DO DEVELOPMENTS IN CORPORATE ORGANISATIONAL STRUCTURES POSE FINANCIAL RISKS ?

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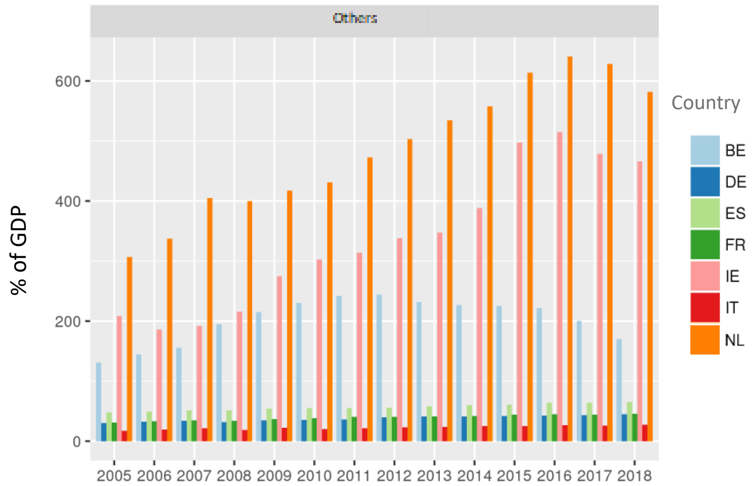
Since the 2008 financial crisis, captive financial institutions (special-purpose financial holding companies), subsidiaries of non-financial corporations (NFCs), have helped to drive growth in the financial sector, causing it to outstrip GDP growth. This trend reflects the increasingly complex and international organisational structures adopted by NFCs, but does not appear to have been accompanied by growth in risky financial transactions by these entities.

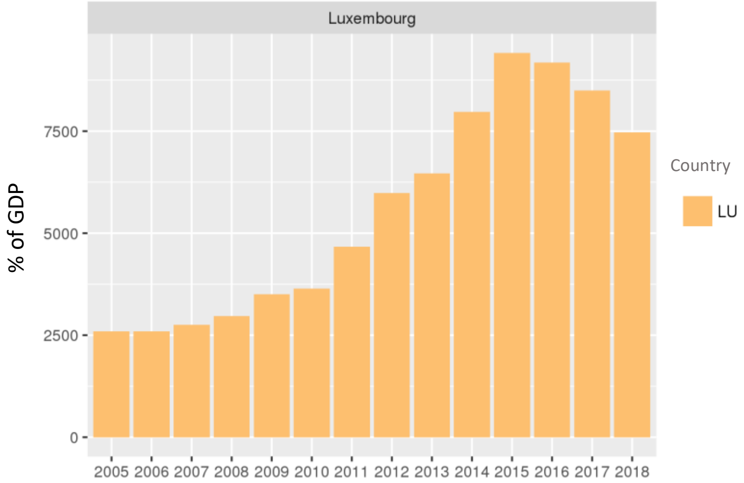
Chart 1a. Foreign direct investment by country, liabilities, % of GDP



Source: ECB

Over the last 20 years, NFCs have organised their international expansion efforts by establishing intermediate holding companies in a number of countries, chiefly Luxembourg, the Netherlands and Ireland, for financial, administrative and tax optimisation purposes (see Levy Garboua, Mouriaux and Sabatini, 2019). Called captive financial institutions, these intermediaries are NFC subsidiaries but belong to the financial sector. Charts 1a and 1b show the stock of foreign direct investments (FDI) held by non-resident entities in resident entities in eight euro area countries, as a percentage of the GDP of each country. The stock of FDI (in EUR billions) increased approximately 7.5-fold between 2005 and mid-2019 in Luxembourg (see Chart 1b) and Ireland, while practically tripling in the six other economies analysed.

Chart 1b. Foreign direct investment in Luxembourg, liabilities, % of GDP



Source: ECB

Does this new organisational approach by NFCs create risks for the financial system ?

The answer to this question depends on the types of transactions undertaken by these entities, as these developments appear to reflect several optimisation goals, i.e. not just tax but also administrative and financial optimisation. The risks to the financial system posed by tax optimisation relate primarily to economic, budgetary and social issues rather than to questions of financial stability. However, multinationals also set up captive institutions in order to centralise financial transactions within a single entity based in a country that is conducive to managing these transactions, for example because of the ease of dealing with investors, or because legal procedures are facilitated. More complex and more global corporate structures mean longer financing chains, with beneficial effects – for instance, efficiency gains can be unlocked by grouping financial transactions within a specialised structure – but also risks, for example by making it easier to set up leveraged arrangements.

Has this new structuring approach, which may be described as vertical disintermediation, in contrast to the horizontal disintermediation associated with trade credit, for example, been accompanied by a sharp increase in carry trading by NFCs and their subsidiaries? Carry trading is an investment strategy that exploits interest rate differences across countries. It consists in borrowing in a country where interest rates are low and then lending in a country where rates are high. To give an example, since interest rates have been lower in the euro area than in the United States in recent years, a fairly typical strategy among companies has been to borrow in euro (specifically by issuing bonds in the euro area) and to lend the resulting funds in US dollars (specifically by buying US debt securities).

Have these developments spurred pronounced use of carry trade transactions?

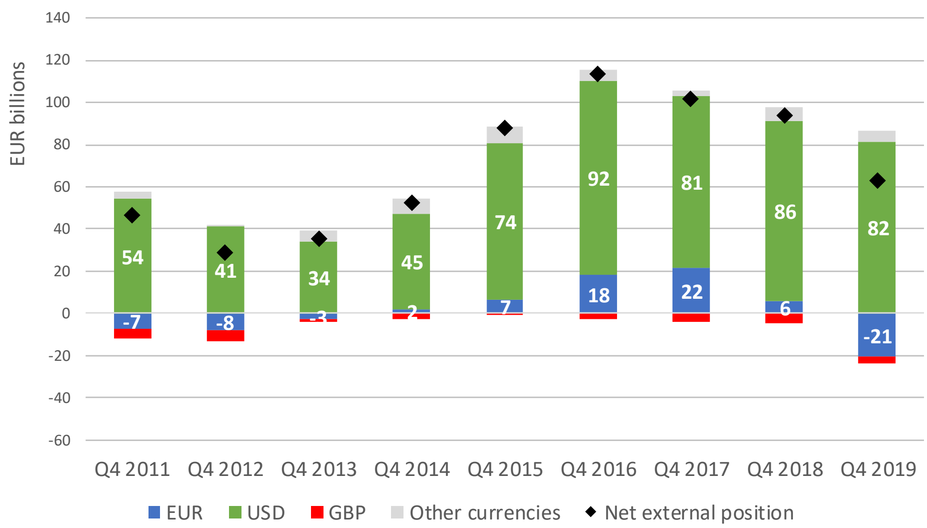
NFCs have different net positions in euro and US dollars

We need to look at company data to answer this question.

To draw up the balance of payments, the Banque de France uses data on companies that are resident in France and that engage in international transactions. In particular, data are provided by major companies referred to as Full Direct Reporters (FDRs). Though offering only a snapshot of NFC activities, these data are a rich source of information, offering valuable insights into the currency positions of these companies.

A currency-by-currency breakdown of the net external position of FDRs (trade and financial assets net of liabilities) reveals a USD surplus (Chart 2). The net external position has fluctuated since 2011 in a range of EUR -20/+20 billion.

Chart 2. FDR net external financial and trade position (EUR billions)



Source: Banque de France, FDR ECO and EFI surveys.
Guide: Trade receivables and payables and financial assets and liabilities of FDRs resident in France vis-à-vis the rest of the world. Diamonds show total external positions.

Breaking down these data a little further to show the net trade position and the net financial position, which is further decomposed into the net positions vis-à-vis group affiliates and non-affiliates, we see, in the fourth quarter of 2019 (see table), that:

1. FDRs are net receivers of US dollars and euro through their trade transactions (+35 billion in both currencies).
2. Their subsidiaries centralise euro, lending them to their parent company in France, which creates financial debt in euro for FDRs vis-à-vis their non-resident affiliates (EUR -52 billion) and a slightly negative position vis-à-vis non-affiliates (EUR -4 billion, see Chart 3).
3. FDRs lend US dollars to their subsidiaries (EUR+43 billion).

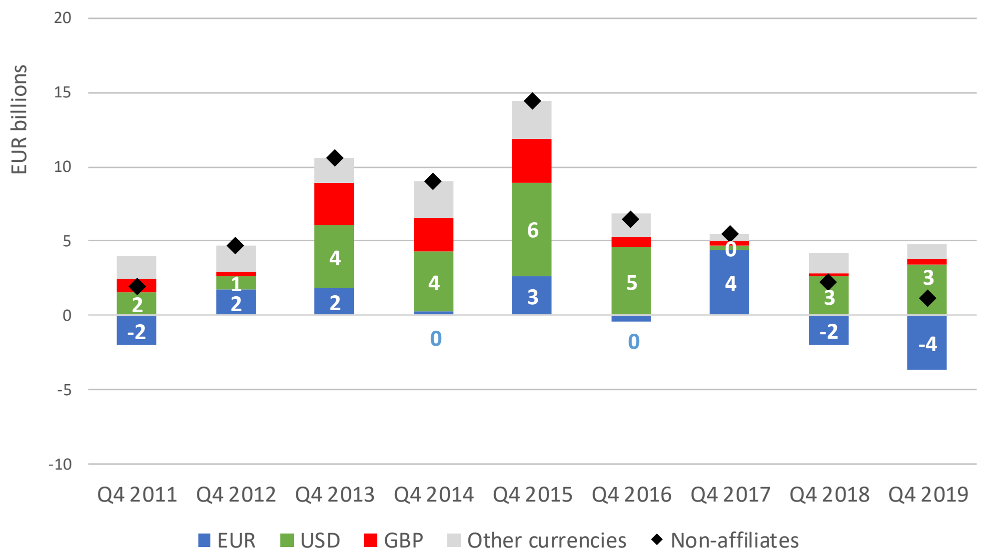
Table. FDR net financial and trade position in Q4 2019, EUR billions

	EUR	USD	total
1 – Net trade position	+35	+35	+74
2 – Net financial position vis-à-vis affiliates	-52	+43	-12
3 – Net financial position vis-à-vis non-affiliates*	-4	+3	+1
4 – Total net financial position	-56	+47	-11
Net financial and trade position	-21	+82	+63

Source: Banque de France, FDR ECO and EFI surveys.

** The net financial position vis-à-vis non-affiliates chiefly covers the international bank deposits and loans position of resident companies.*

Chart 3. FDR net external financial position vis-à-vis non-affiliates



Source: Banque de France, FDR EFI survey.

The data from FDRs do not appear to point to carry trading as such, but reflect trade-related transactions, i.e. their real activity. During normal times, in their international transactions with financial subsidiaries, these large companies have surplus cash that they can then invest, but they do not need to borrow to carry out these financial transactions, unlike in a classic carry trade. These large firms also have other funding sources, such as resident bank debt and bond issuance on French or foreign markets, which allow them to diversify the maturity of intragroup financing. However, while FDRs do not appear to be engaged in carry trading, they are still vulnerable to exchange rate movements or an economic slowdown. In the latter scenario, we would expect cash surpluses to dry up automatically and the share of this financial intermediation in the financial accounts to decline, curtailing the relative share of non-bank financial intermediation.