

**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)**

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## 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**

|   |  |
|---|--|
| <p><i>I. Direct investment</i></p> <p>1.1 Abroad</p> <p>1.1.1 Equity capital</p> <p>1.1.1.1 Claims on affiliated enterprises</p> <p><b>1.1.1.2 Liabilities to affiliated enterprises</b></p> <p>1.1.3 Other capital</p> <p>1.1.3.1 Claims on affiliated enterprises</p> <p><b>1.1.3.2 Liabilities to affiliated enterprises</b></p> | <p>1.2 In reporting economy</p> <p>1.2.1 Equity capital</p> <p><b>1.2.1.1 Claims on direct investors</b></p> <p>1.2.1.2 Liabilities to direct investors</p> <p>1.2.3 Other capital</p> <p><b>1.2.3.1 Claims on direct investors</b></p> <p>1.2.3.2 Liabilities to direct investors</p> |
|---|--|

**Table 2. International Investment Position**

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

<sup>1</sup> 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 than 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**

| <i>Net changes in assets arising from transactions</i> | <i>Net changes in liabilities arising from transactions</i> |
|--|---|
| <b>Direct investment</b>                               | <b>Direct investment</b>                                    |
| 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**

| <i>Assets</i>  | <i>Liabilities</i>   |
|--|--|
| <p><b>Direct investment</b></p> <p>Abroad</p> <p>Equity finance</p> <p>Debt</p> <p>In reporting economy (claims on direct investors)</p> <p>Equity finance</p> <p>Debt</p> | <p><b>Direct investment</b></p> <p>In reporting economy</p> <p>Equity finance</p> <p>Debt</p> <p>Abroad (liabilities to direct investment enterprises)</p> <p>Equity finance</p> <p>Debt</p> |

- 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)