Transactions with Affiliated Financial Intermediaries

Prepared by the Bank of Japan
Transactions with Affiliated Financial Intermediaries

1. Introduction

○ In the *IMF Balance of Payments Manual fifth edition (BPM5)*, the method of compiling financial transactions between units that are not financial intermediaries and affiliated financial Special Purpose Entities (SPEs\(^1\)) is not clearly stated. While the subject has been continuously discussed at meetings of the IMF Committee on Balance of Payments Statistics, no agreement has been reached yet. Currently, the treatment of financial transactions concerning financial SPEs differs from country to country, and is thus a source of discrepancy in the bilateral comparison and cross-country analysis of the foreign direct investment (FDI) statistics. Recently, international transactions involving financial SPEs are increasing as more multinational enterprises (MNEs) establish financial SPEs as convenient vehicles for re-channeling funds. With this in mind, this paper will discuss the treatment of these financial transactions in the Balance of Payments statistics.

—— A preliminary survey to identify the size of other capital transactions involving financial SPEs in Japan is presented in Appendix 1 and 2.

2. Review of the IMF Recommendation

*BPM5 (1993)*

In *BPM5*, financial transactions to be recorded as FDI “comprise not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated”\(^2\). The *BPM5* also recommends that “intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers) - including SPEs with the sole purpose of serving as financial intermediaries - recorded under direct investment capital transactions are limited to those

\(^1\) SPEs, in most cases wholly-owned subsidiaries, are separate legal entities and may be directly held by the ultimate parent company or by an intermediate holding company of multinational enterprises.

\(^2\) *BPM5*, paragraph 359.
transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment.”

However, it is unclear whether direct investment encompasses other capital transactions between units that are not financial intermediaries and affiliated financial intermediaries. Previous clarifications of BPM5 recommendations concerning the transactions of financial SPEs are found in paragraphs 542-544 of the 1996 IMF Balance of Payments Textbook and paragraph 86 of the 1996 IMF Co-ordinated Portfolio Investment Survey Guide. These clarifications have increased the scope of the exception to FDI. As a result, other capital transactions between units that are not financial intermediaries and affiliated financial SPEs whose sole purpose is to serve as financial intermediaries are now excluded from FDI. Still, it is unclear whether direct investment should encompass other capital transactions between units that are not financial intermediaries and affiliated financial SPEs principally engaged in financial intermediation for a group of related enterprises.

The IMF October 1999 meeting of the IMF Committee on Balance of Payments Statistics

Members of the IMF Committee on Balance of Payments Statistics discussed the following at their October 1999 meeting:

— The BPM5 definition of the scope of enterprises included under “banks and other financial intermediaries such as security dealers” should be clarified as being equivalent to the definition found in the following System of National Accounts 1993 (SNA93). The definition includes the following financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. As a result, financial SPEs principally engaged in financial intermediation for a group of related enterprises would be encompassed by that definition.

— The implications of the above clarification are that financial (and investment income) transactions between two related enterprises that are part of (1) other depository corporations (other than the central bank), (2) other financial intermediaries, except insurance corporations and pension funds, or (3) financial auxiliaries, would be excluded from FDI except for transactions in the form of equity capital or permanent debt.

3 BPM5, paragraph 372.
Financial transactions between units that are not financial intermediaries and affiliated financial SPEs should be recorded under FDI.

OECD November 2000 meeting of the OECD’s Working Group of Financial Statistics

Following the above views recommended by THE IMF, the OECD’s Working Group of Financial Statistics reviewed a proposal stating that “financial transactions between units that are not financial intermediaries and affiliated financial SPEs principally engaged in financial intermediation for a group of related enterprises should be recorded under FDI - financial transactions between affiliated financial intermediaries (including banks) would be excluded from FDI except for transactions in the form of equity capital or permanent debt -”. The group, however, postponed its decision.

3. Discussion on the IMF Recommendation

○ Regarding “transactions with affiliated intermediaries”, the IMF proposed that “financial transactions between units that are not financial intermediaries and affiliated financial SPEs should be recorded under FDI - financial transactions between affiliated financial intermediaries (including banks) would be excluded from FDI except for transactions in the form of equity capital or permanent debt -”. The IMF has two rationales for these recommendations:

① Because the structures of multinational enterprises are becoming more complicated, financial transactions between financial SPEs and other members of a group form an integral part of the structure of the direct investment network. If these transactions were excluded from the survey, identifying cross-border transactions and utilizing such data for cross-country analysis, which is the original goal of FDI statistics, would be hard to achieve.

② Unlike banks or securities brokers, financial SPEs are principally engaged in providing financial intermediation services for a group of related enterprises. Such financial intermediation occurs because there is direct investment within the group of related enterprises. This is different from the portfolio investment taking place in financial markets that expect return and appreciation in the value of investments. Considering this aspect, these transactions should be viewed as direct investment.

○ We believe the rationales and the IMF recommendation are appropriate considering the underlying concept of FDI. Furthermore, taking into account the increasing presence of financial SPEs enabling MNEs to pursue the cash efficiency and tax advantages, other capital transactions should be promptly classified as direct investment. Concretely, this
treatment should be included in the next edition of the *IMF Balance of Payments Manual*, which is now being prepared.

○ However, a few points need to be further discussed.

① **The treatment of financial transactions between units that are not financial intermediaries and affiliated financial SPEs whose sole purpose is to serve as financial intermediaries beyond a group of enterprises.**

—— Although few financial SPEs have the “sole purpose of serving in a financial intermediary capacity”⁴, and because the boundary between financial intermediation and many of the services that are auxiliary to financial intermediation has become blurred, financial SPEs whose sole purpose is to serve as financial intermediaries beyond a group of enterprises should be identified and excluded from the statistics. Financial SPEs whose sole purpose is to serve as financial intermediaries are different from the financial SPEs that are mentioned in the above IMF recommendation. The financial SPEs that are discussed in this context are those SPEs that function as financial vehicles between a group of related enterprises and the financial market. Investments to these financial SPEs are more portfolio investments than direct investments. Therefore, such investments should be excluded from the statistics considered as transactions between two financial intermediaries. However, it might be difficult to distinguish financial SPEs whose purpose is to serve as financial intermediaries from financial SPEs principally engaged in financial intermediation for a group of related enterprises.

—— For example, Japanese life insurance companies and trading companies have been establishing corporate-type investment funds in tax havens. Investments in these investment funds are recorded as direct investment when an investor owns 10% or more of the ordinary shares of the fund. The amount of this type of investment, which is actually portfolio investment but recorded as direct investment, has increased to the point that it cannot be ignored. For example, about 10% of Japanese FDI was investment in corporate-type investment funds in 2000. Since this type of transaction distorts FDI figures and confuses users of the statistics, these transactions should be categorized as portfolio investment. In the interim, identifying the magnitude of these de-fact portfolio investments would be useful.

⁴ *BPM5*, paragraph 365, 372
② The treatment of short-term cash transactions using the ‘cash management services’ (CMS)

Considering the fact that more MNEs are utilizing cash management services, cross-border capital transactions between parent companies and affiliated financial SPEs are likely to increase due to the daily cash demands. It is necessary to discuss and decide whether it is appropriate to clarify such transactions as FDI.