ISSUES PAPER # 3

INDIRECT FDI RELATIONSHIPS

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Prepared by the European Central Bank

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Introduction

1. According to international standards, namely the IMF Balance of Payments Manual, 5th edition (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (B-FDI), direct investment statistics should cover all directly and indirectly owned subsidiaries, associates and branches. The incorporation of indirectly related FDI affiliates to direct investment statistics should take place through the appropriate process of consolidation (and according to the percentage of ownership) so as to avoid any double counting.

2. The 10% threshold for the establishment of whether direct cross-border links of ownership should be considered under direct investment statistics appears to be a clear-cut criterion. On the contrary, the rules underlying the identification of FDI relationships between companies without direct links of ownership have traditionally posed many practical problems.

3. According to international standards, the identification of FDI relationships is based on the so-called Fully Consolidated System (FCS), which is used to identify those enterprises in which the direct investor has directly or indirectly a direct investment interest. Thus, FDI statistics should cover transactions and positions between direct investors and all FDI enterprises which are part of the FCS. The traditional presentation of the FCS is usually illustrated by the following chart:

Figure 1: Fully consolidated system

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1 BPM5, paragraph 362 states “Direct investment enterprises comprise those entities that are subsidiaries (a non-resident investor owns more than 50 percent), associates (an investor owns 50 percent or less) and branches (wholly or jointly owned unincorporated enterprises) either directly or indirectly owned by the direct investor”. B-FDI, paragraph 14 reads “[...] inward and outward direct investment statistics should, as a matter of principle, cover all directly and indirectly owned subsidiaries, associates and branches. [...]”

2 A different issue is whether or not the establishment of a different cut-off could not substantially alleviate the respondents’ burden. This aspect will be addressed by a different item of the DITEG’s terms of reference.
4. The FCS basically illustrates which enterprises below company N in the chain should be considered as subsidiaries, associates or branches and whether or not they should be covered by FDI statistics. According to the diagram and the FCS rules companies A, B, C, D, E, F, K and L should be covered by FDI statistics.

5. The FCS is based on the concept of significant influence on management. Following the diagram in Figure 1, the rationale is that once significant influence has been lost (for instance, in the event of an associate of an associate of the direct investor, e.g. Company G in Figure 1), the enterprise falls outside the scope of the FCS.

**Shortcomings of the current treatment**

6. It is generally acknowledged that the FCS is difficult to implement and very few countries are able to fully apply it at present. In addition to the difficulties for respondents to understand its functioning and rationale, one of the reasons behind the current state of play is that unfortunately the rules underlying the FCS are not totally consistent with the accounting guidelines governing the consolidation process.

7. For this reason, reporters usually find this convention extremely difficult to assimilate. In the (fairly limited number of) countries that try to apply the FCS, the information provided by reporters most often covers just (direct and indirect) FDI relationships to the extent that the invested enterprises are covered in the consolidated balance sheet of the group.

8. The FCS seems to respond to the need to establish an unambiguous threshold between direct investment and other categories of the b.o.p. financial account and the i.i.p., namely portfolio investment and other investment. A different borderline could be equally justified as long as it were consistent with the foreign direct investment concept and principles.

**Alternatives to the FCS**

9. As mentioned before, the FCS definition includes all directly and indirectly owned subsidiaries, associates, and branches of the direct investor, even if the indirect ownership by the direct investor is less than 10 percent of ownership or voting power.

10. This paper analyses some further options aimed at establishing the borderline between FDI and other b.o.p./i.i.p. items. More specifically, in addition to the FCS, three more variants are touched upon:

   (i) a narrow definition limited to directly held direct investment enterprises;

   (ii) the “US System” (USS), which uses a cut-off of 10 percent or more ownership for both direct and indirect ownership³; and

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³ The percentage of ownership corresponding to each direct investor is calculated as the simple product of the subsequent links of ownership down the chain.
(iii) the “EU System” (EUS) or majority-ownership criterion (“10/50” definition in the terminology of the BPM5 Draft Annotated Outline), which uses the normal 10 percent threshold for direct relationships and 50 percent ownership for indirect relationships.

11. Obviously the comparison between the above-mentioned four alternatives has to be made on the basis of objective criteria. Two assessment criteria are suggested herewith: (i) changes to the FCS standard rule should imply a simplification of the methodology towards a more practically-oriented approach and should be easier to instruct to reporters; and (ii) the analytical value of the final product (i.e. FDI statistics) should not significantly decrease.

12. Taking as starting point the traditional schema through which the FCS is typically illustrated (as in Figure 1), Figure 2 below delineates the different scope of the four approaches in terms of the resulting coverage of FDI statistics.
Figure 2: differences in scope between the four approaches considered for the treatment of indirect FDI relationships

**Only direct links of ownership**

- **N**
  - 60% (A)
  - 10% (D)
  - 30% (F)
  - 9% (H)
  - 70% (K)

- **A**
  - 55% (B)
  - 60% (E)
  - 25% (G)
  - 100% (J)
  - 100% (L)

- **B**
  - 12% (C)

**Fully Consolidated System**

- **N**
  - 60% (A)
  - 10% (D)
  - 30% (F)
  - 9% (H)
  - 70% (K)

- **A**
  - 55% (B)
  - 60% (E)
  - 25% (G)
  - 100% (J)
  - 100% (L)

- **B**
  - 12% (C)

**US System**

- **N**
  - 60% (A)
  - 10% (D)
  - 30% (F)
  - 9% (H)
  - 70% (K)

- **A**
  - 55% (B)
  - 60% (E)
  - 25% (G)
  - 100% (J)
  - 100% (L)

- **B**
  - 12% (C)

**EU System**

- **N**
  - 60% (A)
  - 10% (D)
  - 30% (F)
  - 9% (H)
  - 70% (K)

- **A**
  - 55% (B)
  - 60% (E)
  - 25% (G)
  - 100% (J)
  - 100% (L)

- **B**
  - 12% (C)
13. The first option limited to direct links of ownership may be immediately disregarded on the grounds that the analytical value of the resulting figures would result seriously damaged. The increasing role of special purpose vehicles and holding companies (which sometimes have a very limited volume of own funds) in the channelling of investment flows may further justify the necessity to go beyond the first counterpart in the compilation of FDI statistics.

14. Leaving aside the first option, the differences in scope between the remaining three approaches are not so significant in this example. Obviously, reality may much diverge and real multinational groups may present complicated structures in which the differences between these options may be more acute.

15. In comparison with the results of applying the FCS, both the USS and the EUS may preserve the analytical value of the resulting statistics fairly well. Equally, both methodologies seem relatively uncomplicated to be instructed to reporters. Therefore, the choice between one and the other option should most likely be based on the conditions underlying the first assessment criterion, namely the extent to which a change in standards would simplify the preparation of statistical reports out of the information usually available to reporters.

16. In this regard, the rules underlying the EUS could be deemed closer to most accounting standards in place than those implicit in the USS. In general, all enterprises down the ownership chain for which there exists majority control/ownership must be included in the consolidated accounting statements of any given multinational group. Therefore, the information may be more easily available to any reporter pertaining to the group than for some specific cases in which the product of the different ownership links exceeds the 10% cut-off.

**Final point for clarification: how to treat domestic direct investment enterprises**

17. Irrespective of the solution finally adopted, there is an important point for which a decision is needed and that should be appropriately addressed in the new version of the BPM5 and the B-FDI. This point refers to whether or not *domestic* direct investment companies for which no direct cross-border links of ownership exist should be incorporated to *foreign* direct investment statistics.

18. In order to better illustrate this question, let us take one of the ownership chains used in the previous diagrams, namely that between the companies N, K and L. Leaving aside the first option (limited to direct links of ownership) the other three options (namely FCS, USS and EUS) will always advocate the consideration of the direct investment company L in direct investment statistics.

19. However, nothing is said in international manuals about what should be done if such indirect ownership relations take place between two enterprises residing in the same economy. In our example, let us assume that N and L are resident in country A and K is resident in country B (see Figure 3).
20. From the point of view of N, should reinvested earnings corresponding to the outward direct investment in K also include those generated by L? Furthermore, should the equity stocks of outward direct investment based on the volume of own funds at book value of K include the retained earnings (reserves) corresponding to L?

21. A similar example could illustrate the same problem from the perspective of inward FDI. For instance, let us assume that now K and L are residents of country B and the mother company N resides in country A (see Figure 4).

22. From the perspective of K, should reinvested earnings attributed to the mother company N include also those generated by L? Furthermore: should the inward direct investment stocks based on the volume of own funds at book value include the retained earnings (reserves) generated by L?
Summary of the proposals / issues for discussion

23. Members of the DITEG are invited to:

(1) express their views on whether a single criterion should rule the coverage of FDI statistics or whether more than one approach could be admitted;

(2) judge the appropriateness of the two criteria proposed in this paper for assessment of the four alternatives, namely (i) degree of simplification of current standards; and (ii) capacity to preserve the analytical value of FDI statistics;

(3) against the arguments mentioned in the note, members of the DITEG are invited to select which of the following alternative approaches should be considered as valid in the new version of the manual:
   (i) Keep the Fully Consolidated System unchanged;
   (ii) Switch to a narrow definition limited to directly held direct investment enterprises;
   (iii) Adopt the “US Methodology”, i.e. a cut-off of 10 percent or more ownership for both direct and indirect ownership; and
   (iv) Adopt the “EU Methodology”, i.e. the normal 10 percent threshold for direct relationships and a 50-percent cut-off for indirect relationships.

24. Finally, members of the DITEG are invited to decide whether or not the reinvested earnings generated by domestic direct investment companies should be incorporated to both inward and outward foreign direct investment statistics (in proportion to the percentage of ownership), namely to the total reinvested earnings and to the value of equity stocks based on the volume of own funds at book value.

Background document