

D.12 Including Intra-Concern [Between Affiliates] Derivatives in Direct Investment

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Intra-concern derivatives, that is, financial derivatives between affiliates, are present in the activities of the multinational enterprises and their classification was discussed at the time of the previous update of the manuals. Anecdotal evidence shows that such derivatives may behave atypically, in particular, they may differ from market terms. Currently, with the exception of financial derivatives associated with the official reserve asset management, all others are included in a separate functional category known as financial derivatives within the balance of payments and international investment position (IIP). This Guidance Note revisits the issue of including financial derivatives between entities in a direct investment relationship in the direct investment functional category. The Note discusses alternatives for possible presentations of such financial derivatives in the balance of payments and IIP. It recommends that intra-concern derivatives continue to be reported in the financial derivatives functional category but that a supplementary “of which: between affiliates” item be added so that economies could separately identify them on a voluntary basis.

SECTION I: THE ISSUE

BACKGROUND

- 1. Intra-concern derivatives are currently excluded from direct investment category.** At present all assets and liabilities arising from positions in financial derivatives between entities in a direct investment relationship, as well as transactions on such instruments between related entities, are excluded from direct investment category.
- 2. It seems logical to have all instruments being used within affiliates under direct investment.** At the same time, it would enable a better analysis of financial derivatives as some financial derivatives may behave atypically. In particular, terms of transactions in financial derivatives inside a corporate group may differ from market terms.
- 3. The classification of the financial derivatives is discussed in the manuals on external statistics, that is, *Balance of Payments Manual (BPM6)*, *OECD Benchmark Definition (BD4)*, and the *2008 System of National Accounts (2008 SNA)*.** The *BPM6* paragraph 6.29 mentions that “Financial derivatives and employee stock options are excluded from direct investment and included in the functional category financial derivatives (other than reserves) and employee stock options.”² The *BD4*

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² The issue of the classification of financial derivatives involving affiliated enterprises in direct investment was already discussed in the context of the publication “*Financial Derivatives: A Supplement to the Fifth Edition (1993) of the Balance of Payments Manual*” in March 2000. This publication reflected a provisional decision made by the BOPCOM in its October 1999 meeting to include financial derivatives in direct investment, while recognizing that the continued classification of financial derivatives within direct investment would depend on country experience in implementing the recommendations. Subsequent consultations with regional groups of balance of payments compilers on their country experience in implementing the provisional recommendation did not support the creation of a separate component for financial derivative transactions within the direct investment category, reflecting concerns about both

paragraph 154 states that “Positions and transactions in financial derivatives between entities in a direct investment relationship should be excluded from direct investment”; paragraph 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”; paragraph 674. “Some of the concepts/recommendations included in this Benchmark Definition may benefit from further refinements or practical examples: (...) viii) Special studies on FDI by type of entity: investment funds; hedge funds; private equity funds; sovereign wealth funds; use of derivatives to gain control; stapled securities”. The 2008 SNA in paragraph 26.93 states that “The definition of the functional category financial derivatives (other than reserves) and employee stock options largely coincides with the corresponding financial instrument class, discussed in chapters 11 and 13. The difference in coverage between the functional category and the financial instrument is that financial derivatives associated with reserve asset management are excluded from the functional category and included in reserve assets. This category is identified separately because it relates to risk transfer, rather than supply of funds or other resources.”

4. **Data on financial derivatives³ collected under present *BPM6* and *BD4* do not provide for quantitative assessment of the scale of intra-group positions and transactions** in international investment position (IIP) and/or balance of payments. Financial derivatives positions held by “other sectors” (sectors other than central bank, banks, and general government) might be considered as a plausible upper bound for intra-group positions excluding those between financial institutions. Considering a group of 28 European countries, they accounted on average for between 25 and 30 percent of derivatives positions for the total economy at the end of 2019,⁴ although with significant heterogeneity across countries: the share is considerably higher in financial centers and in a few Central and Eastern European countries, while it is lower than the average in large economies. The share of financial derivatives positions held by “other sectors” has generally tended to increase over the last decade, although it is not clear whether this trend reflects intra-group positions or positions vis-à-vis non-affiliated companies. In Poland, according to rough estimates, around half of the Financial Derivatives value could be categorized as Direct Investments, that is, half of transactions are conducted between affiliates.

5. **Intra-group derivatives may arise in the context of the multinational enterprise (MNE) group’s approach to risk management and hedging or for the purpose of tax optimization** (see Supplementary information for further details).

the conceptual motivation and the practical implementation (OECD 2001). Consequently, in October 2001 the BOPCOM decided to update its provisional decision and reached the final decision that financial derivative transactions involving affiliated enterprises should be classified under the financial derivatives category (IMF 2001).

³ An overview of the main characteristics and classes of financial derivatives is available in the Final Report of WG ES/WG FA Task Force on Financial Derivatives.

⁴ This amount includes both intra-concern and arm’s length derivatives. The arm’s length portion might account for a larger share.

ISSUES FOR DISCUSSION

6. **There are four main issues for discussion:** (i) whether intra-group derivatives are substantially different in character or purpose from derivatives between unaffiliated parties; (ii) whether intragroup derivatives are closer to the types of intra-group transactions and positions that are included in direct investment or instead to those that are excluded (e.g. debt between affiliated financial corporations); (iii) whether this activity is common enough across countries and/or whether there have been significant changes in this activity over the last two decades that require a different treatment with respect to the one adopted in the *BPM6*; (iv) whether the inclusion of intra-group derivatives in direct investment reduces the analytical usefulness of direct investment statistics.

7. **Regarding the first issue, it is plausible that at least part of intragroup derivatives reflects different purposes with respect to those that are relevant for derivatives between unaffiliated parties.** While the latter are mainly used for risk management (hedging) or speculation (including arbitrage strategies), the former might also include motivations related to the internal organization of the MNE (e.g. companies specialized in treasury functions) or to tax optimization strategies. The limited evidence on the phenomenon is not sufficient, however, to conclude whether or not intra-group derivatives also present systematic differences in terms of instrument type or underlying asset category.

8. **On the second issue, it might be argued that intragroup derivatives are probably closer to other forms of short-term financial flows (some of which are not included in direct investment, for example, debt between financial institutions) than to the types of investment that are traditionally associated with the notion of direct investment (greenfield investment, mergers and acquisitions).** More generally, a broader question is whether direct investment should aim to include all transactions between related parties or only a subset of those (i.e. transactions with a long-term orientation, in line with the lasting interest typically associated with direct investment).

9. **Regarding the third issue, it is possible that the relevance of intra-group derivatives has increased over the last two decades in relation to the increased complexity of the corporate structure of large MNEs.** However, extremely limited evidence prevents a quantitative assessment of the growth and current size of this activity and whether this activity is common enough across countries. Answers from Direct Investment Task Team (DITT) members suggest that the vast majority of countries are not currently able to identify transactions and positions in financial derivatives between affiliated entities. Among the very few countries that already collect data or were able to provide views on this activity, it seems that most positions are either held between financial institutions or vis-à-vis financial institutions.

10. **Regarding the fourth issue, the inclusion of intra-group derivatives in direct investment might reduce the analytical usefulness of direct investment statistics.** For instance, one might question whether the variable nature of these positions is consistent with the notion of direct investment as long-term capital and whether the additional volatility related to the inclusion of intra-group derivatives in direct investment is desirable. An even more serious implication is related to the presentation of financial derivatives on a net basis, which is currently allowed by the manual, in contrast to the

asset/liability presentation for direct investment.⁵ If derivatives are added to direct investment, it will make the statistics difficult to interpret for data users as an individual derivative contract can “flip” between an asset (positive fair market value) and a liability (negative fair market value) depending on the market conditions. The inclusion of financial derivatives would therefore blur the reconciliation between flows and stocks. Rates of return would also be harder to compute and interpret.⁶ Finally, the inclusion of financial derivatives as part of External debt statistics would also require further consideration.

11. Proposed alternatives for treatment of intra-group financial derivatives:

- a. Status quo—financial derivatives between affiliates classified under “Financial Derivatives” balance of payments/IIP item.
- b. Financial derivatives between affiliates classified in “Financial Derivatives”, but with addition of a supplementary item on a voluntary basis: “of which between affiliates.”
- c. Financial derivatives between affiliates of all sectors classified in “Direct Investment.”
- d. Financial derivatives between affiliates classified in “Direct Investment”, but with exclusion of selected financial institutions (similarly to the treatment of debt instruments).⁷

Table 1. Pros and Cons for Each Proposed Alternative

Alternative	Pros	Cons
a – no changes	<ul style="list-style-type: none"> - No changes in reporting systems required - No costs 	<ul style="list-style-type: none"> - No information on intra-group derivatives
b – no changes, but supplementary item	<ul style="list-style-type: none"> - Limited changes in reporting systems, supplementary item on a voluntary basis - Limited costs - Disclosure by countries on a voluntary basis would increase 	<ul style="list-style-type: none"> - Information on intra-group derivatives available for selected economies and sectors only

⁵ The *BPM6* 7.37 states that financial derivatives should be reported separately for both assets and liabilities “by preference”, which means that the distinction is not always possible. The *BPM6* 8.34 explicitly admits that “net settlements are acceptable when gross reporting is impractical”.

⁶ GN B.4 “Reconciliation between flows and stocks” reminds that rates of return should be computed for assets excluding financial derivatives and liabilities excluding financial derivatives. Rates of return would be easier to compute and read in the current situation with a basic rate for each functional category but financial derivatives.

⁷ Specifically, under option d) financial derivatives between affiliated entities would be excluded from direct investment if both entities are financial corporations as detailed in the *BPM6* 6.28: deposit-taking corporations (both central banks and deposit-taking corporations other than the central bank); (b) investment funds; and (c) other financial intermediaries except insurance corporations and pension funds. Notice that some of the relevant financial derivatives market players are included under c), such as: central counterparties (CCPs), security and derivative dealers (on own account), brokers, corporations which arrange derivative and hedging instruments, such as swaps, options and futures (without issuing them), and corporations providing stock exchange and insurance exchange infrastructures.

Alternative	Pros	Cons
	<p>information available for further research, with a view to a possible change in treatment in the future</p>	
<p>c – intra-group derivatives in DI</p>	<ul style="list-style-type: none"> - Consistency (treating transactions between related parties similarly across all instruments) - More analytical understanding of the phenomenon 	<ul style="list-style-type: none"> - It would further increase the distance from what FDI traditionally was supposed to measure (long-term investment in the form of greenfield investment or mergers and acquisitions) - Might increase volatility of direct investment data. - Practical implementation issues: Many countries would need to change their survey forms and even whole data collection systems (with increasing risk of asymmetries if some countries are not able to collect data on intra-group derivatives) - There might be confidentiality issues in countries in which only few MNEs actually use intra-firm derivatives - Reconciliation of flows and stocks would become more difficult - Rates of return would be harder to compute and interpret - It would be very challenging to derive Extended directional Principle data on those potential DI intra-group derivatives.
<p>d – intra-group derivatives in DI, except FI</p>	<ul style="list-style-type: none"> - Lower volatility of financial derivatives positions compared to (c) 	<ul style="list-style-type: none"> - No information on banking/ financial sector, that may generate majority of flows - Implementation issues like for (c) - Reporters might face difficulties in the correct identification of counterpart sectors (which would be necessary to exclude derivatives between affiliated financial institutions)

12. **The difficulty of adding the capital relationship to reporting forms depends on whether data are collected directly or from intermediaries.** The addition of the capital relationship identification to reporting forms seems to be rather easy in the case of direct data collection systems, when resident

reporting entities report positions and transactions on their own account only. It may be more difficult for indirect data collection systems, when data on transactions and positions are reported by financial intermediaries, who may not have all necessary information on capital relationships between their clients. This case includes use of data registered by CCPs (trade repositories) and other kind of clearing institutions.⁸ On the other hand, intra-group transactions are more likely to be over-the-counter (OTC) transactions, where no intermediaries are involved.

SUPPLEMENTARY INFORMATION

13. Intra-group derivatives may arise in the context of the MNE group's approach to risk management and hedging.⁹ MNE groups often centralize operations on financial derivatives in the same manner as for cash pooling and other treasury functions. In this model, the majority or even all of the financial derivatives transactions of the MNE's subsidiaries take place with a single group member (financial center) dedicated to general financial settlements inside a group, which then opens positions in derivatives with non-related entities (outside a group). These positions usually are used to hedge net position of the financial center against other members of a group.¹⁰

14. Intra-group derivatives may also arise for the purpose of tax optimization. Transfer pricing of financial derivatives (i.e. when terms of transactions in financial derivatives inside a capital group differ from market terms) may be used for cross-border income transfers (see OECD (2020)), although actual evidence on these strategies (especially in the academic literature) is missing or very scarce.¹¹

SECTION II: OUTCOMES

15. Authors' analysis and discussion during review confirm that financial derivatives between affiliated entities may behave atypically and may differ from market terms. The outcomes, however, are based on individual case studies as there is very limited aggregate data available to support the views.

16. Detailed elaboration on data sources to identify transactions and positions in financial derivatives between affiliated entities should be included in the update of the BPM7 CG. Further research is needed into financial derivatives within company groups as they may behave differently and serve different purposes (e.g., shifting income) than financial derivatives between unaffiliated parties.

⁸ In case of derivatives intermediated by a CCP, the CCP becomes the counterparty to both sides of the trade, and, thus, the residency of the CCP determines the geographical breakdown of the financial derivatives transactions and positions. Therefore, financial derivative between affiliates with the intermediation of a CCP would not be considered as intra-group derivatives, unless the CCP is part of the same group. It is plausible to assume that the vast majority of intra-group derivatives are not intermediated by a CCP, given that it would not be convenient to the group.

⁹ In some cases, foreign affiliates might actually reduce the need for hedging strategies. For instance, foreign currency is a natural currency hedge: if an affiliate keeps its revenues and expenses in the same currency, there is no need for an exchange rate hedge.

¹⁰ Centralization does not necessarily imply intra-MNE derivatives. For instance, a centralized unit that is responsible for maintaining a stock of a particular currency for use throughout the MNE might engage in derivatives strictly with outsiders while providing the currency at fixed rates within the MNE.

¹¹ Dealing with transfer pricing issues might require specific treatments, for example, partition in the balance sheet into a loan component and a regular, "at-the-money" swap component.

17. **The recommendation is to continue reporting financial derivatives between affiliates under “Financial derivatives and employee stock options” and by adding a supplementary item “of which: between affiliated enterprises” to the financial derivatives presentation.** With the final data breakdowns in the balance of payments, international investment position and external debt, to be aligned with the outcomes of the GN F.4 "Financial derivatives by type".

REJECTED ALTERNATIVES

18. **The option (a) to have no changes was rejected, even though there was a support among DITT members.** The option (b) including the supplementary item allows for those economies for which the issue of financial derivatives is significant to present additional information on a voluntary basis and further research the issue, while allowing to have no changes as in option (a).

19. **The option (c) to include intra-group derivatives to direct investment was rejected** on the basis that financial derivatives between affiliates are not a means of long term investment, would introduce higher volatility to FDI statistics, and would complicate the reconciliation of stocks and flows and the extended directional principle for FDI.

20. **The option (d) which proposed to include in Direct Investment only financial derivatives between affiliates if at least one counterpart is a financial institution was also rejected.** The arguments were mostly the same as in option (c), but also higher implementation costs were raised and potential data quality problems with sector classification of the counterparts.

Annex I. Referenced documents

IMF (2001), Classification of Financial Derivatives in Direct Investment Statistics, BOPCOM 01/45.

OECD (2001), Report on the OECD Workshop on Foreign Direct Investment Statistics held on June 5-7, 2001, Paris.

OECD (2020), [Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10](#), Paris.

Annex II. Supplementary Information

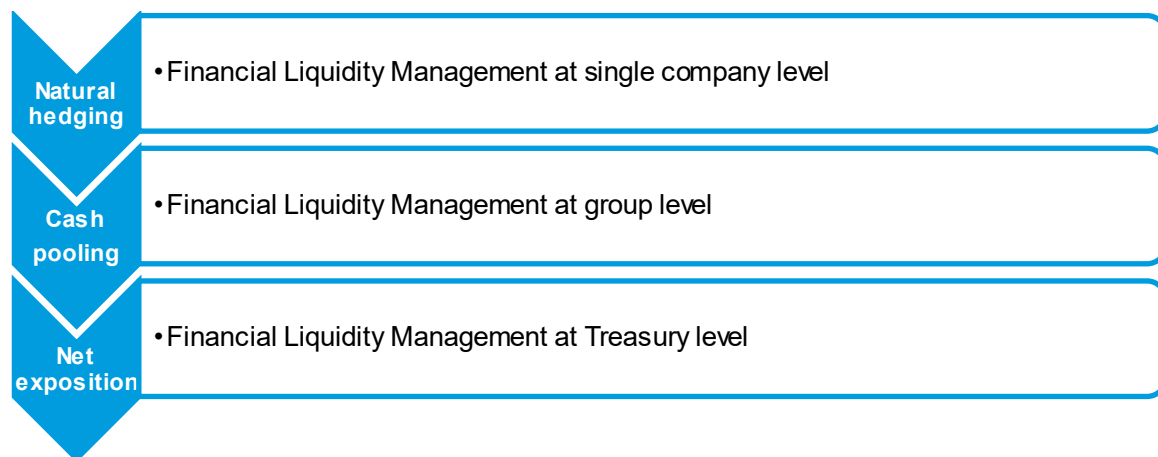
In general, some models of financial risk management by nonfinancial corporations could be identified depending on their capital structure and type of risk to which they are exposed. In the area of organizational status of enterprises (capital dependency) there are two main cases that may lead to different usage of the financial derivatives between affiliates:

- a) subsidiaries in capital group and
- b) parent entity in capital group.

MODEL 1—Subsidiary in Capital Group

In that model, a company is usually supervised by the parent company, which has a Treasury department at its head office. Under Treasury supervision, subsidiaries present risks among themselves, which usually is cash pooling, that is, joint liquidity management and/or consolidation of bank accounts. Cash pooling is conducted by the leading participant—pool leader. Subsidiaries may previously also use natural hedging, particularly, matching cash flows on the asset and liabilities side, at the level of a single entity in order to balance their position to a net position before the group's cash pooling. Intermediate-level companies, that is, subsidiaries and parent companies, simultaneously balance their position at an appropriate level of liquidity management, for example, at the level of companies in the same country.

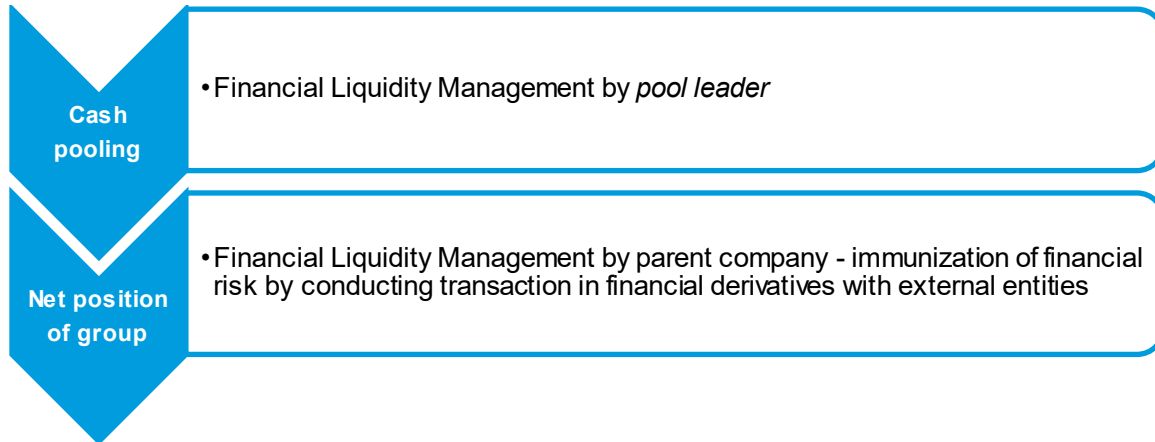
Scheme 1. Hedging in Nonfinancial Companies—the Case of Subsidiary



MODEL 2—Parent Entity in Capital Group

A parent company with a certain group of subsidiaries under its supervision organizes the management of the group's day-to-day liquidity. Once the intra-group position has been settled (balance compensation) it is hedged on the market. Due to the nature of the risks, these are most often tailor-made OTC derivatives and are most often concluded with a financial institution. This situation also applies to self-employed companies which do not have the possibility of internally offsetting balances.

Scheme 2. Hedging in Nonfinancial Companies—The Case of Parent Company



Considering cases presented in annual financial statements of Polish, for example, nonfinancial stock companies these entities are primarily exposed to foreign exchange risk and interest rate risk. The instruments used to mitigate these risks are usually: forward contracts (exchange rate hedging), IRS contracts (usually converting future payments from fixed rate to variable rate or vice versa) and CIRS contracts (used to mitigate both risks).