Implementing the latest international standards for compiling foreign direct investment statistics

HOW MULTINATIONAL ENTERPRISES CHANNEL INVESTMENTS THROUGH MULTIPLE COUNTRIES

February 2015

In 2014, many countries implemented the latest international guidelines for compiling FDI statistics. In this note, we explain a key feature of the new standards and what it means for users of FDI statistics. The note begins by describing how multinational enterprises use of special purpose entities to manage their global finances and operations leads to double-counting in FDI statistics as well as how the latest international guidelines now account for this phenomenon, resulting in more meaningful measurement of FDI. This is followed by showcasing the example of Hungary and how their 2013 statistics provide detail on the source and destination countries of FDI of special purpose entities.

The financing structures of multinational enterprises (MNEs) have grown more complex over time in response to several factors, including the need to manage global production networks and the desire to reduce tax and regulatory burdens. These complex structures often involve the use of special purpose entities (SPEs) to channel investments through several countries before reaching their final destinations. The existence of SPEs is one important factor that can distort foreign direct investment (FDI) statistics. First, transactions by SPEs inflate the FDI flows into and out of the country where they are located as investment passes through via SPEs to its ultimate destination. Second, SPEs can distort the geographic distribution of FDI statistics for countries that host a significant number of them because it can appear they are receiving investment from countries whose investors are just passing capital through SPEs. Likewise, it can appear that investors from this country are investing abroad when that investment really reflects the funds that have been passed through.

To address these issues, the OECD developed the 4th edition of its *Benchmark Definition of Foreign Direct Investment (BMD4)*. BMD4 recommended that countries should compile FDI statistics separately for SPEs so that data for SPEs can be excluded, resulting in more meaningful measures of FDI. With the widespread implementation of the BMD4 guidelines in 2014, detailed information on FDI of SPEs will be available for a large number of OECD countries for the first time. This note will examine the impact of FDI of SPEs at the aggregate level for a number of countries as well as give an example of the newly available geographic detail on the investment of SPEs. These detailed data will be available for more countries when the OECD releases the new database of FDI statistics at the end of March 2015.

Separately compiling FDI statistics for resident SPEs

SPEs are entities that have little or no employment, physical presence, or operations in a country but that do provide important services to the MNE, such as holding assets and liabilities or raising capital. While there is no strict definition of an SPE, an enterprise is usually considered to be an SPE if it has the following characteristics:

- The enterprise is a legal entity, formally registered with a national authority and subject to fiscal and other legal obligations in the economy in which it is resident;
- The enterprise is ultimately controlled by a non-resident parent, either directly or indirectly;
- The enterprise has few or no employees, little or no production in the host economy, and little or no physical presence in the host economy;
- Almost all the assets and liabilities of the enterprise represent investments in or from other countries; and
- The core business of the enterprise is group-financing and holding activities while managing and directing play only a minor role.

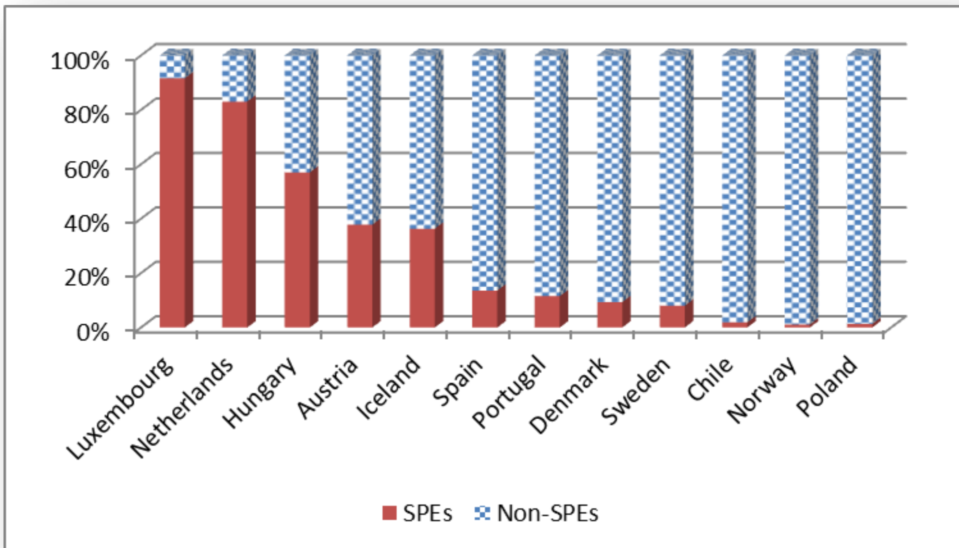
Examples of SPEs include brass plate companies, financing subsidiaries, conduits, holding companies, shelf companies, and shell companies.

BMD4 recommends that countries compile their FDI statistics excluding resident SPEs, and, then, separately for resident SPEs. This recommendation provides a more meaningful measure of direct investment into and out of an economy by removing FDI that involves funds simply passing through the economy via SPEs on their way to other destinations. Such funds distort the country patterns of FDI statistics and inflate the inward and outward data in the statistics. For the country hosting the SPEs, this recommendation improves the measurement of FDI by excluding inward FDI that has little or no real impact on their economies and by excluding outward FDI that did not originate from their economies.

Impact on total FDI stocks of excluding resident SPEs for selected countries

Four countries —Austria, Hungary, Luxembourg, and the Netherlands—have reported FDI flows and positions excluding resident SPEs to the OECD for several years. With the implementation of the latest standards, 9 additional countries—Chile, Denmark, Iceland, Norway, Poland, Portugal, Spain, Sweden, and the United Kingdom—have now reported data excluding resident SPEs.[1] Inward investment positions are the value of the accumulated stock of foreign investment in a host country. Figure 1 shows the percentage of inward positions accounted for by resident SPEs in 2013.[2] The countries are displayed according to share of investment accounted for by resident SPEs.

Figure 1: Share of FDI into SPEs and non-SPEs, 2013



Source: OECD Foreign Direct Investment statistics (BMD4) database

The role played by SPEs varies significantly across countries. It is not surprising that the four countries where resident SPEs account for the largest share of investment are the four that have been reporting their FDI statistics excluding resident SPEs for some time. SPEs account for

1 Series excluding resident SPEs for Estonia, Portugal, and the United Kingdom are confidential or currently not publishable. Norway only reports data excluding resident SPEs for the stocks of FDI and not for FDI flows. FDI statistics excluding resident SPEs are not yet available for Belgium, Canada, Finland, Ireland, Slovak Republic, and Switzerland. Resident SPEs are not present or not significant in Australia, the Czech Republic, Finland, France, Germany, Greece, Israel, Italy, Japan, New Zealand, Slovenia, Turkey, and the United States.

2 Inward positions are shown for Austria, Chile, Denmark, Hungary, Iceland, the Netherlands, Norway, Poland, Spain, and Sweden. Luxembourg and Portugal show a different measure of the value of inward investment: direct investment liabilities. For more information on these two presentations of FDI statistics, see: www.oecd.org/daf/inv/oecdimplementsnewinternationalstandardsforcompilingfdistatistics.htm

more than 90 percent of FDI into Luxembourg, and around 80 percent of FDI into the Netherlands. While lower, SPEs account for more than half of the FDI into Hungary and more than a third of the FDI into Austria.

Of the countries with new reporting excluding resident SPEs, resident SPEs account for more than a third of investment in Iceland, and, so, are very important in explaining FDI in that country. SPEs play smaller, but still significant, roles in investment for Spain, Portugal, Denmark, and Sweden, accounting for 14 percent to 8 percent of investment. On the other hand, SPEs resident in Chile, Norway, and Poland account for 2 percent or less of investment.

Even in countries where SPEs do not play a significant role in FDI currently, it is useful to be able to identify resident SPEs in the statistics so that their role in FDI can be monitored. By their nature, SPEs can be formed easily and can grow rapidly. In addition, SPEs can have large transactions in a particular period that can distort FDI flows due to their role within the MNE of providing financing or holding assets and liabilities. By compiling FDI statistics that exclude resident SPEs, FDI statistics are not overstated by including funds that are simply being channeled through the SPEs, are easier to interpret for policy-making and other purposes, and provide a better measure of FDI that is likely to have an economic impact in the host economy.

Finally, it can be useful to separately identify FDI statistics for resident SPEs even if they do not play a significant role in overall investment because investment into resident SPEs might not follow the patterns of investment into non-SPEs (also called operating affiliates). For example, in 2013, inward investment to Poland was higher when resident SPEs were excluded than when they were included because there was disinvestment from resident SPEs. Thus, investment into operating affiliates was higher than would have been indicated if the statistics did not separately identify investment into resident SPEs.

Detail on the geographic distribution of investment into and out of SPEs: the example of Hungary

With the implementation of BMD4, the OECD began collecting data on the source and destination countries of investment into and out of SPEs. This information can provide valuable information to countries on the investors that are channelling investments through SPEs rather than investing in operating affiliates. Table 1 provides information for the inward and outward investment positions of SPEs in Hungary at year-end 2013. The inward investment position in SPEs is shown on the left hand side, and the outward investment position of SPEs is shown on the right hand side. The first thing to notice is the significant positions in SPEs. For inward investment, SPEs account for USD 142.6 billion of the total position of USD 250.3 billion, or 57 percent. SPEs are even more significant for outward investment, where they account for USD 153.0 billion of the total outward position of USD 191.6 billion, or 80 percent.

Table 1: Inward and outward FDI positions of SPEs in Hungary by selected country
Year-end 2013 (USD millions)

Inward FDI positions in SPEs in Hungary At end 2013			Outward FDI positions from SPEs in Hungary At end 2013		
Total inward FDI positions in SPEs	142,616	100%	152,997	100%	**Total outward FDI positions from SPEs**
of which from:					*of which in:*
Ireland	28,565	20%	54,142	35%	Luxembourg
Luxembourg	25,782	18%	54,103	35%	Switzerland
United States	17,225	12%	20,511	13%	United Kingdom
Spain	15,358	11%	12,297	8%	United States
Cayman Islands	12,838	9%	4,554	3%	Korea, Republic of
Canada	11,849	8%	2,050	1%	Canada
Bermuda	11,673	8%	1,167	1%	Italy
Virgin Islands, British	3,216	2%	898	1%	Cyprus
Jersey	2,858	2%	775	1%	Uruguay
Brazil	2,406	2%	575	0%	Netherlands

Source: OECD Foreign Direct Investment statistics (BMD4) database

The table shows that investors in 7 countries account for about 86 percent of investment into SPEs. These countries include the United States, Spain, and Canada. However, countries where MNEs often locate affiliates to manage their finances and intellectual property and to reduce their tax and regulatory burdens, such as Ireland, Luxembourg, Cayman Islands, and Bermuda, also appear among the top investors in SPEs in Hungary. On the outward side, more than 90 percent of investment by Hungarian SPEs in other countries is accounted for by 4 countries: Luxembourg, Switzerland, the United Kingdom, and the United States. Some of these countries are also often associated with MNEs management of their finances, intellectual property, and tax and regulatory burdens. The prevalence of countries associated with the financial management of MNEs among the top sources and destinations of investment of SPEs gives an indication of the complex structures used by some MNEs in managing their finances and operations.

Given the size of FDI of Hungarian SPEs and its concentration among a small number of countries, it is not surprising that excluding resident SPEs can have a significant impact on the top source and destination countries for FDI into and from Hungary. Table 2 shows the inward investment position in Hungary at the end of 2013 including SPEs on the left hand side and excluding SPEs on the right hand side.

Table 2: Inward FDI positions in Hungary by selected country
Year-end 2013 (USD millions)

	All entities		Excluding resident SPEs		
Total inward FDI positions	250,305	100%	107,689	100%	**Total inward FDI positions**
of which from:					*of which from:*
Luxembourg	39,606	16%	25,958	24%	Germany
Ireland	30,158	12%	13,824	13%	Luxembourg
Germany	25,918	10%	12,400	12%	Netherlands
United States	19,527	8%	11,765	11%	Austria
Spain	16,296	7%	8,371	8%	Curaçao
Cayman Islands	13,131	5%	4,265	4%	United Kingdom
Netherlands	12,973	5%	3,115	3%	France
Canada	12,380	5%	2,918	3%	Switzerland
Bermuda	11,973	5%	2,545	2%	Belgium
Austria	11,963	5%	2,303	2%	United States

Source: OECD Foreign Direct Investment statistics (BMD4) database

When SPEs are included, Luxembourg is the top source of investment into Hungary, but when SPEs are excluded, Germany becomes the top investor. Ireland, Spain, and Canada are among the top sources of investment when SPEs are included, but once investments into SPEs are excluded, they are no longer among the top 10 investors, indicating that much of the investment from these countries was passing through SPEs in Hungary on its way to other destinations. The United States drops from the fourth largest source of FDI to the tenth when SPEs are excluded, indicating that U.S. investors were mostly investing in SPEs rather than in companies with a significant physical presence in Hungary.

Table 3 provides geographic detail for the outward investment position of Hungary. The exclusion of investment from SPEs has a significant impact on the list of top countries receiving FDI from Hungary. The positions in the top 4 recipients of FDI from Hungary when SPEs are included—Luxembourg, Switzerland, the United Kingdom, and the United States—fall significantly when SPEs are excluded, indicating that foreign investors use SPEs in Hungary to channel investment to these destinations.

Table 3: Outward FDI positions in Hungary by selected country
Year-end 2013 (USD millions)

	All entities		Excluding resident SPEs		
Total outward FDI positions	191,558	100%	38,561	100%	**Total outward FDI positions**
of which in:					*of which in:*
Luxembourg	57,645	30%	10,417	27%	Curaçao
Switzerland	54,873	29%	4,276	11%	Belgium
United Kingdom	20,540	11%	3,552	9%	Croatia
United States	12,717	7%	3,503	9%	Luxembourg
Curaçao	10,417	5%	2,864	7%	Cyprus
Korea, Republic of	5,135	3%	2,731	7%	Israel
Belgium	4,276	2%	1,917	5%	Slovakia
Cyprus	3,762	2%	1,111	3%	Bulgaria
Croatia	3,552	2%	876	2%	Romania
Israel	2,937	2%	770	2%	Switzerland

Source: OECD Foreign Direct Investment statistics (BMD4) database

In addition to capital, FDI income also flows through SPEs. Table 4 provides data in FDI income receipts and payments for Hungary including and excluding SPEs. As for the position data discussed above, SPEs account for a large share of FDI income for Hungary. The data indicate that much of the income payments from Hungary represent income originating outside of Hungary and passing through SPEs to the foreign investor. Income payments from SPEs are USD 5.4 billion, and income payments excluding SPEs are USD 6.5 billion. Most of the income receipts of Hungary represent income that is passed through SPEs to foreign investors. Income receipts of SPEs are USD 5.5 billion, and the income receipts excluding SPEs are USD 1.3 billion.

Income payments represent the claims that foreign investors have on the earnings of their affiliates in Hungary as well as the net interest payments from them, and income receipts represent the claims that Hungarian investors have on the earnings of their foreign affiliates as well as net interest receipts from them. The earnings of affiliates can either be distributed back to the foreign investor or the foreign investor can reinvest a portion of these earnings in the foreign affiliate. Reinvested earnings increase the foreign investor’s investment in its affiliate. While it is not possible from FDI statistics to know exactly how these reinvested earnings are used, reinvested earnings are often a good source of funds for expansion. However, reinvested earnings also play a significant role in MNEs tax management practices as taxes on earnings that are reinvested can be deferred under some tax systems.

Table 4 presents detail on FDI income of Hungary by instrument so that the behaviour of SPEs can be compared to the behaviour of non-SPEs (also called operating affiliates). The first thing to notice is that SPEs reinvest a much higher share of their earnings than operating affiliates. As a result, SPEs account for a large share of reinvested earnings of foreign-owned affiliates in Hungary. While it is not possible to know exactly how reinvested earnings are used within the

MNE, it can be assumed that reinvested earnings in SPEs have little impact on the host economy as SPEs have little physical presence in the economy. Were the statistics not available separately for SPEs, this difference in behaviour would not be apparent and it may have been assumed that reinvested earnings in operating affiliates were more important than they really are.

Table 4: FDI income receipts and payments for Hungary by instrument 2013 (USD millions)

Income on Inward FDI - 2013		Income on Outward FDI - 2013	
Payments by SPEs in Hungary		**Receipts to SPEs in Hungary**	
Total income payments by SPEs	5,408	5,505	**Total income receipts to SPEs**
of which :			*of which :*
Dividends	2,464	753	Dividends
Reinvested earnings	3,531	4,651	Reinvested earnings
Net interest payments	-586	101	Net interest receipts
Payments excluding resident SPEs		**Receipts excluding SPEs in Hungary**	
Total income payments excluding resident SPEs	6,522	1,312	**Total income receipts excluding resident SPEs**
of which :			*of which :*
Dividends	3,876	672	Dividends
Reinvested earnings	1,896	638	Reinvested earnings
Net interest payments	751	2	Net interest receipts

Source: OECD Foreign Direct Investment statistics (BMD4) database

Net interest payments are equal to the interest payments the affiliate makes to the foreign investor less the interest receipts it receives from its foreign investor. Normally it is thought that affiliates receive financing, including in the form of loans, from their foreign parents and other parts of the MNE. So, it is expected that affiliates would be making net payments of interest. However, SPEs often play a vital role in raising capital and lending funds to other parts of the MNE. As a result, they may be net lenders to other parts of the MNE and have higher interest receipts than interest payments. The data from Hungary suggest that this may be the case. SPEs have negative interest payments, indicating that they are likely net lenders to other parts of the MNE. In contrast, operating affiliates follow the expected pattern by making net interest payments, indicating that they are likely net recipients of loans from other parts of the MNE.

For outward investment, SPEs again reinvest a much higher share of their earnings in their foreign affiliates than Hungarian investors that are not SPEs. SPEs also have higher interest receipts, indicating that they are probably bigger net lenders than Hungarian investors that are not SPEs.

Conclusion

Some MNEs use complex ownership structures to manage their global operations, their finances, and their intellectual property as well as to reduce their tax and regulatory burdens. The compilation of FDI statistics separately for resident SPEs, as recommended in BMD4, provides a more meaningful measure of direct investment into and out of an economy by removing FDI that involves funds simply passing through the economy via SPEs on their way to other destinations. The impact of investment in resident SPEs varies considerably across OECD countries, accounting for more than 90 percent of the inward investment position in Luxembourg and less than 2 percent of the inward investment positions in Chile, Norway, and Poland.

The detail available on the countries investing in resident SPEs and the countries receiving investment from resident SPEs sheds light on which countries are the most significant investors in SPEs. It can also shed light on how their behaviour may differ from non-SPEs. For example, the data for Hungary reveal that SPEs reinvest more of their earnings than non-SPEs. However, the reinvested earnings of SPES are unlikely to have a significant impact on host economies because of their limited physical presence in the host economy. The data also show that SPEs are likely net lenders to other parts of the MNEs, in line with the important role they play in the financial management of MNEs.

Despite the improvement in measurement of FDI by separately compiling statistics for resident SPEs, the data reveal that MNEs use very complex structures that may involve channelling funds through multiple locations. To address this issue, BMD4 recommends that countries compile statistics on inward investment positions by ultimate investing country, which shows the country of the investor that ultimately owns the investment. The presentation of inward investment by ultimate investing country will be the topic of the next post in this series.

Finally, MNEs may channel investment through operating affiliates as well as through SPEs. Ways to measure and classify capital-in-transit is a topic being researched by the OECD and its member countries. Hungary already presents FDI statistics accounting for both capital-in-transit through operating affiliates as well as FDI flows associated with financial restructuring. More information and Hungary's FDI statistics can be found on the website of the Central Bank of Hungary, Magyar Nemzeti Bank, at http://english.mnb.hu/.

This explanatory paper has been prepared by the OECD Investment Division. For queries, please contact: investment@oecd.org. Find data and more detailed FDI statistics at www.oecd.org/investment/statistics.htm.