ANNEX 3

List of Borderline Cases and Exclusions from FDI

1. List of borderline cases

1.1. SPEs and "capital in transit "

464. Financial corporations such as Special Purpose Entities (SPEs) or conduits that raise funds in open markets on behalf of their parent corporation or fellow enterprises are usually encompassed in the SNA definition of "Other financial corporations". Therefore, non-equity transactions/positions between these financial corporations should be included in FDI. A more detailed discussion of the SPEs and related issues may be found in Annex 7.

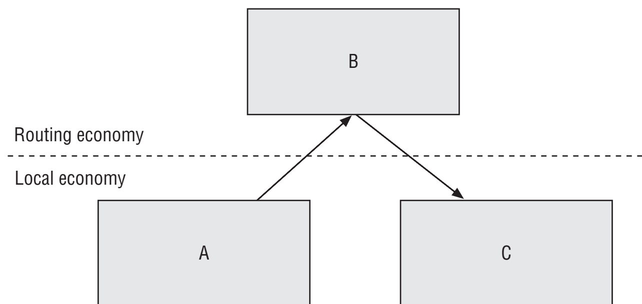
465. Fiscal SPEs are entities owned or controlled by general government that are resident in another territory and used for fiscal purposes. Such entities are resident in their economy of incorporation or registration, not in the economy of their owner. For example, a government may use a special purpose or other entity to issue securities to fund its expenditure. The *Benchmark Definition* recommends that fiscal SPEs should be treated as direct investment enterprises. All financial transactions and positions between them and their parent government should be recorded as direct investment.

466. More generally, cross-border transactions/positions which are pass-through capital (also referred to as "capital in transit ") via structures put in place to facilitate the financing and transfer of investment for multinational enterprises are included in direct investment as they are integral parts of a direct investment relationship identified according to the Framework of Direct Investment Relationships (FDIR). Nevertheless, these transactions often transit through a country without producing the expected impact of FDI in its economy when the final destination of investments is in a different economy. Since these transactions may distort the analysis of direct investment positions/transactions, this edition of the *Benchmark Definition* recommends that countries *i)* in their standard FDI presentation exclude funds going through resident SPEs from the key FDI statistics but to present them as a separate series; and *ii)* on a supplemental basis FDI looking through all (resident and non-resident) SPEs to the first non-SPE in the inward or outward chain. These statistics should be geographically broken down by country of counterpart and by industry classification to facilitate the economic analysis of direct investment. The presentation of direct investment statistics excluding "capital in transit" through operating subsidiaries is subject to further research (see Annex 13).

1.2. Round-tripping

467.   Round-tripping refers to the channelling abroad by direct investors of local funds and the subsequent return of these funds to the local economy in the form of direct investment. From the perspective of the local economy, the simplest example of round-tripping occurs when a domestic investment is disguised as FDI through a subsidiary or associate located abroad, in the "routing economy" (*i.e.* the economy through which the funds are routed). For example in Figure A.3.1 a company A in the local economy provides FDI funds to a non-resident related company (company B) for investing back in another company (company C) in the local economy.

Figure A.3.1. **A simple case of round-tripping**



468.   The simple group structure in Figure A.3.1 can be easily extended to cover other more complex group structures that are conducive to round-tripping. Two examples of such structures are included in Figures A.3.2 and A.3.3 below:

Figure A.3.2. **A case of round-tripping with many entities in routing economies**

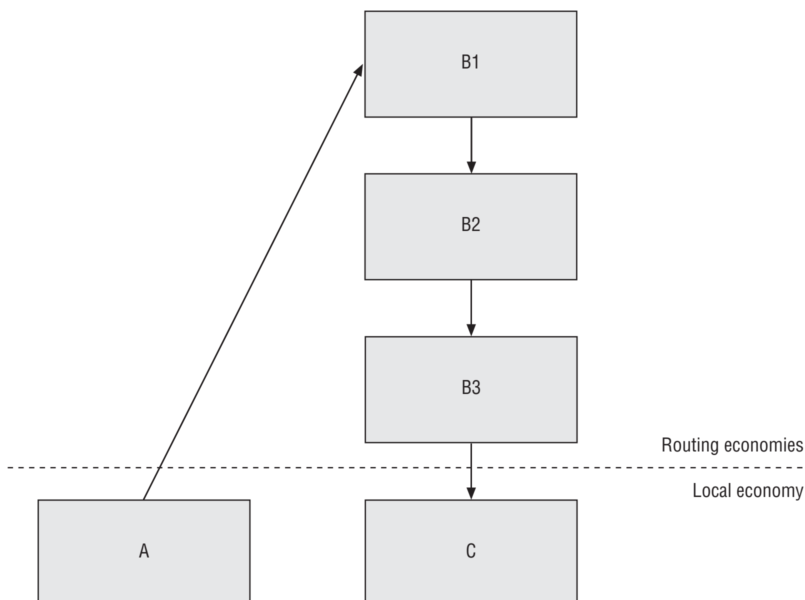


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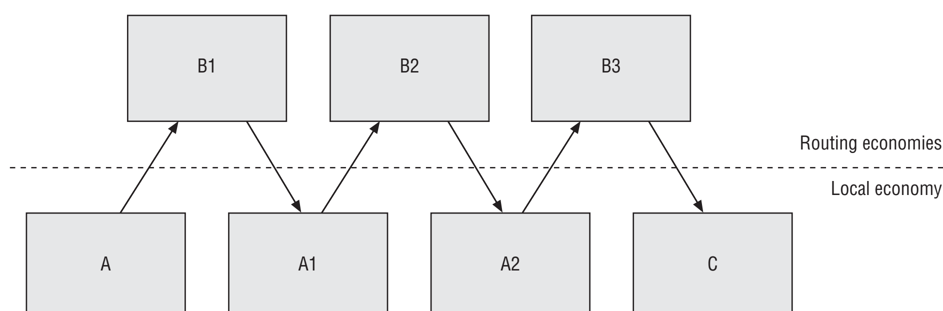
Figure A.3.3. **A case of round-tripping with many entities in routing and local economies**



469. There are many incentives for round-tripping, such as:

- *Tax and fiscal advantages*: Some economies provide preferential policies to attract FDI, including low taxation, favourable land use rights, convenient administrative support, etc. Since it is not always easy for local enterprises to attract foreign investors, they may channel domestic capital abroad which is then repatriated as foreign capital for local investment to take advantage of the preferential treatments only available to foreign investors;
- *Property right protection:* Infrastructure for property right protection in some economies is not well established. Therefore, the enterprises in these economies may have the motivation to locate their wealth in related enterprises set up in overseas economies having better legal and institutional settings for property right protection. Besides, some investors may prefer to conceal their identities by investing through companies set up in offshore financial centres. Capital will then be brought back to host economies in the form of FDI if there are profitable investment opportunities.
- *Expectations on exchange control and exchange rate*: Some economies have control of financial movements and exchange rate. Expectations on changes in exchange control and exchange rate may generate round-tripping for greater flexibility in foreign exchange management.
- *Accessing better financial services*: Financial markets of some economies are not well developed. Enterprises resident in these economies have to access overseas financial markets for better financial services, such as listing of companies in overseas stock markets. The funds raised will be brought back to host economies in the form of FDI. Round-tripping may occur as part of this process.

470. As such, round-tripping of funds flowing between subsidiaries, associates or fellow companies have to be recorded as FDI transactions/positions. For the local economy, they appear as FDI assets for the local funds channelled to routing economies, and as FDI liabilities for the subsequent return of the funds to the local economy. For the routing economy, they appear as FDI liabilities for the funds received from the local economy, and as FDI assets for the return of these funds to the local economy.

471. It may be argued that these round-tripping funds lead to an overstatement of the genuine magnitude of FDI. The *Benchmark Definition* recommends therefore separate supplementary breakdowns when this phenomenon affects significantly FDI data of a country. From the point of view of the routing economy, round-tripping may be partly

linked with "capital in transit " transactions /positions; in this case, the *Benchmark Definition* recommends that round-tripping that takes the form of "capital in transit" would be excluded from the key FDI statistics but separately distinguished. From the point of view of each local economy, the geographical breakdown according to the Ultimate Host Country (UHC) and the Ultimate Investing Country (UIC) could provide users with very interesting information.

1.3. Investment funds

472. The *Benchmark Definition* recommends that, when a collective investment institution (CII) has voting power in a non-resident entity of 10% or more, this relationship should be considered as direct investment. Similarly, when a non-resident enterprise has voting power in a CII of 10% or more, this relationship should be considered as direct investment. More specifically, investment in, and investment by, hedge funds, private investment funds and distressed funds should be included in FDI data if the standard 10% threshold is met.

473. Some concerns have been expressed about the inclusion in FDI of the investments in and by retail mutual funds and master/feeder funds. Although recognising the relevance of such concerns, the *Benchmark Definition* recommends that these investments should not be an exception to the "10%" rule. A more detailed discussion of this issue may be found in Annex 8 which discusses collective investment institutions.

1.4. Payments associated with the acquisition of a right to undertake a direct investment

474. In many developing or transition economies, the government requires the payment of an agreed amount of money by direct investors for the right to undertake a direct investment in the host economy. Often, but not always, these operating or concession rights are related to the extraction of natural resources. In transition economies, compilers refer to these payments as "bonuses". They are legal transactions and should not be associated with poor governance.

475. The *Benchmark Definition* recommends that such bonus payments should be recorded as "direct investment: equity " when there is an intention to establish a direct investment enterprise (such as in the case of a contractual arrangement between the investor and the government).[65]

1.5. Other borderline cases

476. In the process of globalisation of economic activities, cross border transactions are carried out that at first glance may be regarded as foreign direct investment when in fact they do not meet the criteria. For example:

a) An enterprise undertakes to build for a foreign client, usually a government, a complete manufacturing plant, to provide technical know-how, and to manage and operate a plant for a number of years, without an ongoing on-site managerial presence and without other criteria for the existence of a direct investment enterprise being met. It has complete control over day-to-day operations and receives a management fee, paid either in cash or in goods produced by the plant.

65. See the IMF BPM6 for the treatment of such bonus payments when no direct investment enterprise is or will be established.

However, the enterprise has no equity stake in the plant and is performing a cross-border service.

b) An enterprise has a long-term contract with a foreign company, provides it with technical know-how, and has considerable influence over the quality and quantity of output. The enterprise may provide a loan to the foreign company and sometimes will have a member on the company's board. However, there is no equity stake. It is once again a cross-border service.

c) Some host countries have made agreements with a number of foreign enterprises where the host country supplies factory accommodation, electricity, staff accommodation, administration and labour. The foreign enterprise supplies all production machinery, fixtures and fittings for the building and production materials, and is responsible for the initial training of the labour force. The foreign enterprise then pays an agreed piecework rate for each item produced. Where the production machinery and fixtures and fittings remain the property of the foreign enterprise, there is technically a direct investment branch, though the branch's profits will be zero. There is no direct investment interest if the machinery becomes the property of the host country.

d) Some professional firms operate much like a multinational firm, but do not hold equity in one another. For example, unrelated (in an equity sense) accounting or management consulting firms may operate globally under a single name, refer business to one another and receive fees in return, share costs (or facilities) for such items as training or advertising, and may have a board of directors to plan business strategy for the group. This is not direct investment, and would be difficult or impossible to account for as such, but it does have much in common with direct investment.

e) Other cases might include foreign sales and representative offices, as well as foreign stations, ticket offices, and terminal or port facilities of domestic airlines or ship operators. Such offices or activities can be treated as direct investment only if they meet the requirements of residence and the attribution of production in an economy as described in Chapter 3.

2. List of exclusions from FDI

2.1. Transactions/positions/income between related financial intermediaries

477. The *Benchmark Definition* recommends that all inter-company flows – with the exception of those pertaining to equity finance – between certain types of related financial intermediaries should be excluded from foreign direct investment (FDI) transactions and positions. Deposits and other amounts lent by a financial intermediary to its financial intermediary subsidiary or associate located abroad, as well as deposits and other borrowings between such companies, should be classified as "other investment" rather than direct investment. A similar treatment applies to investment between fellow enterprises which are financial intermediaries. Debt securities between related financial intermediaries are classified as "portfolio investment ".

478. On conceptual grounds, permanent debt between selected related financial intermediaries would appear to qualify as direct investment. However, the *Benchmark Definition* recommends that, on grounds of practicality and statistical significance, it should instead be recorded as either portfolio investment or other investment, depending on the instrument.

479. The definition of the scope of enterprises included under "financial intermediary" should be equivalent to the System of National Accounts (SNA) definitions. The SNA classifies financial corporations under three categories, namely *financial intermediaries*, *financial auxiliaries* and *other financial corporations*. Financial intermediaries are institutional units that incur liabilities on their own account for the purpose of acquiring financial assets by engaging in financial transactions on the market. Financial auxiliaries are institutional units principally engaged in serving financial markets, but that do not take ownership of the financial assets and liabilities they handle. Other financial corporations are institutional units providing financial services, where most of their assets or liabilities are not available on open financial markets.

480. The financial corporations sector can be divided into nine sub-sectors according to its market activity and the liquidity of its liabilities (see Box A.3.1 below). Hence, non-equity transactions/positions (and investment income) between two related financial intermediaries, as they are described and numbered in Box A.3.1, that are part of 2) deposit-taking corporations; 3) money market funds (MMFs); 4) non-MMF investment funds or 5) other financial intermediaries, except insurance corporations and pension funds, would be excluded from FDI. While they are financial intermediaries, insurance corporations and pension funds are not treated in the same manner as other financial intermediaries for the purposes of this exclusion.

481. The following Table A.3.1 summarises the transactions/positions included in or excluded from FDI statistics for financial corporations (taking account of the particular treatment of FDI-related financial intermediaries):

Table A.3.1. **Overview of transactions/positions included in and excluded from FDI**

INVESTOR	INVESTEE	Financial intermediaries		Financial auxiliaries	Captive financial institutions and money lenders
		Except ICPFs	ICPFs		
Financial intermediaries Deposit-taking corporations, MMFs, non-MMF investment funds, other financial intermediaries (except ICPFs)	Equity finance	Included	Included	Included	Included
	Debt (including permanent debt)	**Excluded**	Included	Included	Included
ICPFs	Equity finance	Included	Included	Included	Included
	Debt (including permanent debt)	Included	Included	Included	Included
Financial auxiliaries	Equity finance	Included	Included	Included	Included
	Debt (including permanent debt)	Included	Included	Included	Included
Captive financial institutions and money lenders	Equity finance	Included	Included	Included	Included
	Debt (including permanent debt)	Included	Included	Included	Included

2.2. Financial derivatives

482. A financial derivative contract is a financial instrument that is linked to another specific financial instrument or indicator or commodity and through which specific financial risks (such as interest rate risk, foreign exchange risk, equity and commodity price risk, etc.) can be traded in their own right in financial markets. There are two broad types of financial derivatives: forwards (including futures and swaps, other than gold swaps) and options. Financial derivatives are excluded from FDI statistics.

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Box A.3.1 **SNA: classification of financial corporations**

1. Central bank

The central bank is the national financial institution that exercises control over key aspects of the financial system.

2. Deposit-taking corporations except the central bank

Deposit-taking corporations except the central bank have financial intermediation as their principal activity. To this end, they have liabilities in the form of deposits or financial instruments (such as short-term certificates of deposit) that are close substitutes for deposits.

3. Money market funds (MMF)

MMFs are collective investment schemes that raise funds by issuing shares or units to the public. The proceeds are invested primarily in money market instruments, MMF shares/units, transferable debt instruments with a residual maturity of less than one year, bank deposits and instruments which pursue a rate of return that approaches the interest rates of money market instruments. MMF shares can be transferred by cheque or other means of direct third party payments.

4. Non-MMF investment funds

Non-MMF investments funds are collective investment schemes that raise funds by issuing shares or units to the public. The proceeds are invested predominantly in long-term financial assets and non-financial assets (usually real estate).

5. Other financial intermediaries, except insurance corporations and pension funds (ICPF)

Other financial intermediaries except insurance corporations and pension funds consists of financial corporations and quasi-corporations which are engaged in providing financial services by incurring liabilities, in forms other than currency, deposits or close substitutes for deposits, on their own account for the purpose of acquiring financial assets by engaging in financial transactions on the market. It is a feature of a financial intermediary that operations for both sides of the balance sheet are carried out in open markets.

6. Financial auxiliaries

Financial auxiliaries consist of financial corporations that are principally engaged in activities associated with transactions in financial assets and liabilities or with providing the regulatory context for these transactions but in circumstances that do not involve the auxiliary taking ownership of the financial assets and liabilities being transacted.

7. Other financial corporations (Captive financial institutions and money lenders)

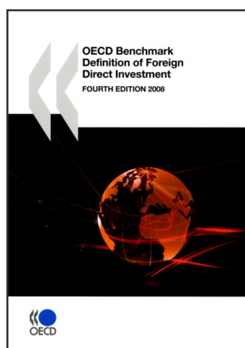
This sub-sector consists of institutional units providing financial services, where most of either their assets or liabilities are not transacted on open financial markets. It includes entities transacting within only a limited group of units such as with subsidiaries or subsidiaries of the same holding corporation or entities that provide loans from their own funds provided by only one sponsor.

8. Insurance corporations (IC)

This sub-sector consists of resident insurance corporations and quasi-corporations and autonomous pension funds. Insurance corporations consist of incorporated, mutual or other entities whose principal function is to provide life, accident, sickness, fire or other forms of insurance to individual institutional units or group of units.

9. Pension funds (PF)

Pension funds included here are those which are constituted in such a way that they are separate institutional units from the units which create them. They are established for purposes of providing benefits on retirement for specific groups of employees. They have their own assets and liabilities and they engage in financial transactions in the market on their own account.



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