

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD
WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS**

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND PAPER FOR DITEG ISSUE # 3

DETERMINING DIRECT INVESTMENT RELATIONSHIPS:

Cross Holdings of Investments and Direct Investment Relationships

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Cross Holdings of Investments and Direct Investment Relationships

Introduction

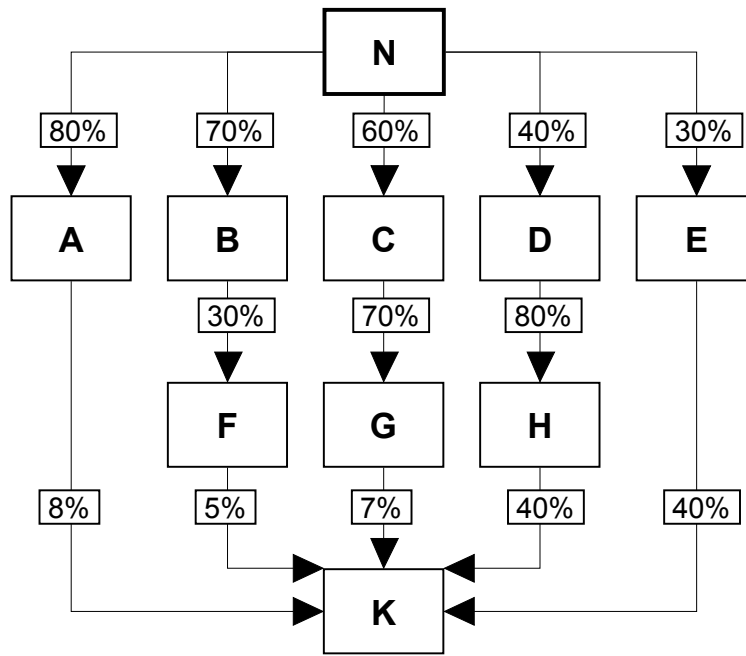
1. During discussions at the DITEG meeting in December 2004, questions were raised in relation to cross holdings and their influence on direct investment relationships as outlined by the Fully Consolidated System. This paper gives an example of a direct investor with a number of enterprise chains which have cross holdings in an enterprise at the bottom of the chain. It analyses which enterprises should be included under the current standards for direct investment and possible problems that occur due to cross holdings.

Direct and Indirect Ownership

2. According to the Balance of Payments Textbook (paragraphs 514-515), direct investment relationships extend to direct investment enterprise subsidiaries, direct investment enterprise associates, and branches directly or *indirectly* owned by the direct investor.

3. Enterprise X is a subsidiary of enterprise N only if:
- (1) enterprise N owns more than half of the shareholders' or members' voting power in X
 - or
 - (2) enterprise X is a subsidiary of any other enterprise that is a subsidiary of N.
4. Enterprise K is an associate of enterprise N only if:
- (1) enterprise N and its subsidiaries own 10 per cent or more of the shareholders' voting power in enterprise K and enterprise K is not a subsidiary of N
 - or
 - (2) enterprise K is a subsidiary of any other enterprise that is an associate of N.

Figure 1



5. Figure 1 gives an example of a direct investor, N, with a number of enterprise chains that have cross holdings in enterprise K. Following the guidelines provided in the Textbook and by going down the chains in Figure 1, the following direct investment relationships exist:

- A is a subsidiary of N.
- B is a subsidiary of N.
- F is an associate of B, and is therefore an associate of N.
- C is a subsidiary of N.
- G is a subsidiary of C, and is therefore a subsidiary of N.
- D is an associate of N.
- H is a subsidiary of D, and is therefore an associate of N.
- K is an associate of H, but is not an associate of N.
- E is an associate of N.
- K is an associate of E, but is not an associate of N.

6. Therefore, based on relationships determined by simply going down the chains, it can be concluded that K is not in a direct investment relationship with N.

7. However, the definition of an associate says that K is an associate of N if N *and its subsidiaries* own 10 per cent or more of the shareholders' voting power in enterprise K. As subsidiaries are controlled by their direct investor, any significant influence that a subsidiary has over another enterprise (an associate of the subsidiary) is ultimately subjected to influence by the direct investor at the top of the chain of subsidiaries. Therefore, it is necessary to look at the voting power of K held by N's subsidiaries:

A is a subsidiary of N and it holds 8 per cent of K.

F is not a subsidiary of N.

G is a subsidiary of N and it holds 7 per cent of K.

H is not a subsidiary of N.

E is not a subsidiary of N.

8. Therefore, the combined total of the voting power of K held by N's subsidiaries is 15 per cent, which makes K an associate of N, under the Fully Consolidated System (FCS).

9. There is no guidance in the current standards on how to record cross holding relationships. For example, from Figure 1, 15 per cent of K's reinvested earnings could be distributed to N directly, or 8 per cent and 7 per cent could be distributed through A and G respectively, and continue up the chain to N. The latter will result in N receiving 9.34 per cent of K's reinvested earnings, in contrast to the former, where N would receive 15 per cent. The latter also requires A and G to record reinvested earnings transactions with an enterprise in which it does not have a direct investment.

10. Questions for discussion:

(i) In theory, are the relationships that result from cross holdings of interest when determining direct investment relationships?

(ii) Should these holdings be recorded at each step in the chain, even if there is not a direct investment relationship between the enterprise at the bottom of the chain and the enterprise immediately above it?

(iii) In practice, are the relationships resulting from cross holdings of material interest? If so, is it possible for compilers and/or providers to identify such cross holding relationships? And even if these relationships can be identified, is the information required under direct investment available? For example, would enterprises N, A and/or G in Figure 1 have information about K's equity capital and reinvested earnings?