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FDI Statistics—Treatment of Inter-Company Transactions of Financial Intermediaries with Non-Financial Entities

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FDI STATISTICS – TREATMENT OF INTER-COMPANY TRANSACTIONS OF FINANCIAL INTERMEDIARIES WITH NON-FINANCIAL ENTITIES

For discussion of the IMF Balance of Payments Committee

Introduction

1. In the context of the review of the IMF Balance of Payments Manual 5th edition (BPM5) and of the OECD Benchmark Definition of FDI 3rd edition (BMD3), the treatment of transactions between affiliated financial intermediaries and non-financial corporations has been discussed on a number of occasions. However, it has not been possible to reach a full agreement so far on the delineation between transactions and positions to be recorded as direct investment, and those to be excluded from this item. In particular the treatment of deposits with financial intermediaries or that of transactions and positions involving conduits require a final compromise in order to finalise the new Manuals.

2. This note intends to shed some further light on the role of financial intermediaries within multi-national groups, and to assess possible consequences in terms of the inclusion in or exclusion from direct investment of (non-equity) transactions and positions between financial intermediaries and other sectors.

3. This note focuses on "financial intermediaries", defined (in line with SNA93 and ESA95) as entities holding assets and incurring liabilities, in such a way that assets and liabilities have different characteristics with respect to maturity, risk or scale: "*The role of financial intermediaries is to channel funds from lenders to borrowers by intermediating between them. They collect funds from lenders and transform, or repackage, them in ways which suit the requirements of borrowers*" [SNA 93 4.78]. In addition, these financial intermediaries place themselves at risk by this transformation activity[2].

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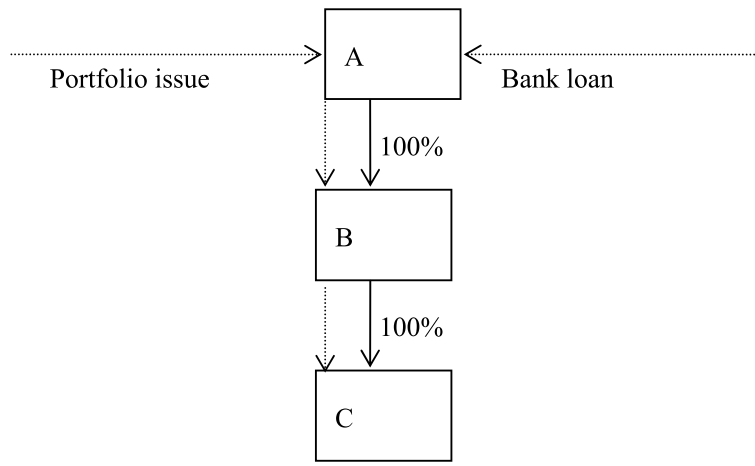
[1] This note was prepared by Pierre Sola.

[2] In other words, legal entities not transforming funds or not taking any transformation risk are not considered in this note as financial intermediaries. The exact borderline between financial intermediaries and other sectors is expected to be discussed under a separate item of the BOPCOM meeting.

The issue(s)

4. In "classical" structures of multinational groups, 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:

Dashed arrow: non-equity financing [e.g. loans]

100%

Plain arrow: equity (FDI) holding

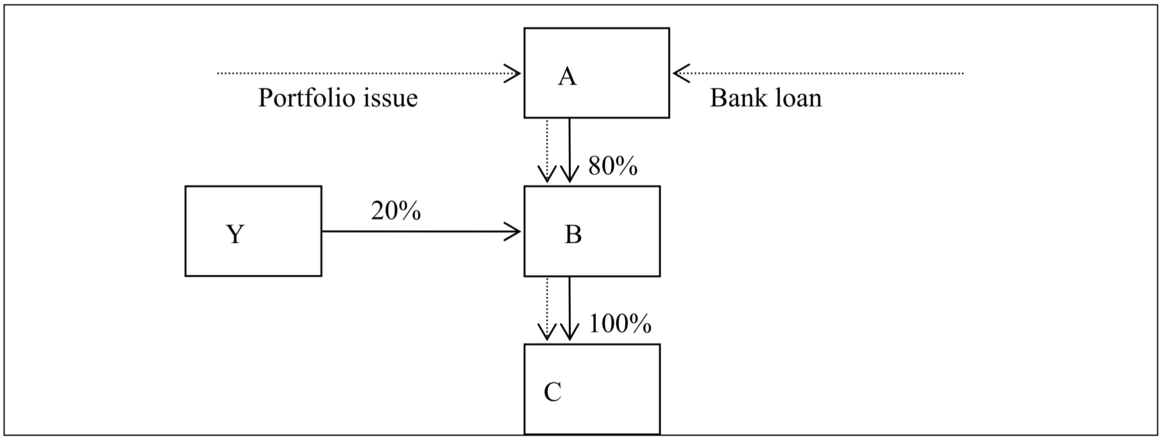
It is assumed that all entities shown are in different territories.

5. 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.

6. B may receive such transfers from A. However, know-how transfers received by C may come from A or for B.

However, as FDI includes not only fully controlled entities, it is likely to include many cases such as shown in example 2, i.e. with some minority holders.

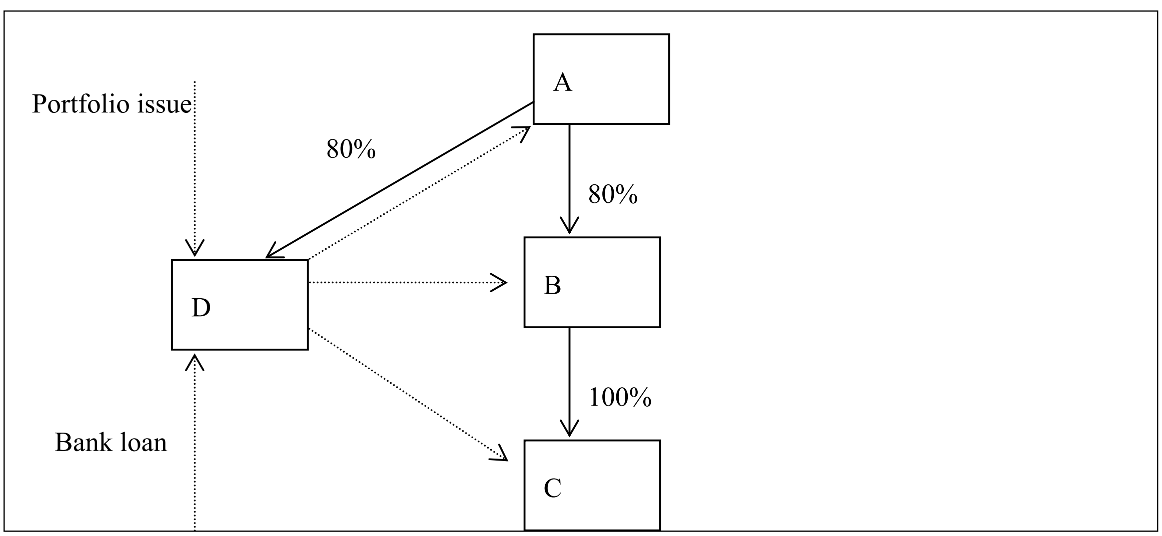
Example 2



7. In this case, both A and Y are direct investors into companies B and C. There may be technological transfers from A to B and C, but also from Y to B and C. In this example 2, A is still likely to be both the decision maker and the main provider of capital to B and C.

8. The widespread recourse to cash pooling and other treasury entities has led to a separation between the functions of (i) decision maker [assumed in this note to go with potential know-how transfer] and (ii) capital provider.

Example 3



9. In example 3, 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.

10. This situation has several consequences:

- 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 markets[3].

- However, one feature of “genuine” FDI is missing, i.e. there will be no technology transfer from D to B or C[4].
- Transactions between D and A may reflect excess cash from B and C being lent back to A e.g. for the purpose of investing in the country of A. However, it may be noted that within the directional principle, loans by B and C to A are deducted from the investment by A in B and C. They may also reflect capital raised on financial markets. To the extent that conditions may partly reflect those granted by the market to A [e.g. if A guarantees D’s borrowing], this financing may have some features of portfolio or other investment[5].
- 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 be regarded as capital in transit), but may in other cases have influence on this economy [i.e. giving rise to significant financial centres and economic growth] if the treasury activity is performed by local staff.
- 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), loans by D would be investment in the country of B (and that of C), while deposits to D may be investment abroad from the countries of B and C. An “inflation” of FDI transactions may therefore be observed, not only in the country of D but also in those of B and C.

11. The case mentioned under examples 1 and 2 may need to be distinguished from the following one:

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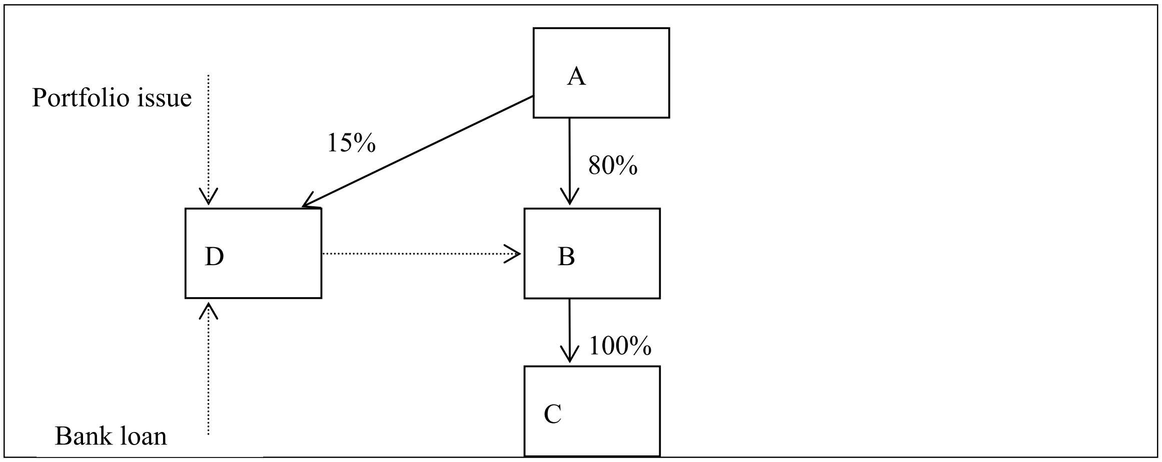
3 This point is often disputed, as it has been argued that D would go bankrupt as some stage if offering better conditions than market financing. However, D might only aim to make no or a low profit, rather than maximize profits like independents banks, and is likely to have lower expenses (e.g. no advertising)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

4 D will also have no “influence” on B and C. However, this is a common feature to FDI transactions between sister companies.

5 In case of a financial crisis in the country of A, the excess liquidity from B and C would probably still be available to A, but D might also have difficulties to raise cash on the markets to finance A.

Example 4



12. 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.

Possible approaches regarding the treatment of financial intermediaries:

13. As far as the FDI treatment of cash-pooling entities, treasuries and banks [and presumably of all financial intermediaries[6]] is concerned, the following approaches may be envisaged regarding non-equity transactions and positions:

- ❖ Approach 1: excluding all transactions and positions involving financial intermediaries from FDI (approach 1.1), or showing them in an "of which" (approach 1.2).
- ❖ Approach 2: One may keep all corresponding transactions in FDI, but add an "of which financial intermediaries held between 10% and 50%" ;
- ❖ Approach 3: it may be relevant to net out transaction and positions involving financial intermediaries, to at least avoid that frequent in and outflows inflate FDI statistics with no clear value for analysis. This netting could be performed on a monthly and quarterly basis (approach 3.1)[7], or it could be implemented only within a specific presentation produced on an annual basis, thus avoiding asymmetry problems in quarterly data and allowing to net compensating flows over a year (approach 3.2).
- ❖ Approach 4: excluding some specific transactions from FDI.

Two approaches have been considered in international fora, i.e. excluding from FDI reverse loans (approach 4.1) or excluding deposits to banks/Monetary Financial Institutions (approach 4.2)

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6 Although this generalisation might call for further investigations: in particular, investment funds may play a very different role and deserve a different treatment.

7 One way of applying this would be to record all transactions by a financial intermediary with a non-financial intermediary as assets for the financial entity and liability of the non-financial [as it would be expected that financial entities aim more at financing non-financials than to obtain funds from them].

The IMF BOPCOM has left open the possibility of excluding reverse investment of SPEs in their direct investors from FDI [see Summary of the BOPCOM meeting of October 2005: http://www.imf.org/external/pubs/ft/bop/2005/summary.pdf, page 9]. The exclusion of reverse investment by financial intermediaries may not be justified in all cases, as suggested by the examples shown in this note. However, such an exclusion may be justified by the fact that the financing obtained by the mother via an affiliated financial intermediary may have many features of portfolio/other investment. In addition, this exclusion could be extended to all reverse loans from any financial corporation to its mother[8], thus covering also empty shells (see note entitled "Distortions in direct investment related to special purpose entities") which lead to very significant distortions in current FDI statistics. This general exception from FDI seems to be sufficiently easy to identify and not to be prone to large asymmetries.

In contrast, the exclusion of deposits to affiliated banks (approach 4.2) would have a significant drawback, as capital transiting via cash pooling centres would be recorded in FDI only in one leg (i.e. MFIs' assets), thus impacting strongly net FDI in the countries where such entities are located. Similarly, this exception would probably distort net FDI figures of other countries, in cases of many inflows and outflows vis-à-vis cash pooling centres.

14. Some EU countries were supportive, whereas others were more doubtful regarding the following choices:

- the exclusion from FDI of all reverse loans by all financial corporations (i.e. approach 4.1), given in particular the large distortions in FDI statistics resulting from empty conduits, and the fact that transactions between financial intermediaries and their mother company often miss a number of usual features of FDI[9].
- Alternatively or in addition, it appears desirable to net out incoming and outgoing transactions and positions involving financial intermediaries, possibly within a complementary approach of FDI statistics (approach 3.2), on an annual basis[10].
- A further "of which financial intermediaries not controlled (but only influenced) by the UIC" may be envisaged, but only on a voluntary basis, as probably difficult and costly.

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

- ***Do you agree with the analysis of the role of cash-pooling centres as proposed in this note?***
- ***Do you think this is representative of the role of most financial intermediaries in FDI statistics? If not , please provide additional information on other cases to be considered;***
- ***Do you agree with the 3 proposals under paragraph 14?***
- ***Should such treatments be envisaged only within annual (possibly only stock) statistics?***

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8 One country has objected that reverse loans were sometimes made to a holding company, and not to the "Ultimate Beneficial Owner" of the Group. The extension of the proposal to all financial corporations would cover both loans to the holding and to the UBO, presumably.

9 It is acknowledged that this exception will not be justified in all cases, but it appears to solve many more problems than it creates.

10 This exact approach for this netting would have to be further specified and may be challenging in practice.