**BOPCOM-05/52**

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

# A Different Way of Presenting FDI Statistics

**Prepared by Eurostat**

**ESCB WORKING GROUP ON EXTERNAL STATISTICS**

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# A DIFFERENT WAY OF PRESENTING FDI STATISTICS

**For consideration by the IMF Balance of Payments Committee and by the OECD Workshop on International Investment Statistics/ Benchmark Advisory Experts Group**

## Background

1. At its meeting on 27 June-1 July, the IMF B.o.p. Committee (BOPCOM) will consider all recommendations of the Direct Investment Technical Experts Group (DITEG). The OECD Workshop on International Investment Statistics (WIIS) already discussed the recommendations of DITEG on 26-28 April and, in particular, item 12 of the DITEG terms of reference, namely *Country identification (Ultimate beneficial owner (UBO)/Ultimate beneficial affiliate (UBA))*.

2. In short, WIIS did not take a firm conclusion on whether further work in this field should solely focus on FDI relationships implying control (more than 50% ownership) as recommended by DITEG. It was considered that the resolution of this and other issues required additional work and, in particular, further input from users. To this end, the WIIS chairman would address a letter to the chairman of the OECD Investment Committee requesting feedback on user requirements in due course.

3. WIIS took note of the thematic meeting of the ECB Working Group on External Statistics (WG-ES), which was to take place on 3-4 May 2005 in Budapest. The agenda of this thematic meeting comprised several FDI aspects related to UBO/UBA issues. WIIS agreed that, should meaningful conclusions be taken by the WG-ES, they would be addressed to the WIIS/Benchmark Advisory Experts Group (BAG), which should come back to WIIS on the issue, as well as to BOPCOM for their subsequent consideration.

4. The next section briefly summarises the outcome of the discussions that took place in the Thematic meeting of the WG-ES, in which the 25 European Union (EU) Member States, the European Commission (Eurostat), Romania, Bulgaria and Switzerland were represented. The

paper presented by Eurostat during the meeting is included as Annex 1. Participants in the meeting also discussed a related DITEG background paper prepared by De Nederlandsche Bank (DNB) and included as Annex 2.

## Outcome of the WG-ES thematic meeting

5. Discussions were based on two papers presented by DNB and Eurostat. The paper of DNB addressed a proposal to redefine the concepts of inward and outward direct investment. *Outward FDI* would be defined as all FDI transactions/positions of resident UBOs, while *inward FDI* would be defined as all FDI transactions/positions ultimately initiated by non-resident UBOs. This would result in a consolidated presentation of FDI, which could be regarded as a form of netting, although both assets and liabilities of inward and outward FDI would still be available (as in the current methodology). Implicitly, this proposal would require maintaining the so-called directional principle in the future standards.[1] The Eurostat paper presented some cases on how data based on UBO/UBA presentations could look like if a symmetric approach were to be followed in both (inward and outward) directions. The examples contained in the paper also considered the result of integrating the DNB's proposals.

6. The WG-ES discussed two issues:

A. is there a need for a supplementary presentation, i.e. for a separate FDI statistic?

B. if so, how should an additional FDI statistic look like?

***A- Is there a need for a supplementary presentation, i.e. for a separate FDI statistic?***

7. In line with the conclusions of WIIS, the WG-ES also considered that prior to any further work, a more precise assessment of users' requirements was absolutely necessary. Tentatively, the WG-ES identified three main types of users to be satisfied, which could have completely different needs:

(i) Broad monetary users, which are mostly interested in the analysis of monetary aggregates, exchange rates and interest rates developments, the monetary presentation of the balance of payments (b.o.p.), etc. These users most likely require for their analysis gross financial flows without exclusions, i.e. the traditional b.o.p. / international investment position (i.i.p.) statistics. While the need for a functional category in the data provided to this kind of users

[1] Concerning this proposal, DITEG did not support its consideration in the core (b.o.p./i.i.p.) accounts. However, the group encouraged further work on some of the ideas contained in the paper in supplementary presentations of FDI statistics. This position was endorsed by WIIS.

may not be self-evident, most WG-ES members were of the view that users - and especially in some countries/areas - will still want to see these breakdowns reflected in b.o.p. and i.i.p. statistics.

(ii) Other users, more interested in measuring the structural changes in the real economy through a number of economic variables such as globalisation, allocation of resources, creation of value, production, economic growth, employment, etc. may be more interested in other (presentation of the) statistics and other variables such as foreign affiliate trade (in services) statistics (FATS), UBO/UBA, etc. For these users, FDI data could be used for different analyses: (i) financing of (productive) activities in the local economy by multinational groups; (ii) "stable" cross-border financing of the local economy; (iii) inter-company financing (the conditions for which may not be fixed only by market prices); (iv) involvement of financial intermediaries (or similar institutions) in these inter-company transactions; (v) how groups organise themselves to e.g. reduce administrative work and taxes, and implications for fiscal policy; etc. Economic users would most likely welcome a distinction between different types of FDI (i.e. greenfield investments versus capital injections and acquisitions, direct versus indirect FDI relationships, etc.).

(iii) International organisations demand statistics with a fair degree of consistency across countries to enable proper interpretation and comparability of worldwide figures. In the case of European countries, the ECB and Eurostat especially require a high level of consistency across Member States for the compilation of meaningful euro area/EU aggregates.

8. While such different users do not necessarily require three different data sets, it was also concluded that all needs could not be served via a single set of data. Furthermore, it was considered that the above scheme on user typologies was still not sufficient to start the work of which statistic / presentation could be most suitable to complement b.o.p. and i.i.p. in meeting additional user demands. Therefore, the group concluded that users' requirements should be looked at more thoroughly. The group proposed, in particular, to study the literature on FDI data and check its definition and the understanding of its content beforehand.

***B- Should the need be eventually confirmed, how should an additional FDI statistic look like?***

9. The WG-ES reckoned that UBO/UBA principles constitute a key user requirement. Some members even pointed out that a supplementary breakdown by economic activity could also be worth exploring. The group considered that such supplementary FDI (stock) statistics can only be provided on an annual basis. Any supplementary data should ensure a sufficient degree of comparability with the i.i.p. While some members of the WG-ES were of the view that both sets

of statistics (i.e. the i.i.p. and the FDI supplementary statistics) would not necessarily require the same totals, other members considered that consistency (identity) of the total FDI-stocks should be deemed of paramount importance.

10. The WG-ES was of the view that a sufficient degree of comparability also needs to be ensured across countries. In particular, proper aggregation of the data should also be a key element (of paramount importance at the euro area/EU level, but also at a worldwide level so as to feed international organisations). It was noted that there would still be a need to educate users about the kind of data they will be invited to analyse.

11. The WG-ES noted a direct link between the UBO/UBA approach and the Coordinated Direct Investment Survey (CDIS), since the latter follows a request by the IMF Board which seems more aligned with a structural-type analysis. Therefore, this issue should most likely be considered at the time of further developing methodology for the CDIS.

**The main conclusions of the discussion can be summarised as follows:**

A. Is there a need for a supplementary presentation, i.e. for a separate FDI statistic?

- The need for a supplementary statistic has to be assessed on the basis of the existing literature beforehand.
- Users' needs should definitely be further explored prior to any additional work.
- Some WG-ES members noted the risk that early changes in the BPM, even with respect to the core accounts, could run the risk of eventually not suiting the needs of (at least some) users. Given that the process of revision is already far underway and the proposals for revision seem not to have been worked out far enough, the WG-ES is of the view that, for the time being, any additional information to be provided to specific users should focus on supplementary FDI statistics rather than on the core accounts. The breakdown by functional categories in the b.o.p. and in the i.i.p. should not be at stake.

B. Once the need is broadly assessed, how should this statistic look like?

- The WG-ES considered that the answer to this question cannot be provided at this stage, but further work should still be devoted to this subject. Nevertheless, the group considered that the paper prepared by Eurostat – in combination with that of DNB – constituted a very promising starting point, though a number of issues still need to be discussed[2].

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2 Whether full symmetry between inward and outward / UBOs – UBAs is absolutely necessary, whether to follow a control approach or whether "influence" should also be pursued, how to compile currency union aggregates, etc.

- In any case, any supplementary data should ensure a sufficient degree of comparability with b.o.p. and i.i.p. statistics.
- Such supplementary FDI statistics can only be provided on an annual basis.
- A sufficient degree of comparability needs to be ensured across countries and possibly with other statistics like FATS.
- The possible link between UBO/UBA principles and the CDIS should also be further studied bearing in mind the eventual participation of EU countries in the CDIS.

## Questions to the IMF BOPCOM and to the OECD BAG/WIIS

*(i) Do members agree that the need for supplementary FDI data should be further investigated? And if so, do they agree that users' needs should be assessed beforehand? Do members have any proposal as to how this user consultation could be undertaken?*

*(ii) If in agreement with the above points, do members agree that, in anticipation of the results of the investigation, further work on the issue should be carried out along the lines drawn out in the paper included in Annex 1?*

*(iii) If the answer to the previous question is "yes", do members agree that further work should be undertaken? Do they consider that such work may also need to be considered in the framework of the CDIS, given that the latter, amongst other things, is aimed at collecting data on structural FDI relationships?*

## Annex 1

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

**BENCHMARK ADVISORY GROUP (BAG)**

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**DRAFT ISSUES PAPER (DITEG/ BAG) # 12 / 3**

# UBO / UBA ASSIGNMENT IN MAJORITY OWNERSHIP CHAINS; BASIC CASES

***PREPARED FOR THE ECB'S THEMATIC MEETING 2005***

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**April 2005**

**BENCHMARK ADVISORY GROUP**

**DRAFT ISSUES PAPER (DITEG/ BAG) #12 / 2**

# UBO / UBA ASSIGNMENT IN MAJORITY OWNERSHIP CHAINS

# BASIC CASES

## I. Introduction: objectives, starting points and concepts of the present paper

1. International standards for economic accounts require FDI statistics to be allocated geographically to the immediate host country/immediate investing country. There is, however, also significant interest among users in having a view of the relationship beyond the immediate host/investing country through to an ultimate owner or beneficiary affiliate in the ownership chain. This could in particular also be of analytical value because it enables 'looking through' the growing FDI funds channeled through e.g. SPEs. The *OECD Benchmark Definition of Foreign Direct Investment* (BMD) provides scope for compiling FDI statistics by 'ultimate host country/ultimate investing country'. However, the BMD does not define these terms; neither does it provide clear guidance on how to apply them.

2. In its December 2004 meeting, DITEG agreed that the geographic allocation on the basis of the Ultimate Beneficiary Owner (UBO) for inward FDI will provide useful supplementary information, especially for FDI stocks and income and for FATS. A follow-up paper was requested to compare possible methods of identifying UBOs based on different ownership relationships. It was also agreed that more work should be done for allocating outward FDI on the basis of the Ultimate Beneficiary Affiliate (UBA). In its meeting of March 2005, DITEG readdressed the issue, especially also discussing the identification of UBAs[3]. The meeting recognised that sets of (often complex) rules could be devised to reflect chains of ownership or significant influence or control.

3. In the March meeting, DITEG came to the following recommendations and conclusions.

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[3] The discussion was largely based on two Issue papers prepared by the Australian Bureau of Statistics and Eurostat (ABS, 2005; Eurostat, 2005). These documents and all other relevant documentation on the current revision of BPM5 can be found on the designated websites of the IMF and Eurostat (http://www.imf.org/external/np/sta/bop/iss.htm; http://forum.europa.eu.int/Members/irc/dsis/bop/library).

- o There was a preference to determine the UBO/UBA chain of enterprises in an FDI group on control (more than 50% ownership)[4]. It was felt that this ensures relative simplicity and it enables the relevant FDI chain to be in principle symmetrical in both directions, i.e. from UBO to UBA and vice versa, as only one path is possible[5]. It will, moreover, result in consistency with FATS data.
- o There was support for the UBO allocation to align with FDI data in that sense that it should reflect the actual amount of equity owned (rather than simply allocating 100% of the equity to the controlling entity as is the case in FATS). This is another prerequisite for the data in the chain to be symmetrical.
- o DITEG recommended considering if the Dutch proposal to net out FDI transactions of especially SPEs (DNB e.a, 2005), could more in general be useful in the framework of UBO/UBA statistics, especially for enterprises in the middle of the chain where FDI capital passes in transit.

4. DITEG felt the need for an additional Issue paper that would take into account the above recommendations and conclusions of the March meeting. It should aim at finding a consistent methodology as regards where and to what extent FDI capital should be assigned up and down an ownership chain. The present paper is the draft version of the requested follow-up paper and is aimed at providing the Participants of the ECB's Thematic Meeting (TM) 2005 the opportunity to give their comments and opinion. The final version of this paper will be addressed to the Benchmark Advisory Group (BAG), who will assist the OECD in drafting the new BMD.

5. The present paper uses the terms UBO and UBA for the enterprises at the extremes of a chain of majority owned enterprises[6]. Enterprises in the middle of the chain are referred to as intermediary affiliates (IMA). Given the starting points discussed above, the paper shows a number of basic FDI chains and the methodological options for presenting them in UBO/UBA statistics. For each example, the paper shows how symmetry between the extremes of the chain can be achieved. Complete symmetry does improve the analytical value of UBO/UBA statistics,

[4] It was recognized that some countries limit foreign equity ownership to, for instance, 49%, so as not to allow inward FDI to result in control. Two views were represented at the meeting: (a) as the restrictions do not allow control, a UBO system based on control should not include these positions; (b) as the restrictions artificially prevent control, a 49% holding can be deemed to represent an interest which can be considered equivalent to control, and such positions should be included. On balance, the meeting supported (b).

[5] From an earlier paper it can be concluded that symmetry cannot be achieved if the FDI chain for UBO/UBA statistics is based on one of the three consolidation methods considered acceptable for FDI statistics in the new Manuals, especially the FCS, the US- and the EU-methods (Eurostat, 2005).

[6] As regards the concepts of UBO and UBA, the terms ultimate investing, ultimate controlling country and ultimate host , ultimate destination country are, respectively, also being used. Given the fact that this paper only discusses majority chains, the UBO is per definition resident of the ultimate investing / controlling country and the UBA of the ultimate host / destination country. In this situation the different terms unambiguously lead to the same result. The 'B' in UBO is sometimes referred to as meaning 'beneficial'; 'beneficiary', in its meaning of 'who reaps the benefits', would seem to have the preference.

but it comes at a cost as regards the collection system. The opinion of the TM 2005 is sought as to the preferred methodology[7].

## II. Simple FDI chain and Dutch netting proposal

6. The left hand side of Scheme 1 shows a simple ownership chain, in which UBO A is the ultimate full owner of UBA C, because A is 100% owner of IMA B who in its turn is full owner of C. The Tables for country A, B and C in Scheme 1 show how these relationships may be presented in the UBO/UBA data of the respective countries. The positions of UBA C (liabilities of 150 vis-à-vis A) are fully 'mirrored' in the assets of A towards C. IMA B's data show that its equity liabilities vis-à-vis A, are fully offset by its holdings of equity assets of C. There is, in other words, no net direct investment in B.

7. The FDI assets and liabilities shown in B's UBO/UBA 'balance sheet' in Scheme 1 can be considered as inflated because on balance there is no direct investment in B. This situation often occurs in countries with large SPE populations, which may hamper the analytical value of the data for the users.

**Scheme 1 UBO/UBA assignment of FDI equity capital in a simple chain (100% ownership)**

**Enterprise relationships**

A = UBO
100% / 150
B = IMA
MV = 150
100% / 150
C = UBA
MV = 150

**UBA/UBO relationships for the respective countries**

**Country A**

| Category | Geogr. alloc. | Val |
|---|---|---|
| FDI assets | UBA C | 150 |

**Country B**

| Category | Geogr. alloc. | Val | Category | Geogr. alloc. | Val |
|---|---|---|---|---|---|
| FDI assets | UBA C | 150 | FDI liabilities | UBO A | 150 |

***Country B: proposal NL***

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| FDI assets | UBA C | -150 |
| FDI liabilities | UBO A | 150 |
| Net inward | | 0 |

**Country C**

| Category | Geogr. alloc. | Val |
|---|---|---|
| FDI liabilities | UBO A | 150 |

**Explanation:**
100% / 150 **shows percentage / market value of equity ownership.**
→ **shows lines of ownership.**
**MV market value of the enterprise.**

[7] The paper deals with stocks of equity and, in one example, other capital. Income is not included. Inclusion would not only complicate the exercise, but might also lead to new issues not addressed in this paper.

**Dutch proposal**

8. DITEG recommended considering whether a Dutch proposal to net SPE data could be applied in the context of UBO/UBA data. The Dutch proposal implies that all FDI positions of SPEs (IMAs in the terminology of this paper) are presented as 'Inward FDI'. The method, which can be seen as a special case of the directional principle, is applied in Scheme 1 under the heading *Country B: Proposal NL*. It results in both FDI assets and liabilities of B being presented on the liability side of its UBO/UBA 'balance sheet', assets with a negative sign. The total net Inward FDI in B adds up to zero, so that the inflation of the data is now prevented. Since the FDI positions of UBAs are –per definition- also recorded as Inward FDI, the proposal implies that Outward FDI can only appear in the data of UBOs.

*Question 1. Do the Participants of the TM 2005 agree that the Dutch proposal to show all FDI positions of Intermediary affiliates (IMAs) as Inward FDI on the liability side of their UBO/UBA 'balance sheet' is a good means to avoid inflated FDI positions in countries with large 'transit' positions of SPEs?*

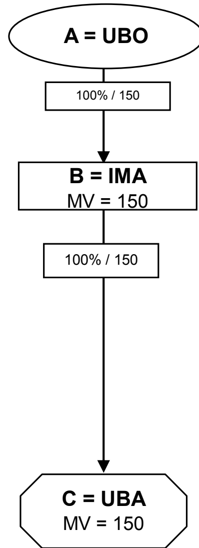
**Dutch proposal with the IMA (SPE/OFI) providing loans on its own account**

9. Scheme 2 basically shows the same positions as the first scheme. Additionally, in this example IMA B, which could be considered an SPE/OFI, has provided a loan to C. The loan, which is of course other capital, is shown as '*Own' assets: loan* on in Scheme 2. The Dutch proposal seems to prescribe that B records this loan as negative inward investment (as shown in Scheme 2, under *Country B*). The reason therefore seems to be that B is not a UBO and can therefore not record Outward FDI on its own 'balance sheet'. This approach has some consequences that should be taken into consideration.

- Country B has an overall negative Inward FDI position (-50). This may be difficult to explain to users.
- It is not immediately clear to which country C should geographically allocate the loan. It would of course be most sensible to allocate it to B. On the other hand, it could be said that the loan should be allocated to a UBO. But in the Dutch proposal (as shown in Scheme 2 under the heading *Country B*) B is not a UBO and does not record any Outward FDI.
- As a consequence, it could be felt that this way of recording results in a lack of symmetry because the Inward FDI loan of C is not mirrored in any Outward FDI.

**Scheme 2 Assignment of Other capital provided by an OFI in the middle of a chain (100% ownership)**

**Enterprise relationships**




**FDI stocks allocated to UBA/UBO**

**Country A**

| Outward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets: equity | UBA C | 150 |

**Country B**

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets: equity | UBA C | -150 |
| 'Own' assets: loan | UBA C | -50 |
| Liabilities: equity | UBO A | 150 |
| Net Assets | ? | -50 |

***Alternative Country B***

| Outward FDI | Geogr. alloc. | Val | Inward FDI | Geogr. alloc. | Val |
|---|---|---|---|---|---|
| 'Own' assets: loan | UBA C | 50 | Assets: equity | UBA C | -150 |
| | | | Liabilities: equity | UBO A | 150 |

**Country C**

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Liabilities: equity | UBO A | 150 |
| Liabilities: loan | ? (UBO B) | 50 |

10. To avoid these consequences, it could alternatively be considered to record the loan of B as Outward FDI, as is shown in Scheme 2 under '*Alternative Country B*'. In this case B would be considered as the UBO for the loan (which appears to be in line with the fact that B would, normally speaking, receive interest over the loan).

*Question 2. Do the Participants of the TM 2005 find that the overall Inward investment of an IMA can be negative because an IMA (SPE/OFI) cannot be considered as a UBO for its FDI funding on its own account?*

*Question 3. If the answer to the previous question is 'no', do the Participants agree that FDI funds provided on its own account by an IMA (SPE/OFI) should be considered as Outward FDI of that IMA (so that negative Inward investment can be avoided)?*

**Note**

For simplicity, the Dutch proposal (to net FDI positions of IMAs in Inward FDI) has been applied in the remaining examples of this paper; the special situation in which negative net Inward positions occur (because IMAs provide FDI capital on their own account), has been avoided.

## III. UBO/UBA assignment in a chain with more than one UBA[8]

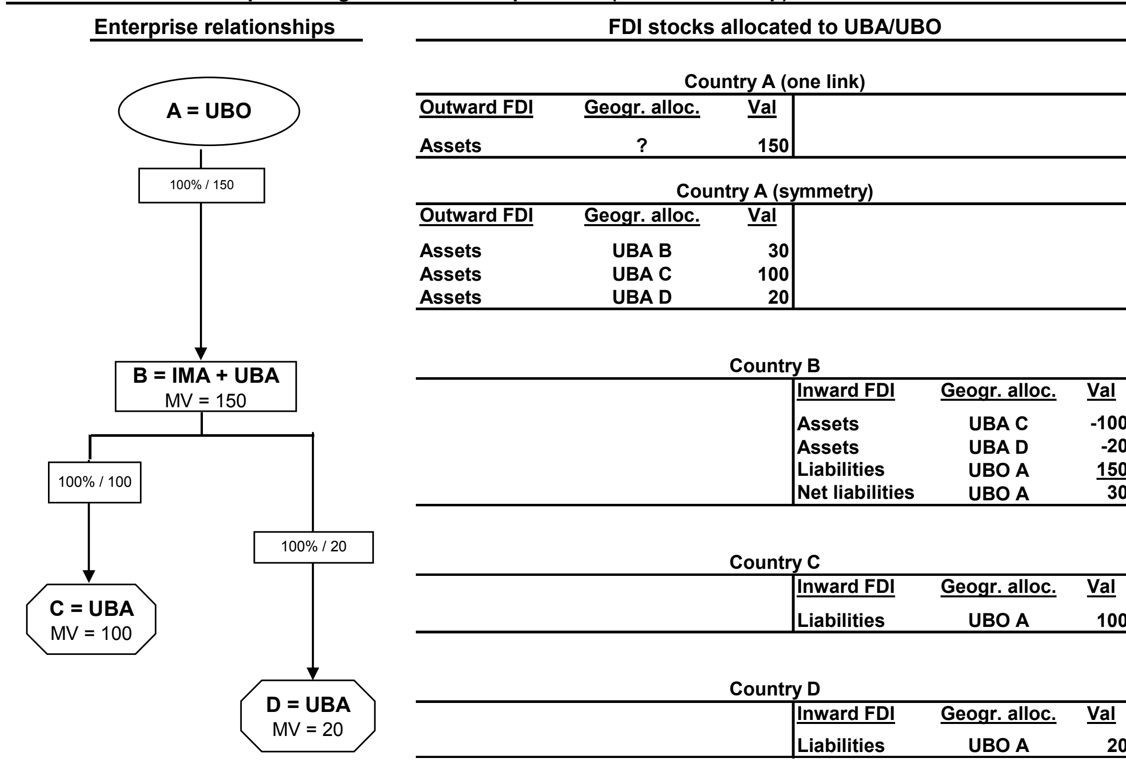
11. Scheme 3 shows a group structure of four enterprises with ownership relationships of 100% and with two UBAs at the bottom of the chain. IMA B in the middle of the chain owns C and D, whose respective market values are 100 and 20. B itself has a market value of 150 and is fully owned by UBO A. Applying the Dutch netting proposal results in this case in a net Inward position of B of 30 (liabilities A of 150, and assets vis-à-vis C and D of -20 and -100). This net Inward position of B (30) is of course identical to its net funding by A. This implies that for that amount B can be considered as a UBA of A.

12. For the FDI Inward positions of B, C and D to be reflected symmetrically in the UBO/UBA 'balance sheet' of A, the latter should break its own Outward position down to show its actual position in each UBA separately. This is shown in Scheme 3 under *Country A: Symmetry*).

*Question 4. Do the Participants of the TM 2005 feel that UBO A should break its Outward FDI position down to reflect the actual positions held vis-à-vis each UBA separately.*

*Question 5. If the answer to the previous question is 'no', can the Participants specify to whom A should assign its Outward position?*

**Scheme 3 UBA/UBO capital assignment in a multiple chain (100% ownership)**




Country A (one link)

| Outward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | ? | 150 |

Country A (symmetry)

| Outward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | UBA B | 30 |
| Assets | UBA C | 100 |
| Assets | UBA D | 20 |

Country B

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | UBA C | -100 |
| Assets | UBA D | -20 |
| Liabilities | UBO A | 150 |
| Net liabilities | UBO A | 30 |

Country C

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Liabilities | UBO A | 100 |

Country D

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Liabilities | UBO A | 20 |

[8] This paper does not include specific examples of affiliates owned by a percentage between 50% and 100%. It can, however, be shown that in order to achieve symmetry the recording in the chain would have to be similar to the example presented in this Section.

## IV. UBO/UBA assignment in chains with non-controlled affiliates

13. As was mentioned in Section I, DITEG has recommended confining the UBO/UBA statistics to relationships of control. Nevertheless, specific guidance may be needed in case a (large) non-controlled affiliate is included in a chain. This is the case in Scheme 4, where B (with market valuation of 150) is 100% owned by A. A small part of B's equity capital (20) is invested in D which is 100% owned by B. The recording regarding D is straightforward. D assigns its Inward FDI capital (20) to UBO A. At the same time, B has a net Inward FDI position vis-à-vis D of -20.

14. Most of B's equity capital is invested in C (130). However, C is not a UBA because B only owns 40% of its equity capital. B therefore cannot assign any Inward FDI to C. Consequently, B has a net Inward FDI position of 130 vis-à-vis A (150 – 20). To achieve symmetry in this case, IMA B should be considered as the ultimate beneficiary affiliate of the funds provided to C. In Scheme 4 this is shown under the heading *Country A: Symmetry*.

**Scheme 4 UBA/UBO assignment in a multiple chain with a non-controlled affiliate**

**Enterprise relationships**

A = UBO
100% / 150
B = IMA
MV = 150
40% / 130
100% / 20
C ≠ UBA
MV = 325
D = UBA
MV = 20

**FDI stocks allocated to UBA/UBO**

**Country A (one link)**

| Outward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | ? | 150 |

**Country A (symmetry)**

| Outward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | UBA B | 130 |
| Assets | UBA D | 20 |

**Country B NET**

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Assets | UBA D | -20 |
| Liabilities | UBO A | 150 |
| Net liabilities | UBO A | 130 |

**Country D**

| Inward FDI | Geogr. alloc. | Val |
|---|---|---|
| Liabilities | UBO A | 20 |

*Question 6. Do the Participants of the TM 2005 find that in a UBO/UBA chain the FDI capital provided to a non-controlled affiliate (as in Scheme 4) should be assigned to the first parent up the chain that can be considered a UBA because it is fully controlled (i.e. B in Scheme 4)?*

*Question 7. If the answer to the previous question is 'no' to whom should the FDI assets provided to a non-controlled affiliate then be assigned on the 'balance sheets' of the direct and indirect parents in the chain (A and B in Scheme 4)?*

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## Annex 2

**DE NEDERLANSCHE BANK**
**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**

# Special Purpose Entities and the measurement of Foreign Direct Investment

**(Some further considerations)**

**Prepared by Frank E.M. Ouddeken**

**Balance of Payments and Financial Accounts Department**

**De Nederlandsche Bank**

**March 2005**

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

**DISCUSSION PAPER: SPEs AND FDI – SOME FURTHER CONSIDERATIONS**

## 1. Introduction

In January 2005 the ECB organised an ad-hoc workshop on SPEs in relation to FDI statistics. The workshop identified the following three different types of SPE-related problems[9]:

1. FDI data of countries that host SPEs are substantially increased on both the inward and the outward investment side due to holding and financing operations of these SPEs;
2. Sight on the final destination and the ultimate origin of direct investment is lost due to ownership chains that cross a number of countries;
3. Some data in Other FDI capital are 'distorted' due to the funding activities of various kinds of specialized entities in the form of reversal loans to the parent company.

It was concluded that for each of these problems different solutions would be necessary and a number of appealing recommendations was arrived at to solve them. These solutions consist of:

- separate identification of the transactions of SPEs and/or separation of SPEs as a sub-sector;
- supplementary (geographical) presentations based on UBO/UHC breakdown;
- exclusion from FDI of reverse investments made by a financial affiliate to the parent.

All these recommendations look very promising and provide to some extent solutions to current problems. Nevertheless, they also raise some questions with regard to the interrelatedness of the various proposals. Do these recommendations sufficiently solve the current problems of the users of FDI statistics? How does a UBO/UHC[10] geographical breakdown of FDI data relate to the standard presentation of FDI? Is there a fundamental difference between transactions of SPEs and "regular" FDI? Is the concept of FDI still defined clear enough after the exclusion of certain types of investment from FDI?

This background paper aims at providing some further considerations on these very complex issues. It should be regarded as a contribution to the discussions. A proposal will be made for an adjustment in the way FDI is currently presented in the statistics, without a need for changing the basic concept of FDI. Starting point will be the questions: "What would users want to be measured as direct investment?" and "How could this be accomplished in practice?"

## 2. Current treatment – from a historical birds-eye view

In the early years of BOP compilation (1950s and 1960s), certain financial transactions took place directly between a resident enterprise and a related non-resident enterprise, its affiliate. Or better: between, what one started to call, a direct investor in one country and a direct investment enterprise in a second country. The concept of Foreign Direct Investment was born. In those days FDI was mainly related to "one-to-one investments", which meant that by the investment a direct relation was established between (only) two economies. Initially, these transactions were mainly restricted to equity investment.

[9] Reference is made to Issue Paper 9_11, prepared by Carlos Sánchez Munoz of the ECB (Feb 2005) for an excellent and more detailed summary of the discussions.
[10] UBO stands for Ultimate Beneficial Owner and UHC stands for Ultimate Host Country.

But after the gradual relieve of capital restrictions these types of operations were steadily broadened to include the direct provision of various kinds of intercompany loans also. From a conceptual point of view, at that time, there was no sound argument for limiting these non-equity transactions to certain types of loans only. Therefore, the concept of FDI came to encompass all types of intercompany equity and credit operations. However, in the perception of many users (and also compilers) FDI statistics were still based on a single one-to-one relationship, which was not so wide of the mark.

During the 1970s and 1980s multinational enterprises became a real widespread and global phenomenon. Many multinational enterprises set up regional headquarters in the form of *sub-holding companies* in the process of structuring their growing global networks. Sometimes this was done in the form of the establishment of Special Purpose Entities with hardly any real presence in the host economy. But this was far from being the rule. Many regular sub-holdings, having real presence in the host economy also, were established as well; for exactly the same purposes and performing exactly the same operations as SPEs. Tax-treaty shopping found its start in those days in order to optimize tax liabilities of the entire group. The further removal of restrictions on cross border financial transactions allowed the free flow of intra-group credit on a worldwide scale. It induced the establishment of *financing companies* in other countries than the head-office, because of comparative advantages of access to capital markets and in order to exploit regulatory differences between countries to the benefit of the entire group. During these decades the nature of FDI progressively changed from "one-to-one investments" to "chain investments", with many indirect links between related enterprises. This was equally true for equity and debt operations.

In the 1990s capital market liberalisation and the abolition of cross border capital restrictions was almost completed. To optimize their financial performance further many multinational enterprises established treasuries for their worldwide group. Deregulation stimulated the development of many specific banking products like "netting", "pooling" and "zero-balancing", further boosting (even on a daily basis) the gross flows between related enterprises. At the end of the decade this resulted in the development of so-called "in-house banks" and "payment factories" responsible for the entire financing and settlement of all payments of the entire group. Also tax-treaty shopping reached ever higher levels of sophistication in the form of "round-tripping". FDI was now circling around across a number of countries.

## 3. Concerns/shortcomings of the current treatment

This evolution of investment and financing behaviour of multinational enterprises has fundamentally changed the character of the financial flows between related enterprises. However, the measurement of FDI has not really been adjusted to reflect this change[11]. The single "one-to-one" relation between the direct investor and the direct investment enterprise seems to have become an exception in FDI operations nowadays. Most transactions, in both equity and debt, are currently undertaken on a "hop, step and jump" basis through a chain of investments passing through many entities located in various countries, which are used as stepping stones. Funding operations are preferably organised from foreign affiliates that are located in the most profitable markets, and the collected funds are passed through the whole global network of the related entities. As a result, *indirect* investment seems to dominate FDI statistics nowadays of many countries. What statisticians currently measure as Foreign Direct Investment has to a large extent become Foreign **In**direct Investment. With it, even the character of these FDI operations has

fundamentally changed. The “investment” character of FDI (in its meaning of being an active ‘stakeholder’ of another country) has eroded and is to a large extent exchanged for a “financing” character (in the meaning of passively holding assets and liabilities). So, FDI statistics can ever more be regarded as statistics on **“Foreign Indirect Financing”** (joke!?). As a result, current data on direct investment hardly provide the users with sensible results; the data no longer have resemblance with the mere intuition of the users. The data are, therefore, hardly applicable to sound economic analyses. All in all, the “raison d’être” of the whole concept of FDI is at stake. The current revision of the statistical manuals simply cannot neglect this phenomenon. Alternative treatments should be given serious consideration in an attempt to make a substantial improvement to the usefulness of FDI statistics.

## 4. Possible alternative treatments

During the previous meetings of DITEG and the ECB Working Groups (WG BOP&ER and WG-ES respectively), its related Task Force (TF-FDI) and during the January 2005 Workshop a lot of proposals have been made by many participants in trying to solve the problems in FDI statistics and especially those related to SPEs. The debate has been lively and fruitful. Nevertheless, the results obtained so far do not seem to create a general feeling by the participants that the real problems in FDI statistics will really be solved. To some extent this seems to be caused by the partial character of the approach followed. We may therefore, run the risk of concluding on partial solutions also. This could easily jeopardize the basic concept of FDI, or at least make the concept rather vague, due to the erosion of its intuitive content. This would most certainly be to the detriment of the users (and in the end the compilers also).

Having read the issues papers and background papers of DITEG and overlooking all proposals made so far, one gets the impression that there is a lack of sufficiently clear criteria for distinguishing between what should be separated and/or excluded from “**relevant or regular”** FDI and what should be included. Proposals have been made for the exclusion/separation from FDI of:

- certain types of transactions, like different kinds of short term capital[12];
- transactions routed via Other Financial Intermediaries in general;
- transactions of SPEs in general or certain specific types of SPEs engaged in funding activities.

However, all these proposals seem to lack sufficiently clear criteria for obtaining unequivocal results. From a conceptual point of view it is hard to defend the exclusion of (certain types of) short term capital from FDI. Other Financial Intermediaries and SPEs are hard to define in a way that is consistently and effectively applicable to all compilers. So, isolation of their operations will be difficult in all circumstances. No matter in what way this separation is accomplished, either by separate identification of the transactions of these entities, or by creating a separate sub-sector. In the recommendations of the January 2005 Workshop it is therefore left to the countries that host SPEs to make this separation on their own account. Although this recommendation makes sense, because it does not require a harmonised identification of SPEs, it does not change the FDI data as they currently are! So, leaving the problems of the users of FDI statistics largely unresolved. Even harder will be the identification of *special kinds* of SPEs (like financial affiliates) in a consistent way by all compilers, with the aim to exclude back-loans to

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[11] One exception worth mentioning is the exclusion from FDI of non-equity operations of SPEs with a sole purpose of serving in a financial intermediary capacity (BPM5; §365). As most SPEs serve many purposes at the same time this exclusion hardly solves the problems related to the distortion SPEs in FDI statistics in practice.

[12] Reference is made to DITEG issue paper #22: FDI – Other capital (with focus on short-term) prepared by De Nederlandsche Bank.

their parents. What makes these entities distinct from other affiliates? What should be done with the classification of the back-loans if these financial affiliates expand their activities to non-financial (real production) operations also?

All these considerations and questions regarding SPEs seem to express a common characteristic of the problems that compilers of FDI statistics are currently confronted with. These problems are not at all exclusively related to SPEs only; the problem is much broader! Regular (i.e. non-SPE) entities generally show the same behaviour as SPEs. Therefore, they "distort" the statistics in exactly the same way as SPEs do. Non-SPEs show the same behaviour, but only to a lesser extent[13]. Non-SPEs also engage in funding operations by using both domestic and foreign affiliates, held either directly or indirectly. Non-SPEs normally engage in a large volume of passing through operations (in the form of both sub-holding and on-lending activities) to the benefit of the entire group. Therefore, it seems necessary to search for more general solutions to the current problems of FDI statistics.

Starting point for considering any alternative treatment should be the answer to the question: "What would the users want to be measured as FDI?" For **outward** direct investment the user's (intuitive) perception of direct investment can be expressed as follows: The effective (net) interest of resident suppliers of capital in another country's *domestic* production capacity. Likewise, **inward** direct investment could be described as: the effective (net) interest of non-resident suppliers of capital in the *domestic* production capacity of the compiler's country. This perception of direct investment, with a clear connotation of being directed to either the domestic or foreign economies, reveals a need to strengthen the ***direct*** character of the concept of FDI; there is a need to strengthen the "one-to-one relationship", to which the concept of FDI originally refers.

Two options can be considered:

A. "Looking through" intermediate entities;
B. Changing the definition of inward and outward FDI.

*A. Looking through*

"Looking through" would imply the treatment of specific entities (call them SPEs) as an extension of the Ultimate Beneficial Owner, or as an extension of the Ultimate Host Country. So far, hardly any participant of the discussion has considered this approach as an acceptable solution. It would be a violation of the basic concept of BOP methodology, which requires the recording of transactions between all residents and non-residents. Moreover, it would make bilateral comparisons of FDI data and the compilation of the euro area BOP impossible. Therefore, UBO/UHC data is considered very valuable by all participants of the debate, but only as supplementary information.

*B. Changing the definition of inward and outward FDI.*

According to the current BOP methodology the distinction between inward and outward direct investment is primarily based on the *residency of the direct investor*[14]. For limiting the impact of indirect investment on FDI it could be considered to base the distinction between inward and outward investment on the

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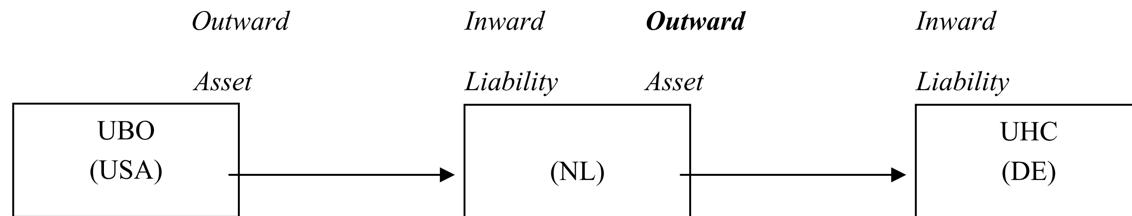
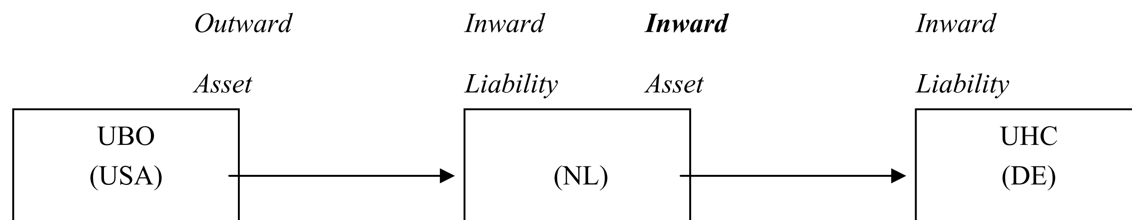
[13] This is not at all true for all non-SPE entities. Some large Dutch multinationals distinguish themselves from SPEs in their debt operations **only** by the fact that they are Dutch based!
[14] The directional principle can be regarded as an exception to this general rule.

*residency of the ultimate initiator* (attention: only the split between inward and outward, not the geographical allocation of inward and outward investment!). In that case outward investment would be defined as all FDI operations of resident UBOs only (no matter how long the round-trip). All FDI operations ultimately initiated by non-resident UBOs (no matter how long the chain of ownership) would be defined as inward FDI. To put it differently: outward direct investment would no longer include cross border investment of resident affiliates of foreign direct investors, but would be recorded as inward investment.

**Current practice:**




**Proposed practice:**




This treatment of FDI transactions is fully consistent with the overall BOP methodology. All assets and liabilities between residents and non-residents would still be recorded in the BOP/IIP. Full knowledge of the residency of the UBO is not required per se; it suffices to know whether the UBO of a specific entity engaged in direct investment operations is a resident of the compiling economy or not[15]. In most cases this information can easily be obtained. Even the geographical allocation of the transactions and positions need not be changed; preferably it should still be based on the first known counterpart, as to allow for the compilation of regional BOP statements, like that of the euro area. Subordinate to the geographical breakdown based on first known counterpart a secondary breakdown by the UBO/UHC would provide in-depth information on each country's FDI structures.

The result of redefining the inward/outward split of FDI in the way proposed, would be a transfer of a part of outward investment to the inward investment side (see figure above); it is that part of outward FDI assets that is ultimately being 'managed' by non-resident majority ownership stakeholders. By doing so, these assets would compensate for the liabilities that these non-resident UBOs have created as inward investment. This would effectively neutralize passing through operations of **both SPEs and non-SPE entities** at the level of the **net** outcome of inward investment (gross assets and liabilities will still be

[15] For the euro area BOP one would have to know whether the UBO is resident of the euro area or not.

available). As a result, the net outcome on inward investment would show the effective interest of non-residents in the domestic economy. With it, also outward investment will be 'cleaned' for the distortion that is created by the passing through investments of entities that are ultimately owned by non-residents.

In an Excel spreadsheet attached to this issue paper an example is worked out showing the consequences of the change in the definition of inward and outward investment. In the example the equity and debt transactions are recorded in four BOP statements for all countries involved in four different investment structures in which the Netherlands is the intermediating country (regular investment; a financing company, pure sub-holding activity and a combined structure). Right next to these four investment structures an analysis is given of the character of the investment flows. Three different types of investment are distinguished:

1. Real direct investment: both equity and debt;
2. Indirect investment: funding activity to the benefit of non-resident UBOs;
3. Indirect investment: passing through operations: sub-holding and on-lending activity

Only the BOP of the Netherlands (NL) is affected by the changed definition due to its intermediate function in the FDI flows. According to the current methodology outward and inward investment would record -305 and 270 respectively, with a net outcome of -35. According to the proposed definition of inward and outward investment both numbers would be -10 and -25 respectively, with the same overall net outcome of -35. The asset and liability split of all FDI components now show sensible results; results that can be given an intuitive understanding.

<u>Outward FDI</u>

Equity:

**Assets**: Gross outward investment of the compiling country's UBO residents.

**Liabilities**: Cross participations.

**Net**: Real net equity investment of the compiling country's UBO residents.

Debt:

**Assets**: Gross extension of intercompany credit to **all** directly and indirectly owned foreign affiliates of UBO residents.

**Liabilities**: Gross funding[16] by **all** directly and indirectly owned foreign affiliates to the benefit of UBO residents.

**Net**: Net financing of a country's foreign affiliates owned by domestic UBOs.

<u>Inward FDI</u>

Equity:

**Assets**: Sub-holding activity plus cross participations of non-resident UBOs.

**Liabilities**: Sub-holding activity, plus real equity investment in the compiling country.

**Net**: Net real investment of foreign UBOs in compiling country.

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[16] No distinction is made in the way this funding is organised. It may be accomplished by issuing bonds, taking up bank loans or by the hoarding of profits.

Debt:

**Assets**: Gross funding to the benefit of foreign UBOs plus passing through of intercompany loans

**Liabilities**: Gross receipt of real investment loans for the compiling country plus the passing through of intercompany loans

**Net**: Net loans received from non-resident UBOs.

With this presentation of FDI the volume of passing through investments can easily be determined by subtracting the net outcome from either the asset or the liability side of the respective instrument. Passing through investments no longer have impact on neither net inward nor net outward investment.

## 5. Further considerations – concluding remarks

This paper can not deal with all the consequences and issues related to the proposed change in the definition of inward and outward direct investment. More study is required. However, some further observation can be made:

- By redefining the inward/outward split net inward and net outward FDI data are corrected for the grossing-up due to intermediating function of direct investment entities. This is equally true for SPEs and non-SPEs. Both inward and outward investment will have regained its usefulness for the users.
- There is no need for any separate identification of SPE transactions per se. Nevertheless, a compiler may want to distinguish between various types of entities for analytical purposes. This should not be part of the standard methodology.
- If SPEs would be separated as a sub-group, it may provide additional information about the funding activity that foreign multinational enterprises have arranged in the compilers country.
- No 'solution' is provided for the 'distortion' of FDI data due to financing activities set up by foreign entities. 'Negative' numbers (higher assets than liabilities on the inward side, or higher liabilities than assets on the outward side) should simply be accepted, as they have a very clear economic meaning: it is the net outcome of the financing function of multinational networks. This should be regarded as information very valuable for economic analysis. It is a matter of judgement whether or not one should exclude these funding activities from direct investment. In my view there is no need for it, because it will be very hard to distinguish between the various sources for funding, like on-lending retained profits or issuing bonds. Moreover, financial affiliates often perform many functions within the group at the same time, or their behaviour develops over time. It is hard to define a concept on unstable characteristics. Nevertheless, the proposal for redefining the inward-outward split, fully allows for excluding certain types of specific entities. However, the concept of FDI would become less clear.
- There is no need for excluding certain types of (short-term capital) transactions from FDI, as most of the flows will be neutralised on the level of the net outcome of inward and outward investment. FDI should be defined as all intercompany financial operations to the largest extend possible.
- The standard presentation of FDI in the BOP should not be changed in one in which the asset-liability split precedes the inward-outward breakdown, because the economic interpretation of the concept of FDI, as presented in this paper, would disappear.
- Bilateral comparison of BOP/IIP statements can no longer be undertaken on the inward and outward level, but should be done on the level of the assets and liabilities.

- The recommendation of the January 2005 workshop to provide additional breakdowns by UBO/UHC seems to make less sense if the inward-outward split is not changed in the way proposed in this paper. One may question the value of such a UHC breakdown of outward investment if outward investment itself can still be dominated by non-resident UBOs. In my view analytically meaningful data on a UBO/UHC basis can only be compiled if the inward-outward split is defined in a way that is consistent with that breakdown.
- Finally, the application of the Fully Consolidated System is much more straightforward if inward-outward is based on the UBO principles. The collection of fully consolidated data is almost always a problem for compilers that host sub-holdings because the enterprises do not consolidate (and are not prepared to do so) at the intermediate level of the host country. Therefore, both inward and outward stocks and reinvested earnings are not properly measured (bilateral discrepancies). With the proposed definition of inward and outward investment this problem is ‘neutralised’, as the assets and liabilities are netted on the inward investment side.