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Clarification C28
Direct investment

FOR INFORMATION

DIRECT INVESTMENT

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Direct Investment

1. This document is a report from the IMF Committee on Balance of Payments Statistics (the Committee) to the Advisory Expert Group (AEG) on National Accounts. It summarizes recent work on foreign direct investment issues by the Committee and OECD's Workshop on International Investment Statistics (WIIS) that is directly relevant to the revision of the IMF's *Balance of Payments Manual*, fifth edition (*BPM5*). Because direct investment is also a national accounting concept, much of the work is also relevant to the review of the *System of National Accounts, 1993* (*1993 SNA*).

2. An IMF/OECD Direct Investment Technical Expert Group (DITEG) was established to make recommendations on the methodology of direct investment statistics for the harmonized revisions of the *BPM5* and OECD *Benchmark Definition of Foreign Direct Investment*, third edition (*Benchmark Definition*).[1] DITEG submitted its recommendations for consideration by the Committee and the WIIS. Details of the working arrangements are set out in Box 1. The conclusions of both groups are very similar. The summary of the Committee's decisions is attached in Annex 1.

3. The major feature of these decisions is that the existing guidelines on direct investment in the balance of payments and international investment position are, in the main, either unchanged or align even more closely with national accounting principles. However, the deliberations led to recommendations for new supplementary detail to assist in the economic analysis of direct investment,[2] and provided a significant amount of valuable compilation guidance.

4. Among the most important areas that are to remain unchanged are:

- the 10 percent ownership threshold for establishing a direct investment relationship;
- the market price principle for the measurement of direct investment equity stocks, which was reaffirmed and emphasized;
- the resident status of Special Purpose Entities (SPEs)[3] in the economies in which they are registered or incorporated;[4]

[1] The fourth edition of the *Benchmark Definition* is scheduled to be published by the OECD by the end of 2007. This will be in advance of the release of the new balance of payments manual (BPM), but it is planned that the two documents will be fully compatible.

[2] In the new BPM, supplementary items are to be distinguished from standard components and will be options that may be considered by countries when a particular issue is of interest to analysts and policymakers.

[3] Includes Special Purpose Entities, Special Purpose Vehicles, brass plate companies, holding companies, and other similar entities that have minimal (or no) physical presence in the economy of their legal domicile.

[4] SPEs should be included in direct investment but where the size of transactions and stocks may be misleading for analysis of direct investment in any particular country, their activities should be reported on a supplementary basis as an "of which" component of direct investment (mostly debt), using national definitions.

- the recognition of the Fully Consolidated System (FCS) as the ideal conceptual basis for delineating the scope of direct investment enterprises within the direct investment relationship; and
- the retention of reinvested earnings as a transaction.[5]

5. Those that are to be changed include two that bring direct investment statistics more into line with national accounting principles, namely:

- A strict application of the asset/liability principle, so that asset claims of direct investment enterprises on their direct investors are no longer netted against liabilities. Similarly, income flows are to be grossed up. Presently, the standards recommend that income payable and receivable between a direct investment enterprise and its direct investor be netted.
- Holding companies as institutional units are to be classified in the financial corporations sector. This change is subject to a decision by the AEG on the discussion of item 25 on holding companies and SPEs that is on the agenda for this meeting. In those instances where such a holding company has subsidiaries in the same economy, compilers should consider also producing supplementary information with the group enterprise classified on the basis of the predominant activity of the "local" group to assist analysis of direct investment data.

6. In addition, the following change has been decided but this only affects the borderline between direct investment and other types of investment, and therefore it has no impact on the instrument based classification of financial instruments in the national accounts:

- "Permanent debt" between affiliated financial institutions is no longer to be considered direct investment.

Box 1. Working Arrangements for the Review of Direct Investment Methodological Issues for the Revision of the *BPM5* and the *Benchmark Definition*

The DITEG was created in 2004 as a joint IMF/OECD expert group to make recommendations on the methodology of direct investment statistics for the revision of the *BPM5* and the *Benchmark Definition*. DITEG held three meetings (June 2004 in Paris, December 2004 in Washington, D.C., and March 2005 in Paris) and has now been terminated after conclusion of its work. DITEG was jointly chaired by the IMF and OECD and serviced by a joint IMF-OECD secretariat. Countries and international organizations that provided members to the DITEG were Australia, Belgium, Canada, Colombia, France, Hong Kong SAR, Japan, the Netherlands, Russian Federation, South Africa, Tunisia, United Kingdom, United States, ECB, Eurostat, IMF, OECD, and UNCTAD.

The coverage of DITEG's work program was based on a list of items identified by the Committee and the WIIS as issues for review and resolution. DITEG's conclusions and recommendations were submitted for consideration to the Committee and the WIIS. All issues and outcome papers are published on the IMF's external website at www.imf.org, as are the decisions of the Committee.

The Committee considered the recommendations of DITEG at its meetings in October 2004 and June/July 2005. WIIS deliberations were presented for information to the Committee. The conclusions of both groups were very similar, mainly due to the high level of expertise of their memberships and the close cooperation and the degree of transparency between the IMF and OECD staffs.

[5] The Committee, however, recommended that the treatment of reinvested earnings should be reviewed by an expert group that it considered should be set up to review the concept of income within the balance of payments and national accounting framework. This work would become part of the research agenda beyond the deadlines for completion of the new BPM and reviewed SNA.

DIRECT INVESTMENT

DELIBERATIONS OF THE IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS (COMMITTEE), AS PART OF THE REVISION TO THE IMF'S *BALANCE OF PAYMENTS MANUAL*, FIFTH EDITION (*BPM5)*

Issue	***Outcome***	***Comments***
1. Valuation of: (i) direct investment equity: *whether the market price principle should be stressed, and, if so, how this should be applied to unquoted shares.* (ii) branches: *whether intangible assets should be included in the value of a branch.*	 (i) The Committee reaffirmed the market price principle and agreed to give it greater emphasis in the new balance of payments manual (BPM). For unquoted shares, several alternatives (depending on circumstances) were considered acceptable as proxies for market valuation. These included: recent transaction price; net asset value (with and without intangibles); capitalization ratio; and own funds at book value. (ii) The Committee agreed that, in principle, all assets of a branch should be included in determining value of the owner's equity.	 Unchanged. Improved compilation guidance. Aligned with SNA.
2. Definition of direct investment: 10 per cent threshold of voting power/equity ownership, employment (i) Whether the 10 percent threshold of voting power/equity ownership should be changed to 20 percent (in line with international accounting standards) and whether employment should be used as a criterion to determine whether there was "real" direct investment. (ii) Whether to adopt the same terminology with regard to subsidiary, affiliate, branch, unincorporated enterprise as in the 1993 SNA.	 (i) The Committee decided to retain 10 percent equity ownership as the threshold for establishing the direct investment relationship. The Committee decided not to use employment as a criterion for determining "real" direct investment. (ii) The Committee agreed that the new BPM should adopt same terminology as the SNA.	 Unchanged. Aligned with SNA.
3. Indirect investment—Fully Consolidated System (FCS), "US Method," or the "EU Method"	The Committee confirmed that the FCS represents the ideal conceptual basis for delineating the scope of direct investment enterprises within	Unchanged. Improved compilation guidance.

Issue	*Outcome*	*Comments*
	the direct investment relationship. Both the "US Method" and the "EU Method" (or the "10/50 rule") were deemed acceptable proxies for the FCS.	
4. Mergers and aquisitions	The Committee agreed that new breakdowns relating to mergers and acquisitions should be shown in the BPM as supplementary items.	New supplementary detail.
5. Reinvested earnings: (i) as affecting national saving (ii) of indirectly owned direct investment enterprises	 (i) The Committee agreed to retain current treatment in the new BPM but recommended the creation of an expert group to review the concept of *income* in the balance of payments and national accounts. The group would not be expected to report until after the new BPM and the reviewed SNA are published, and so its work would become part of the research agenda beyond these deadlines. (ii) The Committee clarified how reinvested earnings should be aggregated along a chain of indirectly owned enterprises.	 Unchanged for present revision. Improved compilation guidance.
6. Bring together all direct investment issues (stocks, flows, income, and other activities between affiliates) in an appendix to the new BPM	The Committee agreed that such a presentation should be described in an appendix and adopted on a supplementary basis in the BPM.	
7. Directional principle and reverse investment	The Committee decided that direct investment positions, financial transactions, and income should be presented on a gross basis, under assets, liabilities, receivables, and payables (rather than including reverse investment flows on a net basis). The Committee agreed to retain reverse investment (i.e., investment by a direct investment enterprise in its direct investor, even when the reverse equity holding is less then 10 per cent) as direct investment.	Aligned with SNA principles. Unchanged.
8. Special Purpose Entities (SPEs), shell companies, holding companies, offshore enterprises (units, sectorization, residence, transactions)	The Committee agreed that SPEs, shell companies, etc., are resident in the economy in which they are legally domiciled.	Unchanged. Consistent with a decision at the December 2004 AEG meeting.

Issue	*Outcome*	*Comments*
	The Committee agreed that holding companies as institutional units should be classified in the financial corporations sector and that compilers should consider also the production of supplementary direct investment data classified by the sector of the enterprise group resident in the same economy.	To be separately considered under AEG issue #25 at this AEG meeting.
	The Committee concluded that further consultation is required to address whether non-equity transactions and positions between a "conduit" SPE and a related nonfinancial entity should continue to be included in direct investment. This issue, which may lead to a change that affects only the borderline between direct investment and other functional categories, is under consultation among direct investment experts.	Possible change that would affect only the borderline between direct investment and other functional categories of investment.
	The Committee agreed that, to enhance the analytic usefulness of data on direct investment, data on "SPEs" be shown on a supplementary basis, using national definitions, for countries where these entities are important and where the size of direct investment transactions and stocks might otherwise be misleading.	New supplementary detail.
	The Committee agreed that users' requests concerning more information on SPEs should be provided, by making use of standard principles within the BOP framework, while noting that no single solution to SPE operations would be appropriate in all cases.	
	The Committee noted a need to explore ways of determining the main characteristics of SPEs, which can be used by countries in isolating SPEs transactions and positions.	Consistent with a decision at the December 2004 AEG meeting.
	The Committee agreed that supplementary positions and income	New supplementary detail (possibly only described in the

Issue	***Outcome***	***Comments***
	data on a Ultimate Beneficial Owner (UBO)/Ultimate Beneficiary Affiliate (UBA) basis be generated outside the core accounts of the BOP.	OECD *Benchmark Definition of Foreign Direct Investment*).
9. Rules for identification of branches	The Committee endorsed the view that the existing criteria (including the one-year rule, flexibly applied) should be applied to determine whether a branch is a separate institutional unit. The Committee emphasized that the absence of an income statement and a statement of assets and liabilities would make the collection of data for a branch very difficult.	Unchanged. Consistent with a decision of the December 2004 AEG meeting.
10. Country identification (UBO/UBA and immediate host/investing country)	(i) The Committee recognized that, for country and sector analysis, the immediate host/investing country concept should be the principle for identifying host and home countries for the core accounts. (ii) The Committee recognized that supplementary information on the UBO/UBA basis would be valuable for analysis of direct investment positions and income outside the core accounts. See also issue #8.	Unchanged in the core accounts. New supplementary detail (possibly only described in the *Benchmark Definition*).
11. Round tripping *Round tripping refers to the channeling by direct investors of local funds and the subsequent return of these funds to the local economy in the form of direct investment.*	The Committee confirmed that round tripping should be included in direct investment, with separate supplementary breakdowns included in the BPM presentation. This decision could be partly affected by the results of the consultation described under issue #8.	Unchanged in principle. New supplementary detail.
12. Permanent debt between affiliated financial institutions (other than insurance corporations and pension funds)	The Committee agreed that, on conceptual grounds, permanent debt represents direct investment but that, on grounds of practicality and statistical significance, should be recorded as either portfolio investment or other investment, depending on the instrument.	Change that affects only the borderline between direct investment and other functional categories of investment.
13. Land and buildings owned by non-residents	The Committee agreed that, subject to the outcome of considerations of the issue by Canberra II, at its meeting in September 2005: - the treatment of long-term leases of land and buildings, and, by extension, other natural resources, by	Subject to AEG decisions at this meeting on relevant Canberra II proposals.

Issue	*Outcome*	*Comments*
	nonresidents needs to be clarified in the new BPM; - where an effective change of ownership takes place (comparable to a finance lease) that a notional resident entity be created, in the same manner as with an outright purchase of land and buildings, and other natural resources; - such an acquisition by a notional entity represents an equity investment.	
14. Use of maturity and full instrument split for direct investment	The Committee decided that an instrument breakdown of direct investment that is consistent with the SNA instrument breakdown, and a maturity split, should be included in the supplementary items, with compilation priority being given to the instrument split.	Alignment with SNA for instruments. New supplementary detail on maturity.
15. Transactions/positions between banks and affiliated (financial and nonfinancial) entities	The Committee agreed to continue the present exclusion from direct investment of non-equity transactions and positions between affiliated financial corporations (other than insurance corporations and pension funds). In addition, see decisions regarding permanent debt (issue #12) and consultations regarding conduit SPE activities (under #8).	Unchanged.
16. Banking activities: *payments by a branch to its nonresident head office that result in a zero balance in the branch's income account*	The Committee agreed that such payments should be treated as income, and not to try to separate any other elements (such as service payments).	Clarification.
17. Shipping companies: *should recording transactions/positions under direct investment related to shipping companies be further clarified in the BPM?*	The Committee agreed.	Unchanged. Improved compilation guidance.
18. Natural resource exploration and construction: *should existing rules in determining the residency of enterprises operating in construction and natural resource exploration be preserved?*	The Committee agreed.	Unchanged.
19. Other capital (focusing on short-term instruments): *that all other capital transactions and stocks, both long-term and*	The Committee agreed to retain present treatment.	Unchanged.

Issue	***Outcome***	***Comments***
short-term, between direct investment related enterprises should be included in direct investment and not in other investment (other than the specific exceptions mentioned in #8, #12, and #15) and thus to keep the existing treatment unchanged		
20. Inter-company transactions and amounts outstanding with fellow companies (i) Should they be included in direct investment? (ii) If yes, is the asset/liability principle the most appropriate treatment for the transactions between fellow companies?	 (i) The Committee agreed (ii) The Committee agreed	 Unchanged. Clarification.
21. Valuation of real estate (i) Encourage the use of real estate price indexes (despite their methodological heterogeneity among countries) rather than a more general price index to calculate the market value of real estate stocks (ii) Reject the use of acquisition cost in the same purpose	 (i) The Committee agreed. (ii) The Committee agreed.	 Improved compilation guidance. Improved compilation guidance.
22. Collective investment schemes (units, sectorization, residence, transactions) (i) When hedge funds, private investment funds, and distressed funds have equity ownership in a nonresident entity of 10 percent or more, should such relationships be considered direct investment, or should there be some exceptions to the "10 percent" rule? (ii) Should feeder funds be treated as direct investors in their nonresident master funds if they hold 10 percent or more of the equity in the master?	 (i) The Committee decided to treat investment in, and investment by, hedge funds, private investment funds, and distressed funds as direct investment if the standard 10 percent threshold is met. (ii), (iii) and (iv) The Committee had divided views on the appropriateness of applying the 10 percent rule to investment in and by retail mutual funds and master/feeder funds. The Committee noted that it is necessary to have a	 Clarification. Affects only the borderline between direct investment and other functional categories of investment. Clarification to be resolved. Affects only the borderline between direct investment and other functional categories of investment. The decisions of this AEG meeting on AEG issue #44a may assist in the resolution.

Issue	*Outcome*	*Comments*
(iii) If equity investment by retail mutual funds in a nonresident entity meets or exceeds 10 percent of equity on issue, should the relationship be regarded as direct investment? (iv) How can these funds be identified?	definition in order to apply an exception and that further work needed to be done on this issue, in conjunction with other groups that may be examining this topic.	