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

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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:

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 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?”

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1 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.
2 UBO stands for Ultimate Beneficial Owner and UHC stands for Ultimate Host Country.
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. 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. 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 Indirect 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 even 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.

3 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.
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;
• 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 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.

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4 Reference is made to DITEG issue paper #22: FDI – Other capital (with focus on short-term) prepared by De Nederlandsche Bank.
extent. 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. For limiting the impact of indirect investment on FDI it could be considered to base the distinction between inward and outward investment on the 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

5 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!
6 The directional principle can be regarded as an exception to this general rule.
(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:**

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<thead>
<tr>
<th>Outward Asset</th>
<th>Inward Liability</th>
<th>Outward Asset</th>
<th>Inward Liability</th>
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<tr>
<td>UBO (USA)</td>
<td>(NL)</td>
<td>UHC (DE)</td>
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**Proposed practice:**

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<tr>
<th>Outward Asset</th>
<th>Inward Liability</th>
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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\(^7\). 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

\(^7\) For the euro area BOP one would have to know whether the UBO is resident of the euro area or not.
investment (gross assets and liabilities will still be 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.

**Outward FDI**

**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\(^8\) 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.

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\(^8\) 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.
Inward FDI

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.

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 extent 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.