clarifications have increased the scope of the exception to FDI flows. As a result, *other capital* transactions between enterprises that are not financial intermediaries and affiliated SPEs that have the sole purpose of serving as financial intermediaries are now excluded from FDI.

10. Whereas in the *BPM5*, security dealers are defined as other financial intermediaries, in the *SNA93*, they are considered to be primarily engaged in activities closely related to financial intermediation and are part of financial auxiliaries. Thus, to include security dealers, the definition would need to refer to financial auxiliaries.

11. *BPM5*, paragraph 379.

12. Refer to the definition of this sub-sector provided in paragraph 4.95 of the *SNA93*.

13. *BPM5*, paragraph 365.

14. *Benchmark*, paragraph 144.

17. Unfortunately, the BPM5 recommendations and these previous clarifications are creating practical difficulties for compilers. It is unclear to many balance of payments compilers under which circumstances *other capital* transactions with affiliated financial SPEs should be recorded in FDI. The application of the recommendation concerning financial SPEs is a source of discrepancy in the bilateral comparison of the data. For instance, Germany and Belgium include in their FDI statistics the transactions of SPEs that are principally engaged in providing financial intermediation services for the related group of enterprises, while Austria and The Netherlands would exclude them.

18. Recently, users in the Fund have expressed the views that the transactions between a non financial corporation parent company and its affiliated financial SPE abroad (especially in offshore centers) would be more usefully shown as part of FDI. The economic argument supporting that view is that, unlike banks or securities brokers, the financial SPEs exist for the sole purpose of facilitating financial intermediation for the group of enterprises. It is only because of the direct investment relationships between the group of enterprises and the financial SPEs that financial intermediation occurs. Recording the transactions of these financial SPEs with the group under FDI would highlight the importance of the direct investment relationships.

19. *In order to arrive at a proper clarification of BPM5 recommendations, the members of the IMF Committee on Balance of Payments Statistics supported the following views at their October 1999 meeting:*

- *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 SNA93 financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. 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.*

III. Payments associated with the acquisition of a right to undertake a direct investment

20. In many developing or transition economies, the government requires the payment of a fixed amount of money by direct investors for the right to undertake a direct investment in the host economy. Often, but not always, these operating or concession rights are related to the extraction of natural resources. In transition economies, compilers refer to these payments as “bonuses”. They are legal transactions and should not be associated with poor governance. The issue is to determine whether or not such bonuses constitute direct investment transactions and to recommend a common recording practice for such transactions.

21. The payment of a bonus could either be associated with the payment of a tax or rent (property income). In the *System of National Accounts 1993 (SNA93)*, clear guidance is provided concerning the

classification of transactions as government taxes or as rent. For instance, a government could forbid the pursuit of certain activities, unless specific permission is granted by issuing a license for which a fee is demanded. Such a fee should be treated as a tax if the government does not exercise some proper regulatory function in association with the issuance of the license¹⁵. On the other hand, when the owner of subsoil assets, which is often a government unit, grants a concession to another institutional unit entitling the latter to extract the asset, this arrangement is treated as property income (rent) in the *SNA93*¹⁶. For example, “enterprises engaged in exploration may make payments to the owners of surface land in exchange for the right to make test drilling or investigate by other means the existence or location of subsoil assets. Such payments are also to be treated as rents even though no extraction may take place”¹⁷.

22. Thus, for transactions associated with natural resources, whether extraction or exploration, the payment of bonuses should be treated as rent. In the *SNA93*, rent is a form of property income received by the owners of tangible non-produced assets, mainly land and subsoil assets, for putting the assets at the disposal of another institutional unit. In the *BPM5*, there is no standard component for rent under *income*, as it is assumed that only property income from the ownership of financial assets (e.g., income in the form of interest, dividends, and reinvested earnings of direct investment enterprises) is receivable from non-resident institutional units.

23. For the purpose of balance of payments, the contra-entry for the actual payment of the rent (bonus) by the direct investor to the government of the host economy would unambiguously be recorded under direct investment if the direct investor has already established the direct investment enterprise in the host economy (and the rent would be recorded in the host economy’s national accounts as a resident to resident transaction taking place between the direct investment enterprise and the government). In the instances when the payment of the bonus takes place before the direct investment enterprise is legally established in the host economy, the transaction should be recorded under direct investment when the compilers are aware of the clear intention to establish a direct investment enterprise by the non-resident unit making the bonus payment. For instance, this would be the case when there is a contractual arrangement to that effect between the investor and the government of the host economy. This treatment is consistent with the recommendation in the *BPM5* that “it is reasonable to assume that an institutional unit has a center of economic interest in a country if the unit has already engaged in economic activities and transactions on a significant scale in the country for one year or more, or if the unit intends to do so”¹⁸.

24. Another difficulty arises in the instances where the bonus is not associated with rent but is a tax. That would be the case when a government charges a fee for granting the license authorizing the establishment of the operations in the host economy and such operations are not directly associated with the use of natural resources or land. In those instances, the recommendation would be that the contra-entry corresponding to the payment of the tax by the direct investor to the government is recorded under direct investment (as provision of *equity capital* or *other capital* by the investor by the investee) when the investor is establishing or will imminently establish a direct investment enterprise in the host economy. The tax as such would be recorded as a resident to resident transaction in the host economy’s system of national accounts. In the instances where the investor is engaged in economic activities in the host economy for a period of less than a year, does not maintain a separate set of accounts, or satisfies other residency criteria, a direct investment enterprise is not established. In those instances, the contra-entry to the actual payment of the tax by the investor would be recorded under current transfer in the balance of payments.

15. *SNA93*, paragraph 7.55.

16. *SNA93*, paragraph 10.129.

17. *SNA93*, paragraph 7.133.

18. *BPM5*, paragraph 63.

25. These clarifications would leave an unresolved issue that is related to the payment of rent to the host economy for short-term operations by non-resident enterprises. Enterprises involved in exploitation of fishing or forestry resources may operate in the host economy for less than a year, not maintain a separate set of accounts, or not satisfy other residency criteria before completing their operations. Such non-resident enterprises would still be required to pay rent to the owners of the resources (usually the government) and these payments are *income* flows in the *SNA93*. At the moment, there is no *BPM5* standard component under *income* that would allow compilers to properly classify rent transactions.

26. In order to clarify the *BPM5* recommendations, the Committee members supported the following views:

- *The contra-entry to the payment of a rent (bonus) by a non-resident investor to the government authorities should be recorded under direct investment when there is a clear intention to establish a direct investment enterprise (such as in the case of a contractual arrangement between the investor and the government).*
- *The contra-entry to the payment of a rent by a non-resident enterprise, when no direct investment enterprise is or will be established, should be recorded under “income; investment income; other investment” until a “rent” sub-component of income is included in the balance of payments manual. Rent would be paid by non-resident enterprises when they make payments to exploit movable natural resources such as in the case of tree cutting rights or fishing rights in a country’s territorial waters.*

IV. Shutdown of a FDI enterprise set up for natural resources exploration

27. The recommendations in both the *BPM5* and the *Benchmark* are that “*expenditures of direct investment enterprises established for exploration of minerals and other natural resources in an economy are treated as capital expenditures (fixed capital formation)*”¹⁹. In addition, it is stipulated that “*if the exploration proves unsuccessful and results in a shutdown of the enterprise, no further balance of payments entries are recorded. Rather, a negative stock adjustment is made in the direct investment position of the direct investor in the host economy, and an equal reduction is made in the liability position of that economy to that of the direct investor. (Both adjustments fall under the heading other adjustments in the international investment position.)*”²⁰.

28. Some balance of payments compilers have argued that a stream of negative reinvested earnings flows should be recorded over a number of years (in the current account of the host economy) until the stock of fixed capital corresponding to the total exploration expenditures of the direct investment enterprise has been fully amortised as consumption of fixed capital, with corresponding entries recorded for the investing economy. Such treatment would be consistent with the *System of National Accounts 1993 (SNA93)* that recommends (paragraph 10.91) that the capitalized exploration costs should be amortized as consumption of fixed capital over the average service lives of such exploration assets. According to that argument, the direct investment enterprise continues to exist and the equity value remains until it is fully amortized. Each year, the direct investment enterprise will have negative reinvested earnings equivalent to the amortization of the exploration asset. If this amortization approach is not adopted, there is an asymmetric treatment of unsuccessful expenditures in natural resources exploration in the host economy’s national balance sheets, such as expenditures of “national” enterprises would be amortized whereas those of direct investment enterprises would be written-off.

19. *BPM5*, paragraph 383, with similar wording used in the *Benchmark*, paragraph 60.

20. *BPM5*, paragraph 383.

29. There are three possible approaches to resolve the issue that is raised by the *BPM5* recommendations for the treatment of expenditures associated with natural resources exploration. The first approach has been presented in the previous paragraph. However, it is unsatisfactory in a balance of payments context; following the shut-down of the enterprise set-up for natural resources exploration, the direct investor does not have any claim on the host economy and, symmetrically, the host economy does not have any liability to the investor. Thus, the flows of reinvested earnings that are recorded are purely artificial and cannot be associated with any non-resident claims or liabilities.

30. A second approach, which would also satisfy the requirements of the *SNA93*, would be to record a capital transfer, by the direct investor to the host economy, that corresponds to the residual value of the natural resources exploration costs. It would be the contra-entry for the equity capital withdrawal by the direct investor that follows the shutdown of the operation. When the direct investment enterprise shuts-down its exploration activities, two entries would be recorded in the balance of payments; (1) a decrease of the host economy's liabilities under *direct investment, equity capital* and (2) an equivalent credit entry under *capital transfer, other sectors, other*. This second entry corresponds to a transfer of know-how to the host economy equal to the value of the exploration expenditure not yet depreciated under consumption of fixed capital. The advantage of this approach is that compilers could apply the recommendations of the *SNA93* and depreciate the unsuccessful exploration expenditures at a normal rate although these assets would not have any counterpart liabilities. However, this is not a preferred approach; the direct investor did not willingly transfer this know-how concerning the location of dry holes, in the instances of oil exploration, but was simply faced with non-profitable operations and forced to write-off these expenditures.

31. The third approach, which is the one set out in *BPM5* and the *Benchmark*, is to use the other adjustments heading of the IIP statement. This approach creates an asymmetry in the treatment of the natural resources exploration expenditures that cannot be resolved under the framework of the *SNA93*. Expenditures undertaken by the "national" enterprises of an economy would automatically be recorded as formation of fixed capital that would be depreciated based on the average service lives similar to those used in the related industry. The same treatment would also apply to successful exploration expenditures undertaken by non-resident investors (that are setting up direct investment enterprises in the host economy for exploration purposes). On the other hand, under this approach, compilers would consider that, for unsuccessful exploration expenditure of direct investment enterprises, there are no assets created and no further entries required in the accounts other than two entries under "*other volume changes in non-financial assets n.e.c.*" in the *other changes in volume of assets account* of the domestic economy and of the rest of the world account to write-off the remaining stock of fixed capital associated with unsuccessful exploration expenditures.²¹

32. At their October 1999 meeting, Committee members endorsed the third approach proposed for the balance of payments treatment of the shut-down of direct investment enterprises involved in exploration of natural resources, which is the approach recommended in BPM5.

21. This practice would be justified based on the recommendation for the "*Abandonment of production facilities before completion or being brought into economic use*" included in paragraph 12.46 of *SNA93*. However, such practice would be in contradiction with the recommended *SNA93* treatment for expenditures in natural resources exploration.

ANNEX 2

Extracts from *Financial Derivatives: A supplement to the 5th edition (1993)*
of the *Balance of Payments Manual*, International Monetary Fund

XVIII. Direct Investment

[...]

Direct Investment Capital

[...]

369. The components of direct investment capital transactions, which—as noted in paragraph 330—are recorded on a directional basis (i.e., resident direct investment abroad and nonresident direct investment in the recording economy), are equity capital, reinvested earnings, ~~and~~ other capital associated with various intercompany debt transactions, and financial derivatives. Equity capital comprises equity in branches, all shares in subsidiaries and associates (except nonparticipating, preferred shares that are treated as debt securities and included under *direct investment*-other capital—see paragraph 370), and other capital contributions. Reinvested earnings consist of the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. If such earnings are not identified, all branch earnings are considered, by convention, to be distributed. Because undistributed (reinvested) earnings result in additions to direct investors' equity in subsidiaries and branches, these earnings are included as direct investment capital transactions in amounts equal to (and with opposite sign) the corresponding entries recorded under direct investment income. (See paragraphs 278, 288, and 321.)

[...]

New paragraph

370a. The subcategory of *direct investment*-financial derivatives covers financial derivative transactions between directors and direct investment enterprises unless the transactions are part of the usual banking transactions described in paragraph 372.

[...]

372. The recording of intercompany transactions that (1) take place between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers) or SPEs serving solely as financial intermediaries and (2) are recorded as direct investment capital transactions is 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, to transactions associated with fixed assets. Deposits and other claims and liabilities (including financial derivatives) related to the usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, within the categories of *portfolio investment*, *financial derivatives*, 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.

[. . .]

Extent of Net Recording

375. *Direct investment* is often referred to as an asset for the economy of the direct investor and as a liability for the economy in which the direct investment enterprise operates. Actually, investor and enterprise have claims on, or liabilities to, each other—although the investor could be expected to have net foreign claims and the enterprise to have net foreign liabilities. It is recommended in the *Manual* that direct investment transactions in equity capital, and other capital (intercompany debt), and financial derivatives be recorded for assets (claims) and liabilities. Thus, in addition to a net investment transaction for each of these components, separate entries are made for the change in claims of direct investors on, and the change in liabilities to affiliated enterprises. These entries are made under *direct investment-abroad* and vice versa for *direct investment-in* reporting economy. For recording *direct investment* in the international investment position, the same entries are made. See the table presenting the standard components of the international investment position at the end of Chapter 23. However, as noted in Chapter 23, the related direct investment income on equity and debt is shown on a net basis for each direction.