**BOPCOM-05/48**

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

# Reverse Investment and Directional Principle

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

**OUTCOME PAPER (DITEG) # 7 AND # 8**

**FEBRUARY 9, 2005**

1. **Topic:** Reverse investment and directional principle

2. **Issues:** See DITEG Issue Paper # 7 and # 8 by the United States (November 2004), which, in turn, references IMF issue paper #7 and #8 (dated May 2004 and discussed at the June 2004 DITEG meeting).

3. **Recommendations:**

(i) In regard to the standard components of the international investment position, a significant majority of the group (13 of 16) agreed that direct investment positions representing claims on foreign residents should be presented gross under assets, and that direct investment liabilities representing claims on residents of the reporting economy should be presented gross under liabilities. This is a change from the existing international standards, which nets claims on affiliated enterprises against liabilities to affiliated enterprises in the direct investment functional categories.

(ii) The same majority agreed that flows on assets should be presented separately from flows on liabilities, rather than netting flows on reverse direct investment interests in the direct investment functional categories.

(iii) In the case where a direct investment enterprise holds an equity interest of less than 10 percent in the direct investor, the experts had split views regarding whether this holding should be recorded in direct investment (as under existing standards) or recorded as portfolio investment (resulting in a change to existing standards). As further elaboration:

a. DITEG agreed that the categories pertaining to equity finance claims on direct investors, and to equity finance liabilities to direct investment enterprises, would be very narrowly defined. Although this is the present standard, some members were concerned about confidentiality and about their country's inability to show data for these rows;

b. DITEG had questions regarding whether reinvested earnings should be recorded on this investment, should the existing standards be retained. Under existing standards, reinvested earnings should be recorded on the reverse equity investment; the Annotated Outline asked whether this treatment should be retained, and members generally felt that it should not.

(iv) Most who spoke felt that, even were equity in a reverse investment relationship to be treated as portfolio investment, other capital should remain in direct investment. However, in a situation where an SPE, acting as a conduit for the raising of funds external to the group, and having a reverse investment with its direct investor, the treatment of nonequity transactions between the SPE and the direct investor (or the rest of the group) was not considered in this discussion. See Outcome paper #11 (Affiliated nonfinancial enterprises and financial SPEs).

(v)There was little discussion of income flows at the December 2004 DITEG meeting. At the June 2004 DITEG meeting, it was proposed that income flows be reported gross under receipts and payments if direct investment positions are reported gross under assets and liabilities, and no one spoke against this proposal at the June or December 2004 DITEG meetings. It was noted in December that this treatment would eliminate instances of negative interest income flows in direct investment in the case where SPE's act as conduits for the raising of debt for direct investors.

4. **Rejected Alternatives:**

(i) The group rejected the existing international standards, which call for the netting of reverse equity and reverse debt investment in the direct investment functional categories.

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

*(i) Do the Committee and the WIIS agree that direct investment positions and flows should be presented on a gross basis, under assets, liabilities, receipts, and payments, as appropriate, rather than including reverse investment flows and positions on a net basis in direct investment?*

*(ii) Do the Committee and the WIIS feel that reverse equity investment of less than 10 percent should be included in direct investment (as under existing standards), or – on either conceptual or practical grounds -- should such holdings be included in portfolio investment?*

*(iii) Do the Committee and the WIIS have a view as to whether debt transactions and positions between a direct investment entity with less than 10 percent in its direct investor and the direct investor (or other members of the group) should be recorded as direct investment (excepting, for separate consideration, those instances where an SPE acts as a conduit for external financing for the group as a whole) or as other investment?*

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

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

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**ISSUE PAPERS #7 AND 8**

# REVERSE INVESTMENT AND DIRECTIONAL PRINCIPLE

**(Combined Into One Paper)**


**Prepared by John Joisce**
**IMF Statistics Department**


**May 2004**

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP**

**ISSUES PAPER #7 AND 8**

**Reverse Investment And Directional Principle**

*Reverse investment* occurs when a direct investment enterprise (DIE) has acquired a financial claim on its direct investor (DI). There is a difference in treatment between those situations where the DIE holds less than 10 per cent of the ordinary shares or voting power of the DI and those where the DIE holds 10 percent or more of the ordinary shares or voting power of the DI. The *directional principle* only applies in the former case, so that where the DIE has a claim on its DI, it is recorded under *direct investment in the reporting economy*, resulting in the netting of the asset against the liability at the total level for direct investment in the reporting economy, (and vice versa under *direct investment abroad*).

## I. Current international standards for the statistical treatment of the issue

When *reverse* equity *investment* constitutes 10 percent or more of the ordinary shares or voting power in the DI, there is a second, separate direct investment relationship, that is, the reverse investment items are shown under the heading of the second direct investment relationship. Accordingly, each enterprise is both the DI and DIE of the other enterprise, so that they are recorded under the asset/liability principle.

When the reverse investment does not reach 10 percent of the ordinary shares or voting power in the DI, *BPM5* does not recommend that a second direct investment relationship be recognized. In this situation, *BPM5* (paras. 370) recommends that such an asset (liability) be recorded as a claim on the DI under direct investment in the reporting economy (or as liabilities to affiliated enterprises under direct investment abroad), with the result that they are netted off at the aggregate level of direct investment abroad and direct investment in the reporting economy. This is the *directional principle*. See the tables below (drawn from *BPM5.* Note the footnote to the IIP table. Items bolded are reverse investment.)

**Table 1. Balance of Payments**

| | |
|---|---|
| *1. Direct investment* | |
| 1.1 Abroad | 1.2 In reporting economy |
| 1.1.1 Equity capital | 1.2.1 Equity capital |
| 1.1.1.1 Claims on affiliated enterprises | **1.2.1.1 Claims on direct investors** |
| **1.1.1.2 Liabilities to affiliated enterprises** | 1.2.1.2 Liabilities to direct investors |
| 1.1.3 Other capital | 1.2.3 Other capital |
| 1.1.3.1 Claims on affiliated enterprises | **1.2.3.1 Claims on direct investors** |
| **1.1.3.2 Liabilities to affiliated enterprises** | 1.2.3.2 Liabilities to direct investors |

**Table 2. International Investment Position**

| *A. Assets* | *B. Liabilities* |
|---|---|
| 1. *Direct investment abroad** | 1. *Direct investment in reporting economy** |
| 1.1 Equity capital and reinvested earnings | 1.1 Equity capital and reinvested earnings |
| 1.1.1 Claims on affiliated enterprises | **1.1.1 Claims on direct investors** |
| **1.1.2 Liabilities to affiliated enterprises** | 1.1.2 Liabilities to direct investors |
| 1.2 Other capital | 1.2 Other capital |
| 1.2.1 Claims on affiliated enterprises | **1.2.1 Claims on direct investors** |
| **1.2.2 Liabilities to affiliated enterprises** | 1.2.2 Liabilities to direct investors |

* Because direct investment is classified primarily on a directional basis – abroad under the heading of ***Assets*** and in the reporting economy under the heading of ***Liabilities*** – disaggregations of claims/liabilities are shown for the components of each, although these sub-items do not strictly conform to the overall headings of ***Assets*** and ***Liabilities***.

For income flows, *BPM5* para. 276 recommends that income flows be netted between the DI and the DIE (while maintaining a separation of net flows on equity from net flows on debt) where the reverse investment by the DIE does not reach the 10 percent threshold.

## II. Concerns about the current treatment

The rationale for the directional principle is that the investment by the DIE in the DI represents disinvestment[1] (*BPM5*, para. 371). It is rooted in the definition of DI, that there must be a minimum of 10 percent of the ordinary shares or voting power in one entity by another for a DI relationship to be established. If a DIE does not own 10 percent (or more) of the ordinary shares or voting power in the DI, the DIE cannot be a direct investor in the DI.

The implication, and practice, of these different treatments is that there is an inconsistency in the treatment of reverse investment above and below the threshold of 10 percent. Moreover, the income flows are netted between the DI and DIE (where the latter has less than the threshold of equity holding in its DI), breaking the link to specific assets and liabilities, and contrary to the gross principles of recording applicable to income flows, in general.

There is a further anomaly between the treatment of a DIE holding less than 10 percent of the equity in the DI, on the one hand, and of a "sibling" advancing funds to another "sibling" in

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[1] In instances where a DIE is a shell company, with minimal share capital, and which is used merely as a financing conduit to raise funds for on-lending to its nonfinancial DI, there is no disinvestment, as the amounts on-lent would be substantially greater than the amounts invested by the DI. Moreover, the application of the directional principle would result in very large negative direct investment. This issue was raised as an issue in the Annotated Outline, 5.27.

another economy, with both sharing the same DI, but neither sibling having any equity investment in the other. In the latter case, the transaction/position is recorded gross, under direct investment abroad (by the lender) and under direct investment in the reporting economy (by the borrower), in the same manner as if the sibling advancing the funds were holding 10 percent or more equity in the other sibling. In other words, the directional principle applies when the DIE has an equity investment of greater than zero but less that the threshold in the DI, but it does not apply where there is a zero equity investment between siblings.

## III. Possible alternative treatments

- Adopt a **strict application of the asset/liability principle.** To address the inconsistency of the treatment of claims by a DIE on its DI (depending on whether the DIE holds more or less than the 10 percent threshold), a **strict application of the asset/liability principle could be adopted**. Such a claim by a DIE on its DI when the DIE does not hold sufficient equity to meet the threshold would be recorded under direct investment abroad, rather than being shown under direct investment in the reporting economy. In order to recognize the reverse investment dimension of this relationship, a new heading *Direct investment in reporting economy (claims on direct investor)* would be shown under net changes in assets arising from transactions, for the balance of payments, and on the asset side, for the IIP. Similarly, for liabilities to affiliated enterprises of the direct investor, this item would be shown on the liability side, for the IIP, under *Direct investment abroad: liabilities to direct investment enterprises*. See Tables 3 and 4.

.

**Table 3. Balance of Payments**

| *Net changes in assets arising from transactions* | *Net changes in liabilities arising from transactions* |
|---|---|
| **Direct investment** | **Direct investment** |
| Abroad | In reporting economy |
| Equity finance | Equity finance |
| Debt | Debt |
| In reporting economy (claims on direct investors) | Abroad (liabilities to direct investment enterprises) |
| Equity finance | Equity finance |
| Debt | Debt |

**Table 4. International Investment Position**

| *Assets* | *Liabilities* |
|---|---|
| **Direct investment** | **Direct investment** |
| Abroad | In reporting economy |
| Equity finance | Equity finance |
| Debt | Debt |
| In reporting economy (claims on direct investors) | Abroad (liabilities to direct investment enterprises) |
| Equity finance | Equity finance |
| Debt | Debt |

- This approach would eliminate the unacknowledged inconsistency between *BPM5* and the *1993 SNA* and would avoid a violation of the principles set out in the *1993 SNA* (para. 2.84) that "(n)etting financial assets (changes in financial assets) against liabilities (changes in liabilities) is especially to be avoided."

- The reporting of reverse investment data in this manner would represent a presentational change. However, it would mean that total direct investment abroad and total direct investment in the reporting economy would each be recorded gross (an important principle within the system), while it would leave analysts free to choose whether they wish to use net or gross values.

- This alternative treatment would also have the practical benefit of leaving aggregates less affected by whether compilers are able to implement the separate identification of reverse investment. In other words, if a loan by a DIE to its DI is not identifiable as being part of a DI relationship, but is captured in the ITRS, it will be recorded gross, as part of "Other investment: Liabilities: Loans" in the balance of payments of the economy in which the DI is resident; however, if the loan were identifiable, it would be recorded under "Direct investment abroad: Liabilities to affiliated enterprises" and would be netted in the total of this item. In the fashion, international comparability is impaired.

- **Record gross income flows between the DI and the DIE where the DIE holds less than the threshold**, to be consistent with the general principle that flows in the current account should be recorded gross**.**

  - This approach would be more consistent with economic analysis, where rates of return on assets (liabilities) are calculated on a gross basis.

- Moreover, adopting this approach would eliminate instances of negative interest income flows where SPEs act as conduits for the raising of debt for the DI, and where the SPEs have minimal share capital.

## IV. Points for discussion

*1 ) What are the views of DITEG members regarding the difference in treatment of reverse investment between DIEs with a holding of 10 percent (or more) of the voting shares or voting power in the DI compared with DIEs with less than this threshold?*

*2) What are the views of DITEG members regarding the application of the strict asset/liability principle?*

*3) What are the views of DITEG members regarding the proposal that income flows on reverse investment be recorded on a gross basis, while still allowing net data to be derived?*

## References

*Annotated Outline for the Revision of* BPM5, IMF, April, 2004 (Chapter 5, Section B.1; 10.44)

*1993 SNA* (para. 2.82)

*BPM5* (paras. 276, 370 and 375)

*Benchmark Definition*, third edition, OECD, 1996 (paras. 36-37, 40)

*Balance of Payments Textbook*, IMF (para. 529)

**IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics**

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP**

# Issue Papers 7 & 8
# Directional Principle and Reverse Investment

**Prepared by Ralph Kozlow**
**U.S. Bureau of Economic Analysis**
**November 2004**

**Introduction**

1. The existing international guidelines for differentiating between direct and portfolio investment, and between direct investment assets and liabilities, have generated interest and discussion. Situations that are being discussed by DITEG include those (a) where there is reverse equity investment, or reverse equity and debt investment, by the direct investment enterprise (DIE) in its direct investor (DI), (b) where there is equity and/or debt investment between siblings (i.e., companies that are both owned by another company, located in a third country), and (c) where there is equity and/or debt investment between grandparents and grandchildren.
2. In addition, changes in the presentation of data on reverse investment are being discussed. In an issue paper on DITEG issues 7 & 8 presented at the June 2004 DITEG meeting (Reverse Investment and Directional Principle, by the IMF Statistics Department), a potential new presentation scheme for reverse investment was explained, which was to more strictly follow an asset/liability presentation instead of netting assets and liabilities under direct investment classifications.
3. My paper touches on both of the above areas. It first discusses conceptual issues regarding what reverse positions should be included in direct investment. It then proposes an alternate presentation.
4. More specifically, the presentation scheme explained in the earlier DITEG paper works best if the following two assumptions hold true. The first assumption is that existing international standards regarding what constitutes direct investment equity (as opposed to portfolio investment equity) is maintained, and the second assumption is that data are of sufficient "density" that the new presentation scheme is workable by a substantial majority of countries. In this paper, I question each of these assumptions. I conclude with a proposal to classify reverse equity investment of less than 10 percent in a direct investor in portfolio investment instead of in direct investment, for both conceptual and practical reasons.
5. For clarity, two cases are briefly separately discussed below – (a) where the DIE owns 10 percent or more of the equity of the DI, and (b) the case where the DIE owns more than zero but less than 10 percent of the equity of the DI.

## Discussion

6. The tables from the June 2004 DITEG paper that illustrate an alternative presentation scheme are reproduced below, with rows labeled for ease of reference:

**Balance of Payments ***

| *Net changes in assets arising from transactions* | *Net changes in liabilities arising from transactions* |
|---|---|
| **Direct investment** | **Direct investment** |
| A1 Abroad | L1 In reporting economy |
| A2 Equity finance** | L2 Equity finance** |
| A3 Debt | L3 Debt |
| A4 In reporting economy (claims on direct investors) | L4 Abroad (liabilities to direct investment enterprises) |
| A5 Equity finance** | L5 Equity finance** |
| A6 Debt | L6 Debt |

**International Investment Position***

| *Assets* | *Liabilities* |
|---|---|
| **Direct investment** | **Direct investment** |
| A1 Abroad | L1 In reporting economy |
| A2 Equity finance** | L2 Equity finance** |
| A3 Debt | L3 Debt |
| A4 In reporting economy (claims on direct investors) | L4 Abroad (liabilities to direct investment enterprises) |
| A5 Equity finance** | L5 Equity finance** |
| A6 Debt | L6 Debt |

* The table labeled Balance of Payments corresponds to table 3, and the table labeled International Investment Position corresponds to table 4, of the IMF's June 2004 DITEG issue paper, on issues 7 and 8.
** Using terms in *BPM5*, "equity finance" is equivalent to equity capital and reinvested earnings.

7. **Case where the DIE owns 10 percent or more of the equity of the DI**
   a. In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is a second direct investment relationship. Under these standards, each relationship would be recorded on a gross basis under the asset/liability principle.
   b. Under the existing standards and the June presentation scheme, entries will appear on rows A2 and L2 in the above tables (equity finance assets on direct investment abroad, and equity finance liabilities on direct investment in the reporting economy). No entries will appear on row A5 (equity finance claims on DIs in the reporting economy) or L5 (equity finance liabilities to DIEs).

c. I have no concerns about the existing international standards or about the proposed method of presenting these transactions and positions.

**8. Case where the DIE owns more than zero but less than 10 percent of the equity of the DI**

a. In this circumstance, the existing international standards (which are not challenged in the June DITEG paper) state that there is reverse direct investment equity investment. In looking at the tables in the earlier DITEG paper, this is the only circumstance that would give rise to entries on row A5 or on row L5.

b. <u>Conceptual issue:</u> In this circumstance, it is not obvious why reverse equity investment of less-than-10 percent is recorded in direct investment rather than in portfolio investment. The equity investment of less-than-10 percent is not for the purpose of exercising a significant degree of influence on the management of the enterprise, and so it would also be consistent with existing concepts to record this level of equity investment in portfolio investment. Stated differently, if there is a less-than-10 percent equity investment in both directions, both investments are classified in portfolio investment. It is unclear why, if one of the parties increases its investment in the other from less-than-10 percent to 10 percent-or-more, it necessarily leads to removal from portfolio investment of the equity investment that had been, and that remains, below the 10 percent threshold.

c. <u>Practical issue:</u> As noted above, under the June DITEG proposal, the types of investments that are to be classified on rows A5 and L5 are quite narrowly defined. Entries would appear on one of these lines only in the case where there is a 10-percent or more equity investment in one direction, and a greater-than-zero but less-than-10 percent equity investment in the other direction. It is unlikely that these arrangements exist to an extent that data could be published at most bilateral levels or, for many countries, even at global levels. It would be inappropriate to develop new standard components for the BOP and IIP accounts where a sizable number of countries could not present any information due to confidentiality issues.

**Recommendations**

9. For both conceptual and practical reasons, I recommend recording equity investments of less-

than-10 percent in portfolio investment rather than in direct investment. This would be a change from the existing international standards, but such a change seems warranted.

a. I am not recommending any changes to the existing international standards in regard to the classification of debt positions. It perhaps could be argued that, if reverse equity investments of less-than-10 percent are classified in portfolio investment, then debt positions in the same direction should also be classified in portfolio investment. But I believe that it could be argued even more strongly that it is consistent with broad concepts to record such debt investment in direct investment. Note that, if there is zero equity investment in the DI by the DIE, it is noncontroversial that debt liabilities of the DI to the DIE are to be recorded in direct investment. The creation or existence of a small (i.e., of a less-than-10 percent) equity investment in the DI by the DIE does not provide justification for seriously considering reclassifying the debt liabilities of the DI from direct investment to portfolio or other investment.

10. If my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is accepted, then the presentation scheme for reverse investment described in the June paper cannot be accepted, because there will be no entries on the rows pertaining to equity finance claims on direct investors or equity finance liabilities to direct investment enterprises.

11. Even if my recommendation to record equity investments of less-than-10 percent in portfolio investment rather than in direct investment is rejected for some reason, the presentation scheme described in the June paper still should not be accepted, because it would add rows to the list of standard components for which very few countries could show substantial data before encountering confidentiality issues.

12. Finally, if my recommendation is accepted regarding the inclusion in portfolio investment of the less-than-10 percent equity investments, then I propose the presentation scheme shown on the following tables. Compared with the presentation illustrated in the June DITEG paper, the rows pertaining to reverse equity finance investment (A5 and L5) are eliminated (because such investment would be defined out of direct investment). In addition, the subtotals for reverse investment (that had appeared on rows A4 and L4) are replaced with new subtotals, for total debt (assets and liabilities):

**Balance of Payments**

| *Net changes in assets arising from transactions* | *Net changes in liabilities arising from transactions* |
|---|---|
| **Direct investment** | **Direct investment** |
| Equity finance | Equity finance |
| Debt | Debt |
| Debt (claims on DIEs) | Debt (liabilities to DIs) |
| Debt (claims on DIs) | Debt (liabilities to DIEs) |

**International Investment Position**

| *Assets* | *Liabilities* |
|---|---|
| **Direct investment** | **Direct investment** |
| Equity finance | Equity finance |
| Debt | Debt |
| Debt (claims on DIEs) | Debt (liabilities to DIs) |
| Debt (claims on DIs) | Debt (liabilities to DIEs) |

## Points for Discussion

1. *In regard to the IMF's June 2004 issue paper on DITEG issues 7 & 8, do DITEG members agree that the rows in the classification scheme pertaining to equity finance claims on DIs, and to equity finance liabilities to DIEs, are very narrowly defined? If so, do DITEG members agree that this raises substantial concerns about their country's or organization's ability to show much data on these rows?*
2. *Do DITEG members agree that, on conceptual and/or practical grounds, there is merit in considering changing the existing international standards, to reclassify equity investment by the DIE in the DI from direct investment to portfolio investment in the case where the ownership interest is less than 10 percent?*
3. *Do DITEG members have comments on any of the other issues raised in this paper?*

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

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

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# BACKGROUND PAPER ISSUE 7

# THE APPLICATION OF THE DIRECTIONAL PRINCIPLE

**Prepared by Balance of Payments and Financial Accounts Department**

**De Nederlandsche Bank**

**June 2004**

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

**BACKGROUND PAPER 3: INDIRECT INVESTMENT – EXAMPLE FROM PRACTICE**

This paper on the application of the directional principle was prepared for the thematic meeting of the ECB Working Group on Balance of Payments and External Reserves Statistics, June 2004.

## *1. Introduction*

The directional principle is a recording method for intercompany transactions in FDI. The recording of these transactions is dependent on the direction of the once established FDI relationship. When the resident company is…

1. a mother company, all intercompany transactions should be recorded under FDI outward.
2. a subsidiary (>50%) or associate (≤ 50%), all intercompany transactions should be recorded under FDI inward.

For example, according to the directional principle, when a resident subsidiary or associate grants a loan to its mother company abroad, this loan should be recorded as an asset under FDI inward (see *IMF Textbook*, Chapter 9).

Both the IMF's *Balance of Payments Manual 5$^{th}$ Edition* (BPM5) and the *OECD's Benchmark Definition on Foreign Direct Investment, 3$^{rd}$ edition* (Benchmark) relate to the directional principle, in §371 and Annex 4 respectively. The report of the *ECB/Eurostat Task Force on Foreign Direct Investment* also refers to the directional principle. In chapter 1, it is explained how the principle should be applied. Although the TF-FDI-report contains various examples of the application of the directional principle, these examples are not exhaustive and leave room for different interpretations. More specifically, it is not made explicit to how many levels up or down the chain the directional principle should be applied. For a consistent application of the directional principle, a common understanding is needed. Without such a common understanding countries are likely to continue to apply the directional principle according to their own understanding which may lead to asymmetries in the balance of payments of the euro area.

## *2. The impact of different methods*

The following methods can be distinguished to apply the directional principle:

1. the 'Dutch' method
   - Only direct vertical links (only transactions and positions between mother company – daughter company are subject to the directional principle)
2. the method recommended by the TF-FDI (Chapter 1 of the TF-FDI report)
   - Direct and indirect vertical links (transactions and positions between mother company – daughter company – granddaughter company are subject to the directional principle)

3. the 'Irish' method
   - Direct and indirect links, both vertical and horizontal (transactions and positions between all group companies including sisters and cousins are subject to the directional principle;

in the case of loans between sister companies, this implies that both counterparts to each transaction record all flows as (positive or negative) inward FDI)

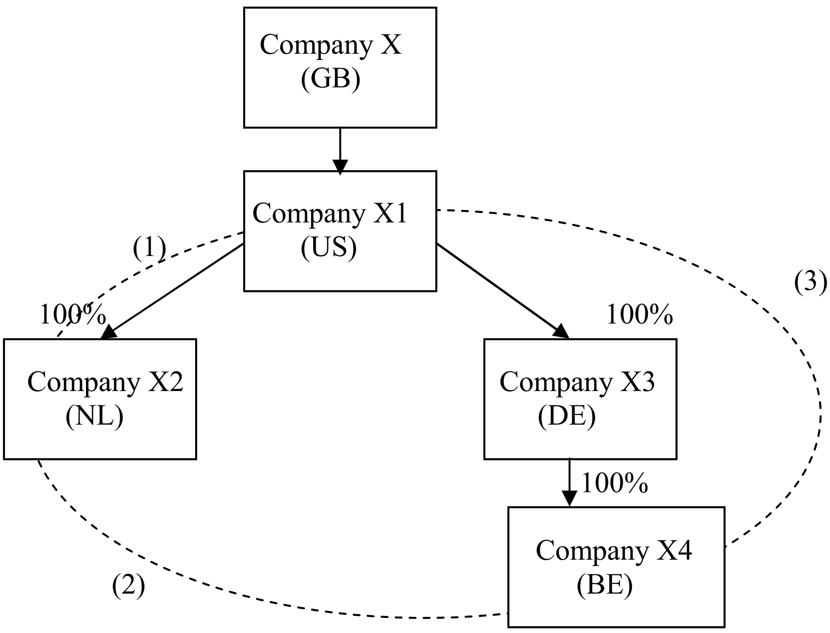
4. the method accepted by the OECD as an alternative to the general recommendation (namely (2) above) (see Annex 4 of the Benchmark)
   - Direct and indirect links, both vertical and horizontal, are subject to the directional principle (similar to the Irish method but all flows are allocated to the mother company)

The impact of the different approaches is illustrated in the following **case**:

A company in the United States, company X1, has two fully-owned (100%) subsidiaries in both the Netherlands (company X2) and Germany (company X3). In turn, company X3 owns a 100%-subsidiary in Belgium (company X4). In addition, company X1 is 100% owned by a British company X.

Dutch company X2 receives a EUR 1,000 loan from its American mother company X1 and channels these funds to Belgian company X4. In turn, company X4 lends this money back to company X1 (see dotted line in the diagram below).

***Group structure case***




Key to symbols:

_____ : ownership line

- - - - - : financial flow

Levels in the group structure:
Level 1: Company X
Level 2: Company X1
Level 3: Company X2 and company X3
Level 4: Company X4

The balances below show how the compilers of the countries involved in the transaction should record the transactions using the 4 methods described above. In addition, the consequences for the balance of payments of the euro area are described.

The application of the directional principle
(in EUR)

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Method 1** | **The Dutch application** | | | | | | | | | | |
| US compiler | | | | NL compiler | | | | BE compiler | | | |
| (1) Outward - asset on NL | 1,000 | (3) Inward - liability to BE | 1,000 | (2) Outward - asset on BE | 1,000 | (1) Inward - liability to US | 1,000 | (3) Outward - asset on US | 1,000 | (2) Inward - liability to NL | 1,000 |
| **Method 2** | **Method of TF-FDI report** | | | | | | | | | | |
| US compiler | | | | NL compiler | | | | BE compiler | | | |
| (1) Outward - asset on NL | 1,000 | (3) Outward - liability to BE | 1,000 | (2) Outward - asset on BE | 1,000 | (1) Inward - liability to US | 1,000 | (3) Inward - asset on US | 1,000 | (2) Inward - liability to NL | 1,000 |
| **Method 3** | **The Irish application** | | | | | | | | | | |
| US compiler | | | | NL compiler | | | | BE compiler | | | |
| (1) Outward - asset on NL | 1,000 | (3) Outward - liability to BE | 1,000 | (2) Inward - asset on BE | 1,000 | (1) Inward - liability to US | 1,000 | (3) Inward - asset on US | 1,000 | (2) Inward - liability to NL | 1,000 |
| **Method 4** | **The OECD Benchmark** | | | | | | | | | | |
| US compiler | | | | NL compiler | | | | BE compiler | | | |
| (1) Outward - asset on NL | 1,000 | (3) Outward - liability to BE | 1,000 | (2) Inward - asset on US | 1,000 | (1) Inward - liability to US | 1,000 | (3) Inward - asset on US | 1,000 | (2) Inward - liability to US | 1,000 |
| (2) Outward - asset on BE | 1,000 | (2) Outward - liability to NL | 1,000 | | | | | | | | |

**BALANCE OF PAYMENTS EURO AREA**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Method 1 - Dutch application (GROSS) | | | | Method 1 - Dutch application (NET) | | | |
| (NL) Outward - asset on BE | 1,000 | (NL) Inward - liability to US | 1,000 | (BE) Outward - asset on US | 1,000 | (NL) Inward - liability to US | 1,000 |
| (BE) Outward - asset on US | 1,000 | (BE) Inward - liability to NL | 1,000 | | | | |
| Method 2 - Method of TF-FDI report (GROSS) | | | | Method 2 - Method of TF-FDI report (NET) | | | |
| (NL) Outward - asset on BE | 1,000 | (NL) Inward - liability to US | 1,000 | Assets | 0 | Liabilities | 0 |
| (BE) Inward - asset on US | 1,000 | (BE) Inward - liability to NL | 1,000 | | | | |
| Method 3 - Irish application (GROSS) | | | | Method 3 - Irish application (NET) | | | |
| (NL) Inward - asset on BE | 1,000 | (NL) Inward - liability to US | 1,000 | Assets | 0 | Liabilities | 0 |
| (BE) Inward - asset on US | 1,000 | (BE) Inward - liability to NL | 1,000 | | | | |
| Method 4 - The OECD Benchmark (GROSS) | | | | Method 4 - The OECD Benchmark (NET) | | | |
| (NL) Inward - asset on US | 1,000 | (NL) Inward - liability to US | 1,000 | Assets | 0 | Liabilities | 0 |
| (BE) Inward - asset on US | 1,000 | (BE) Inward - liability to US | 1,000 | | | | |

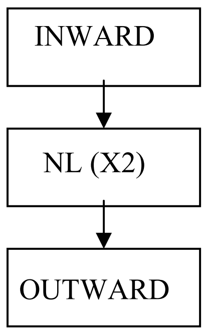
On a country level basis, the gross balances (i.e. inward and outward FDI considered separately) of all 3 countries show a zero balance when methods 3 and 4 are applied. This means that the transaction would not be shown in the BOP of the countries involved. When method 2 is applied, only the balances of the US and BE would be zero on a gross basis. In other words, following method 2 while the US and BE would not show any trace of these loans in their respective balance of payments, NL would show flows both on inward and outward FDI, even if the net balance would amount to zero. The application of method 1 would not result in gross zero balances for any of the 3 countries.

With reference to the balance of payments of the euro area, one can observe that only method 1 would result in cross-border gross flows (inward and outward FDI). One can also observe that as long as all countries involved apply the same method, the application of method 1 does not lead to asymmetries in the euro area aggregate; this of course, holds for all methods.

## *3. Further analysis of methods 3 and 4*

To apply the methods 3 and 4 correctly, two conditions must be fulfilled by the compiler:

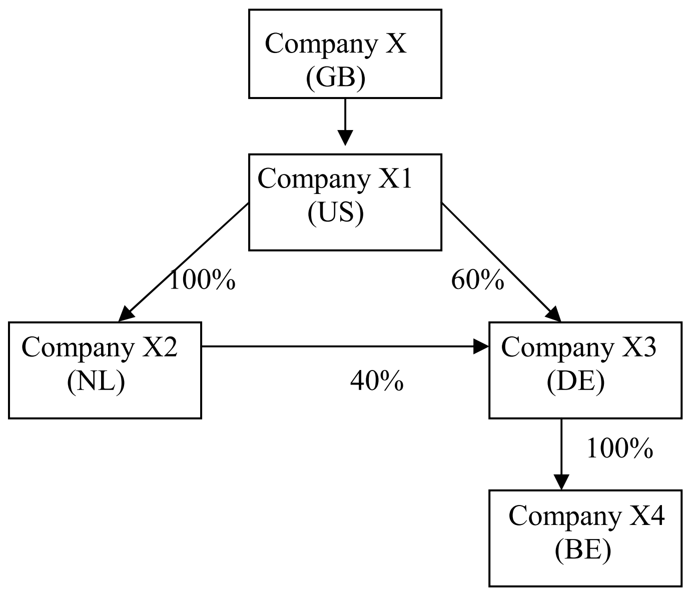
1. The entire structure of the enterprise or group should be clear;
2. The 'inward' and 'outward' part for any entity within the group structure should be identified.
   - The 'Inward' part refers to all entities above the entity involved – thus the mother company and all other entities up the chain;
   - The 'Outward' part refers to all entities below the entity involved – thus the daughter company/-ies and all other entities down the chain;
   - In our example, from the point of view of company X2 all companies in the group are inward according to methods 3 and 4 (X2 has no daughter companies and thus has no outward entities in the group).




Only if these conditions are fulfilled, both methods 3 and 4 can be applied correctly. However, in many cases it is impossible for the compiler to decide to which part of the group (inward part or outward part) an entity belongs.

For example, let's change the case described above. In this case, company X1 owns 100% in company X2 and 60% in company X3. Company X2 owns the remaing 40% in company X3. In turn, company X3 owns 100% in company X4 (see below).

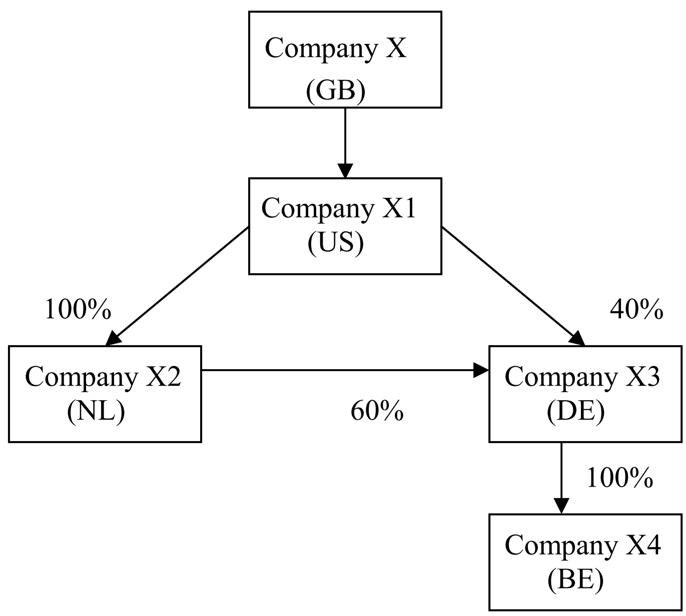
***Group structure A***




One can say that company X2 should view all entities as 'inward' because company X1 majority-owns X2's sister company X3 and, indirectly, company X4. Company X2 would still have no outward relations within the group. Therefore, all flows from X2 to and from the other companies in the group, should be recorded under 'inward'. If there would be full knowledge about these structures, the methods 3 and 4 could still be applied.

However, what happens in the recordings when company X2 owns 60% in company X3 and company X1 owns 40% in company X3 (see below)? What changes will occur in the reporting and, more importantly, in the inward and outward part of the group structure?

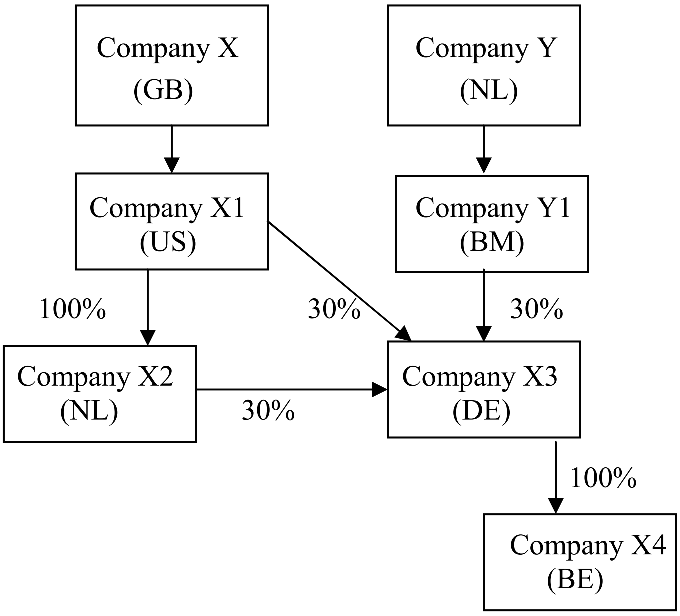
***Group structure B***




One can say that company X2 should now view entity X3 as an 'outward' company, because X3 has become a daughter company of X2. In addition, because X4 is a daughter company of X3, X4 also changes from 'inward' to 'outward'. Companies X and X1 are still 'inward' companies. Again, assuming full knowledge on these structures, methods 3 and 4 can still be applied.

To make the example even more complex, what happens to the inward and outward structure of the company and its reports when the following organisational structure occurs:

***Group structure C***




This organisational structure seems exaggerated but structures like these exist in practice, especially when Special Purpose Entities (SPEs) are involved. In this example it is very difficult to decide which part of the organisation is 'inward' and which part is 'outward', from the point of view of company X2. To complicate matters further, what will happen to the inward/outward parts if the reporter (company Y) in country NL can report on a country level basis (which is the practice in the Netherlands)? For company Y all entities can be viewed upon as outward but for company X2 some are inward and some are outward.

**Conclusions with respect to methods 3 and 4**

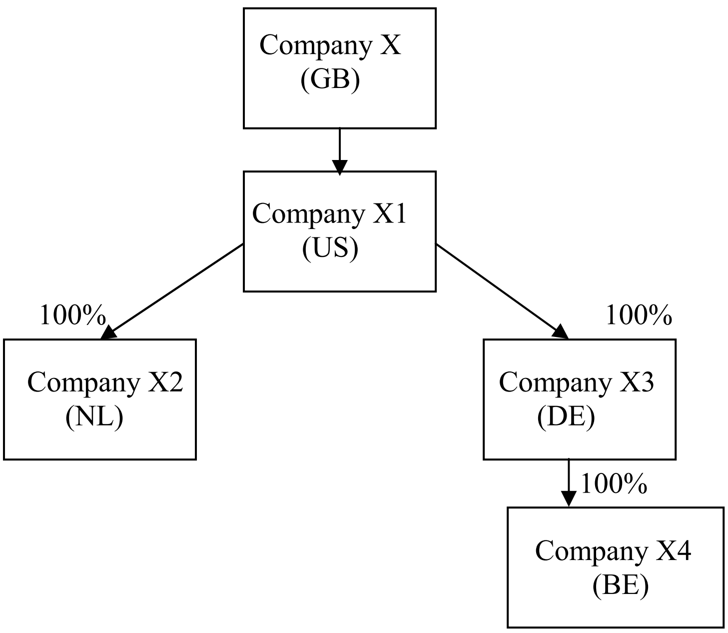
As mentioned on page 5, two conditions should be fulfilled for a correct application of methods 3 and 4. However, when the 'inward' and 'outward' entities cannot be identified, e.g. because the organisational structure is not known or leaves room for interpretation, methods 3 and 4 become hard to use. Moreover, when the structure of a specific group changes because of a new acquisition or a reshuffling of entities, one must redefine all entities as 'inward' or 'outward'.

Furthermore, method 4, the alternative method of the OECD Benchmark, is difficult or even impossible to apply on practical grounds (besides the argument of inward/outward). To record all flows involved correctly, company X needs information on the loan from BE to the US (see initial example). The US compiler does not have any information on the lending and borrowing transactions between non-resident affiliates of the group, which are beyond the scope of the US BOP. In general, the offsetting entries should always be recorded by the mother company of the group, under the general assumption that all financing within a DI group ultimately originates from the parent companies. This would eventually create a geographical allocation problem, since undoubtedly, the countries where sister companies are located record transactions vis-à-vis each other (i.e. attributed to the direct counterpart) instead of vis-à-vis the country where the mother company is located.

## *4. Further analysis of methods 1 and 2*

Compared to the methods 3 and 4, the methods 1 and 2 are much easier to apply and do not lead to asymmetries in the euro area aggregate when applied consistently by all compilers (just like methods 3 and 4). When a cash-settlement system is used, method 1 would seem the easiest way to apply the directional principle. Method 2 can also be applied, but a compiler then would need more information on the group structure and may have to put up a register with all interlinkages within groups. This makes method 2 somewhat harder to apply than method 1.

Although it is feasible to apply method 2, De Nederlandsche Bank has so far chosen to apply method 1 instead of method 2, because it has not been made explicit yet to which levels in a group structure the directional principle should be applied. To illustrate the problems that might arise, let's look at the initial case again (also refer to page 4 for the recording of the transactions):




Key to symbols:
_____ : ownership line

Levels in the group structure:
Level 1: Company X
Level 2: Company X1
Level 3: Company X2 and company X3
Level 4: Company X4

One could interpret the recommendations of the TF-FDI as such, that companies X2 and X3 (level 3) should apply the directional principle when a loan is granted to companies X1 (level 2) and X (level 1). In addition, company X4 (level 4) should apply the principle when it grants a loan to companies X3 (level 3) and X1 (level 2). However, it has not been made explicit in the report whether company X4 (level 4) would also have to apply the directional principle when it grants a loan to its greatgrandmother X (level 1) – thus a three- level difference. Moreover, suppose company X also has a mother company (level 0) or even a grandmother (level -1) – should the Belgian company also apply the directional principle to loans that it grants to these companies (a four-level and a five-level difference respectively)?

According to method 1, company X4 will record all of its transactions to X1, X and X2 (and beyond) as an Outward – asset. A transaction to X3 would be subject to the directional principle. Therefore, all transactions from X4 to X3 will be recorded under Inward – asset. According to method 2, company X4 would record all of its transactions to X3 and X1 as an Inward – asset. This comparison between method 1 and method 2 illustrates the asymmetries that might arise (e.g. with respect to the recording of transactions with X1) if the scope of the application would differ.

All in all, one can conclude that a consistent application of the directional principle requires a clear choice, either:

1. compilers use method 1, restricting the application of the directional principle to 1 level, or
2. compilers use method 2; however, in that case it should be clear to all compilers that it should be applied to the whole vertical chain

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

**DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

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**BACKGROUND PAPER # 7A**

# Compilation of Direct Investment Statistics for Ireland - Selected topics

**Prepared by Central Statistics Office, Ireland**

**March 2004**

# OECD Workshop on International Investment Statistics
# 22 - 24 March 2004, Paris

### Compilation of Direct Investment statistics for Ireland - Selected topics

### Central Statistics Office, Ireland

[Revised 26 March 2004 to define CSO meaning of the terms 'affiliate' and 'affiliated']

## 1. Introduction

This paper focuses on a small selection of the more important issues for the Central Statistics Office (CSO) concerning compilation of foreign direct investment (and related) statistics for Ireland. It briefly describes the CSO's approach to the collection and compilation of the relevant data, particularly regarding its treatment of:

- *direct investment/other capital* in the context of the application of the *directional principle* for recording transactions/positions between related enterprises;
- enterprises which may be regarded as Special Purpose Entities (SPEs); and,
- transactions of foreign affiliates[i] which are booked through a resident direct investment enterprise.

The aim of the paper is to highlight certain problematic aspects of direct investment statistical compilation and classification and to provide some input into the current international deliberations concerning the revision of the IMF's Balance of Payments Manual (5th Edition) and the review of the OECD's *Benchmark Definition of Foreign Direct Investment*. In its preparation, various documents have been examined, the main ones being:

- the IMF manual referred to (and generally known as BPM5) along with its companion documents, the Compilation Guide (CG) and the Textbook (TB);
- the OECD's Benchmark Definition of Foreign Direct Investment (3rd Edition) i.e. BMD3;
- the draft annotated outline of the Balance of Payments manual update prepared by the IMF for consideration by the IMF Balance of Payments Committee (BOPCOM); and,
- the final report of the joint ECB/Eurostat Task Force on Foreign Direct Investment.

Prior to dealing with the issues listed above, it may be worthwhile to briefly outline the importance of direct investment in Ireland's economic development and also to describe the CSO's statistical compilation arrangements.

## 2. Importance of Direct Investment in Ireland

Inward direct investment (IDI) into Ireland has been extremely important in the development of the Irish economy over the last thirty years or so and has been the major source of the country's notably high economic growth rate during the 1990s. Within a European context, it is probably fair to say that up to now IDI has been relatively more important for Ireland than for (most of) its other EU colleagues generally. A number of multinational companies (MNCs) have a very significant presence in Ireland.

It is also important to mention that Ireland is not only a recipient of IDI. Over much of the last two decades it has engaged to an increasing extent in outward direct investment (ODI). Table 1 shows Ireland's direct investment statistics for 2001 and 2002 along with its GDP and GNI figures against which a relative scale of the importance of direct investment to an economy can be measured.

Both IDI and ODI were marked for many years by a focus on manufacturing activity. This still continues but over time the establishment of services enterprises at home and abroad has become increasingly important. The main manufacturing activities engaged in by IDI enterprises cover production of computing and office equipment, chemicals and pharmaceuticals, and drinks concentrates; ODI operations have concentrated mainly on food processing, construction products and packaging products. Within the services sector, IDI concentrates mostly on software supply and on financial services (the latter mostly located in the IFSC[1] in Dublin) while ODI focuses very much on financial and marketing/distribution services.

***Table 1. Direct investment in Ireland, 2001 and 2002***

| | 2001 | 2002 |
|---|---|---|
| | ***€ billion*** | |
| **Direct Investment in Ireland :** | | |
| Flows | 10.8 | 25.9 |
| Stocks (end-year) | 163.3 | 176.1 |
| **Direct Investment Abroad :** | | |
| Flows | -4.5 | -3.3 |
| Stocks (end-year) | 39.0 | 33.2 |
| **GDP at market prices** | **114.7** | **129.3** |
| **GNI at market prices** | **96.4** | **103.4** |

The need to have reliable and meaningful statistics on direct investment is therefore obvious.

For completeness and to put direct investment activity in context within Ireland, it is probably worthwhile mentioning that inward and outward *portfolio investment* and *other investment* activity are also significant – see Table 2 below but are mostly due to IFSC activity. Collection and compilation of the statistics for these domains gave rise to issues and experiences that are outside the scope of this paper but which are nevertheless important and hopefully can be dealt with elsewhere.

[1] I.e. the International Financial Services Centre established in 1987
[2] Including financial derivative contracts

*Table 2. Ireland's stock of foreign investment, 2001 and 2002*

| | 2001 | 2002 |
|---|---|---|
| | € billion | |
| **Investment into Ireland - TOTAL** | **860.3** | **904.9** |
| Direct Investment | 163.3 | 176.1 |
| Portfolio Investment | 400.8 | 411.8 |
| Other Investment [2] | 296.2 | 317.0 |
| **Ireland's investment abroad - TOTAL** | **839.7** | **875.3** |
| Direct Investment | 39.0 | 33.2 |
| Portfolio Investment | 493.7 | 539.2 |
| Other Investment [2] | 300.6 | 297.7 |
| Reserve assets | 6.4 | 5.2 |

## 3. CSO's Direct Investment compilation system

The CSO operates an integrated quarterly survey compilation system which is designed to collect all BOP and IIP relevant data from survey respondents. Data collection is statutory and each respondent provides detailed information on all BOP transactions (along with details of stocks of foreign assets and liabilities) with non-residents. Internal CSO data are used (foreign trade statistics; travel statistics) and administrative data are also obtained. The system is designed to ensure (in so far as possible) that the BOP/IIP statistics in general are collected and compiled to facilitate compliance with the fundamental international (i.e. BPM5) standards. The next section describes, however, the treatment adopted by the CSO for recording direct investment/other capital transactions (and stocks) between related enterprises in a way that differs from that recommended by the BPM5 and the BMD3. The CSO treatment does, however, closely follow an 'alternative approach' described by the OECD (in BMD3).

## 4. Treatment of Direct Investment – Other Capital and the Directional Principle for recording flows/positions between related direct investment enterprises

The central issue here concerns the treatment of flows/positions between those related enterprises covered by a *direct investment relationship* but where reverse equity investment by a direct investment enterprise in its direct investor is *less than 10%.* Questions arise on (a) the clarity and rationale of some of the classification rules defined in the relevant documentation (IMF's BPM5, TB and CG; OECD's BMD3), and (b) the meaningfulness of the resulting statistics based on these rules (or recommendations). The treatment recommended for recording reverse transactions/positions (equity or other capital) between a direct investment enterprise and its direct investor appears clear, whether the reverse equity investment is less than 10% or otherwise.

In collecting and compiling direct investment flows and positions, the CSO (believes that it) applies the BPM5 rules described in paragraphs 359 – 375, noting in particular that Paragraphs 371 and 372 refer respectively to the treatment of reverse investment and to the treatment of transactions between affiliated[i] monetary and other financial intermediaries (including SPEs having the sole purpose of serving as financial intermediaries). The CSO also applies (to the extent that is practically possible) the *fully consolidated system* (FCS) described in the OECD's BMD3 (Paragraphs 15 and 16). These specific paragraph references seem to focus primarily on the treatment of flows/positions in both directions between the direct investor and the direct investment enterprise.

The treatment of flows/positions between those related companies coming within the overall ambit of the *direct investment relationship* criteria does not appear to be specifically mentioned in BPM5. However, both the IMF's TB (in Paragraphs 529 and 531 - 533) and the OECD's BMD3 (in

Paragraphs 36 and 37 and in Annex 4) provide additional material on this aspect. To illustrate, the diagram below (Figure 1) shows the case of a loan transaction between "sister" enterprises (**B** located in Ireland and **C** located in France, both enterprises having the same US parent, **A**, but having no ownership links between them). The Irish enterprise advances a loan of €250m to the French enterprise.

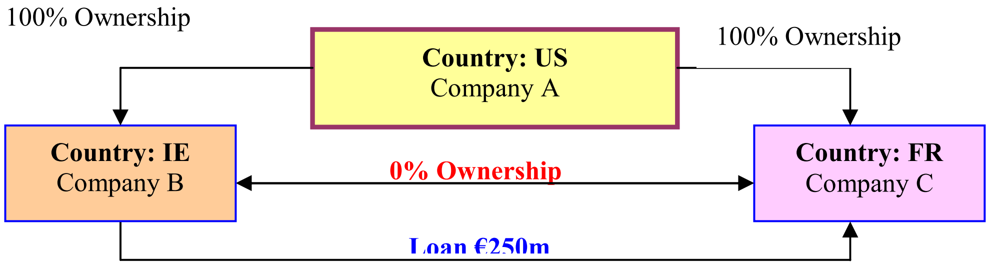


***Figure 1***

The recommended IMF and OECD treatments is to record this transaction in Ireland's BOP under *direct investment abroad* as follows (Figure 2):

| | | |
|---|---|---|
| **BOP for Ireland** | | |
| ***Direct investment abroad*** | | |
| (IMF) | Other capital | - €250 m |
| (OECD) | Other capital<br>Fellow subsidiaries | - €250 m |

***Figure 2***

The CSO wishes to draw attention to the following points:

- this recommended treatment appears to ignore the <u>direction</u> of the original investment into the enterprise advancing the loan and, as a result, appears to tend more towards the *assets/liabilities* approach. This appears to be a fundamental departure from the basic philosophy underpinning the directional principle
- the rationale for doing so is not obvious. In any event, in the context of the philosophy underlying the measurement of direct investment, it would seem inappropriate to allocate the transaction illustrated to *direct investment abroad* given that there is no basic equity ownership (or permanent debt, in the case of financial intermediaries and qualifying SPEs) linkage between the two enterprises in the first place. Even if a direct equity ownership linkage did exist, it would only seem appropriate to apply the recommended treatment if this equity ownership amounted to at least 10% of the share capital of enterprise C (if less than 10%, netting would take place as 'normal');
- the treatment inflates the gross investment flows (and positions) at the level of the headline aggregates: *direct investment in the reporting economy* and *direct investment abroad.* The wisdom of this outcome needs to be assessed in the context of how statistical users and economic commentators might be expected to interpret the resulting data;
- classification of the transaction at the most detailed BOP component level is not mentioned under the IMF approach. Within the BPM5 standard components, the only 'available' heading is *other capital/claims on affiliated enterprises*. The OECD posting is under the heading o*ther capital/fellow subsidiaries*. Thus, both approaches do not use the standard detailed

classification heading. This apparently trivial point may be simply that i.e. an immaterial comment. But could it be that the term 'affiliated enterprise' is not regarded as covering these (or similarly related) companies under the BPM5 or BMD3 concept of the directional approach?

In making these observations, the CSO is strongly of the view that a more rigid adherence to the directional principle is required, particularly where reverse flows/positions occur between enterprises engaged in a direct investment relationship. In Ireland, users of the statistics view inward direct investment as totally distinct from outward direct investment. The former is (naturally) seen as originating abroad but it is recognised that a number of related direct investment enterprises may be located in Ireland and that there may be two-way flows between these within Ireland and also with their related non-resident enterprises. On the other hand, outward direct investment is seen as originated by 'indigenous' Irish enterprises and similar two-way flows can occur. Thus, the key interest is in 'bottom line' data on direct investment into the country and on direct investment abroad. There would appear to be a justifiable case for clearly maintaining the purest directional distinction possible in compiling these key aggregates and avoiding the potential misinterpretation of the results emerging from a recording basis which transposes some of these transactions/positions across the directional 'divide'.

Accordingly, bearing both practical and theoretical considerations in mind, the CSO has extended the principle of *netting*, at the level of the headline aggregates *DI abroad* and *DI in the reporting economy*, those flows/positions occurring between enterprises covered by a direct investment relationship. This allows users to immediately assess what is the key statistical outcome, in a directional sense, in measuring Ireland's direct investment. Within the specified BPM5 standard sub-components, of course, the CSO records the relevant transactions/positions on a *gross* basis. Thus, for detailed analytical purposes, it is possible to produce the results according to the detailed BPM5 standard components (and sub-components).

The CSO, unhappy with the recommended treatment referred to above, was very much relieved to see a 'chink of light' in the possibilities offered by the OECD's thinking. The BMD3 in Annex 4 goes considerably further than the TB in that (while recommending the TB treatment) the BMD3 provides for an alternative (see Paragraphs 137 and 139 – 143) approach. It may be noted that this alternative approach does not have the status of a 'recommended' treatment. Nevertheless and in the context of its own circumstances and viewpoint, the CSO has opted for the 'alternative' approach for the reasons described earlier i.e. it considers the resulting data to be statistically (and possibly economically) more meaningful than those resulting from the recommended approach.

The following example and diagram illustrate the treatment adopted by the CSO for transactions that occur between directly or indirectly related enterprises. A US direct investor, **A**, acquires 100% ownership of an Irish subsidiary, **B**, through a €400m equity investment. **B** acquires a reverse €50m equity (less than 10%) investment in **A** and also advances a loan of €250m to a French subsidiary, **C**, of **A**. There is no ownership linkage between **B** and **C**.

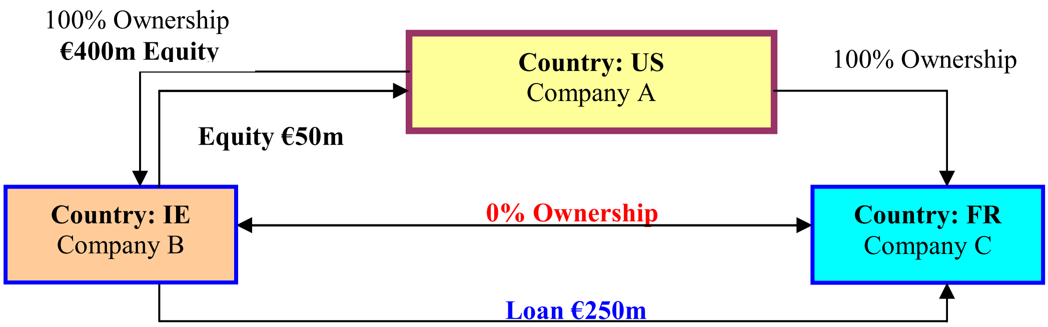


***Figure 3***

The Ireland BOP direct investment postings made by the CSO are as follows.

| **BOP for Ireland** | |
|---|---|
| ***Direct investment in Ireland*** | ***€100 m*** |
| Equity capital | |
| Claims on direct investors | - €50 m (US) |
| Liabilities to direct investors | €400 m (US) |
| Other capital | |
| Claims on direct investors | - €250 m (FR) |

***Figure 4***

The headline aggregate here reflects the final impact on direct investment into Ireland of the various transactions engaged in by enterprises which are in a direct investment relationship. In the BPM5 recommended approach discussed above, the transactions illustrated would result in *direct investment in Ireland* of €350m and *direct investment abroad* of €250m, *net* overall direct investment *for* Ireland being €100m.

It may be useful to look at the actual direct investment statistics for Ireland under both treatments to see how significant the effects are. Table 3 below shows the results for both stocks and flows for the years 2001 and 2002.

***Table 3. Direct investment in Ireland, 2001 and 2002***

*Comparison of CSO treatment and that recommended in the BPM5*[3]

[3] Discrepancies in totals due to rounding

| | | BPM5/OECD Recommended Approach | | | CSO Approach | | |
|---|---|---|---|---|---|---|---|
| | | *Equity & Reinvested Earnings* | *Other Capital* | *Total* | *Equity & Reinvested Earnings* | *Other Capital* | *Total* |
| | | € billion | | | | | |
| **Direct Investment in Ireland** | | | | | | | |
| **2001** | **Flows** | 20.4 | **-6.8** | **13.6** | 20.4 | **-9.6** | **10.8** |
| | **Stocks** | 150.9 | **73.7** | **224.6** | 150.9 | **12.5** | **163.3** |
| **2002** | **Flows** | 27.5 | **13.4** | **40.9** | 27.5 | **-1.6** | **25.9** |
| | **Stocks** | 165.8 | **77.8** | **243.6** | 165.8 | **10.4** | **176.1** |
| **Direct Investment Abroad** | | | | | | | |
| **2001** | **Flows** | -3.8 | **-3.5** | **-7.8** | -3.8 | **-0.7** | **-4.5** |
| | **Stocks** | 33.2 | **67.0** | **100.2** | 33.2 | **5.8** | **39.0** |
| **2002** | **Flows** | -5.9 | **-12.3** | **-18.2** | -5.9 | **2.6** | **-3.3** |
| | **Stocks** | 30.2 | **70.4** | **100.6** | 30.2 | **3.0** | **33.2** |
| **Net Direct Investment – Ireland** | | | | | | | |
| **2001** | **Flows** | 16.6 | -10.3 | 6.3 | 16.6 | -10.4 | 6.2 |
| | **Stocks** | -117.7 | -6.7 | -124.4 | -117.7 | -6.7 | -124.3 |
| **2002** | **Flows** | 21.5 | 1.1 | 22.6 | 21.5 | 1.1 | 22.6 |
| | **Stocks** | -135.6 | -7.4 | 143.0 | -135.6 | -7.4 | 142.9 |

This table clearly shows that, for Ireland at least, there can be quite significant flows/positions recorded under *direct investment/other capital*. If these are recorded on the basis of the BPM5 recommendation, then both the 'other capital' and the 'total' entries for *direct investment in Ireland* and *direct investment abroad* will be inflated. Thus, for end-2002, the inward stock of other capital is €77.8 billion under the BPM5 approach and €10.4 billion under the CSO approach i.e. a difference of over €67 billion. The overall headline inward direct investment aggregate under the two approaches for end-2002 is: €243.6 billion and €176.1 billion respectively. Outward direct investment is correspondingly affected i.e. €70.4 billion (BPM5) compared to €3.0 billion (CSO). The net stock position under both approaches is, of course, the same (apart from minor rounding errors). A similar situation is evident for end-2001 stocks and also for the flow statistics for both years (but the flow figures are less dramatic). A further important point is that these effects are more marked when the results are examined on a geographical basis (i.e. by region or by country).

The CSO view (as mentioned earlier) is that the inflated figures resulting from the BPM5 recommendation (can) distort the picture and potentially lead to misinterpretation of the impact of direct investment. Hence, it has adopted a treatment based on the alternative approach described by the OECD in BMD3.

In conclusion, the points which underpin the CSO's thinking and the reason for its approach are reiterated in the box below. As stated above, they are put forward as an input into the deliberations on updating the *Benchmark Definition* and the BPM5. The CSO thinks that this issue is particularly important in the light of the current proposals to treat reverse direct investment more on an assets/liabilities basis in the revised (i.e. BPM6) manual i.e. a definite departure from the basic philosophy of the directional approach. In addition, the CSO is concerned that there are also suggestions to re-classify certain reverse transactions involving financial securities (other than equity), as well as loans, from direct investment to portfolio investment and to other investment, depending on the nature of the transaction. The CSO view is that all financial transactions between affiliates[i] within the direct investment relationship should be retained within the category *direct investment* and that the directional principle should strictly apply.

**Summary basis for CSO treatment of Direct Investment/other capital**

- Given that the *directional principle* rather than the *assets/liabilities* approach is recommended for recording direct investment, the headline aggregates *direct investment in the reporting economy* and *direct investment abroad* should be good indicators of the fundamental statistical outcome for an economy of both inward and outward investment, particularly where transactions involving related enterprises in a wider enterprise group occur. This view essentially extends the basic BPM5 idea of *netting* any reverse flows/positions in DI between the direct investment enterprise and its direct investor (where reverse equity is less than 10%), to all enterprises in a direct investment relationship. Thus, while the collection and compilation system could produce information on the detailed gross flows between these enterprises, the main (i.e. original) DI abroad/reporting economy aggregates would show the *net* impact on an economy for each side of the directional divide.
- Where flows/positions occur between "sister" companies (i.e. where there are no equity ownership links between them) in different economies, it appears statistically meaningless to follow the IMF and OECD recommendation and to allocate these flows/stocks to the 'reporting economy' or to 'abroad' without reference to the direction of the original investment establishing the existence of direct investment. Thus, the recommended treatment seems to contradict the basic philosophy of measuring direct investment on a directional basis; in fact, it appears to advocate the use of an *assets/liabilities* approach instead for recording flows/stocks between certain related enterprises. Furthermore, the interpretation and 'understandability' of the resulting headline and sub-component statistics is made more difficult.
- Under the BPM5/BMD3 recommendations, the flows/positions recorded between "sister" companies do not lend themselves to classification and posting within the BPM5 "standard components" framework.
- Distortion caused by inflating gross headline aggregates under the BPM5/BMD3 approach. This will be more marked when the figures are examined on a geographical basis (i.e. by region, by country etc.)
- No equity basis for categorising inter-company flows as abroad / in the reporting economy.

## 5. Treatment of Special Purpose Entities

There are various types of so-called 'special purpose companies' operating in Ireland (mostly in the IFSC). These entities are non-physical operations (no premises, no employees) and tend to provide services to related entities within the group structure. They are generally loosely referred to as SPCs (Special Purpose Companies), SPEs (Special Purpose Entities), SPVs (Special Purpose Vehicles) or SPICs (Special Purpose Investment Companies). Collective investment institutions may also be regarded as SPEs by some interests. The terms referred to above may be used differently and may be interpreted differently by compilers and users and it is difficult to establish standard definitions. From its viewpoint, the CSO is not greatly concerned with these labels but rather with whether the entities concerned have genuine economic activity and whether they should be regarded as statistical units operating in the Irish economy. A further obvious concern is the classification of their capital transactions and stocks with non-residents by type of functional investment (direct, portfolio or other investment) as well as any income or services flows occurring.

In Ireland, SPEs or SPCs generally refer to captive insurance or reinsurance companies, agency reinsurance companies, captive finance companies and agency treasury companies. SPVs are usually involved in the securitisation of assets of a company or a number of companies as a means of raising finance. SPICs are used for investment in portfolio securities. However, it should be understood that these terms are used quite loosely and are interchangeable to some extent.

A brief description of these companies is given in the box below.

### SPEs in Ireland

**Special purpose investment companies (SPICs)**

SPICs are inward Direct Investment enterprises engaged in outward portfolio investment.

**Captive insurance/re-insurance companies**

These companies are engaged in the provision of insurance and re-insurance services. The captive structure allows for self-insurance by large companies. However, the structures also allow for the provision of standard re-insurance services within the company group. In general, these companies are inward Direct Investment enterprises.

**Asset finance companies – lending, leasing and other corporate finance**

Asset finance refers to the financing of operations secured on particular assets. Aviation and shipping finance are examples, but other types of assets are included e.g. computer hardware, railway stock etc. These are Direct Investment entities with non-resident owners. Most if not all of these companies are financial intermediaries or MFIs therefore only transactions in permanent debt and equity are considered as *direct investment* transactions.

**Captive and agency treasury companies**

These companies are used to manage both risk and liquidity in the financial activities of companies. They are also involved in international cash management/netting arrangements. In general, these companies are inward Direct Investment enterprises.

**Special purpose vehicles (SPVs)**

These are companies established for specific purposes, a common example is receivables securitisation, where investors purchase securities in a company whose assets are the trade receivables of a separate company which have been bought by the SPV. In general the securitisation process creates securities that depend on financial assets which would not otherwise be tradable. These companies are direct investment enterprises. The investors into the securitised vehicles do not hold ordinary shares and tend to hold either non-participating preference shares or other notes. The structures are used as an off-balance sheet means of raising finance.

For the purposes of this paper, collective investment institutions (which are both inward and outward portfolio investment enterprises) are not regarded as SPEs by the CSO. Otherwise, based on the CSO BOP Statistical Register system, there are approximately 600 entities (i.e. around 11% of all BOP statistical reporters) which may be labelled as SPEs and which are covered by the CSO's BOP/IIP survey collection system. They are roughly distributed as follows:

| | |
|---|---|
| ➢ Captive insurance/reinsurance | 181 |
| ➢ Special purpose investment companies (SPICs) | 4 |
| ➢ Other SPEs (treasury, asset financing, leasing, securitisation) | 415 |

Where they meet the criteria specified below, the CSO views these 'SPE' entities as *statistical units* operating within the economic territory of Ireland and having a centre of economic interest there. The relevant (internationally accepted) criteria require that statistical units:

- are capable of owning assets, of incurring liabilities and of engaging in economic activities (primarily if not exclusively financial services activities) and transactions with other units in their own right (even though their operation may require the services of 'auxiliary' companies such as management companies, administrators, investment advisers, etc.);
- are incorporated in Ireland generally as Public Limited Companies (PLCs);
- prepare and file company accounts;
- pay corporation taxes to the revenue authorities in Ireland.

The determination of whether an entity qualifies as a statistical unit is somewhat subjective but, nevertheless, requires that, in addition to the first, at least two of the other criteria are fulfilled.

Those entities that are direct investment enterprises are covered by Ireland's direct investment statistics. However and while some analyses could be produced, there are no data currently available to quantify the contribution of SPEs in monetary terms to these statistics. From a familiarity with the collection system, it is known that the impact of SPEs is quite significant.

In conclusion, the CSO view is that these entities, where they qualify as statistical units, should be included in their own right in the statistical systems of the country of their location.

## 6. Transactions of foreign affiliates[i] which are booked through a resident direct investment enterprise

This section of this paper is not directly concerned with the collection and compilation of direct investment statistics. It *is* concerned with certain trading and accounting practices engaged in by companies related within a group structure in regard to transactions involving non-related third parties. The approach to recording these transactions is the issue in question.

As already mentioned, foreign-owned multinational companies (MNCs) have a significant presence in Ireland. Monitoring their structure, activities, trading and accounting practices as well as their BOP reporting arrangements require ongoing attention by the CSO, particularly as the relevant characteristics can frequently change. The focus is on the approach adopted by the CSO in recording the receipts and expenditure of the entity located in Ireland where the goods and services supplied need not be *produced* by the Irish entity but are delivered to a foreign third party customer by non-resident affiliates[i] of the Irish operation. There is a need to stress that the particular type of trading practice outlined is simply one of a number of scenarios that are encountered. MNC group structures facilitate the types of arrangements encountered but membership of a group structure is not a strict requirement for their existence.

The CSO approach is fundamentally based on the recommendations of the BPM5 but certain modifications are made where thought necessary in the interest of the clarity and understandability of the results.

Consider the following situations (which are simplified versions of more complicated activities and practices). A direct investment enterprise located in Ireland (B) and owned by (say) a Dutch investor (A), records in its accounts all payments and receipts arising in respect of the supply, installation, maintenance, etc. of equipment to an unrelated Luxembourg company (C). The goods and services supplied are sourced from and delivered by an affiliate[i] (D) of the Irish entity located in France. B records in its accounts €2 billion receipts from C and €1.8 billion payments to D for supplying the equipment, installing it and providing operation training and maintenance services etc. to C on behalf of B.

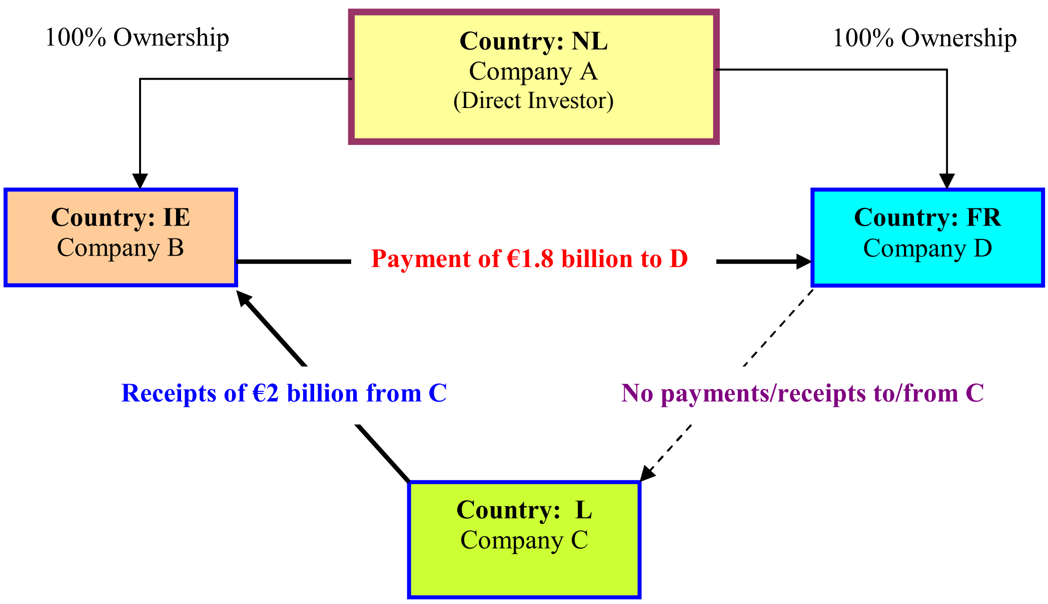


***Figure 5***

As both the goods and services obtained by the Luxembourg company (C) have been sourced from and delivered by a non-resident (French) foreign affiliate[i] (D) of the Irish entity (B), the CSO treats the transactions described above on a <u>net</u> basis (i.e. €0.2 billion credit) under the *merchanting* heading in the 'Services' part of the BOP Current Account. This is an important extension by the CSO of the BPM5 definition of *merchanting* (as it applies to goods supplied which do not enter or leave the compiling economy) to include services sourced and delivered abroad by a non-resident entity. The main reason for adopting this approach is to reduce the potential for statistical distortion arising from these very large transactions in both goods and services sourced abroad.

While a gross treatment may be implicit in BPM5, there appears to be no explicit discussion of such delivery of services in the Manual documentation or any explicit reference as to how the relevant transactions should be treated. The Manual on Statistics of International Trade in Services, however, does refer to the requirement for gross recording of services purchased by the merchant connected to the delivery of the merchanted goods (e.g. transport, insurance, etc.). While this is probably reasonable, it may be difficult on economic statistical grounds to extend the gross treatment to other services such as installation, maintenance, etc. where these are not provided directly by the lead party in the transaction. The CSO position is that gross recording in the type of situation described can lead to very large service credits and debits which can be misinterpreted by users and commentators, particularly when such large aggregate flows in the statistics presented are referenced against employment levels in a particular industry. In saying this, it is acknowledged that net recording by one compiler can lead to distortions or asymmetries where counterpart compilers may have no option but to record the transactions on a gross basis in their BOP statements.

Consequently, the CSO is anxious that this issue be examined further in the context of compiling statistics on inter-affiliate services transactions and on BOP compilation generally. It may also be useful to consider the possibility of supplying gross data for international users and net data for national users although many of the latter also use the statistics published by the international organisations.

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[i] In this paper the terms ‘affiliate’ and ‘affiliated’ are taken to refer to companies or unincorporated entities which are related to one another either through direct or indirect ownership links or through non-ownership linkages. These relationships cover entities related within an ownership chain or across chains within the same company group.