Chapter 5. Classifications:
Financial Instruments, Functional Categories, Maturity, Currency, and Type of Interest Rate

5.1 An introduction to this chapter will note that classifications such as financial instruments, functional categories, maturity, currency, and type of interest rate relate to several different parts of the international accounts. It will also state the objectives of classification, namely to develop aggregates that (i) group similar items, and (ii) separate items with different characteristics and causes.

A. Financial Instruments

1. General issues

5.2 This section will briefly define financial instruments. The relationship between financial assets and other financial instruments will be explained, as per *MFSM* para. 117. Also instruments that are not financial assets will be identified (viz., contingencies, guarantees, nonfinancial contracts). It will be noted that the financial assets classification generally applies to both claims (described as assets) and obligations (described as liabilities). There are exceptions in that monetary gold and SDRs are international financial assets with no counterpart liabilities and that “accounts receivable” is an asset, while “accounts payable” is the corresponding liability.

5.3 The objectives of classification of financial instruments will be spelled out. The potential dimensions by which instruments can be classified are numerous, so the classification involves identifying the most economically crucial features. The implications of a high degree of financial innovation will be discussed—in particular, that the classification will need to define the instruments with reference to the characteristics, not just specific types of instrument, so that it is applicable to new instruments and helps deal with hybrid and other borderline cases. The importance of classification of financial assets for understanding financial markets and for consistency with other datasets, particularly monetary and financial statistics, will be highlighted. In addition, the financial asset classification will be presented as the foundation for the functional category classification, which in some cases takes into account the type of instrument.

2. Overview of classification of financial instruments

5.4 It is proposed to adopt an instrument classification that is based largely on that of the *MSFM* (see Chapter IV) and the *1993 SNA* (see p. 589). Also, see Table 5.1 ahead. The differences are (i) a rearrangement into broad category headings: equity, debt instruments, and other instruments, and (ii) some clarification of terminology. In addition, an explicit concordance is made between the assets and the corresponding income. The underlying components remain identical.

Table 5.1. Proposed Instrument Classification and Terminology for the New Manual

Type of Financial Instrument	Corresponding Type of Income
Equity Finance, covering:	
- equity securities	}dividends,
of which equity in mutual funds	}withdrawals of income from quasi-
of which equity in money market mutual funds	} corporations (distributed branch profits),
-reinvestment of earnings[1]	reinvested earnings,
- other equity (not including net equity in insurance technical reserves and pension funds)	
	other: (securities lending)?
Debt, covering:	
- debt securities	}interest
- long-term	}
- short-term	}
- loans	}
- currency and deposits	}
- accounts receivable/payable	}
- trade credit and advances	}
- other accounts receivable/payable	}
- other debt instruments	}
of which arrears[2]	
	other: (securities lending)?
Other instruments, covering:	
- monetary gold	generally none; gold lending fees
- *financial gold*[3]	*generally none; gold lending fees*
- SDRs	rate of return
- net equity in insurance technical reserves and pension funds	dividends, property income attributed to insurance policy holders
- financial derivatives and employee stock options	none
- financial derivatives	
- forwards	
- options	
- employee stock options	

Possible additional instrument classifications shown in italics.
[1] An imputed instrument for the imputed financial transaction.
[2] Possible sub-item that could be added as a component of any debt instrument on an "as relevant" basis.
[3] If included as an asset, financial gold would appear in international transactions, but not the international investment position, as there is counterpart liability which means that the positions lack an international dimension.

5.5 Definitions of debt and equity will be given, based on definitions in *1993 SNA* para 11.86–87 and the *Debt Guide* para. 2.3. Certain financial assets that have no counterpart liability do not qualify as debt or equity and so have been included under "other." Given that equity in insurance reserves and pension funds has components of both equity and debt, it has been classified to "other" (The *BPM5*, para. 474 and the *Debt Guide* both treat it as "debt," but defined contribution schemes have equity elements.) In addition, financial derivatives do not meet the definitions of debt or equity, so they have been classed as other.

[Question: Is the debt/equity/other split suitable?]

5.6 The *BPM5* instrument classification appears implicitly in conjunction with the functional and institutional sector classifications. It differs in order and in some details from *MFSM/1993 SNA*, as shown in the following table.

Table 5.2. Comparison of *1993 SNA/MFSM* and *BPM5* Instrument Classifications

1993 SNA/MFSM	*BPM5*
Monetary gold and SDRs	Two components are shown separately, not grouped.
Currency and deposits Currency Transferable deposits Other deposits	The total is not split among the three components.
Securities other than shares	Called "debt securities." Split into: Bonds and notes Money market instruments ("Bonds and notes" and "money market instruments" were defined by maturity, rather than their qualities as instruments.)
Loans	Same.
Shares and other equity	Called "equities" or "equity securities." (For direct investment, reinvested earnings is shown separately for transactions only.)
Insurance technical reserves Net equity of households in life insurance reserves Net equity of households in pension funds Prepayment of premiums and reserves against outstanding claims	Included with "other assets." (The three components are not shown separately, but are included as a supplementary item for national accounts purposes.)
Financial derivatives	Same.
Other accounts receivable Trade credit and advances Other	 Called "trade credits." Included with "other assets."

5.7 The following more detailed comments on the proposed instrument classification should be noted:

(a) Monetary gold and SDRs will continue to be shown separately, as in the *BPM5* classification, because of their analytical importance in the international accounts.

(b) “Securities” will be defined.

(c) “Debt securities” is considered to be a clearer term than “securities other than shares,” which is used in the *1993 SNA* and the *MFSM,* so the *BPM5* term will be maintained.

(d) The generic term “equity finance” will be used, as opposed to “shares and other equity,” which is used in the *1993 SNA* and the *MFSM.* “Equity finance” is considered to be a clearer term and it is also shorter. It will be used instead of “equity capital,” to avoid confusion with the term “capital” in the capital account.

(e) “Equity in mutual funds” would be proposed as a supplementary or memorandum item under equity. It would include equity in mutual funds, unit trusts, and other collective investment schemes, other than life insurance and pension funds to be identified separately from “equity finance” in view of their importance. Within such collective investment schemes, there could be separate components for the type of investment, namely (a) money market (see next point); (b) real estate; (c) stocks; and (d) mixed, as supplementary information, where this information is felt to be analytically important.

[Questions: (i) Should more detail on collective investment schemes be included? (ii) If so, how much detail? (iii) Should they be standard or supplementary items?]

(f) Money market mutual funds (MMMFs) and other pooled investments that are included in broad money (as discussed in *MFSM* para. 100) may be shown as a supplementary category. In light of the treatment in the *MFSM* of such holdings as “deposits” and recognizing their money-like properties, the manual will recommend that, where significant, they need to be identified separately for reconciliation with monetary and financial statistics. (However, it will be recognized that this is not usually a concern in international accounts data.)

(g) As agreed by the Advisory Expert Group on National Accounts in its February 2004 meeting, the manual will recommend an instrument category “financial derivatives and employee stock options” with the subcategories of (i) financial derivatives and (ii) employee stock options. Although employee stock options share some characteristics with financial derivatives, they do not fully meet the definition of financial derivatives.

[Question: Is the proposed treatment of employee stock options suitable?]

(h) A more detailed breakdown of financial derivatives by their instrument types will be mentioned as possible supplementary items, viz., (i) forwards, and (ii) options (as in the *Debt Guide* Table 7.11). Financial derivatives could also be classified by risk categories: (i) foreign exchange; (ii) interest rate; (iii) equities; (iv) commodities; and (v) other; on a supplementary basis.

[Questions: (i) Is an additional split of financial derivatives desirable? (ii) If so, how much detail? (iii) If so, as standard or supplementary items?]

(i) If arrears on debt and/or nonperforming loans are of economic interest, compilers should consider either or both as an optional "of which" component for relevant position items.

- Arrears are shown separately in *Debt Guide* Table 4.1. Arrears will be defined as in the *Debt Guide* para. 3.36. (Cases of arrears need not be limited to Exceptional Financing. The desirability of identification of arrears is not limited by whether or not going into arrears is treated as an imputed transaction or not, as discussed in Chapter 3 Accounting Principles. However, if a transaction is imputed, all arrears are classified as short-term; if a transaction is not imputed, they will be classified according to the original instrument.)
- Nonperforming loans are a related but not identical concept, often defined by payment being overdue by more than a specified time.

[Questions: (i) Is this proposal suitable? (ii) Should data be limited to liability positions data, or should the possibility be opened for asset positions? (iii) Should arrears, nonperforming loans, both, or a mixture be adopted? (iv) How should the category be defined?]

(j) Financial gold could be considered for reclassification as a financial asset, rather than a good, because of its role in financial markets. As a result, international transactions would be recorded in the financial account, rather than as goods, and would be netted, rather than gross. However, the positions would not be included in the international investment position because they lack the international element that arises for monetary gold included in reserve assets.

[Question: Should financial gold be treated as a financial asset?]

(k) Trade-related credit. Trade credit is limited to credit extended by suppliers, so the *Debt Guide* paras. 6.9–11 introduce a wider concept of trade-related credit that includes trade credit, trade-related bills, and credit by third parties to finance trade. Trade-related bills and credit by third parties to finance trade could be identified as a separate component of loans as supplementary information where they are considered statistically significant and analytically useful.

[Question: Should an optional category for trade-related credit be created?]

(l) Reinvestment of earnings. This imputed instrument is used for the financial account entry that corresponds to the imputed income item for reinvested earnings. (Further discussion appears in Chapter 7, Financial Account, and Chapter 10, Primary Distribution of Income Account.)

[Question: Are the proposals in this paragraph, other than those for which there are specific questions, suitable?]

The rationale for the classification will be stated, for example, the role of currency and deposits in monetary analysis, and the residual claim nature of equity interests. It will be noted that financial innovation has resulted in new types of instruments.

3. Discussion of the classification of particular instruments

5.8 After introducing the main types of financial assets, this chapter will go on to discuss the application of the general classification to particular situations. This discussion will largely follow Chapter IV of *MFSM* (paras. 116–181) because the content and level of description is considered appropriate for this manual. However, it should be elaborated and updated to account for any subsequent developments in particular cases:

(a) Repurchase agreements, securities lending, and gold swaps will be defined and illustrated. The instrument classification will be highlighted by identification of security and loan aspects. An example will be given. (See *MFSM* paras. 142–148 and BOPCOM-01/16.)

(b) The borderline between monetary gold and other gold will be discussed, and the process of monetization and demonetization of gold will be explained. (In addition, if financial gold were to be recognized as a financial instrument, the borderline with nonfinancial gold would also be discussed.)

(c) Gold loans, gold swaps, and gold deposits will be defined. Possible treatments are as the gold staying on the books of the gold provider, in conjunction with a loan or deposit. (See *MFSM* paras. 154–164, *Debt Guide* paras. 3.31 and 3.34, and *GFSM 2001* para. 7.115.)

(d) Employee stock options will be classified as a subcategory under a new instrument category "financial derivatives and employee stock options," the other subcategory being financial derivatives.

(e) Inclusion of financial leases as loans will be noted. (It is proposed that financial leases will be noted under Chapter 5 Classifications, Chapter 6 International Investment Position, Chapter 7 Financial Account, and Chapter 10 Primary Income, with a full exposition in an appendix to the manual.)

(f) Loans that have been traded will be classified as securities under certain conditions, as stated in the *Debt Guide* para. 3.29. It will be noted that many loans are traded but not sufficiently to become securities.

(g) Depository receipts are classified in the same way as the underlying security, as noted in Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence.

(h) Ownership of mutual funds, unit trusts, and other pooled investments will be regarded as equity, regardless of what kind of assets the fund holds. In contrast, because the assets of an asset-backed security remain owned by the issuer, the security is a debt instrument.

[Comment: This treatment is adopted because the investors in mutual funds, etc. have ownership rights, and otherwise these entities would have no owners. The treatment is unchanged from BPM5 para. 388.]

(i) Convertible bonds will be classified as debt securities until the option to convert them is exercised, at which time they will be classified as the new instrument.

(j) Islamic instruments will be discussed, with a reference to Appendix 2 of *MFSM* as a source for further information.

(k) Trade credit and advances that are sold to another party (e.g., discounting of an importer's bill) will be treated as ceasing to be trade credit and advances and will be classified as a loan or some other instrument, depending on its nature.

(l) Financial reinsurance will be explained and will be treated as a loan.

(m) Activation of guarantees. Chapter 3 Accounting Principles will state the recommended treatment in instances when a debt guarantee is invoked. It will state that, once the guarantee has been invoked, the debt of the primary debtor is assumed to have been repaid and then assumed by the guarantor, as its own debt. However, Chapter 3 Accounting Principles notes that guarantees are not recognized as liabilities until invoked.

[Questions: (i) Are these treatments suitable? (ii) Are there other particular issues?]

4. Other issues associated with the instrument classification

5.9 There will be an outline of the classification of specialized government-to-government instruments, such as capital subscriptions to international nonmonetary organizations including development finance institutions, and payments agreement balances, as discussed in *BPM5*, para. 432.

B. Functional Categories

5.10 The five current functional categories will be highlighted as the major classification for each of financial transactions, positions, and income (with the exception that financial derivatives do not give rise to income). It will be noted that the classification combines functions and instruments to give a useful breakdown of investment flows and levels. The proposed category and instrument breakdown is shown in the following table. Table 5.3 shows a combined classification by functional category, major instruments, and maturity.

Table 5.3. Proposed Functional Category and Instrument Breakdown

Assets	*Liabilities*
Direct investment	**Direct investment**
Abroad	In reporting economy
Equity finance	Equity finance
of *which* Reinvestment of earnings[1]	of *which* Reinvestment of earnings[1]
Debt	Debt
(Other instruments if applicable)	*(Other instruments if applicable)*
In reporting economy (claims on direct investors)[2]	Abroad (liabilities to direct investment enterprises)[2]
Equity finance	Equity finance
Debt	Debt
(Other instruments if applicable)	*(Other instruments if applicable*)
Portfolio investment	**Portfolio investment**
Equity securities	Equity securities
Debt securities	Debt securities
Long-term	Long-term
Short-term	Short-term
Financial derivatives and employee stock options	**Financial derivatives and employee stock options**
Financial derivatives	Financial derivatives
Forwards	Forwards
Options	Options
Employee stock options	Employee stock options
Other investment	**Other investment**
Equity finance[3]	Equity finance[3]
Debt	Debt
Loans	Loans
Currency and deposits	Currency and deposits
Accounts receivable	Accounts payable
Trade credit and advances	Trade credit and advances
Other accounts receivable	Other accounts payable
Other debt instruments	Other debt instruments
Other instruments	Other instruments
Net equity in insurance companies technical reserves and pension funds	Net equity in insurance companies technical reserves and pension funds
Reserve assets	
Monetary gold	
SDRs	
Foreign exchange	
Currency and deposits	
Securities	
Equity securities	
Debt securities	
Other claims	

The instrument breakdown is discussed in the section of this chapter on financial instruments.

[1] Reinvestment of earnings is an imputed financial transaction, rather than a different type of claim, and so is not relevant for the IIP or Other Changes in Financial Assets and Liabilities Account.
[2] If reverse investment continues to be shown under direct investment, rather than included under portfolio or other investment (see below under direct investment).
[3] If untraded equity instruments are excluded from portfolio investment, as discussed under portfolio investment below.

1. Direct investment

5.11 This section will state the features that distinguish direct investment from other categories and why it requires a separate functional category, along the lines of *BPM5* paras. 359–361 and *BPT* paras. 509-513. The section on direct investment will give a more detailed definition of direct investment than *BPM5*. This section will present, primarily under direct investment, the issues of the borderline between direct investment and other categories. There will be a cross-reference to the appendix on *foreign affiliates trade in services statistics* in Chapter 9 Goods and Services. It will be noted that the definition of foreign affiliate used in *foreign affiliates trade in services statistics* differs from the direct investment definition.

5.12 Data for income, transactions, and positions between enterprises in direct investment relationships will be presented under “direct investment abroad” and “direct investment in the reporting economy.” This treatment will also apply in cases of reverse direct investment (described below, i.e., where the direct investment enterprise has less than 10 percent of the ordinary shares or voting power in the direct investor). That is, these claims/liabilities will be recorded, as appropriate, as “claims on direct investor” and “liabilities to direct investment enterprise” and be shown under “assets” or “liabilities.” In contrast, these were shown as offsets under “direct investment in the reporting economy” and “direct investment abroad” in *BPM5*. The direction of the direct investment relationship will still be apparent from the title of these items.

a. What is a direct investment relationship?

5.13 The definition of direct investment will be largely the same as *BPM5* and the *Benchmark Definition of FDI*, with the IMF 2002 clarifications. Using the same approach as *BPM5* paras. 359–374, this chapter will state the concept of direct investment (i.e., investment associated with a lasting interest, implying an effective voice in management, so that it tends to behave in a different way from other forms of investment). The operational definition in *BPM5* for the establishment of a direct investment relationship involves 10 percent or more of ordinary shares or voting power by a direct investor in a direct investment enterprise. As in *BPM5*, the operational definition will be endorsed as the sole criterion in order to ensure international consistency and to avoid subjective judgments, such as those about actual exercise of control or an effective voice in management. The definition includes ownership and voting power held indirectly, as discussed in more detail under chains of direct investment below. It will be noted that ownership and voting power are normally the same. Cases where they may differ are for “golden shares” and indirect ownership via partly owned subsidiaries, as discussed under indirect investment below.

[Question: (ii) Should the 10 percent threshold be changed to 20 or 50 percent?]

[Comment: International accounting standards use a 20 percent threshold. Foreign affiliate trade statistics use a 50 percent threshold].

5.14 Subsequent to the definition of direct investment, the terms "direct investor," "direct investment enterprise," and "direct investment finance" will be defined. This section will define the terms "affiliate/affiliated enterprise," "subsidiary," and "associate." "Branch" will also be defined, with a cross-reference to Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence.

5.15 As in *BPM5* para. 367, it will be noted that direct investors may be enterprises, individuals, associated groups of individuals and enterprises (such as unincorporated joint ventures), estates, trusts, or governments. The following specific cases will be mentioned:

(a) A nonprofit institution serving households (NPISH, as defined in Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence) may be a direct investor in a corporation. However, flows between two NPISHs are treated as transfers, rather than investment, because it is considered that financial flows in these cases are seldom driven by investment considerations.

(b) This section will state principles for application to intergovernmental organizations, insurance companies, mutual funds, funds of funds, and pension funds (as both direct investors and direct investment enterprises), to be decided during the review process for this manual.

(c) This section will also guide compilers on how to treat a group of related individuals as a direct investor (e.g., where various members of the same family have interests in the same company).

5.16 The section will discuss the issues for determining whether enterprises are in a direct investment relationship when the enterprises are linked by a chain of direct investment ownership. Options to be considered are:

(a) a narrow definition limited to directly held direct investment enterprises; and

(b) a broader definition to include both directly and indirectly held direct investment enterprises as in:

    (i) the "Fully Consolidated System" (FCS) definition, which includes all directly and indirectly owned subsidiaries, associates, and branches of the direct investor, even if the indirect ownership by the direct investor is less than 10 percent of the ownership or voting power. *BPM5* adopts the FCS definition, although the term is not used (see *BPM5* para. 362; also see *Compilation Guide* para. 687 and *BPT* para. 517 for examples);

    (ii) the "US Methodology" (USM) definition, which uses a cutoff of 10 percent or more ownership for both direct and indirect ownership, but not voting power. It differs from the FCS definition in cases where there is less than 10 percent of ownership but 10 percent or more of indirect voting power (i.e., where one of the links in the chain of ownership is a subsidiary, as illustrated in *BPT* para. 517 example in the case of Company C); and

(iii) the "10/50" definition adopted by the European Union, which uses the normal 10 percent threshold for direct relationships but 50 percent ownership for indirect relationships.

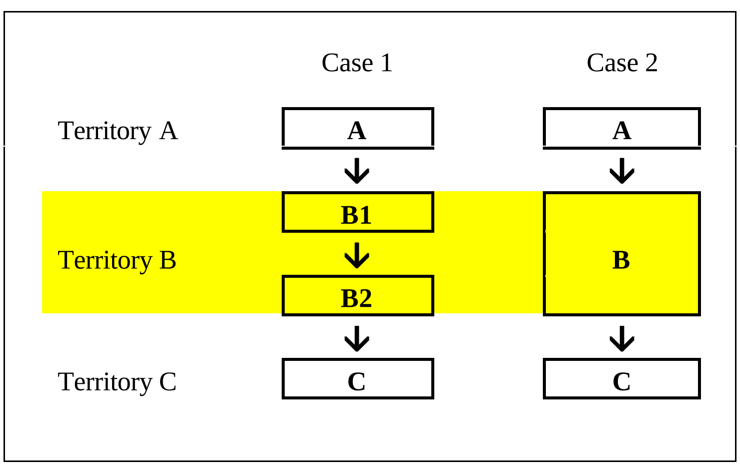
Examples will be provided for the definition adopted. There will be a cross-reference to Chapter 10 Primary Distribution of Income Account for the implications of chains of direct investment for the concept of retained earnings.

[Comments: The complex structures of some international company groups would not be taken into account if indirect holdings are omitted. However, the FCS is difficult to implement, and very few countries are able to fully apply the FCS at present.

Note the relevance of the inclusion of both "ordinary shares" or "voting power" in the definition of direct investment above. The FCS definition is implied by the use of "voting power" in the definition.]

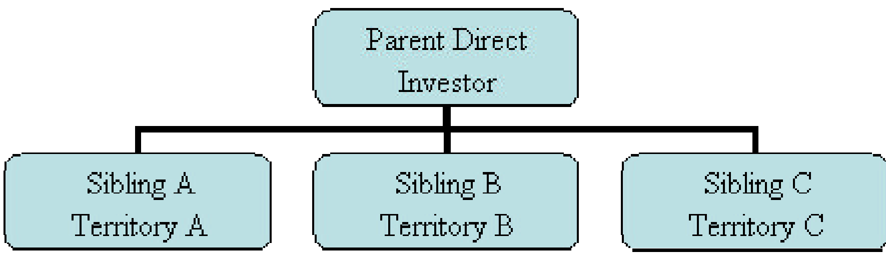
[Question: Which of the definitions specified above should be adopted?]

5.17 If the broader definition for determining direct investment relationship is followed, this chapter will discuss the case of a direct investment chain of ownership where at least one link in the chain involves two enterprises in the same economy. It is proposed that this situation would not preclude direct investment relationships between other enterprises in the chain. For example, where ↓ indicates a subsidiary, it is proposed that A is in a direct investment relationship with C in both situations.



5.18 It will be noted that if two enterprises (sometimes called "siblings") have the same direct investor, those two enterprises are in a direct investment relationship with each other, even if neither has any equity interest in the other. Without a direct investment equity interest between them, the items do not meet the definitions of either "direct investment abroad" or "direct investment in the reporting economy." So the convention in para. 529 of *BPT* that international transactions between siblings are classified according to the direction of the flow is used. To clarify these complex cases, examples will be used.

For example,



if Sibling A has less than 10 percent of the ordinary shares or voting power in Sibling B or vice versa:
(a) a loan by Sibling A to Sibling B would be reported under direct investment abroad in Territory A and direct investment in the reporting economy in Territory B; and
(b) a loan by Sibling B to Sibling A would be reported under direct investment abroad in Territory B and direct investment in the reporting economy in Territory A.

5.19 A term such as "group of affiliated enterprises" or "group of related enterprises" could be adopted. It would be noted that some enterprises may be members of two or more groups.

5.20 The special case of reverse investment by a direct investment enterprise in its direct investor will be discussed, with *BPM5* para. 371 as a starting point. Reverse investment will be defined, that is, when a direct investment enterprise acquires a claim in its direct investor.

(a) When this reverse equity investment constitutes 10 percent or more of the ordinary shares or voting power, then 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 direct investor and direct investment enterprise of the other enterprise.

(b) When the reverse investment does not reach 10 percent of the ordinary shares or voting power, there is not a second direct investment relationship.

- In this situation, *BPM5* para. 375 recommended that such an asset (liability) be recorded as claims on direct investors under direct investment in 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 assets and liabilities. In income, *BPM5* paras. 276 and 375 went further and recommended netting the reverse income flows.

- It is proposed that, for the new manual, such claims on direct investors by a direct investment enterprise will be shown, on the asset side, rather than on the liability side. In order to retain the reverse investment nature of this relationship, a heading *Direct investment in reporting economy (claims on direct investor)* will be shown on the asset side. Similarly, for liabilities to affiliated enterprises by the direct investor, it is proposed that this item be shown on the liability side, under *Direct investment abroad: liabilities to direct investment enterprises*. The consequence of this change is that assets and liabilities will each be shown gross. Similarly, income items would be shown gross. It will be noted that it may be useful for analysis to net reverse investment items with their corresponding primary values.

- The reporting of reverse investment data on a gross basis leaves analysts free to choose whether they wish to use net or gross values. At the same time, it eliminates the unacknowledged inconsistency between *BPM5* and the *1993 SNA* and a violation of the statement in *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 proposed treatment also has the practical benefit of leaving aggregates less affected by whether compilers are able to implement the separate identification of reverse investment.

The treatments will be illustrated with examples.

> *[Question: Should the discontinuity between reverse investment above and below the threshold be considered?]*

5.21 The special case of "round tripping" will be discussed. It will be defined, that is, the channeling by direct investors of local funds to SPEs abroad and the subsequent return of the funds to the local economy in the form of direct investment. It will be explained that this practice may be motivated by confidentiality, tax planning, and other incentives available to foreign investors. The manual will indicate that, as at present, these transactions are to be treated on a gross basis, that is, as direct investment abroad for the funds channeled to SPEs abroad, and as direct investment in the reporting economy for the subsequent return of the funds to the local economy. (However, transactions and positions directly between the direct investor and the direct investment enterprise in the same economy would be outside the scope of the international accounts, as being resident-to-resident.)

5.22 In cases where round tripping is considered to be significant, compilers will be encouraged to publish supplementary information by partner country that identifies the extent of round tripping. An example will be given of such a presentation of data.[1] (That presentation would also be compatible with the ultimate beneficial owner/ultimate destination presentation of partner data discussed in Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence.)

[Question: Is this treatment suitable?]

5.23 Some special cases will be noted:

(a) Acquisition of land and associated assets and preparatory expenses for future direct investment units will be noted under this heading as giving rise to an imputed direct investment transactions. (There will be a cross-reference to Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence.)

(b) Cases of foreign ownership or influence outside the scope of direct investment—for illustration, enterprises operating under a common name with cross-holdings of less than 10 percent in each other, without a clear "parent"; unrelated foreign investors (from the same or different territories) holding 10 percent or more of the ordinary shares or voting power in total, but where none individually meets the 10 percent threshold; any investments by domestic residents in a direct investment enterprise in the same territory; and franchises and affiliation agreements without ownership. In all those cases, the relationships do not meet the definition of direct investment.

(c) Transactions prior to the establishment of a direct investment relationship are not included under direct investment. For example, an initial acquisition of 7 percent of the voting power is excluded, while a subsequent acquisition of 5 percent later in the same period would be treated as direct investment. At the time of the transaction that reached the direct investment threshold, there would also be two entries for reclassification of the earlier investment in the other changes in financial assets and liabilities account, that is, one entry to subtract the holding from portfolio investment and another to add it to direct investment. Similarly, a reclassification would be made for divestment that takes an interest below the 10 percent threshold.

(d) Notional units for branches, ownership of land, and preliminary expenses. Chapter 4 Economic Territory, Units, Residence, Sectors mentions cases where a separate enterprise is imputed for statistical purposes even though it is not a separate legal entity. It will be noted in this section that such imputed units are almost always direct investment enterprises.

5.24 The relationship with the *1993 SNA* definitions of "direct foreign investment" and "foreign-controlled enterprises" will be discussed along the lines of *BPM5* para. 362.

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[1] For example, see the presentation in *External Direct Investment Statistics of Hong Kong 2001,* Hong Kong Special Administrative Region, Census and Statistics Department, 2001.

b. What is covered in direct investment transactions, positions, and income?

5.25 It will be noted that, while the instruments for recognizing a direct investment relationship (discussed in subsection (a) above) relate to ordinary shares or voting power, once the relationship is established, all subsequent financial transactions, positions, and income on financial assets occurring between the affiliated enterprises are included in direct investment, not just those financial assets associated with ordinary shares or voting power that define the relationship.

5.26 It will be noted that there may be a need to impute some financial transactions between direct investors and their direct investment enterprises. For example, if goods or services have been supplied to a direct investment entity (in particular, a branch) without explicit payment, there should be an offsetting entry in direct investment in the financial account. Transfer pricing is discussed in more detail in Chapter 10 Primary Distribution of Income Account.

5.27 This section will discuss specific instances of financial transactions and positions between affiliates that are excluded from direct investment:

(a) Nonpermanent debt between affiliated financial intermediaries is excluded from direct investment. (Permanent debt and equity are included). The definition of permanent debt and possible exclusion of all debt between affiliated financial intermediaries will also be considered. (See BOPCOM-01/20B and *IMF, Recommended Treatment of Selected Direct Investment Transactions* (2002).

- "Affiliated financial intermediaries" is defined as "other depository corporations," "other financial intermediaries," and "financial auxiliaries" in the *1993 SNA/MFSM* institutional sector terminology. Insurance corporations and pension funds are not covered by this exception. As clarification, the two parties do not have to be the same type of financial intermediary for the exception to apply, for example, one could be an "other depository corporation" and the other an "other financial intermediary."

- "Permanent debt" will be discussed, as in *BPM5* para. 372, BOPCOM-99/19, *http://www.imf.org/external/np/sta/di/fditran.htm*, and *Clarification Of Foreign Direct Investment (FDI) Concepts: "Permanent Debt."*

- The rationale for the exclusion of this debt from direct investment will be given that these instruments are largely oriented to liquidity management outside the direct investment relationship.

[Questions: (i) Should this exception be extended to all debt? (ii) Alternatively, should "permanent debt" be defined further, and if so, how?]

(b) Debt between special purpose entities (SPEs) that have the primary function of financial intermediation and affiliated nonfinancial enterprises. The possible exclusion of these flows from direct investment will be reviewed in the light of whether such flows are considered to be predominantly oriented to the direct investment relationship or not.

[Questions: (i) How should debt between SPEs that have the primary function of financial intermediation and affiliated nonfinancial enterprises be classified? (ii) What is the meaning of "SPEs that undertake financial intermediation"?]

(c) Insurance technical reserves (*BPM5* para. 379, *BD3* para. 63) are liabilities to claimants and policyholders and are included in other investment. When the claimant or policyholder is in a direct investment relationship (whether both parties are insurers or one is not an insurer and the other is its captive insurer), the investment appears to satisfy the definitions of both direct and other investment. The rationale for excluding these transactions and positions from direct investment will be given, namely, that technical reserves are liabilities to policyholders and claimants, rather than the insurance company. To simplify the reporting and to use the same rationale as the financial intermediary exception (i.e., that this investment is associated with the normal operation of the activity), insurance technical reserves will all be included under "other investment."

[Question: Is this treatment applicable to captive insurance?]

(d) Participation in international organizations is excluded from direct investment (*Benchmark Definition of FDI,* para. 61).

(e) Financial derivatives are excluded from direct investment on the grounds that financial derivatives involve risk transfer, which is distinct from the function of direct investment. Accordingly, financial derivatives between related enterprises are included in the functional category financial derivatives.

[Question: Should any other cases of exclusions of financial transactions/positions between enterprises in a direct investment relationship be listed?]

c. Other issues associated with direct investment

5.28 Consideration will be given to breaking down "debt instruments" into long term and short term, in view of interest in assessing potential vulnerability associated with direct investment. However, the limitations could be noted, as in *BPM5* para. 339. Also, where "debt instruments" contains a variety of instruments other than loans, and where these other instruments are significant, supplementary information could be encouraged to identify the instruments, in order to permit reconciliation with the *1993 SNA* financial account and balance sheets.

[Questions: (i) Should debt in direct investment be broken down (a) between long-term and short-term components, and (b) into the underlying instruments to permit reconciliation with the 1993 SNA financial account and balance sheets? (ii) Are the concerns about the "arbitrary" nature of these debts appropriate?]

5.29 This section will clarify that "debt instruments" includes both intercompany debt (i.e., when the debtor and creditor are separate legal entities, as presently mentioned in both *BPM5* and *Benchmark Definition of FDI*) and intracompany debt (i.e., cross-border debt transactions between direct investors and their branches abroad or other unincorporated direct investment enterprises, a case not mentioned in *BPM5* and *Benchmark Definition of FDI*).

5.30 There will be cross-references to Chapter 6 International Investment Position, Chapter 7 Financial Account, and Chapter 10 Primary Distribution of Income Account.

5.31 In addition to other breakdowns that also apply to other types of investment, such as instrument and geographic breakdowns, two possible supplementary classifications specifically for direct investment will be set out. These are:

(a) Kind of activity. Two possible bases are the industrial classification of the direct investor or the direct investment enterprise. (The most practical option is for the industry of the unit in the compiler's own territory, i.e., industry of the direct investor in the case of direct investment abroad, and industry of the direct investment enterprise for direct investment in the reporting economy. However, this could result in inconsistent classifications by the counterparties.)

[Question: Should kind of activity be discussed as a supplementary item?]

(b) Mergers and acquisitions, in order to separate them from other direct investment, could be identified in the balance of payments (but not the IIP). There is no standard definition among the countries that presently compile data on mergers and acquisitions (as discussed in OECD, *Harmonisation Of Mergers And Acquisitions (M&A) Statistics*). Work would need to be done to develop a harmonized definition so that results could be compared internationally.

[Questions: (i) Should there be an additional breakdown in the standard BOP components that identifies mergers and acquisitions as a subset of direct investment? Alternatively, should the breakdown be a supplementary item? (ii) If so, what definition should be adopted?]

2. Portfolio investment

5.32 Portfolio investment will be defined. Two alternative definitions for portfolio investment could be based on:

(a) legal form of instrument, that is, any securities that are not included in direct investment or reserve assets (as in *BPM5* para. 385); or
(b) whether the securities are traded in organized financial markets.

The two definitions overlap, to a large degree, but differ for untraded or nontradable securities (such as shares in open-end mutual funds, unlisted companies, and unincorporated enterprises). If such securities were excluded from portfolio investment, they would be included under other investment. Possible reasons for changing to the second definition would be as follows:

- The concept behind portfolio investment would be more coherent. At present, it is largely a residual instrument classification.
- The tradability element has clearer implications for economic analysis, for example for volatility.
- Tradability might result in a more meaningful borderline, for example, nontraded debt instrument is similar to a loan.
- The requirement that the instrument be readily traded on organized financial markets will provide a clear link to the valuation principles for portfolio investment based on market prices.

[Question: Should portfolio investment be defined by instrument or by tradability?]

5.33 If the second definition were adopted, there will be an elaboration on the features of organized financial markets.

5.34 Instruments raising particular issues will be mentioned:

(a) Loans that have been traded will be reclassified as debt securities, if certain criteria are met, as described in the *Debt Guide*, para. 3.29.

(b) The treatment of tradable debt securities that once traded but have been delisted or that trade infrequently or not at all will be stated.

- To treat these cases as being reclassified to other investment would have the benefit of keeping "portfolio investment" limited to traded instruments, with observable market prices.

- To treat these cases as portfolio investment would have the benefit of avoiding moves back and forth between portfolio and other investment, and the associated anomaly of the valuation principle between market and nominal values.

[Question: Should debt securities that previously traded but no longer do so be treated as portfolio investment or other investment?]

(c) Securities with embedded derivatives should be included as portfolio investment, and no attempt should be made to separate the option from the underlying.

3. Financial derivatives and employee stock options

5.35 Consistent with the discussion under Section A.2 above (Financial Instruments/Overview of classification), the manual will recommend a new functional category "financial derivatives and employee stock options." This section will cover what is included in *Financial Derivatives Supplement to the Fifth Edition of the Balance of Payments Manual* (2000), as well as including the later decisions (in 2002) that clarified classification of financial derivatives between affiliated entities, and employee stock options. It is proposed that all financial derivatives be included in this functional category, including those related to the management of reserve assets. Depending on decisions made, a revision of the title of the functional category to "financial derivatives and employee stock options excluding reserves" could be considered.

[Note: This issue is discussed further and a question asked under Reserve Assets.]

5.36 The section will note cases where transactions between two parties for a particular derivative occur in both directions. In such cases, it may not be feasible to apply the netting principle, which requires separate presentation of transactions in assets and transactions in liabilities. The section will note that presenting net changes of transactions in both assets and liabilities for such financial instruments may be acceptable. This issue will also be covered or cross-referenced in Chapter 6 International Investment Position and Chapter 7 Financial Account.

[Question: A question on the recording basis for these transactions is raised in Chapter 3, Accounting Principles, Section E, Aggregation and Netting.]

5.37 When an entity has both asset and liability transactions for financial derivatives, the manual will recommend that transactions be recorded gross, that is, that transactions in assets are to be kept separate from transactions in liabilities. However, it will recognize that "net reporting," that is, that transactions in assets will be netted against transactions in liabilities, may be accepted if gross data are impractical. For positions data, it will be stated that assets should be recorded separately from liabilities in all cases. This issue will also be covered or cross-referenced in Chapter 6 International Investment Position and Chapter 7 Financial Account.

[Question: Is this acceptable? Or should all transactions be reported gross?]

5.38 The classification of employee stock options will be discussed. While employee stock options do not fully meet the definition of financial derivatives, they share some characteristics with financial derivatives. Employee stock options will be classified as a sub-category under "financial derivatives and employee stock options."

5.39 Payments made under a financial derivative contract before net settlement (in those cases where there is a lag between the payment by one party and that of the counterparty) will be classified as "loans." For example, in an interest rate swap, a fixed-for-floating swap may involve a monthly interest payment (e.g., for the floating leg) and an annual coupon payment (e.g., for the fixed leg). In that case, the monthly payment is classified as a "loan" (under "other investment") that is removed from the balance sheet when the reciprocal coupon payment is made. Only at that time will the financial derivative be regarded as having been settled—as the net difference.

[Question: Is this classification suitable?]

5.40 There are cases where an upfront payment is made when over-the-counter (OTC) swaps are entered into. The manual will propose that these upfront payments represent loans, unless they are otherwise identifiable as a fee, in which case they are a financial service.

[Question: Is this treatment suitable?]

5.41 The manual will discuss the treatment of changes in value of swaps that occur merely through the passage of time. It will note that, as financial derivatives do not involve advancing funds, they do not earn interest, and, therefore, such changes in value are valuation changes.

[Question: Is this treatment suitable?]

5.42 Premium payments under credit default swap payments are classified as financial derivatives.

[Question: Is this treatment suitable?]

5.43 Examples could be provided to illustrate some complex derivative arrangements.

4. Other investment

5.44 Other investment will be defined in the same way as *BPM5*, both as a residual and in terms of specific instruments. (As noted under portfolio investment above, there is a proposal to move untraded equity and debt securities from portfolio investment to other investment.) It is a residual concept, that is, instruments other than those included in direct investment, portfolio investment, and reserve assets. Particular components are:

(a) trade credit and advances;

(b) loans;

(c) currency and deposits;

(d) other financial assets/liabilities other than those included under direct investment or reserves (would include untraded equity and debt securities under proposal under portfolio investment above); and

(e) insurance and pension fund technical reserves.

5.45 Instruments raising particular issues will be mentioned:

(a) The conditions for a loan to become sufficiently traded to be reclassified as a security will be noted, following the *Debt Guide* para. 3.29 (and also included in Chapter 5 Classifications, under instruments). The implications for valuation of classifying a particular claim as a debt security will be stated.

[Question: Should the requirements for a tradable loan to become a security include that the debtor is not legally prevented from buying back the debt, which is necessary to ensure that the market value is also relevant to the debtor?]

(b) In some instances, it is difficult to separate deposits from loans. However, in line with *MSFM* (footnote 8, para.139), this section will note that these instruments should, nevertheless, be kept separate and that they should be distinguishable on the basis of the representation in the documents that evidence them.

(c) It will be noted that financial leases will usually be included as part of “other investment” under “loans” (unless between affiliated enterprises, in which case they will be included under direct investment).

(d) Where an upfront payment is made when an over-the-counter swap is entered into, this section will propose that this upfront payment represents a loan, unless it is otherwise identifiable as a fee.

(e) Financial claims imputed for other cases of imputed change in ownership (e.g., goods for processing) will be discussed.

(f) The discussion of “loans” will elaborate on the use of Fund credit and loans from the Fund, along the lines of that presented in the *BPT* para. 592. This could be presented in an appendix (or a box), along with information on other Fund-related issues, such as remuneration, arrears to the Fund, etc.

(g) It will be stated that benefits under life insurance or pension funds will be regarded as "other investment" transactions, that is, they are treated as withdrawals of equity, as in *BPM5*.[2] The results of the ongoing work on this topic by an IMF electronic discussion group and the decision of the ISWGNA on this issue will be taken into account in the new manual. This issue will also be mentioned in Chapter 7 Financial Account and Chapter 11 Secondary Distribution of Income.

(h) Payments made under a financial derivative contract before net settlement (in those cases where there is a lag between the payment by one party and that of the counterparty) will be classified as loans, as noted under financial derivatives above,

(i) Long-term concessional loans to the International Development Association will continue to be treated as loans rather than current or capital transfers.

(j) It will be noted that trade credit and advances have an independent meaning.

(k) Certain financial transactions and positions between affiliated enterprises that have a limited connection to the direct investment relationship are included under other investment, as discussed under direct investment above.

5. Reserve assets

5.46 The definition of reserve assets will be stated, along the lines of para. 424 in *BPM5* and paras. 9 and 64 of the *Reserves Template,* but it is proposed that the definition remove "and/or for other purposes" in para. 424 of *BPM5* as it is too vague.

[Questions: (i) Is this change acceptable? (ii) If so, does there need to be a definition of "for balance of payments purposes"?]

5.47 It will be explained that these assets must be under the effective control of the monetary authorities and be available for use should the need arise. The concepts of "effective control" and "availability for use" will be discussed (see below). This section will also refer to the Fund's *Guidelines for Foreign Exchange Reserve Management* (*GFERM*) (2001) and explain the relationship between it and the manual. This section will also refer to the supporting document on the Fund's external website Foreign Exchange Reserve Management: Operational and Technical Issues (2002) (GFERM Documentation). The introductory section will explain the treatment of reserves in the *Reserves Template* and in the *GFERM* (neither of which existed when *BPM5* was drafted).

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[2] The *1993 SNA* treats benefits from pension funds as both secondary income and as withdrawal of investment. This treatment is rather complex and is designed for reasons related to household income that do not apply to the international accounts. The difference was not noted in *BPM5*.

5.48 This section will state that reserve assets include monetary gold, SDRs, reserve position in the Fund, and foreign exchange, with a further breakdown by instrument (currency and deposits, securities, and other claims). It is proposed that, unlike *BPM5,* as modified in *Financial Derivatives Supplement to the Fifth Edition of the Balance of Payments Manual* (2000), financial derivatives not be included in reserves and that "other claims" be included as a component of foreign exchange rather than shown as a separate component of reserves.

[Question: Are the proposed treatments of financial derivatives and other claims acceptable?]

5.49 It will be noted that SDRs and gold have no counterpart liability.

5.50 The counterpart liability for other reserve assets will be stated as being obligations of nonresidents, that is, obligations of residents will not qualify, as explained in the *Reserves Template* paras. 62 and 69.

5.51 The particular instruments that may or may not be included in reserves will be discussed in more detail, as they are more limited in ways that do not arise for other functional categories:

(a) Gold deposits (also called gold on loan in the *Reserves Template*) will be included under gold (*Reserves Template* para. 99). This item will be limited to monetary gold.

(b) Silver bullion, diamonds, and other precious metal and stones will not be included (*Reserves Template* para. 98). These are outside the scope of IIP.

(c) Gold and securities that have been transferred under gold swaps between monetary authorities, repurchase agreements, securities lending, or as collateral will not be included as reserve assets. (This would represent a change from some treatments in *Reserves Template* paras. 82-88 and para. 101 but avoid double counting of the security and the funds raised through repurchase agreements.)

(d) Assets created under swap agreements will be treated as in *BPM5* para. 434.

(e) Equity can potentially be included in reserves if it meets all the requirements of the definition, as in *Reserves Template* para. 79.

(f) Lines of credit will not be included as they are not assets, as in *Reserves Template* para. 73.

[Questions: (i) Is the change to exclude assets under repurchase agreements acceptable? (ii) Are any other changes necessary?]

5.52 Although it is proposed that this manual no longer use “monetary authorities” as an institutional sector (see Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence), “monetary authorities” will be defined as a functional concept that is essential for holding “reserve assets.” Monetary authorities comprise the central bank and certain operations usually attributed to the central bank (and other institutional units, such as currency boards and monetary authorities) but sometimes carried out by other government institutions or commercial banks (*Reserves Template* para. 21).

5.53 This section will explain that the concepts of “effective control” and “usability,” as stated in the *Reserves Template* para. 65, underpin the concept of “availability.”

5.54 “Effective control" will be applied to determine whether the monetary authorities have control over the liquid foreign currency claims on nonresidents of entities that do *not* comprise part of the monetary authorities. This section will state that, to comprise part of “reserve assets,” the liquid foreign currency claims on nonresidents owned by other government or public sector bodies or other depository corporations must meet a test of effective control. Specific guidelines for interpreting effective control over the foreign assets of entities that do not comprise part of the monetary authorities will be provided. This section will also address the question of how the potential double counting of the assets is to be addressed. Other relevant considerations are as follows:

(a) Effective control must be evidenced by prior contractual arrangements that give the monetary authorities access on demand to the assets in question. The contractual arrangements must be actual and definite in intent.

(b) Working balances will need to be considered on the basis of effective control, rather than included by convention, as in *BPM5* paras. 433 and 443.

[Questions: (i) Are there any other issues concerning control to be dealt with? (ii) Should assets owned by other agencies but under the effective control of the monetary authorities be shown as a separate component of reserves and/or should those assets be not recorded as the assets of the owner to avoid double counting?]

5.55 *BPM5* is not explicit on the inclusion of pooled assets in reserve assets. It will be noted that pooling arrangements and investment in securities that are used to hold other securities raise the possibility of the part of the ultimate liability being owed by residents, and hence the potential to generate international liquidity is undermined.

[Question: Should pooled assets be able to be included as reserve assets?]

5.56 The term “available for use” is synonymous with “liquidity,” which in turn implies “marketability” for some instruments (e.g., securities). Liquid foreign currency claims on nonresidents owned by the monetary authorities will comprise part of “reserve assets.”

Principles will be stated that provide an interpretation of the concept of “available for use,” viz.:

(a) only foreign currency assets will be included (*Reserves Template* para. 66);

(b) nonconvertible foreign currency assets will not be included (*Reserves Template* para. 67);

(c) the kind of market for the instrument must be stated (for example, an established secondary market is a sufficient condition; the availability of a potential market could qualify, but the funds will be required to be unambiguously available if the asset is to be included in reserves);

(d) foreign currency assets must be available on demand (for example, deposits (see *Reserves Template* para. 91), and gold loans (see *Reserves Template* para. 99). Or they must be marketable with minimum cost and time and with ready sellers and buyers, for example, securities (*Reserves Template* para. 65, footnote 19);

(e) pledged assets that are encumbered by a nonresident party (such as collateral for a third party loan) will be excluded, as stated in *Reserves Template* para. 72. Pledged assets that are encumbered by the monetary authorities for prudential purposes (such as a sinking fund) will be included, as stated in *BPM5* para. 426;

(f) reserve assets will be required to “be of a sufficiently high quality (investment grade and above)” to qualify as being sufficiently readily available, as in *Reserves Template* para. 89;

(g) the asset’s ability to be involved in a repurchase agreement sufficiently enough to make it liquid will be stated. (It is proposed that it not be sufficient for the asset’s inclusion or otherwise should be based solely on the liquidity of the instrument itself); and

(h) a noncomprehensive list of examples will be given of instruments that are definitely considered as sufficiently liquid (e.g., gold, SDRs, reserve positions in the Fund, foreign exchange holdings) and those that are definitely not considered to be sufficiently liquid (e.g., long-term loans, real estate). (The examples are from *BPM5* paras. 431–432 and *Reserves Template* paras. 74–76.)

5.57 An appendix will cover the particular issues associated with reserve assets of monetary and currency unions and reserve assets held by a national central bank that is a member of a monetary union.

5.58 This section will note that, in presenting reserves data by institutional sector, compilers may wish to adopt a supplementary institutional sector “monetary authorities,” as noted in Chapter 4 Economic Territory, Units, Institutional Sectors, and Residence.

5.59 *BPM5* states (para. 426) that the financial assets comprising reserves cannot unambiguously be identified in a meaningful way simply through the application of objective criteria. It is now proposed to give the concepts of ownership, control, and usability much clearer and tighter operational meaning, in order to reduce the ambiguity in determining which financial assets comprise reserves.

> *[Questions: (i) Is it possible to develop objective criteria for the identification of reserves? (ii) If so, what are those criteria?]*

5.60 It will be noted that this functional category occurs only on the asset side. *BPM5* encouraged Liabilities Constituting Foreign Authorities' Reserves (LCFAR) as a supplementary classification. The classification for LCFAR will be discontinued since it is considered to be impractical and has not been implemented.

5.61 It will also be noted that borrowings that may have been undertaken to bolster reserve assets are not to be shown as negative entries in reserve assets.

5.62 This section will note that reserve assets give an incomplete picture of the authorities' international liquidity position, for example by omitting related liabilities. The *Reserves Template* provides a satellite presentation, that is, it is based on the core concepts of the international accounts but provides considerable extra detail on components of reserve assets, as well as other kinds of assets, associated liabilities, and other foreign currency drains and seeks information on future flows. It is envisaged that the *Reserves Template* will be updated in line with the revised manual.

C. Classification by Maturity

5.63 Debt items can be classified by maturity. This chapter will provide a definition of short and long term, as in *BPM5* para. 336, that is, short-term debt is one year or less, long-term debt is more than one year. It will note the complexity of the distinction in practice (due to rollovers, early termination options, etc.). *MFSM* para. 311 recognizes a medium-term maturity, that is, two years or less, but more than one year.

> *[Question: Should an additional category for more than one to two years be considered?]*

5.64 Maturity can be expressed in terms of original maturity (as adopted in *BPM5*) or residual maturity. This section will adopt original term as the basis for recording. The residual maturity is considered more relevant for analyzing liquidity, which relates to balance sheet positions. To accommodate these needs, this section will adopt, as a supplementary presentation for the IIP, the approach used in the *Debt Guide* (Table 7.1), namely:

(i) short-term debt on an original maturity basis;
(ii) long-term debt due for payment within one year or less; and
(iii) long-term debt due for payment in more than one year.

With this presentation the short-term or long-term split can be presented on either a residual or original maturity basis

[Question: Is this approach suitable?]

5.65 In cases of obligations that consist of tranches with different maturities, it will be stated that the amount should be split into the separate components, as per *Debt Guide* para. 2.76.

D. Classification by Currency

5.66 Classification of data by currency was dealt with in the *Debt Guide* paras. 6.12–6.14 and encouraged for the Coordinated Portfolio Investment Survey. However, the methods are not dealt with in *BPM5* or *CPISG2*.

5.67 In the case of debt, the classification is usually straightforward when all aspects relate to the same currency. In some cases, there are relationships to two or more currencies:

(a) When the debt is payable in one currency but linked to another in amounts, the debt will be classified with the currency that it is linked to, as this reflects the underlying economic reality. (Consistent with Eurostat News Release 24/97, *Accounting Rules Complementary Decisions of Eurostat on Deficit and Debt* and *Debt Guide* para. 7.19; contrary to *BPM5* para. 397, *1993 SNA* para. 7.104.) (This treatment has implications for the measurement of interest and holding gains; see Chapter 10 Primary Distribution of Income.)

(b) Some aspects of the loan are payable according to different currencies (e.g., principal from one currency, accrual of interest in another); then the debt needs to be split according to present values of the components.

5.68 In the case of equity, the classification is according to the currency of the market in which the share is traded or, if not traded, the jurisdiction where the entity is incorporated. This information may be collected on a supplementary basis.

5.69 It will be recognized that a split by currency is of potential analytical interest to the extent that it shows exposure to exchange rate changes. It is useful in deriving changes in value owing to exchange rate changes on debt securities—how these changes are recorded is shown in Chapter 8 Other Changes in Financial Assets and Liabilities Account. However, the manual will point out the limitations in the interpretation of currency splits. In the case of equity, the currency of the market in which the share is traded does not necessarily reflect the currencies to which the equity is exposed. In the case of debt securities, foreign currency exposure may be hedged, so that data could be misleading if information on hedging is not collected (as shown in, for example BOPCOM-02/73).

5.70 The standard components will identify a foreign currency/domestic currency split for external debt. The manual will also urge that the analysis should take into account relevant hedging, if applicable, so that a full view of exposure to exchange rate changes can be obtained.

> *[Question: Should a foreign currency/domestic currency split for external debt be a standard or supplementary item? Should it be encouraged for assets as well?]*

E. Classification by Type of Interest Rate

5.71 This section will note the classification of debt instruments as being either variable-rate or fixed-rate as a possible supplementary breakdown, not to be included in the standard components. The classification is adopted in the *Debt Guide* paras. 6.15–17. The *Debt Guide* definitions would be adopted.

CLASSIFICATIONS: FINANCIAL INSTRUMENTS, FUNCTIONAL CATEGORIES, MATURITY, CURRENCY, AND TYPE OF INTEREST RATE

References:

BPM5:
Ch XVI, XVII-XXIII Instruments
Ch XVIII Direct investment
Ch XIX Portfolio investment
Financial Derivatives: *Financial Derivatives: Supplement to BPM5* (2002 version)
Ch XX Other investment
Ch XXI Reserves
LCFAR paras. 340, 447–450
Maturity paras. 336–339

BPT
Financial instruments paras. 482–483
Functional categories paras. 509–554
Maturity paras. 489–490
Direction of investment para. 529

External Debt Statistics: Guide for Compilers and Users
Financial assets paras. 119–144
Currency paras. 181–183

International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template

IMF, *Guidelines for Foreign Exchange Reserve Management* (2001) (available on www.imf.org/external/np/mae/ferm/eng/index.htm) and the related *Foreign Exchange Reserve Management: Operational and Technical Issues (internal)*

CPISG2 ch 3

OECD Benchmark Definition of Foreign Direct Investment (3rd edition) 1996

1993 SNA Financial assets paras. 11.62–101

MFSM Financial assets Chapter IV and Appendix 2

Australian Bureau of Statistics, *Measuring Australia's Foreign Currency Exposure*, BOPCOM-02/73

Bank of Japan, *Capital Transactions Associated with Permanent Debt with Financial Affiliates Under Direct Investment*, BOPCOM-03/46A

Bank of Japan, *Transactions with Affiliated Financial Intermediaries*, BOPCOM-01/21

Banque de France, *Repo-type Transactions Issue: The French Experience Relating to Stocks*, BOPCOM-01/40

European Central Bank, *Updating BPM5: Possible Expansion of the Sector Breakdown*, BOPCOM-02/64

European Central Bank, Financial Flows and Stocks Task Force, *Financial Derivatives: Framework for Discussion; Full Report on Conceptual Aspects; Full Report on Practical Aspects*, BOPCOM-98/1/30

Eurostat, *Accounting Rules Complementary Decisions of Eurostat on Deficit and Debt*, News Release 24/97

Eurostat, *Treatment of Indirect FDI Relationships*, BOPCOM-02/34

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IMF, *Clarification of the Recommended Treatment of Selected Foreign Direct Investment Transactions*, BOPCOM-01/20B

IMF, *The Macroeconomic Statistical Treatment of Reverse Transactions*, BOPCOM-01/16

IMF, *Mutual Funds and "Fund of Funds": Portfolio Investment or Direct Investment?*, BOPCOM-01/22

IMF, *Working Group on Repurchase Agreements and Securities Lending*, BOPCOM-01/17

IMF, *Recommended Treatment of Selected Direct Investment Transactions (2002)* http://www.imf.org/external/np/sta/di/fditran.htm (based on previous BOPCOM decisions)

IMF, *Classification of Financial Derivatives in Direct Investment: Letter Sent to IMF's Balance of Payments Correspondents Promulgating the Final Decision of the Committee* BOPCOM-02/77

IMF, The "Fully Consolidated System" (paper presented at OECD Workshop on International Investment, March 2003)

R. Kozlow, *Exploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment* (BOPCOM-02/35)

National Bank of Belgium, *The Practical Implementation of the Directional Principle in Foreign Direct Investment: Some Countries' Experience and the Belgian Case,* BOPCOM-02/33

OECD, *Clarification of Foreign Direct Investment Recommendations*, BOPCOM-01/20A

OECD, *Clarification Of Foreign Direct Investment (FDI) Concepts: "Permanent Debt"* (paper presented at OECD Workshop on International Investment March 2003)

OECD, *Harmonisation Of Mergers And Acquisitions (M&A) Statistics* (paper presented at OECD Workshop on International Investment March 2003)

Changes from *BPM5*:

(a) *Changes proposed:*

There will be greater integration of the financial asset classification with *MFSM*/*1993 SNA*, while containing a debt/equity/other split (paras. 5.4–6, table 5.1).

Claims by direct investment enterprises on direct investors and liabilities to direct investment enterprises by direct investors will be shown on the asset and liability sides, as appropriate (Table 5.3, para. 5.20).

A new financial instrument and a functional categories will be introduced for "Financial derivatives and employee stock options" with subcategories for "financial derivatives" and "employee stock options" (para. 5.7(g)).

A definition of when tradable loans are to be classified as securities will be introduced (paras. 5.8(f), 5.45(a)).

The treatment of Islamic financial instruments will be discussed (para. 5.8(j)).

The applicability of direct investment outside the usual corporate structures will be clarified (unincorporated joint ventures, mutual funds, insurance companies, trusts) (para. 5.15).

The treatment of permanent debt between affiliated financial intermediaries will be clarified in line with previous Committee decisions (para 5.27(a)).

Debt between a branch and its parent will be discussed (para. 5.29).

The definition of reserve assets will remove "and/or for other purposes" (para. 5.46).

Financial derivatives will be excluded from reserve assets (para. 5.48).

Securities provided under repurchase agreements will be removed from reserve assets (para. 5.51(c)).

"Other claims" in reserve assets will be included under "foreign exchange," rather than as a separate item (Table 5.3).

The concept of LCFAR will be dropped (para. 5.60).

Debt instruments indexed to a particular currency will be classified to that currency (para. 5.67).

(b) *Changes raised as an option:*

Additional breakdowns of equity in mutual funds could be introduced (para. 5.7(e)).

Additional breakdown of financial derivatives is proposed (para. 5.7(h)).

Arrears and/or nonperforming loans could be shown as a supplementary subclassification of relevant instruments on an "of which" format, where relevant (para. 5.7(i)).

Financial gold could be considered as a financial instrument (para. 5.7(j)).

The threshold for direct investment could be reviewed (para. 5.13).

The definition of direct investment in cases of complicated structures will be clarified or changed (with the options being the "directly held," "FCS," "USM," and "10/50" definitions). This issue is linked to the use of voting power and/or ownership in the definition of direct investment (paras. 5.16–5.18).

"Round tripping," "mergers and acquisitions," and kind of activity splits could be introduced as supplementary data for direct investment (paras. 5.22, 5.31).

Direct investment debt finance could be broken down into long-term and short-term instruments (para. 5.28).

Debt between special purpose entities that have the primary function of financial intermediation and affiliated nonfinancial enterprises could be excluded from direct investment (para 5.28(b)).

Non-traded equity and debt securities could be included in other investment, rather than portfolio investment (paras. 5.32, 5.34).

Treatments of various financial derivatives are proposed (paras. 5.39–5.42).

The inclusion of pooled assets in reserves will be considered (para. 5.55).

A classification for medium-term maturity is raised as a possibility (para. 5.63).

Debt could be broken down into variable-rate and fixed-rate interest as a supplementary item (para. 5.71).

Terms to be included in glossary
(for inclusion in a cumulatively developed glossary for all chapters):

Accounts receivable (asset) / payable (liability)
Affiliate/Affiliated enterprise
Arrears
Asset
Asset-backed security
Associate
Bonds and notes
Branch
Claim
Convertible bond
Credit derivatives
Currency (and deposits?)
Currency swaps
Debt
Debt security
Deposits
Direct investment
Direct investment abroad
Direct investment enterprise
Direct investment finance
Direct investment in reporting country
Direct investor
Employee stock option
Equity, equities
Equity security
Financial asset
Financial derivatives
Financial gold (if adopted as financial asset); contrast with industrial gold
Financial instrument
Financial leases/leasing
Financial reinsurance
Fixed-rate interest

Foreign currency
Forward
Fully consolidated system (FCS) – if adopted as definition, proposed to replace this term by something clearer, such as "indirectly-held direct investment relationships"
Gold—see financial, monetary, nonmonetary
Gold deposit
Gold on loan
Gold swap
Hedging
Indirectly-held direct investment relationships
Insurance technical reserves
Interest rate swaps
International reserves (or just "reserves" or "reserve assets"?)
LCFAR (if retained as a concept)
Liability
Loan
Long-term
Monetary gold
Money market instrument
Money market mutual funds
Mutual fund (includes unit trusts)
Nonmonetary gold
Nonpermanent debt
Obligation
Options
Original maturity
Other debt instrument
Other deposit
Other investment
Over-the-counter
Permanent debt
Portfolio investment
Reinvested earnings
Repurchase agreement (repo)
Residual maturity
Retained earnings (contrasted with reinvested earnings)
Reverse direct investment
Reverse repo
Round tripping
Securities lending
Securitization
Short-term
Sibling

Special Drawing Right (SDR)
Special purpose entity (SPE), special purpose vehicle (SPV)
Subsidiary
Swap
Trade credit and advances
Trade-related credit
Transferable deposit
Underlying
Variable-rate interest