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Treatment of Indirect FDI Relationships

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TREATMENT OF INDIRECT FDI RELATIONSHIPS

Points for discussion for the FDI Eurostat/ECB Task Force[1]

This document presents various points for the discussion of the "indirect control and UBO" sub-group of the TF FDI. Section 1 considers indirect control/interest in FDI statistics. It reviews the definitions used for considering indirect FDI relationships according to different systems, the case of fellow affiliates, the effects on FDI variables to be recorded, the case of intermediate FDI owners. An overview of the current coverage on the basis of the SIMSDI information is also given. Section 2 is about the allocation of inward stocks by country of UBO. Section 3 turns to the problem of sources for obtaining the information and provides a summary of the work made by Eurostat and Member States in the Framework of the enterprise business register.

The main references are the OECD Benchmark definition (BD) and the IMF BoP Compilation Guide (CG). Business accounting principles are also considered, drawing on International Accounting Standards (IAS) principles. The work of the Eurostat joint WG on FATS is also taken into account.

1. SYSTEMS OF CONSOLIDATION FOR FDI

The BPM5 §362 defines direct investment enterprises as subsidiaries, associates and branches either directly or indirectly owned by the direct investor. It then refers to the CG.

The Fully Consolidated System is a theoretical system described in the BD and in the CG. The US and the German systems are those used in these countries for FDI statistics. They are also described in the BD. The definitions in terms of business accounting principles (used for consolidated accounts of enterprises on a voluntary or compulsory basis according to countries) are here taken from IAS (27, 28).

a) The Fully Consolidated System (FCS) is defined as a system that considers as direct investment enterprises (DIE) all enterprises in which the direct investor (DI) has directly or indirectly an FDI interest (BD§15).

[1] This document has been written by Paolo Passerini (Eurostat, Unit B5).

For the existence of direct FDI interest the BPM5, the BD and the CG recommend the application of the 10% rule. For determining the existence of *indirect FDI interest*, in the FCS the following rules apply (see BD §16, CG §685):

- If the DIE is a *subsidiary (>50%)*, the FDI relationship extends to the DIE's subsidiaries, sub-subsidiaries, and first-level associates of the DIE's subsidiaries and sub-subsidiaries.

- If the DIE is an *associate (>10% for bop statistics)*, DIE's subsidiaries and sub-subsidiaries are also considered associates of the DI. DIE's associates are not considered to be in FDI relationship with the DI.

(Branches have the same treatment as subsidiaries.)

For *inward FDI*, indirect FDI interest applies to other units resident in the declaring country. For *outward FDI*, indirect FDI interest applies to other units except those that are resident in the declaring country.

Indirect ownership shares are calculated by multiplying ownership shares along the chain going from the DI to the DIE. So, if A holds 60% of B and B holds 60% of C, A indirectly holds 36% of C.

However, in the FCS, the indirect equity (or voting power) share is not used to determine the existence of the indirect FDI interest (as in the USA system), but the rules above apply. Indirect shares are instead of importance when it comes to the part of FDI reinvested earnings and stocks of indirectly owned DIEs that accrues to the DI.

b) In the US system the indirect FDI interest exists if the indirect ownership share is at least 10%.

c) The German system (used in the FDI stock survey conducted by the German Central Bank) considers indirect DIEs in the following manner.

- If the first DIE is a subsidiary, its first-level subsidiaries and associates are considered as DIEs. Moreover, if the first DIE owns 100% of another enterprise, subsidiaries and associates of this last are also considered, and so on as long as there are subsidiaries held at 100%.

- If the first DIE is an associate, indirect relationships are not considered.

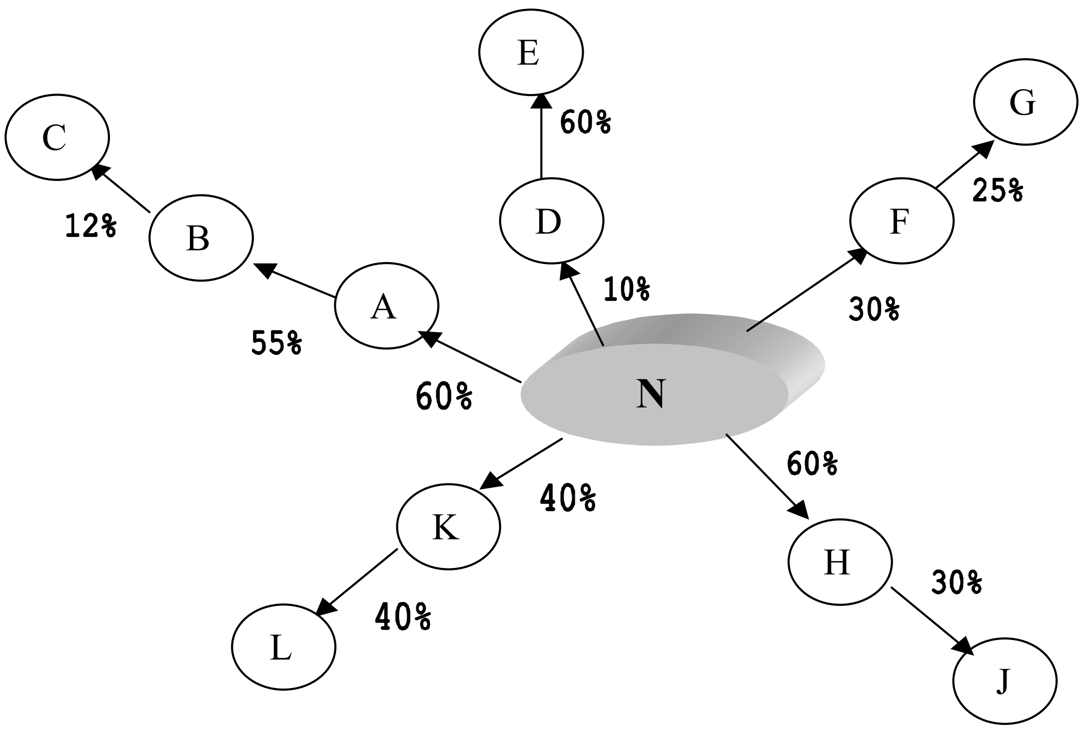
d) Business accounting principles. Reporters may be asked for FDI variables with respect to their subsidiaries and associates according to the business accounting principles. The rules of consolidation of International Accounting Standards consider subsidiaries directly or indirectly held and associates held by the DI or by one of its subsidiaries. For associates, the existence of "significant influence" is presumed with the possession of at least 20% of equity or voting power.

Examples

Figure 1 summarises various typical cases presented in the BD. It shows the different coverage of the various systems for each case.

Figure 1

Examples on the scope of indirect control/influence considered by different systems



Units excluded:

Fully Consolidated System: G, L
US System: C, E, G
German System: C, E, G, L
International Accounting Standards: C, D, E, G, L

Figure 2 considers a three-country example. The example tries to highlight the complications due to group structures in which majority ownership is obtained by the parent company through a combination of minority shares (*multiple minority* subsidiaries).

For country 1 outward FDI, a possible consequence is that units C and E are considered as associates of N rather than subsidiaries. In the FC, German and IAS systems, this would lead to the exclusion of units F and G. In the US system the same could occur if the indirect ownership shares are calculated without considering all the lines of ownership.

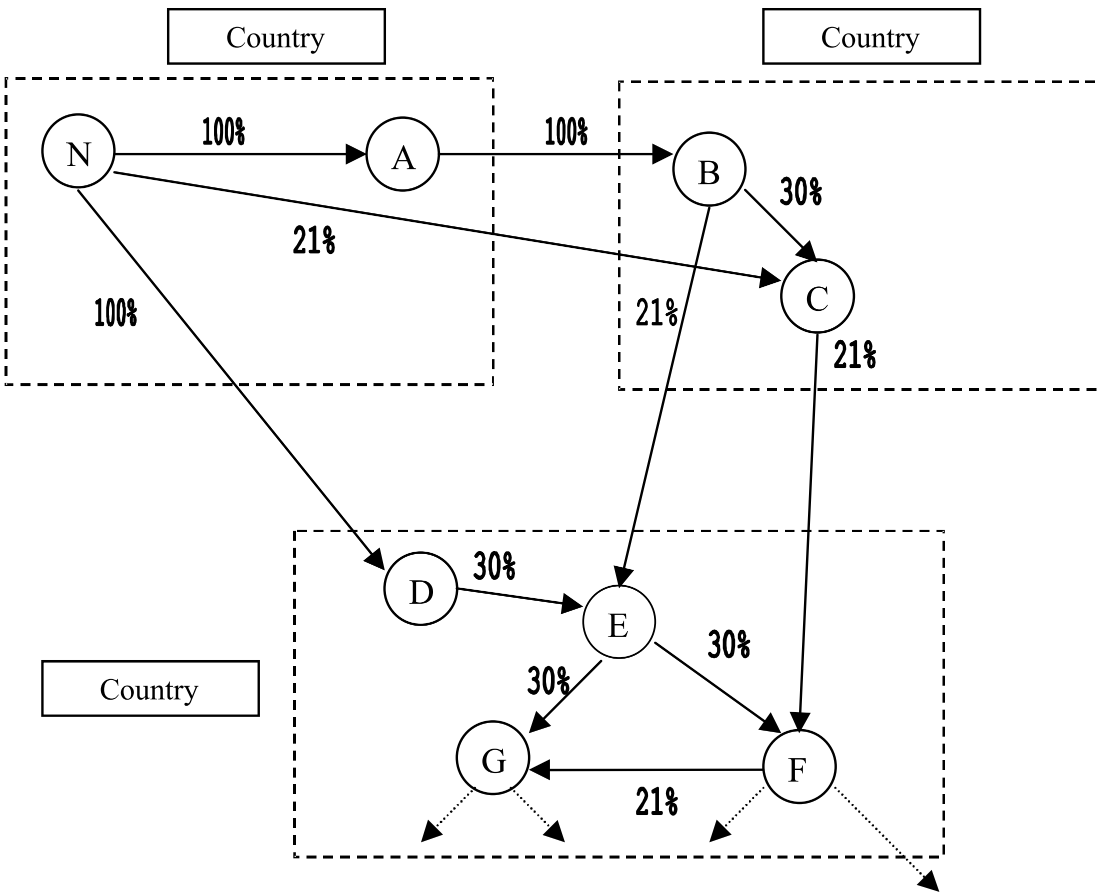
For country 2 inward FDI, the classification of C as a subsidiary requires the knowledge that B is controlled by N.

For outward FDI, country 2 has associates E and F.

In country 3 inward FDI the coverage of F and G requires the knowledge of the various links.

Figure 2

Three-country example with *multiple minority* subsidiaries



Fully consolidated system (% of N's indirect ownership into brackets)

Country 1:	Subsidiaries B (100%), C (51%), D (100%), E (51%), F (26%) and G (20%)
Country 2:	Subsidiaries B Associates E
Country 3:	Subsidiaries D, E, F

1.1. Special case in the FCS: fellow affiliates

When two DIEs resident in different countries but belonging to the same group (DI) have financial transactions between themselves, according to the FCS these transactions should be recorded as FDI irrespective of the existence of ownership shares of one unit into the other.

Annex 4 of the BD treats this case through an example in which three countries are involved. It gives two alternative ways of recording that are equivalent in terms of net inward/outward FDI.

It should be noted that Annex 4 of the BD refers to "loans or balances due between fellow *subsidiaries* and branches or indirectly *controlled* direct investment enterprises" (§135). The CG (§689) refers in an example to transactions between an *associate* and a *subsidiary* of the same parent company. The CG gives the general rule that all DIEs being in direct investment relationship with the same DI are considered to be in direct investment relationship between each other.

1.2. Effects on FDI variables recorded

The main reference is Annex 1 of the BD. This presents a detailed example showing the differences in FDI flows arising from the use of consolidated/unconsolidated systems:

- The most important differences concern reinvested earnings. In consolidated systems, reinvested earnings accruing to indirect DIEs should be recorded as FDI income and as financial flows, in proportion to the indirect share of ownership of the direct investor.

- Other financial flows (excluding reinvested earnings) going from the direct investor to an indirect DIE, or financial flows between fellow affiliates, will also be not recorded by unconsolidated systems (for example, if N in figure 1 finance directly enterprise B or E, or if B finances enterprise H).

- The recording of positions should be consistent with that of flows. FDI positions should take into account changes due to reinvested earnings and to other financial flows arising from indirect FDI relationships.

1.3. Summary of current coverage for indirect FDI

The following table taken from the IMF/OECD SIMSDI (updated in February 2002) summarises the coverage of indirect FDI relationships in OECD countries (Member States in bold). Two Member States (Denmark and Ireland) apply the FCS, eleven apply it partially, while The Netherlands and Luxembourg do not apply any system of consolidation. Reinvested earnings of indirect DIEs are covered only by Denmark, Finland, Ireland and Sweden. Lastly, transactions between fellow affiliates are taken into account by nine Member States.

Table 14.

Countries that take account of indirectly owned FDI enterprises in their statistics

OECD countries	Countries that include earnings data of indirectly owned FDI enterprises	Countries that classify all equity and other capital transactions within a group of related enterprises as FDI without consideration of the percent of equity held by these enterprises in each other	Countries that apply the Fully Consolidated System		
			Not applied	*Partially*	*Fully*
Australia	yes	yes			fully
Austria	**no**	**yes**		**partially**	
Belgium	**no**	**yes**		**partially**	
Canada	yes	yes			fully
Czech Republic	yes	no			
Denmark	**yes**	**yes**			**fully**
Finland	**yes**	**yes**		**partially**	
France	**no**	**no**		**partially**	
Germany	**no**	**yes**		**partially**	
Greece	**no**	**no**		**partially**	
Hungary	no	no	not applied		
Iceland	yes	yes			fully
Ireland	**yes**	**no**			**fully**
Italy	**no**	**no**		**partially**	
Japan	no	no			
Korea	no	no	-	-	-
Luxembourg	**no**	**no**	**not applied**		
Mexico	yes	yes			fully
Netherlands	**no**	**yes**	**not applied**		
New Zealand	yes	yes		partially	
Norway	yes	no			fully
Poland	no	no	not applied		
Portugal	**no**	**yes**		**partially**	
Slovak Republic	yes	no		partially	
Spain	**no**	**yes**		**partially**	
Sweden	**yes**	**yes**		**partially**	
Switzerland	yes	yes		partially	
Turkey	no	no	not applied		
United Kingdom	**yes**	**no**		**partially**	
United States	yes	no		partially	
Total OECD (30)					
Yes	**15**	**15**		**-**	**-**
No	**15**	**15**		**-**	**-**
Not applied			**5**		
Partially	**-**	**-**		**17**	**-**
Fully	**-**	**-**		**-**	**7**
Response not available			**1**	**-**	**-**

1.4. Intermediate FDI owners

In the example of figure 2 units resident in country 3 would be considered as DIEs by both country 1 (the country of the ultimate owner N) and country 2 (the country of the intermediate owner B). On the one hand, this may be a source of asymmetries between inward and outward FDI. On the other hand, the problem of possible double counting in building extra-EU aggregates for outward FDI arises if in the example countries 1 and 2 are member states and country 3 is the extra-EU. Tables 4 and 8 of Annex 1 of the BD can be used as examples.

This point arose for FATS during the FATS joint WG of March 2002. In FATS, only majority ownership chains are considered and the variables of indirectly controlled affiliates are allocated 100% to the country of control. In FDI, a similar situation arises for reinvested earnings and for the corresponding FDI stocks, though the effect may be diluted because reinvested earnings are not allocated 100% but in proportion of the indirect ownership share.

2. UBO

In line with the suggestion made in the BD (§45), the proposal of Eurostat within the draft BoP regulation is to calculate inward stocks data broken down by both the country of the first foreign parent and by the country of the UBO (ultimate beneficiary owner). The BD does not give a definition of the UBO. During the discussion at the FATS WG, it was accepted that for FATS purposes the following definition would be used:

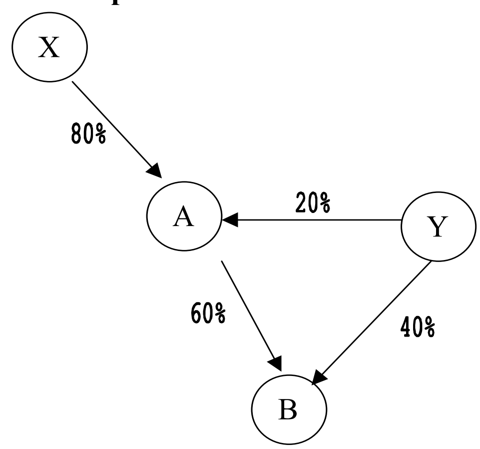
The *ultimate beneficial owner* is the first person in the chain (beginning with and including the first foreign owner) that is not controlled by another person.

The use of the term "controlled" (rather than "majority-owned"[2]) is preferable for FATS because (direct) majority ownership is seen just as a practical criterion to approximate the target concept of control. It could be less preferable for FDI that measure the financial interest of direct investors even for cases where control is absent. However, as long as the criteria of control and majority ownership are correctly applied at each step of the chain, the choice between the two criteria appears to be mainly led by practical considerations.

Instead, the discussion at the FATS WG of March 2002 showed that it could be misleading to base the selection of the UBO on the percentage of indirect ownership, even if this percentage is above 50% for a direct investor not owned by any other foreign person. This is the case of Y, who holds indirectly 52% of B in the example reproduced below. However, X (holding 48%) should be considered the UBO by the application of the step-by-step majority ownership rule.

Figure 3

Example on the selection of the UBO



In conclusion, for resident subsidiaries held by a single *first-shot* foreign owner (or by more than one *first-shot* foreign owner belonging to the same group), similar results obtain for FATS and for FDI. For FDI, the effect is the re-allocation of inward FDI stocks to the country of the UBO irrespective of the indirect ownership share held by the UBO, which may be well below the 50% (see on this point BD §43).

[2] The same definition with "majority-owned" instead of "controlled" is the one used by the BEA for USA UBO inward stocks.

For FDI, however, also minority shares held by foreign investors should be considered. In this respect, the UBO of the given resident DIE can be either a national entity or another foreign entity. In principle, the problem is to ascertain whether there is a link between the UBO and the other foreign owners of the unit. If the other owners belong to the same UBO, it seems that also the minority shares should be attributed to the country of the UBO. If not, or if the information is not available, the case becomes even more problematic and the pros and cons of possible solutions are to be examined.

Table 11.
Allocation of geographical FDI position data

OECD countries	**Countries compiling geographical breakdown in respect of the:**			
	Immediate host/investing country		**Ultimate host/investing country**	
	Inward	**Outward**	**Inward**	**Outward**
Australia	IM	IM		
Austria		**IM**	**UL**	
Belgium	**IM**	**IM**	**UL**	**UL**
Canada	IM	IM		
Czech Republic	IM	IM		
Denmark	**IM**	**IM**	**UL**	**UL**
Finland	**IM**	**IM**		
France	**IM**	**IM**		
Germany	**IM**	**IM**	**UL**	
Greece	**IM**	**IM**		
Hungary	IM	-		
Iceland	IM	IM		
Ireland	**IM**	**IM**	**UL**	**-**
Italy	**IM**	**IM**		
Japan	IM	IM		
Korea	IM	IM		
Luxembourg	**IM**	**IM**	**UL**	**UL**
Mexico	IM			
Netherlands	**IM**	**IM**		
New Zealand	IM	IM		
Norway	IM	IM		
Poland	IM	IM		
Portugal	**IM**	**IM**	**UL**	
Slovak Republic	IM	IM		
Spain	**-**	**-**	**-**	**-**
Sweden	**IM**	**IM**	**UL**	**UL**
Switzerland	IM			UL
Turkey	-	-	-	-
United Kingdom	**IM**	**IM**		
United States	IM	IM	UL	
Total OECD (30)				
Immediate host/investing	**24**	**21**		
Ultimate host/investing			**9**	**5**
Response not available or not applicable	**2**	**5**		

The table above from the IMF/OECD SIMSDI of February 2002 shows that eight Member States allocate inward FDI positions by country of the UBO. All of them except Austria allocate inward stocks also by the country of the immediate owner.

3. INFORMATION ON ONGOING WORK ON GROUP BUSINESS REGISTERS

Information on groups clearly plays a decisive role for recording indirect FDI relationships and for identifying the UBO. Possible sources of this information are the respondents themselves, private databases such as Dun&Bradstreet's "Who owns whom" database, or official statistical sources such as the enterprise business registers.

Following the Mandate of the TF, the work should focus particularly on the practical implementation of the various principles/definitions involved. The practical possibilities and costs of putting in practice the definitions outlined above should be analysed.
This section gives a contribution in this direction with a short summary of the recent work on groups made by Eurostat (unit D1) and Member States in the framework of the enterprise business register. A complete summary document of the state of art (the draft of chapter 21 of the *Business Register Recommendations Manual*) is given in annex.

- Definition of enterprises group. Council Regulation (EEC) N° 696/93 on Statistical Units defines the Enterprises Group (EG) as *"an association of enterprises bound together by legal and/or financial links. A group of enterprises can have more than one decision-making centre, especially for policy on production, sales and profits. It may centralise certain aspects of financial management and taxation. It constitutes an economic entity which is empowered to make choices, particularly concerning the unit it comprises".*
- Consideration of truncated Transnational Enterprise Groups (i.e., the national parts of a Transnational Enterprise Groups - TEG). The main difficulties encountered for the integration of information on EG and TEG into the BR are both of methodological and practical nature. On the methodological side there is the issue of harmonising concept and definition among MS and also among different institutions within MS. From the practical side there is the obstacle to reach a factual co-operation among national independent subjects managing such data, as well as that of finding qualitatively acceptable sources to be used.
  In particular, as far as TEGs are concerned, the current impossibility to use a single comprehensive source containing cross border information on equity and non-equity links among enterprises, implies that only truncated TEGs can be observed in national registers, based on national collection systems. This limitation can be reduced by the adoption at international level of a common framework of concepts concerning the nature of such links. One of the main concept to agree on is that of control, as the basic link to identify enterprise groups, especially as far as operational rules are concerned.
- The concepts of control, indirect control, etc. There is convergence with the definitions used for FATS, even if the wording may be different. In particular, the "group head" as defined by the explicative note n°4 in Council Regulation (EEC) N° 696/93 on Statistical Units (*"a parent legal unit which is not controlled either directly or indirectly by any other legal unit")* coincides with the UBO.
- Variables to be recorded in the business register for resident units (see annex). In particular, shares by owner of legal units if at least 10%; identifier of the Group Head; nationality of the Group Head.