

Methodological questions regarding debt securities: residency of issuer, location of issue, residency of obligor¹

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An important methodological question in categorizing debt securities (and indeed in categorizing all types of securities) is how to determine to which country the security should most appropriately be attributed. Common possibilities include classifying according to the *residence of the issuer*, according to the *location of the issue* (the actual market into which the security is issued), or according to the *residence of the ultimate obligor*. Additional considerations can include the intended target investor audience of the security, which may also be related to the currency of the issue. In many cases, the classification is straightforward, but as noted below, the complex nature of international financial markets and of corporate legal structures can make the task more difficult. This paper discusses some of the issues raised by the different possibilities for country attribution.

The International Monetary Fund Balance of Payments convention for country of attribution of securities is straightforward: securities should be assigned by the *residence of issuer* of the security, where residence is determined by the economic territory under whose laws an enterprise is incorporated or registered.³ Attributing securities by residence of issuer can in many cases give different outcomes than if securities are classified by *location of issue*, especially for securities that are internationally traded. This distinction may matter more for countries where financial markets are developed and where cross-border investment is sizable. However, this convention may be in conflict with the basic concept of residence determined by *center of economic interest*, that is, the location where a significant amount of economic activity takes place.⁴ It may also be in conflict with a wish to associate a security with the *country of the obligor or guarantor*. To illustrate these points, consider a few specific examples:

A straightforward example: Ford Motor Company (United States) issues US dollar-denominated securities in the United States

In this case, there are no conflicts in classification or interpretation. Such debt securities are clearly US obligations, and in the balance of payments accounts, any non-US resident holdings of Ford Motor Company securities are recorded as US liabilities to foreigners in the US International Investment Position (IIP). The *residence of issuer* is the United States, because Ford Motor Company is incorporated in the United States. In this case, the *location of issue* is also the United States, and the *residence of obligor* (Ford Motor Company) is also

¹ The views expressed should be interpreted as those of the author and not as reflecting the views of the Board of Governors of the Federal Reserve System or any other person associated with the Federal Reserve System.

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³ See IMF Balance of Payments Manual Sixth Edition (Draft), section 4.143, available at <http://www.imf.org/external/pubs/ft/bop/2007/pdf/BPM6.pdf>.

⁴ See, for example, IMF Balance of Payments Manual Sixth Edition (Draft), section 4.123.

the United States. And Ford Motor Company's *center of economic interest* is also clearly the United States.

Note also that such securities correspond to the Bank for International Settlements (BIS) definition of US "domestic" debt securities: securities that have been issued by residents in domestic currency (with a few exceptions) and targeted at resident investors.⁵

Now consider the example where Ford Motor Company issues securities abroad, with the (presumed) intention of attracting foreign investors

In this example, the *residence of issuer* (Ford Motor Company) is still the United States, and the *residence of obligor* (Ford Motor Company) is also still the United States. However, the *location of issue* is no longer the United States, and instead is most likely the European market, either Luxembourg or the United Kingdom. And if the securities are issued in the European market, they may well be issued in euros, rather than US dollars. Such securities correspond to the traditional BIS definition of US "international" debt securities, because they have been issued by US residents in a foreign market (and targeted to non-US investors), and also (if issued in euros) because they are issued in a foreign currency.

The main point to consider is that although the securities are issued abroad, they are still the obligations of a US-incorporated enterprise and for balance of payments purposes, we would want such securities to be included as US liabilities in measures of the US IIP. So in this case, the *residence of issuer* still corresponds to the *center of economic interest*, whereas the *location of issue* does not. A side point is that there can be useful information about the currency of issue: it may provide useful information on the extent of foreigners' dollar versus non-dollar claims on the United States, but this aspect is not central for determining the country of attribution.

Similarly, consider the example of American Honda Motor Corporation (the US subsidiary of Honda Motor Co.) issuing securities in the US market

These securities are also considered US securities because of *location of incorporation* of American Honda Motor Corporation. In this case there is again no conflict between the *residence of issuer*, the *location of issue*, or the *residence of first guarantor* of the securities (American Honda). Such securities will again be considered obligations of US enterprises, and foreign holdings of such securities will be included as US liabilities in the US IIP. There is a slight wrinkle in the possibility that Honda Motor Co. (Japan) might (ultimately) guarantee the securities, but such a guarantee is not certain. Investors generally understand this distinction, and thus the prices of securities issued by subsidiaries such as American Honda Motor Corporation will not necessarily move with prices of parent companies. It also makes "economic sense" to consider the securities of American Honda Motor Corporation as US securities, because the center of economic activity is the United States, and the securities themselves are backed by real US assets in the form of US manufacturing facilities.

However, there are certainly reasons when the *location of issue* is a major consideration

If, for example, a country such as Argentina issues a debt security in the United States, the security has to be issued in accordance with US laws. Such information (and the

⁵ See BIS Papers No 14, "Guide to the international financial statistics", available at <http://www.bis.org/publ/bppdf/bispap14.pdf?noframes=1>.

consequences for investor rights and protections) is clearly information that is important to investors: investors want to know the *location of issue*, and thus keeping statistics on location of issue is important and informative. However, the security is still ultimately the obligation of Argentina, and should be included in measures of Argentina's external debt, and thus for balance of payments purposes, we care about the *residence of issuer*. This is a case where the *residence of issuer* (Argentina) is in conflict with the *location of issue* (United States), but not with the *residence of obligor* (again, Argentina). And as with the case of Ford Motor Company issuing euro-denominated securities directly in the European market, the currency of issue may provide additional information on the willingness of foreigner investors to acquire local versus dollar-denominated Argentinean debt, but this is again a side issue relative to the appropriate country of attribution.

Where we have potentially more serious problems of measurement and interpretation

More serious problems of attribution may arise from reincorporations, establishment of shell corporations, and creation of Special Purpose Vehicles (SPVs) in offshore financial centers (for example, Bermuda or Cayman Islands), or with incorporation as a Delaware affiliate in the United States.

Under the balance of payments convention, securities issued by Delaware affiliates are considered US securities. Likewise, securities issued by Bermuda or Cayman affiliates are considered non-US securities, even if the issuer (for example the SPV) is established by a US entity. The complication caused by these situations is that the *residence of issuer* may be at odds with the *center of economic interest or activity*, and may also be at odds with the *residence of obligor*. Although attribution according to the balance of payments convention may be straightforward according to residence of issuer, the attribution may make less "economic sense."

Consider, for example, securities issued by KfW International Finance, Inc: a Delaware affiliate of KfW (Germany)

Under the balance of payments *residence of issuer* convention, debt securities issued by the Delaware affiliate are considered US securities in the US IIP. This is the case even though the sole function of KfW International was to issue debt securities on behalf of and guaranteed by its parent, KfW. In addition, the *location of issue* was frequently Europe. And although the securities were issued by KfW International Finance (Delaware), it was understood by investors that the *obligor/guarantor* was KfW (Germany). So in this case, there are not only conflicts between *residence of issuer* and *location of issue*, but a more serious question of whether *residency of issuer* gives a meaningful economic interpretation – is there any "economic sense" in which these Delaware-issued securities have a meaningful connection with the US economy?

Similar problems of economic interpretation arise from debt securities issued by Cayman affiliates

According to the *residence of issuer* convention, debt securities issued by Cayman affiliates are not considered US obligations, even if the issuing entity is established by a US enterprise. In the US cross-border portfolio data, we have seen the consequences of a proliferation of SPVs in the Caribbean established by US financial firms specifically to issue asset-backed securities, where the assets frequently have been pools of US loans. US investors' holdings of such securities are considered holdings of foreign securities. This is a growing concern: Of foreign debt securities held by US residents in December 2006, nearly 15% (\$242 billion) were securities issued by entities incorporated in Caribbean financial

centers. By December 2007, such holdings had grown to \$294 billion, or 18% of all foreign debt securities held by US residents.

From the Cayman perspective, we expect that they would not wish to include such securities in the Cayman IIP, because these securities are not truly obligations of the Cayman Islands: activities of the shell corporations usually have no physical presence in the Cayman Islands, and have no real economic relation to the Cayman economy. And so an “*economically sensible*” IIP for the Cayman Islands would exclude both assets and liabilities of the SPVs. However, inclusion of these securities as cross-border assets of the United States but exclusion of them from the IIP of the Cayman Islands greatly complicates the ability to compare IIPs across countries.

A further issue that can arise from the establishment of SPVs and shell corporations is that in some cases it may not be a straightforward task to identify and classify securities according to *residence of issuer*. Such complications may arise when SPVs are established in both Delaware and the Cayman Islands, and securities are issued by either entity or at times are “co-issued” by the two entities jointly. Similar issues may arise with SPVs established in other financial centers. In practical terms, it can be difficult for data compilers to distinguish between Delaware and Cayman securities issued by SPVs that fall under the same “umbrella” entity. And according to the specific legal structure of such entities, “co-issues” may be more correctly considered wholly the issue of one or the other of the SPVs, for example either entirely “Cayman” or entirely “Delaware”.

Concluding remarks

In determining the country of attribution of securities for cross-border data collection, the balance of payments convention is to assign securities by *location of residence*. In some cases, this attribution may conflict with that of attribution by *location of issue*, but as the above examples involving securities issued by Ford Motor Company and American Honda Motor Corporation illustrate, in most cases, the *residence of issuer* classification will give a result that also makes “economic sense” in terms of the center of economic activity of the issuer and also corresponds to the *residence of the obligor* of the issue.

Residence of issuer can be straightforward to apply, especially if data are collected at the individual security level. It is possible (at least in theory) to determine the location of incorporation of the issuing entity. In practice, however, this may not always be a straightforward task. Complexities of the legal structures of various offshore or shell corporations can make it difficult to determine the issuer’s legal residence, even if data are collected at the security level. And the above examples involving activities of Delaware affiliates and of SPVs established in offshore centers illustrate the further complication that data collected and presented according to the *residence of issuer* convention may be less satisfactory than data presented by *residence of obligor*.