IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #14

PERMANENT DEBT BETWEEN AFFILIATED FINANCIAL INTERMEDIARIES

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I. Current international standards for the statistical treatment of the issue

1. The fifth edition of the IMF *Balance of Payments Manual (BPM5)* indicates that "intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g. security dealers)—including [Special Purpose Entities] SPEs with the sole purpose of serving as financial intermediaries—recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share) capital, or in the case of branches, fixed assets. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries as classified, as appropriate, under portfolio investment or other investment." (Paragraph 372.)

2. The third edition of the OECD *Benchmark Definition of Foreign Direct Investment (BD3)* states that "in the case of banks, all intercompany flows – with the exception of those considered to represent permanent debt or equities – with related affiliates should not be counted as direct investment. Similar considerations apply to financial intermediaries... and to SPEs whose sole purpose is to serve as financial intermediaries. OECD recommends that intercompany flows between affiliated entities involved in these activities be excluded from direct investment. (Paragraph 40.) Although the *BD3* defines permanent debt simply as "representing a permanent interest" (paragraph 61), a footnote indicates that "[Bank of International Settlements] BIS "second-tier" capital might be a useful indication for compilers regarding what represents permanent debt."

3. The *Balance of Payments Textbook (BOP Textbook)* (paragraphs 542-544) specifically excludes from the direct investment data all non-equity/permanent debt transactions between a nonfinancial enterprise and an affiliated SPE with the sole purpose of financial intermediation, and specifically includes such transactions between a nonfinancial enterprise and an affiliated SPE with the primary purpose of financial intermediation

4. These statements have caused confusion in the past, for a number of reasons:

(a) The *BPM5* text could be interpreted as applying only to those transactions between affiliated banks and between affiliated financial intermediaries, and not to transactions between affiliated banks and affiliated financial intermediaries.

(b) The *BD3* text which refers to intercompany flows with related affiliates could be interpreted as referring to all related enterprises, including nonfinancial enterprises, and not just to those that are banks or financial intermediaries.

(c) Neither the *BPM5* or the BD3, or the *BOP Textbook* were clear about what exactly was meant by financial intermediaries.

(d) There seemed to be little justification for the differing treatment of SPEs with the sole purpose of financial intermediation and those with the primary purpose of financial intermediation, given that there is essentially no economic difference between the two types of SPEs.

5. As a result, following discussions with the relevant working groups at the OECD and the ECB, at its October 2001 meeting the IMF's Committee on Balance of Payments Statistics (the Committee) amended the treatment recommended in the international manuals. The decision affecting the treatment of permanent debt, which was promulgated in May 2002 in the document *Recommended Treatment of Selected Direct Investment Transactions*, was as follows: "The *BPM5* definition of the scope of enterprises included under "banks and other financial intermediaries such as security dealers" should be clarified as being equivalent to the following *SNA93* financial corporations sub-sectors: other depository corporations (other than the central bank); other financial intermediaries, except insurance corporations and pension funds; and financial auxiliaries. As a result, SPEs principally engaged in financial intermediation for a group of related enterprises would be encompassed in that definition.

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

- Financial transactions between units that are not financial intermediaries and affiliated financial SPEs abroad should be recorded under FDI."

The statement promulgating this decision emphasized that the effect of the last recommendation is that there is no longer be any difference between the treatment of SPEs that have the sole purpose of financial intermediation and the treatment of SPEs that have the primary purpose of financial intermediation.

II. Concerns/shortcomings of the current treatment

6. The argument has been made that there is little economic difference between permanent debt, which the present methodology specifies should be included in the direct investment data, and other types of debt and liabilities related to usual banking and financial

intermediation activities, which are to be excluded from the direct investment data, in that ultimately, the funds are all fungible. [1]

7. Concerns have been expressed about the difficulty of implementing the recommended treatment, with the result that many countries do not include permanent debt in their data on other capital.

8. The vagueness of the definition of permanent debt has also raised concerns, not least because it can lead to asymmetries in the bilateral data. To address this issue, the 2003 SIMSDI questionnaire asked respondent countries to provide the definition of permanent debt that they use in their direct investment data, with the aim of determining the extent to which there is consensus about what countries view as being permanent debt.

9. The IMF's *Annotated Outline for the Revision of the Balance of Payments Manual, Fifth Edition (AO)* stated that the definition of permanent debt and the possible exclusion of all debt between affiliated financial intermediaries will be considered in the revision of *BPM5*, and asked whether permanent debt between affiliated financial intermediaries should be excluded from direct investment, and whether, and how, the definition of permanent debt should be expanded.

III. Possible alternative treatments

10. There are two options:

(a) To retain the existing methodology for the treatment of permanent debt, as clarified in the decision of the Committee promulgated in 2002, and to amend the manuals to provide a more detailed definition of permanent debt.

(b) To amend the present methodology by removing permanent debt between affiliated banks and between affiliated financial intermediaries from the direct investment data and instead classifying it under Portfolio Investment or Other Investment as appropriate.

11. The comments on the questions raised in the *AO*, namely, *(i) Should this exception [to transactions between units in a direct investment relationship] be extended to [permanent] debt? (ii) Alternatively, should "permanent debt" be defined further, and if so, how?*

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[1] See the paper prepared by the US Bureau of Economic Analysis for the 2002 meeting of the IMF Committee on the Balance of Payments Statistics, *Exploring the Borderline between Direct Investment and Other Types of Investment: The U.S. Treatment.*

(Paragraph 5.27), show support for retaining the present methodology of including in the direct investment data permanent debt between affiliated financial intermediaries.

Total responses	4	
Yes	1	
No	3	

12. The preliminary results of the 2003 Survey on the Implementation of Methodological Standards for Direct Investment (SIMSDI) also tend to support option (a). Those results indicate that the number of countries that include permanent debt in their direct investment data has improved in recent years. Of the 86 countries[2] for which the issue is applicable, 56 (or almost two thirds) now include permanent debt between affiliated banks, and 46 include permanent debt between affiliated financial intermediaries.[3]

13. The 2003 SIMSDI results also support the need for further defining permanent debt and indicate that the precise definition being used varies across countries, with the most common definition being "subordinated loans". Of the 29 countries that had provided this information at the time of writing, 15 defined permanent debt as being "subordinated loans" or "subordinated debt" [4], including 2 countries that had an additional criterion of a maturity of 5 years or more. Five countries used definitions similar to those given in the *BPM5* and *BD3* of "debt involving a permanent or lasting interest" [5], 4 countries used the definition of "perpetual debt or debt with no fixed maturity" [6], 1 country defined permanent debt as being "both subordinated loans and perpetual debt", 3 countries defined permanent debt as being "debt that is part of the equity capital", and the remaining 2 countries defined it as being all "long-term loans between affiliated banks and between affiliated financial intermediaries".

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[2] At the time of writing, 22 respondent countries had indicated that they did not compile data on the other capital component of direct investment, and the 2003 SIMSDI questionnaire responses for 5 OECD countries and 3 non-OECD countries had not been received.

[3] This compares with the results of the 1997 SIMSDI, when half the countries included permanent debt between affiliated banks, and one third of the countries included permanent debt between affiliated financial intermediaries.

[4] Including Australia, Croatia, Estonia, Germany. Hungary, Ireland, Luxembourg, Norway, Portugal, Russia, Slovenia, Spain, and Switzerland.

[5] Including Kazakhstan, Kuwait, Lebanon, and Thailand.

[6] Including Finland, Hong Kong SAR, and the United Kingdom.

IV. Points for discussion

1. Do the DITEG members consider that the existing methodology for the treatment of permanent debt, as clarified in the decision of the Committee promulgated in 2002, should be retained?

2. If so, do the DITEG members consider that the definition of permanent debt should be amended to clarify the meaning of "permanent or lasting interest"?

3. If so, which, if any, of the following definitions do the DITEG members prefer:

(a) "Debt that represents a permanent or lasting interest, in the form of subordinated debt" ***or***

(b) "Debt that represents a permanent or lasting interest, in the form of subordinated debt and perpetual debt" ***or***

(c) Debt that represents a permanent or lasting interest, in the form of subordinated debt and perpetual debt, that also has the purpose of acting as equity"?

4. If the DITEG members do not prefer any of the definitions cited in (3) above, what should the amended definition of permanent debt be?

5. If the answer to 1 above if "No", do DITEG members consider that the present methodology should be amended by removing permanent debt between affiliated banks and between affiliated financial intermediaries from the direct investment data and instead classifying it under Portfolio Investment or Other Investment, as appropriate, in the balance of payments statistics?

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