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Distortions in Direct Investment Related to Special Purpose Entities

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EUROPEAN CENTRAL BANK

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DISTORTIONS IN DIRECT INVESTMENT RELATED TO SPECIAL PURPOSE ENTITIES

For discussion of the IMF Balance of Payments Committee

Introduction

1. As a follow-up to a study of user needs regarding direct investment statistics, presented to the IMF Balance of Payments Committee in June 2005, the ESCB[2] Working Group on External Statistics has further investigated the possible distortions in direct investment (FDI) statistics caused by "Special Purpose Entities" (SPEs). A workshop was held in March 2006 in the ECB on this issue, with representatives of EU (and acceding) Member States, and the participation of Art Ridgeway, editor of the revised Benchmark Definition of FDI (BMD), John Motala (IMF) and Luis Ortega (Banco de Mexico). Further work was performed in the course of 2006, partly in cooperation with members of the OECD Workshop on International Investment Statistics, which set up in April 2006 a project group to further investigate this issue, also in response to the user needs for additional data series on "genuine FDI", as expressed by the OECD Investment Committee.

2. This note intends to inform the Committee of the outcome of the investigations performed so far. While a consensus has emerged, at least at European level, on the need to correct the main distortions observed in FDI statistics, and a number of potential solutions have been discussed, there is still no consensus on the solutions to be provided. This note describes the main approaches envisaged so far.

The views of the Balance of Payments Committee are kindly requested on the following questions:

1. **Do you agree with the identified distortions in FDI statistics as described in Section 2? Are you aware of other distortions?**
2. **What are your views on the envisaged solutions to these distortions, as described in Section 3?**
3. **More specifically, what should be shown as "FDI in an economy", "FDI abroad" and what should be excluded from these aggregates, given the above-mentioned distortions?**

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[1] Prepared by Pierre Sola.

[2] European System of Central Banks, i.e. the ECB and the national central banks of the 25 EU countries.

4. **Considering that a number of the envisaged solutions could possibly not be applied within b.o.p. and i.i.p. statistics, it may be considered to apply them in annual additional data. What are the views of the Committee on the communication issues to be considered in such a case?**

Section 1 – Phenomenon at stake: multiplication of specialised entities in multi-national groups

3. As highlighted in a report of the OECD Task Force on Financial Intermediation[3], financial innovation has not only led to the creation of new – sometimes complex – instruments, but has also "encouraged 'traditional' financial corporations to set up specialised institutions or to outsource the management of such instruments". This trend has also been developed by non-financial corporations, in order to reach efficiency gains, and in a number of cases to minimise their tax and regulatory burden[4].

4. As a result, an increasing number of "special" or "ad hoc" entities have been created by corporations - and by governments, in many cases with no production of goods and services and under different legal regimes.

5. While there is no agreed definition for such entities (partly because in some countries, reference is made to a special legal status rather than to economic categories), usually referred to as SPEs in FDI statistics. Investigations performed in the ESCB about these SPEs have allowed to identify the most common types of SPEs in Europe: see Annex 1.

6. The economic sectors for the b.o.p./i.i.p. and national accounts statistics are currently being reviewed, so that it is difficult to provide a classification yet. On the basis of the current Manuals and of the decisions taken so far, SPEs might be classified according to their main economic activity,[5] as follows:

- non-financial corporations: entities whose main activity is the production of goods and/or non-financial services. This would include in particular shared service centres (sharing resources for administration, marketing, accounting or other services), entities doing merchanting or entities owning licences or patents for the group or a regional partition of the group;
- financial intermediaries: entities performing transformation/repackaging of funds (i.e. transforming funds in terms of maturity, risk, scale and the like, and bearing the corresponding risk[6]);
- financial auxiliaries: providing financial services (rather than financial intermediation);

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[3] Report dated 17 September 2003, entitled "Measuring the production of financial corporations" and presented to the OECD National Accounts Experts Meeting in October 2003, page 5.

[4] As illustrated in some well-known cases, e.g. for the U.S. company "Enron", specialised entities have also been used in order to modify the financial situation and/or statements of some corporations.

[5] This list does not include the general government sector, as government is by definition a domestic sector in an economy, while the SPEs under consideration for FDI purposes are generally those set up in different territories as compared with their "mother". It happens, though, that such entities are created by, or on behalf of, foreign government agencies; this case is not considered in the note as it mostly has implications for government finance statistics (and was considered by the TFHPSA).

[6] An additional feature, though not explicit in current standards, is that financial intermediation implies some pooling of funds. As a result, an entity having all liabilities vis-à-vis one counterpart may not be regarded as a financial intermediary. The definition is in any case to be clarified in updated standards.

- empty shells: entities providing no goods or services (therefore entities without production and staff) and performing no financial intermediation.

7. Usually the economic classification of these entities intends to reflect their (primary) actual economic role, so that entities with similar names may be classified in different categories. For instance, entities called "conduits" may either be financial intermediaries, if they actually perform financial intermediation (including bearing the corresponding risk), or empty shells if they do not. Similarly, the classification of entities holding and managing (or not) subsidiaries is currently under discussion in international fora, and is likely to differentiate between those actively managing their groups and those playing only a role in legal terms.

Section 2 – Why these developments may distort the information content of FDI statistics

8. FDI statistics may be used for a variety of purposes. However, the investigations described in a note submitted to the BOPCOM in June 2005 (http://www.imf.org/external/pubs/ft/bop/2005/05-76.pdf) indicate that users of FDI statistics generally focus on the analysis of the impact of globalisation, and the effects of FDI on variables such as growth and employment. The literature also suggests that these users may expect direct investment to be characterised by some stability over time, implied to some extent by the notion of "lasting interest" in the FDI definition[7]; and to include specific features, e.g. affecting economic growth and employment in the target country and bearing financial conditions influenced by internal needs of multinational groups, rather than prevailing financial market conditions.

9. The proliferation of entities within multi-national group overall tends to increase the frequency and number of intra-group - and therefore FDI - transactions and positions, which may not bear the above-mentioned characteristics. Basically, the following two issues have been identified:

- ❖ Transactions/positions having no effect on an economy: "Capital in transit"

  Example 1*: a company located in the US, investing 1 million euros in China via an entity based in Luxembourg:*

  US ====> LU ====> CN

  One key feature of "capital in transit" is that it may occur not only through SPEs but also though any "usual" corporation.

- ❖ Transactions/positions [usually in other instruments than equity] having the characteristics of other cross-border investment rather than those of FDI

[7] However, stability is interpreted by some users as resilience at times of strains in financial markets, while others interpret this as low volatility over time.

Some transactions and positions, e.g. involving “empty shells”, meet the statistical definition of FDI (i.e. basically they are transactions between affiliated entities) and have an impact on the economy, but do not bear the above-mentioned features of FDI.

Example 2*: a company located in the US creates an entity in the Netherlands Antilles, which legally issues the bonds and lends the proceeds to the mother company in the US.*

NA ====> US

10. These two main distortions affect both the countries where entities involved in such entities (usually SPEs, but any other company in the case of “capital in transit”) are located as well as counterpart countries, but in different ways. This may be summarised through the following table:

	Host country	**Counterpart country**
Capital in transit	Positions and transactions having no effect on the local economy *Illustration: should the transaction/positions of example 1 be shown as “genuine” FDI in LU?*	Wrong geographical allocation of the country’s positions/ transactions[1] *Illustration: should the country breakdown of FDI statistics of the US and CN show LU as counterpart in example 1?*
Distinction between FDI and other cross-border investment	[Non-equity] positions and transactions not having the expected features of FDI *Illustration: should the transaction/position of example 2 be recorded as “genuine” FDI statistics of NA ?*	[Non-equity] positions and transactions not having the expected features of FDI *Illustration: should the transaction/position of example 2 be recorded as “genuine” FDI statistics of the US ?*

[1] In some cases, investment initiated in one country may be re-directed back to the same country. In such cases, the wrong geographical allocation may result in overestimated total FDI in that country.

11. Investigations suggest that the two issues described above may lead to more or less significant distortions depending on the type of SPE at stake and possibly the role of the entity regarding the corresponding positions/transaction. The work performed so far has led to distinguish (i) empty shells, (ii) financial intermediaries, and (iii) non-financial corporations and financial auxiliaries. Annex 2 provides more detailed examples and explanations of the issues at stake.

Section 3 – Envisaged solutions

12. The following solutions have been envisaged to solve, at least in part, the above-mentioned distortions. These solutions are envisaged to be implemented only on a yearly basis, and probably outside the (monthly or) quarterly compilation of b.o.p./i.i.p. statistics, due to costs constraints, and because the main analytical needs are anyway perceived to focus to a large extent on annual data.

Envisaged approaches for "host countries" of capital in transit

13. The work performed so far in the ESCB has allowed to identify several approaches. Some of these approaches could be combined. These scenarios are made more explicit through examples, described under Annex 3.

<u>Scenario 1</u>: *defining "capital in transit" and identifying all transactions and positions meeting this definition.*

14. It may be envisaged to define "capital in transit" as "financial transactions (and/or resulting positions) going through a country without significantly affecting its economy." Capital significantly transformed (e.g. in terms or maturity, risk, scale) was proposed to be excluded from this definition, as the transformation usually implies some active work and therefore some impact on the economy (by fostering job creation, for example), and may convert capital with the characteristics of portfolio or "other" investment into capital with those of FDI.

15. This method requires identifying very precisely the positions and transactions intended to be excluded, on the basis of a definition of capital in transit. It requires in particular to identify capital in transit going through non-financial entities. The effort for reporters and compilers however seems to be much higher with this approach than with others, as the process to identify capital in transit is resource-intensive (in particular in communicating with the respondents to get survey data in line with the reporting guidelines). This method may also be prone to asymmetries, as capital in transit may not be easy to identify for reporters. The ESCB Working Group on External Statistics (WG-ES) has therefore proposed to reject this approach.

<u>Scenario 2</u>: *defining entities typically involved in capital in transit*

16. This scenario could be based on the above-mentioned definition of capital in transit. The proposal discussed by the WG-ES referred to the identification of "empty shells", defined as legal entities having no production [and also no staff], and performing no financial intermediation. Transactions/positions of such entities may be seen as clear cases of capital in transit.

17. This method allows identifying only the capital in transit going through empty shells, as defined above. It seems to be feasible in practice, and is in line with the definition of direct investment and its analytical features as agreed by the WG-ES, following investigations by an ad hoc "FDI Workshop". The main drawback is that this approach does not cover all capital in transit – according to the above definition - as it misses capital in transit going through other entities.

Scenario 3: using the "netting" approach

18. A proposal was made to identify gross and net positions/transactions of (a) entities with a non-resident "Ultimate Beneficiary Owner" (UBO[8]) and (b) entities with a resident UBO. This proposal is referred to as "scenario 3a" in this note. A variant of this approach, whereby all transactions and positions would be netted at the level of each resident entity, was also considered: this is described as "scenario 3b" thereafter. Both scenarios 3a and 3b go beyond the SPE issue and propose to redefine FDI in the economy and FDI abroad; this redefinition would therefore be applied not only by host countries of SPEs but by all countries[9].

19. As described in more detail in a note entitled "Supplementary FDI Statistics based on the conceptual framework of ultimate beneficial ownership/control" by Gerrit van den Dool, Bruno Terrien and Frank Ouddeken, dated April 2006, scenario 3a focuses on the gross and net investment received in the country by foreign controlled groups, and the (gross and net) investment abroad by locally controlled groups. Assets (vis-à-vis non-residents) of local entities of foreign groups provide a broad measure of "capital in transit", although it would include indistinguishably the assets (vis-à-vis non-residents) of local entities (of foreign groups) investing abroad capital raised within the country. One issue is whether this approach provides a better proxy of the "FDI in the economy" than currently recorded, as the liabilities of entities from foreign groups would include those of "empty shells" and other "SPEs", while the net investment in these entities may be much lower than the inward FDI actually playing a role in the economy. Conversely, some users may find it more logical that FDI in the reporting economy would only refer to foreign groups, while FDI abroad would be only performed by entities of local groups, which is also one feature of this approach.

20. Scenario 3b takes the view that FDI in the economy should be the sum of the net FDI received by local entities "absorbing" foreign investment (in net terms). Conversely, FDI abroad would be the sum of the net FDI invested abroad among "net foreign investors". This approach would net fewer positions/transactions than scenario 3a, and not separately identify entities of local/foreign groups, but would also allow for a complete coverage of "capital in transit", i.e. would not be restricted to a category of companies as scenario 2. Like scenario 3a it might exclude from FDI in the economy some capital playing a role in an economy.

Envisaged approaches for counterpart countries to "capital in transit"

21. While it could be envisaged to identify counterparts "looking through" the capital in transit, the WG-ES has taken the view that it would be more useful to focus on identifying the "Ultimate Investing

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[8] "Ultimate Beneficial Owner" should be understood in this note as similar to the "Ultimate Investing Country", though focusing on the "mother company" while the latter term would be the "country of the mother company".

[9] The redefined aggregates would however be compiled in addition to the current ones, rather than replace them.

Country" and "Ultimate Host Country", i.e. the country of the head office of the whole group and the country of the final subsidiaries in the chain, respectively, which may be analytically more meaningful.

22. There are several ways to construct such data. One difficulty is to produce figures consistent across countries as much capital is raised along chains of affiliates. The compilation of meaningful euro area/EU aggregates makes this symmetry issue particularly sensitive. Collecting UHC data, and to some extent UIC data, would in addition impose a significant additional burden on reporters.

Envisaged approaches to identify positions and transactions not having the characteristics of FDI

23. A number of approaches have been discussed in the WG-ES. The main options may be summarised as follows:

- either identifying in (or possibly excluding from) FDI some specific transactions/positions: in particular, the identification of "reverse loans", i.e. loans from any entity to its mother company[10], could solve a number of the identified distortions, although admittedly it might also lead to identify/exclude a few transactions bearing the usual features of "genuine" FDI;
- or identifying specific entities and some of their transactions/positions:
  - all transactions and positions of "empty shells"
  - and/or non-equity transactions and positions of "financial intermediaries" [this category could even be fully excluded from FDI]
- or netting on a yearly basis specific transactions/positions and entities, namely non-equity transactions and positions involving (resident or non-resident) financial intermediaries

[10] This could mean either the ultimate head of the group (the "ultimate investing country") and/or the direct mother, which could be e.g. a holding company.

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Annex 1: Examples of entities treated in some counties as SPEs:

- Shared services centres (sharing resources for administration, or marketing, or financial services) : The shared service centre (SSC) is a concept in which a business organisation consolidates all its administrative functions and in-house services in one place. The SSC promises to save a bulk of money, and provide better services to the company's internal customers[1].

- Entities doing merchanting, i.e. buying and selling goods from/to non-residents

- Entities owning holding licences or patents

- Investment Funds[1]: all collective investment undertakings (CIUs) investing in financial and non-financial assets to the extent that their sole objective is the investment of capital raised from the public.

- Hedge funds: any CIU which applies unconstrained investment strategies in order to achieve positive absolute returns, and whose managers, in addition to management fees, are remunerated in relation to the fund's performance.

- Securities and Derivatives Dealers[1]: investment firms which are authorised to provide investment services to third parties by investing in securities on own account as their business.

- Holding corporations /head offices (managing and controlling financial corporations) [1]

- Holding corporations / head offices (managing and controlling non-financial corporations)

- Holding corporations (only controlling financial corporations) [1]

- Holding corporations (only controlling non-financial corporations)

- Financial corporations engaged in lending [1]: entities specialised in lending activity, including in particular financial leasing[2], factoring, mortgage lending, consumer lending.

- Cash pooling centres: Such entities ensure "pooling cash in a central account to offset debit and credit balances. A cash pooling system can optimise the use of excess cash and interest yield, reduce interest expense and costly intra-company transactions, and the like"[3].

- Treasury centres: Treasury centres are usually in charge of managing the treasury activities of their group, including in particular:

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1 Definition quoted from Hong, Liang and Wannfors, Mats. (2000), *Euro cash pooling and shared financial services*, Göteborg, Graduate Business School

2 For statistical purposes, leasing is defined as financial leasing when the leasing period covers all or most of the economic lifetime of the durable good. At the end of the leasing period, the lessee often has the option to buy the good at a nominal price (ESA 95, Annex II).

3 Definition quoted from Hong, Liang and Wannfors, Mats. (2000) – see footnote above.

- Cash flow and cash position forecasting.
- Banking and cash management.
- Liquidity management: The treasury function has to ensure that the company has sufficient liquid funds available to ensure a smooth running of its operations and to meet short-term financial obligations as and when due. Moreover, treasury is also responsible for investing surplus funds.
- Funding management: The treasury function has to source and secure funds for the needs of the business.
- Debt portfolio management: The treasury function has to manage the debt portfolio which emerges from the accumulation of individual financing transactions so as to achieve an acceptable cost and risk profile for the portfolio over time.
- Risk management: The treasury function has to advise on and implement effective hedging of treasury type risks, especially, foreign exchange, interest rate and commodity price risks, as well as liquidity, credit and counterparty risks.
- Bank, financial counterparty and rating agency relationship management[4].

• Conduits entities whose main activity is to raise funds from international markets and lend the proceeds to their group

• Financial Vehicle Corporations[1]: securitisation vehicles

[1] Entities identified as "Other Financial Intermediaries" (Sector S123) by the ESCB.

[4] Extract from the "Guide To Treasury Best Practice & Terminology" handbook, quoted in https://www.marketplace.lloydstsb.com/doc/glossary/organisation.html.

Annex 2: Identified distortions in FDI statistics related to the various categories of SPEs

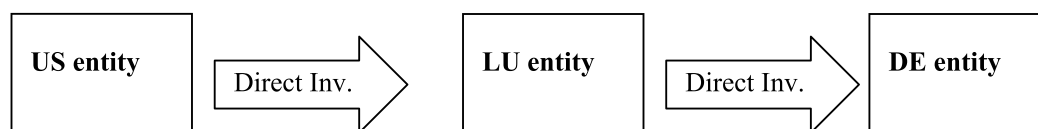
This annex focuses on the two types of distortions described under section 2, seen from both the point of view of the host country of SPEs and that of counterpart countries.

- **Issue 1: empty shells**

Issue 1.1: "capital in transit" going through "empty shells"

Two main cases have been identified:

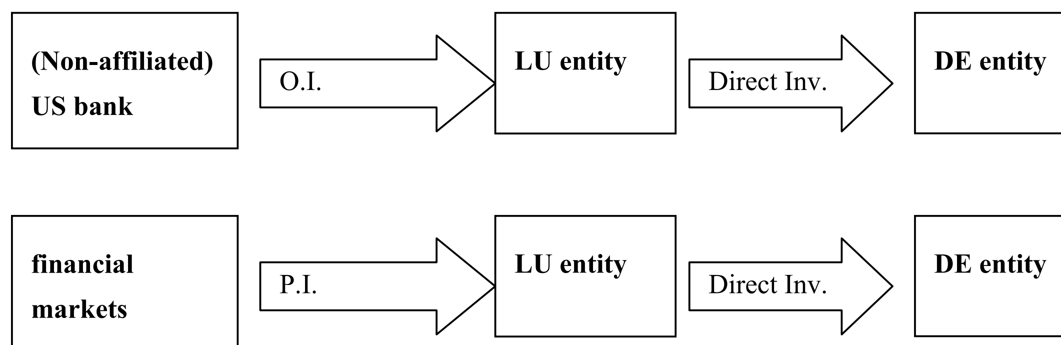
Case 1: pure "re-directing"of FDI



Host country: LU should inform users that the corresponding transactions and positions have no impact on the LU economy.

Counterpart country: DE would ideally provide information to users that the direct investment transaction or position is vis-à-vis the US.

Case 2 : Empty shell raising funds as other or portfolio investment [e.g. passive conduit] and lending the proceeds to its mother company [as FDI]:



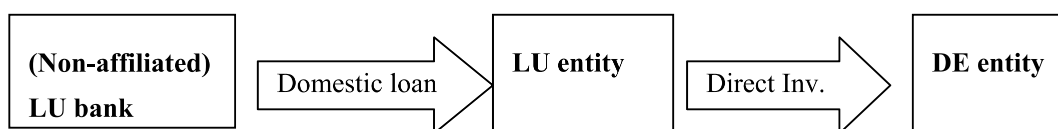
Host country: LU should either inform that the overall in and outflows have no effect on its own economy, or provide supplementary information to users that the outward direct investment is analytically more similar to "other investment" (O.I.) or "portfolio investment" (P.I.). The latter approach focuses on the distinction between FDI and other/portfolio investment: see issue 1.2 below.

Counterpart country: DE should provide supplementary information to users that the inward direct investment is analytically more similar to "other investment". Again, this issue actually focuses on the distinction between FDI and other/portfolio investment: see issue 1.2 below.

Issue 1.2: Transactions/positions having the characteristics of other cross-border investment rather than those of FDI

The case 2 above raised the issue of the distinction between FDI and other/portfolio investment for at least the "counterpart country", and possibly the host country of the SPE.

Case 3: empty shell raising local funding and lending the proceeds to its mother company



Host and counterpart country: LU and DE should provide supplementary information to users that the direct investment transaction/position is analytically more similar to "other investment".

❖ **Issue 2: financial intermediaries:**

Issue 2.1: "capital in transit" going through "financial intermediaries"

Two rather different cases may have to be distinguished:

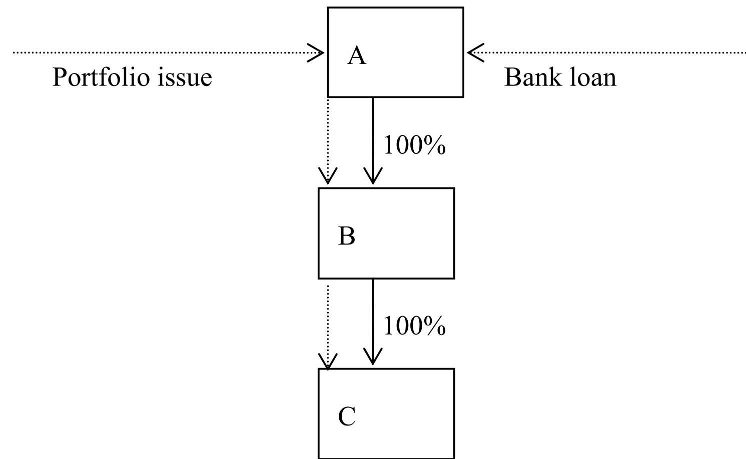
- first case: transactions involving no labour/value added in the entity:

The same transactions and positions as described for empty shells may be performed by financial intermediaries. It would however be very difficult and costly to identify them separately.

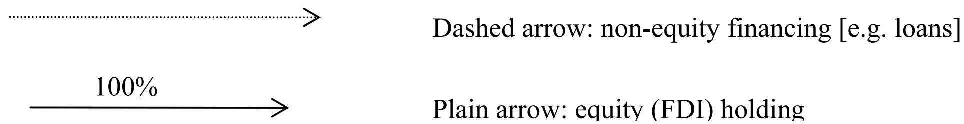
- second case: transactions involving some labour/value added in the entity: e.g. some "transformation" of funds

Some users of FDI statistics might have in mind "classical" structures of multinational groups, by which the mother company centralises both the decision making and the financing of the group. Such a situation may be summarised in the following chart:

Example 1



Legend:



It is assumed that all entities shown are in different territories.

In this example 1, company A has direct investment in companies B and C. This FDI is likely to be more stable than other financing (e.g. more resilient in times of strains on financial markets) and to be accompanied with transfers of know-how from A to B and C. Although FDI is not a measure of know-how transfer, the more FDI is received in a country from another country, the more it is likely that the receiving country will also receive know-how transfers[5].

However, the widespread recourse to cash pooling and other treasury entities has led to a separation between the functions of (i) decision maker [assumed to be associated with potential know-how transfer] and (ii) capital provider.

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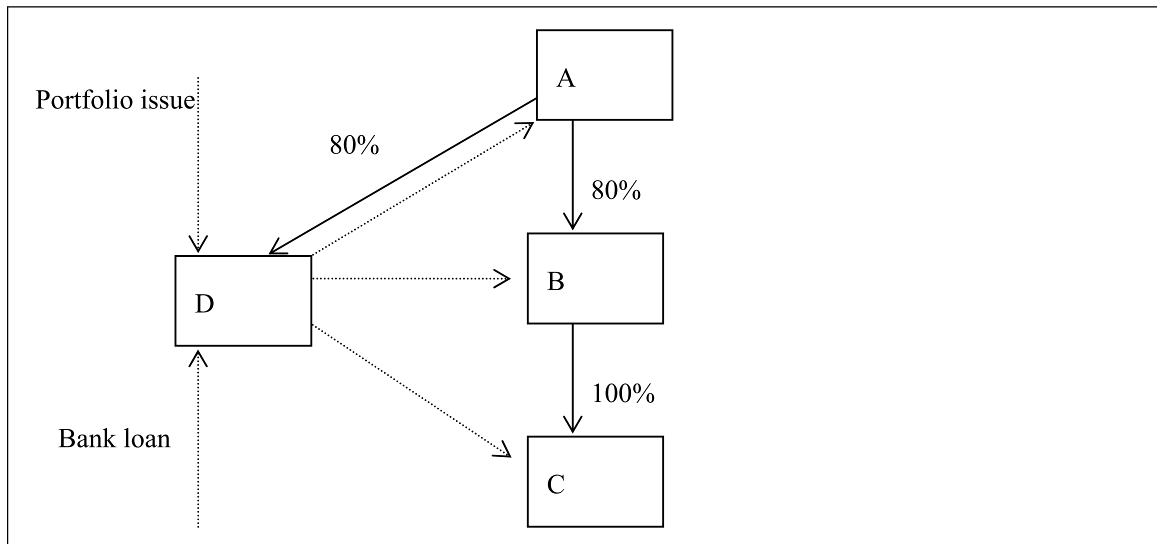
[5] B is likely to receive such transfers from A. However, it is not certain whether C received such know-how transfers from B or from A.

Example 2



In example 2, company A may only hold equity capital in B and C for limited amounts, and D may provide day to day financing, and even receive temporary excess liquidity from A, B or C and lend to the other companies of the group[6].

From the point of view of the *host country* of the financial intermediary, the financing flows between members of the group and channelled via D may in some cases have no influence on the economy where D operates, and may therefore be regarded as capital in transit. However, they may in other cases have influence on this economy [e.g. giving rise to a significant financial centre and economic growth] if the treasury activity is performed by local staff.

Issue 2.2: Transactions/positions having the characteristics of other cross-border investment rather than those of FDI

The example above also raises issues as to whether corresponding transactions and positions will have the usual features of FDI:

- *Counterpart country:* Transactions between D and B, and between D and C, reflect the same financing as provided by A in example 1. From this point of view, it looks delicate to justify that company's D transactions and positions would not be "genuine FDI". In particular, they are likely to have the same stability and resilience to financial market crises as those of example 1, and may go together with slightly better terms than if B and C were to obtain financing from banks or securities

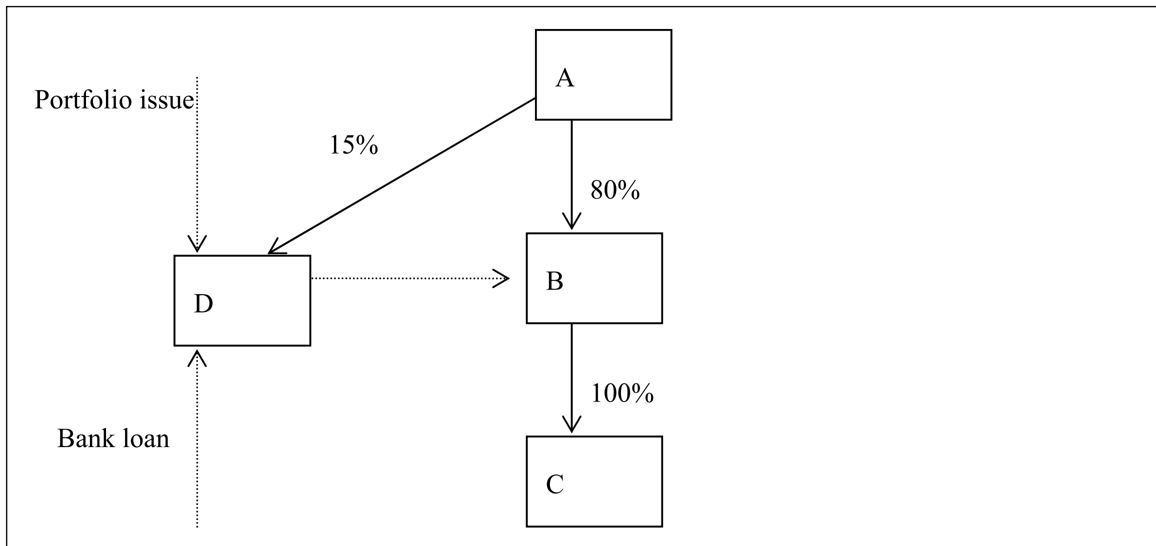
[6] As a possible illustration, see for instance Renault Finance in the organisational chart of the Renault Group, pages 18-19 of the following Annual Report: http://www.renault.com/renault_com/fr/images/REN_DRF_06_FR_LIVRE_tcm1119-387109.pdf.

markets[7]. However, one feature of "genuine" FDI is missing, i.e. there will probably be no technology transfer from D to B or C.

- *Both host and counterpart countries:* While the financing by A in example 1 might have been relatively stable, company D may be much more active in managing the liquidities of the group, which may result in significant daily flows between D and A, B and C. At least in the case of transactions between D and B and those between D and C (i.e. transactions between sister companies), money going out would be in assets, while the money going in would/may be in liabilities, though the net FDI financing within the group may be much more limited. An "inflation" of FDI transactions may therefore be observed, not only in the country of D but also in those of A, B and C.

A further issue has arisen of whether the behaviour of the financial intermediaries may not be significantly different depending on various criteria, especially whether the group has only limited influence on the financial intermediary:

Example 3



In this case, the transaction between B and D is likely not to be part of the group financing strategy, and may be very similar to "other" or portfolio investment, in terms of financing conditions and of stability.

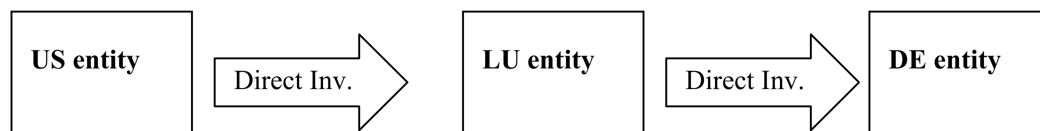
[7] This point is often disputed, as it has been argued that D would go bankrupt at some stage if offering better conditions than market financing. However, D might only aim to make no or a low profit, rather than maximize profits as independent banks, and may have lower expenses than independent banks (e.g. no advertising). This would allow D to provide slightly better conditions than those of an independent financial institution.

❖ **Issue 3: non-financial corporations and financial auxiliaries:**

As these entities contribute to GDP in the country where they are located (more precisely in the territory where their main centre of economic interest is located), and are not mainly involved in other financing activities, FDI transactions of these sectors usually include a higher proportion of "genuine" FDI.

However, such entities may also be used to transmit "capital in transit" or intra-group transactions not having the characteristics of FDI, which as above may be difficult to disentangle from other transactions[8].

One key issue refers to entities managing their group, sometimes called "holding" entities or "head offices". Such entities are usually part of the investment chain [as the legal decision power lies with shareholders]. The following example may be considered:



This example would be different from that considered under "Issue 1.1" above, to the extent that the entity in Luxembourg would be effectively managing the German entity [e.g. it could be in charge of managing the European part of the US group, or in charge of managing specific activities of this group all over the world]. While the capital invested in Luxembourg may be fully reinvested abroad, the Luxembourg entity usually affects the economy of Luxembourg, as having staff and production.

[8] A distinction may however be easier than with financial intermediaries, to the extent that their balance sheet may include very few large transactions/positions with non-residents, which could possibly be identified, at least for the largest ones. However, from a statistical point of view, this identification could be made only in the host country, and not in the counterpart country, thus possibly raising issues in terms of symmetry of recording.

Annex 3: Example illustrating the various envisaged solutions

It is supposed that the following ten enterprises have the following stock data, e.g. at end-2004. The economy considered is the euro area. It should be kept in mind that the various envisaged presentations would not show individual data, but ***only the totals, shown in bold*** for each scenario.

EUR millions

	Sector	**Positions in direct investment at end-2004**				**Country/ zone of UIC[3]**	**Country/ zone of UHC[3]**
		Liabilities		**Assets**			
		Equity	**Other capital**	**Equity**	**Other capital**		
A	Car	40				US	Euro area
B	Telecom.	5			30	US	CN
C	Empty shell[1]	60		20	40	US	CN
D	Electricity	50				US	Euro area
E	Treasury company of the same group a D	2	90		80	US	CN
F	Food		60	7		Euro area	CN
G	Cash-pooling centre (of a local[4] group doing wholesale trade)		25		30	Euro area	CN
H	Empty conduit[2]				10	US	CN
I	Computers	20		15		US	CN
J	Steel	14				Euro area	Euro area

[1] Defined as an entity having no production and no staff, and doing no financial transformation (see definition of financial transformation under Section 1 of the note).

[2] Empty shell, as defined above, but with the special characteristics that it (legally) issues securities and lends the proceeds to its mother company.

[3] UIC: Ultimate Investing Country; UHC: Ultimate Host Country

[4] In other words, G and the wholesale group are resident in the same economy.

Explanations:

- company F would be controlled by a local group and financed by a treasury (sister) company outside the country;
- company J would be controlled by a local group (i.e. a group resident in the same economy), but with a minority ownership (say 14% of voting securities) by a US company;
- the loans by company G are vis-à-vis a “sister company”; and

- H would be financed through the issuance of bonds for EUR 10 million, recorded as portfolio investment. It would also have equity capital held in the US, but assumed here to be of negligible amount, e.g. EUR 1 000.

The recording in current FDI statistics would be as follows:

Current recording

Enterprise	EUR millions FDI - equity		
	In the economy	Abroad	Net
A	40		
B	5		
C	60	20	
D	50		
E	2		
F		7	
G			
H			
I	20	15	
J	14		
Euro area	**191**	**42**	**149**

Enterprise	EUR millions FDI - other capital		
	In the economy	Abroad	Net
A			
B		30	
C		40	
D			
E	90	80	
F	60		
G	25	30	
H		10	
I			
J			
Euro area	**175**	**190**	**-15**

	FDI - total		
	In the economy	Abroad	Net
Euro area	**366**	**232**	**134**

The various alternative approaches envisaged so far may be summarised as follows:

a) "Scenario 2": The above-mentioned definition of capital in transit would refer to the current concept [applying or not the directional principle[9]], excluding capital "going through" brass plate entities as FDI. Legs not recorded as FDI could relatively easily be singled out under this approach as shown below;

[9] This principle, applied in the BPM5 and BMD3, requires to record investment by a daughter company into a mother company as a reduction in the initial direct investment rather than additional FDI in the opposite direction.

Scenario 2: separate identification of "empty shells"

Enterprise	In the economy	FDI - equity (EUR millions) Abroad	Net
A	40		
B	5		
C	0	0	
D	50		
E	2		
F		7	
G			
H			
I	20	15	
J	14		
Euro area	**131**	**22**	**109**

Enterprise	In the economy	FDI - other capital (EUR millions) Abroad	Net
A			
B		30	
C		0	
D			
E	90	80	
F	60		
G	25	30	
H			
I			
J			
Euro area	**175**	**140**	**35**

	In the economy	FDI - total Abroad	Net
Euro area	**306**	**162**	**144**

Or: "of which" items of the core accounts in the current recording
Capital in transit going through empty shells:

	Liabilities	Assets
	Liabilities	**Assets**
	FDI - equity: +60	**FDI- equity : 20**
		FDI other cap.: 50
	PI: +10	
C	FDI - eq.: +60	FDI - eq.: 20
		FDI - oth. Cap.: 40
H	PI: +10	FDI - oth. Cap.: 10

b) The definition of capital in transit applied for scenario 2 could be extended to cover also capital transformed within a country, thus not only referring to capital going through empty shells but also through affiliated financial intermediaries. Some explanation would however be needed of why netting is applied to financial entities and not to non-financial ones.

c) As described in more detail in the note “Supplementary FDI Statistics based on the conceptual framework of ultimate beneficial ownership/control” by Gerrit van den Dool, Bruno Terrien and Frank Ouddeken, dated April 2006, another approach may be to “net out” capital in transit. One way to do so would be to regard as inward investment in a country “all FDI operations ultimately initiated by non-resident UBOs (no matter how long the chain of ownership)”[10], and outward investment the transactions involving local groups (i.e. groups with a resident “UBO”). This would allow to show as FDI abroad only positions/transactions of local groups.

Scenario 3a: Distinction foreign/resident UBO)

Enterprise	Direct investment - equity						
	Inward (enterprise with non-resident UBO)			Outward (enterprises with resident UBO			Net
	Liabilities	Assets	Net	Liabilities	Assets	Net	
A	40						
B	5						
C	60	20					
D	50	0					
E	2	0					
F					7		
G							
H							
I	20	15					
J		0		14			
Euro area	**177**	**35**	**142**	**14**	**7**	**7**	**149**

Enterprise	Direct investment - other capital						
	Inward (enterprise with non-resident UBO)			Outward (enterprises with resident UBO			Net
	Liabilities	Assets	Net	Liabilities	Assets	Net	
A	0						
B		30					
C	0	40					
D	0	0					
E	90	80					
F				60	0		
G				25	30		
H		10					
I							
J							
Euro area	**90**	**160**	**-70**	**85**	**30**	**55**	**-15**

Enterprise	Direct investment - total						
	Inward (enterprise with non-resident UBO)			Outward (enterprises with resident UBO			Net
	Liabilities	Assets	Net	Liabilities	Assets	Net	
Euro area	**267**	**195**	**72**	**99**	**37**	**62**	**134**

[10] See note entitled “Special Purpose Entities and the measurement of Foreign Direct Investment”, by Frank Ouddeken, March 2005.

d) Under the approach of "scenario 3b", capital may be deemed "reinvested abroad" or "invested from abroad" if it affects the assets and liabilities of the same company[11]. In other words, a company with external (FDI) liabilities of 100 and external (FDI) assets of 10 would give rise to recording of FDI in the reporting economy of 90. Conversely, a company with external liabilities of 20 and external assets of 150 would give rise to the recording of FDI abroad of 130. Based on this approach, the recording would be as follows:

Scenario 3b: Netting at enterprise level

Enterprise	FDI - equity (EUR millions)		
	In the economy	Abroad	Net
A	40		
B	5		
C	40	0	
D	50		
E	2		
F		7	
G			
H			
I	5		
J	14		
Euro area	**156**	**7**	**149**

Enterprise	FDI - other capital (EUR millions)		
	In the economy	Abroad	Net
A			
B		30	
C		40	
D			
E	10		
F	60		
G		5	
H		10	
I			
J			
Euro area	**70**	**85**	**-15**

	FDI - total		
	In the economy	**Abroad**	**Net**
Euro area	**226**	**92**	**134**

Or: "of which" items of the core accounts in the current recording
Capital in transit going through local companies:

	Liabilities	Assets
	FDI - eq.: 35	**FDI - eq.: 35**
	FDI other cap.: 105	**FDI other cap.: 105**
C	FDI - eq.: 20	FDI - eq.: 20
I	FDI - eq.: 15	FDI - eq.: 15
E	FDI oth. Cap: 80	FDI - oth. Cap.: 80
G	FDI oth. Cap: 25	FDI - oth. Cap.: 25

[11] One could also take the point of view of groups of companies. However, this may be economically debatable, as many groups operate in different economic sectors, and is likely to raise even more difficult compilation issues. Alternatively, one may regard the company level as too aggregated, as companies may also be involved in various economic activities. However, in the absence of separate accounting data by activity, it appears difficult to collect such data.