

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD  
WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS  
DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)**

---

**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 ( $\leq 50\%$ ), 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<sup>th</sup> Edition* (BPM5) and the *OECD's Benchmark Definition on Foreign Direct Investment, 3<sup>rd</sup> 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)

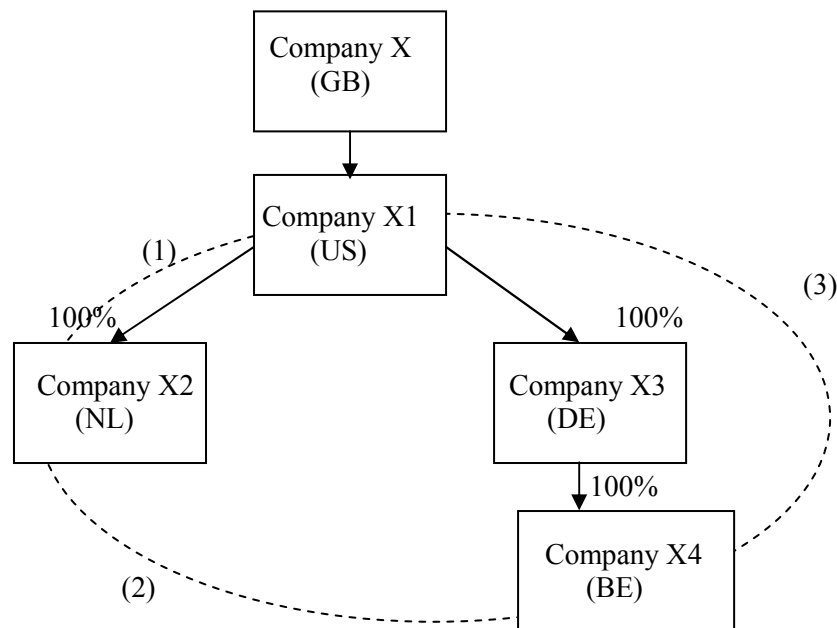
4. the method accepted by the OECD as an alternative to the general recommendation (namely (2) above) (see Annex 4 of the Benchmark)
  - Direct and indirect links, both vertical and horizontal, are subject to the directional principle (similar to the Irish method but all flows are allocated to the mother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



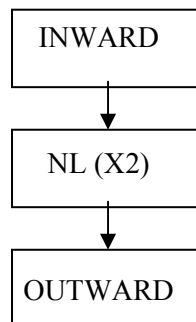
On a country level basis, the gross balances (i.e. inward and outward FDI considered separately) of all 3 countries show a zero balance when methods 3 and 4 are applied. This means that the transaction would not be shown in the BOP of the countries involved. When method 2 is applied, only the balances 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***

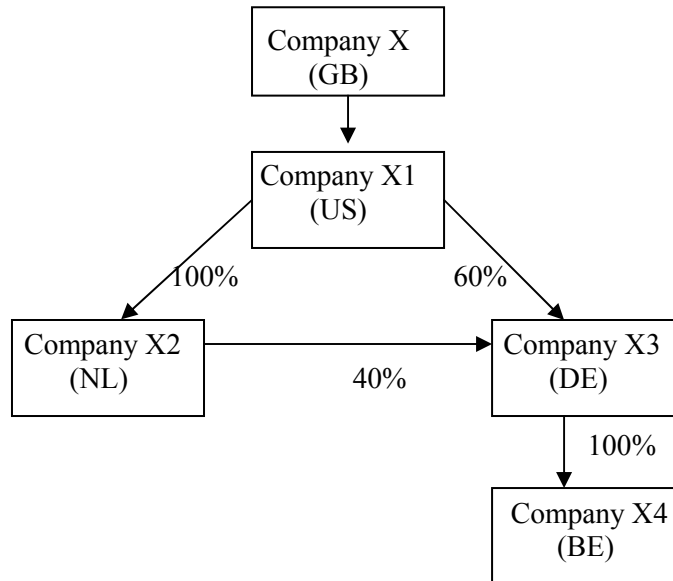
To apply the methods 3 and 4 correctly, two conditions must be fulfilled by the compiler:

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).



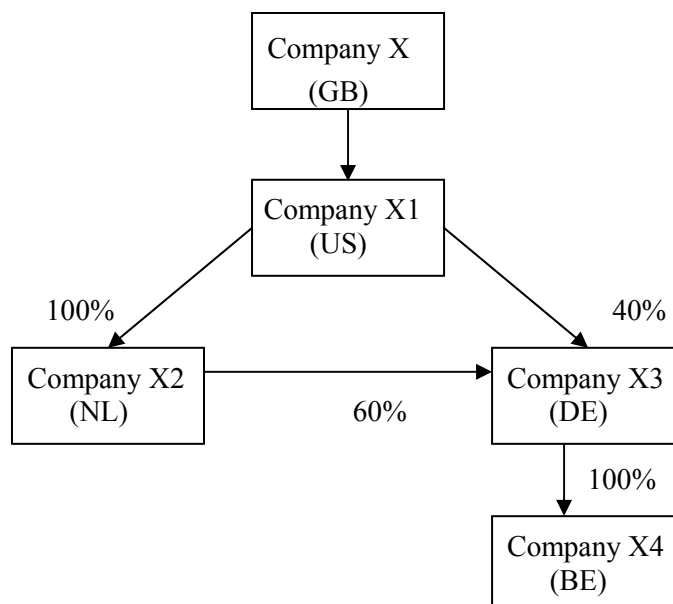
Only if these conditions are fulfilled, both methods 3 and 4 can be applied correctly. However, in many cases it is impossible for the compiler to decide to which part of the group (inward part or outward part) an entity belongs.

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 remaining 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?

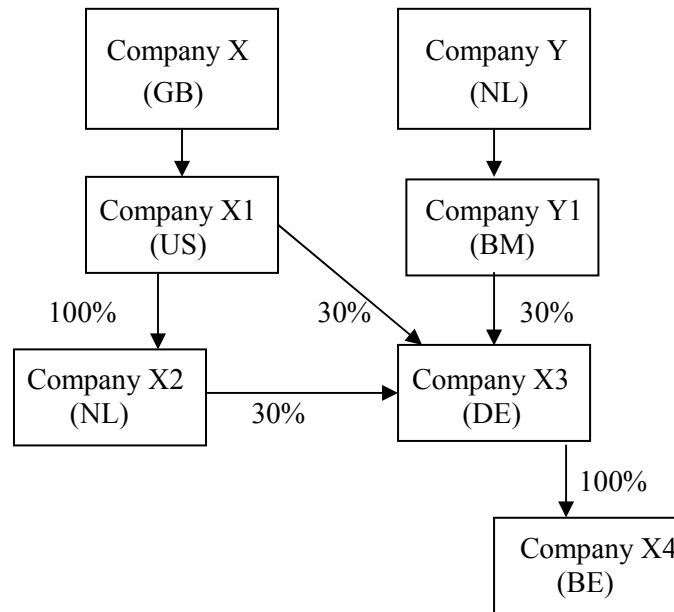
**Group structure B**

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’.

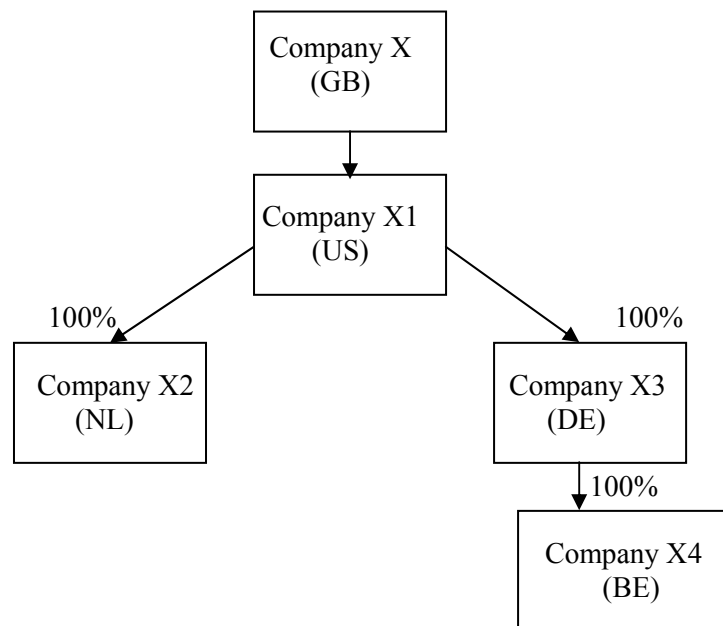
Furthermore, method 4, the alternative method of the OECD Benchmark, is difficult or even impossible to apply on practical grounds (besides the argument of inward/outward). To record all flows involved correctly, company X needs information on the loan from BE to the US (see initial example). The US 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