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## **Working Party on Financial Statistics**

### **THE CLASSIFICATION OF HOLDING COMPANIES AND HEAD OFFICES PROBLEMS ENCOUNTERED BY THE ICBS**

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*This document has been prepared by Mrs. Noemi Frisch Tsekhman (Central Bureau of Statistics, Israel) and will be presented under item 1.a of the draft agenda*

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## **THE CLASSIFICATION OF HOLDING COMPANIES AND HEAD OFFICES PROBLEMS ENCOUNTERED BY THE ICBS**

### **1. Introduction**

This paper presents the problems experienced at the Central Bureau of Statistics in Israel regarding the implementation of the definitions and the sector classification of the holding companies and head offices according to the SNA2008. First the background for the update of the SNA and the definitions from the SNA 2008 are presented. After that some practical questions are raised and an example from the Israeli economy is given in order to present the problems encountered, when classifying data for such companies. Then, we raise some points "for and against" classifying the specific example as holding company and describe our treatment and finally suggest additional guidelines for the implementation of the classification and a possible extension of the classification.

### **2. The definitions in SNA 1993 and SNA 2008**

*One of the issues brought up in the framework of the update of SNA was the treatment of holding companies and head offices. SNA 1993 refers to holding companies as one of the two types of parent corporations (SNA1993, 4.36-4.38)*

“The first consists of a corporation with significant production of its own which acquires control over other corporations in order to strengthen its own position as a producer.

On the other hand, the principal function of a corporation may be to control and direct a group of subsidiaries, without having any other significant production of its own. Such a corporation is described as a “holding corporation” or “holding company”.

Each individual corporation should be treated as a separate institutional unit, whether or not it forms part of a group. “

*It also refers to the classification of holding companies by sector:*

“Holding corporations (i.e. corporations which direct a group of companies) are classified as follows:

- (a) in sector S.11, non-financial corporations, if the preponderant type of activity of the group of corporations which are market producers, as a whole is the production of goods and non-financial services ;
- (b) in sector S.12, financial corporations, if the preponderant type of activity of the group of corporations as a whole is financial inter-mediation.” (ESA 95, 2.100).

***During the discussions towards the update of the SNA the need to make changes in the classification of sectors and institutional units was brought up. The background was:***

First, the ESA 95 and the MFSM 2000 have a more detailed description of the financial corporation than the SNA1993 and their classification deviates from the SNA. According to the MFSM a holding company should be classified to other financial intermediaries subsector, and not by the predominant sector of the group of corporations it owns as recommended in the 1993 SNA. Second, the development of the financial markets since 1993 should be taken into account. Third, policy and analytical needs in the context of monetary and financial stability analysis. (source: Classification and Terminology on financial corporations in the updated SNA – Fourth meeting of the advisory group on national accounts)

Some concerns were raised during the discussions: The change in classification would lead to an extension of the subsector “other financial intermediaries”, and the question was raised, if it would be correct to classify a holding company for a non financial group as financial sector.

Another important point raised by Statistics Sweden was the need to keep the link between SNA and ISIC.

***The updated definition of holding company and head office according to the 2008 SNA is as follows:***

“Head offices and holding companies

4.53 Two quite different types of units exist that are both often referred to as holding companies. The first is the **head office** that exercises some aspects of **managerial control** over its subsidiaries. These may sometimes have **noticeably fewer employees**, and more at a senior level, than its subsidiaries but it is **actively engaged in production**. These types of activities are described in ISIC Rev. 4 in section M class 7010 as follows:

*This class includes the overseeing and managing of other units of the company or enterprise; undertaking the **strategic or organizational planning and decision making role** of the company or enterprise; exercising **operational control and manage the day-to-day operations** of their related units.*

Such units are allocated to the non-financial corporations sector unless all or most of their subsidiaries are financial corporations, in which case they are treated by convention as financial auxiliaries in the financial corporations sector.

4.54 The type of unit properly called a **holding company** is a unit that holds the assets of subsidiary corporations but **does not undertake any management activities**. They are described in ISIC Rev. 4 in section K class 6420 as follows:

*This class includes the activities of holding companies, i.e. units that hold the assets (owning controlling-levels of equity) of a group of subsidiary corporations and whose principal activity is owning the group. The holding companies in this class **do not provide any other service** to the enterprises in which the equity is held, i.e. they **do not administer or manage other units**.*

Such units are always allocated to the financial corporations sector and treated as captive financial institutions even if all the subsidiary corporations are non- financial corporations.”

### **3. Problems with implementation of the updated definitions**

We have encountered some problems using the updated treatment in our accounts.

1. It is not so clear what level of management control is required for a company to be classified as head office. The case of companies acting as financial managers of a group – taking loans from banks, giving loans to the subsidiaries, and issuing bonds is relatively straight forward. But in the many cases holding companies are also responsible for the main business decisions for the entire group and exercise managerial control over the companies in the group, the classification is not so clear. In such cases the recommendation seems to be to classify them as “head office”. But, if these companies are not actively engaged in production, should they be classified as “holding companies” despite their management function?
2. The decision making role (type of decisions) should be different at the Group level and at the enterprise level. It is not clear, what “day to day operations” means?
3. The Holding company definition seems very restrictive: “*The holding companies in this class do not provide **any** other service to the enterprises*” and may make the classification difficult to implement.
4. Another question raised is whether both kind of companies can hold their subsidiaries and collect management fees? Has the volume and kind of services (for which the management fees are collected) any impact on the classification?
5. Is it right to say that the **only** income for holding company should be earning (losses) from subsidiaries?

Below an example of such problems is presented.

#### **4. An example of problems with implementation taken from the Israeli economy**

##### ***The Israeli economy***

**The Israeli economy** is small and quite concentrated. The 10 largest groups of companies hold 41% of the market value of the traded companies (all companies traded at the Tel Aviv Stock Exchange). These large groups hold **both financial and non financial companies** through holding companies (some of them with a pyramid structure). In these kind of companies the power of the controlling shareholders is significant.

According to the 2009 consolidated balance sheets, the total assets of the economy is 1916 billion USD, which is 9.4 times the GDP in this year. The total assets of the financial sector is estimated as 530 billion US\$ which is 28% from the total economy (and 36% from the financial assets).

##### ***EXAMPLE – IDB***

“**IDB Holding** is one of Israel’s largest holding companies, and it invests, through investee companies, in leading companies in various sectors of the Israeli economy and overseas (in financial and non financial companies including: financial services, communication, industry, real estate, retail and services...).

The final parent company of IDB Holdings is Ganden Holdings Ltd. The owner is the final controlling shareholder.

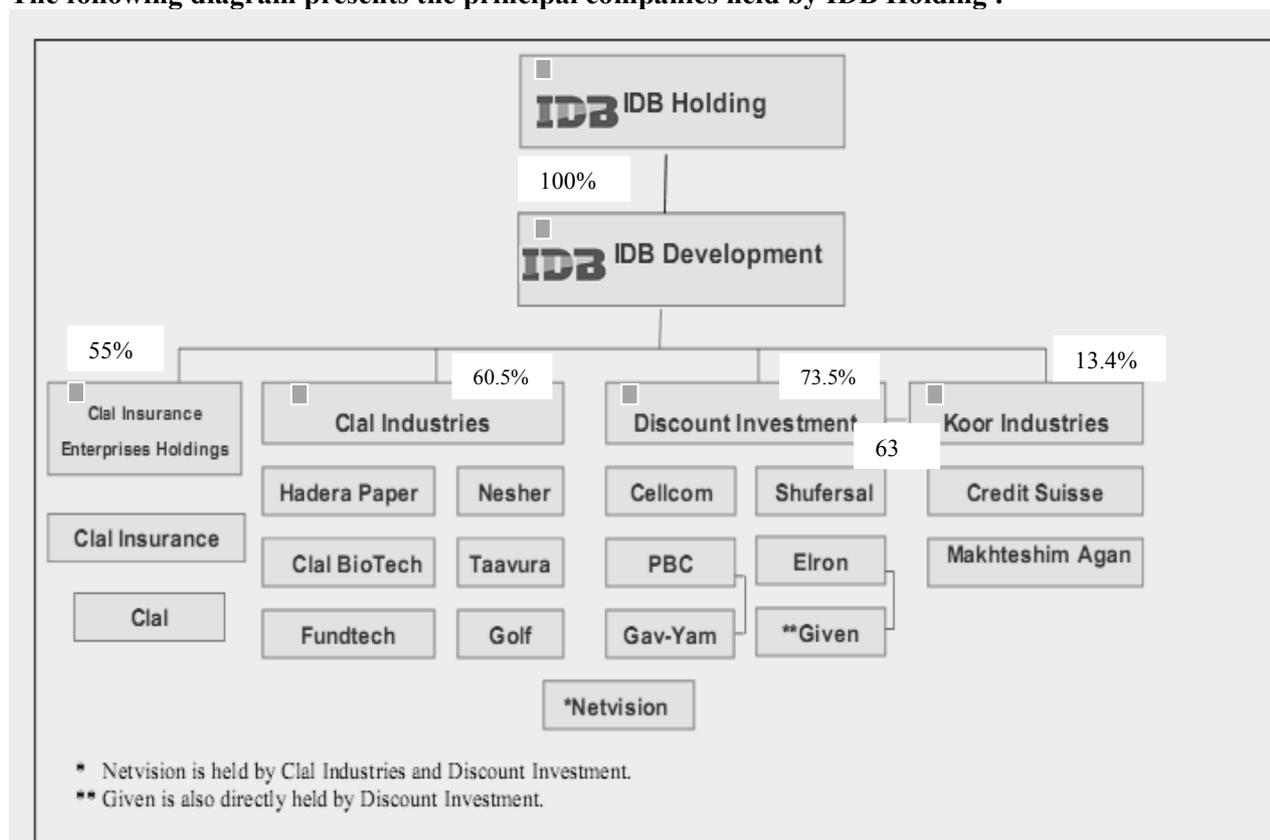
The owner serves as the Chairman of the Board of the Company, IDB Development, Discount Investments and Clal Industries and he also serves as a director in principal companies of the IDB Group including Clal Insurance Enterprises Holdings, Clal Insurance Company, Shufersal, Cellcom, Mashav, Neshar, Property & Building, Koor Industries and Makhteshim Agan. The owner **sets the policy of the Company and the Group, directs its activity and leads its business strategy, while taking charge of the significant transactions of the Group, in Israel and abroad, and managing and supervising on an ongoing basis the activity of the Company and the Group**".

Probably, the decisions taken at this level are for more general issues than the day-to-day decisions. For example, the specific production activities of price policies are taken at the enterprise level and not by the Group.

"The consolidated financial statements include the financial statements of companies that are controlled by the Company (subsidiaries). **Control** exists when the Company has the **power to govern, directly or indirectly, the financial and operating policies of the controlled company**. In assessing the existence or absence of control, potential voting rights that are immediately exercisable are taken into account. "(Source: 2010 annual report of IDB holding corporation).

For example, the owner of Ganden Holdings Ltd holds 55% of the shares of IDB Group, the last holds 75% of Discount Investments, which holds 47% of Cellcom. The owner has only 19% of the shares of Cellcom, but he definitely controls the company.

The following diagram presents the principal companies held by IDB Holding :



Source: Report of the boards of directors on the financial condition of the company for the year ended December 31, 2010 - [http://www.idb.co.il/objects/IDBH\\_2010\\_Eng.pdf](http://www.idb.co.il/objects/IDBH_2010_Eng.pdf)

According to the financial statement from the annual report (on stand alone basis provided to The Israel Securities Authority) all the six companies: IDB Holding, IDB Development, Koor Industries, Discount Investments, Clal Industries and Clal Insurance Enterprises Holdings, are described as holding companies and have similar structure of assets and liabilities.

All these companies have a small number of employees at a senior level, administrative and headquarter positions. IDB holding and IDB Development share manpower, IDB Development is the employer of the relevant employees, and IDB Holding participates in the manpower expenses of IDB Development (except for a few employees). IDB Holding and Clal Industries entered into an agreement by which the Company provides to Clal Industries management services. Agreements exist between IDB Development and a number of investee companies, by which IDB Development provides management services to those companies, including, e.g., to companies: DIC, Clal Industries and Clal Insurance Enterprises. (source: annual report).

Assets:

Investments in investee companies (the largest sum)

Loans provided to subsidiaries (relatively small, depends on the company)

Cash and financial investments (relatively small)

Liabilities:

Bonds (the largest sum)

Loans from banks and from subsidiaries

Income:

Net earnings (Losses) from investee companies

Management fees (part of the companies)

**Data on the six holding companies of the group (year 2010):**

The total assets of the IDB Group is 35 billion US\$ on a consolidated basis

Company	Total assets (annual report 2010 - stand alone basis)	Number of employees (annual report 2010 - stand alone basis)
IDB Holdings	0.9 billion US\$	A few
IDB Development	2.6 billion US\$	51 – senior positions
Koor industries	1.8 billion US\$	10 - senior positions
Discount investment	3.9 billion US\$	33 - senior positions
Clal industries	1.4 billion US\$	35 - senior positions
Clal insurance enterprises holdings	1.3 billion US\$	Not available

**For and against classifying these six companies as holding companies:**

<b>Holding company</b>	<b>Head office</b>
The owner of the group does not undertake the day-to-day operations at the enterprise level.	The owner of the group sets the policy, directs its activity, leads its business strategy, and manages and supervises on an <b>ongoing</b> basis the activity of the Company and the Group.
The main asset is Investments in investee companies (holding other companies)	Issue bonds and provide loans to the subsidiaries
Issue bonds and provide loans to the subsidiaries – engaged in financial intermediation	Few employees at a senior level
The main income is earnings (Losses) from investee companies	Providing part of the management services
Has no significant production at its own	

If all six companies will be classified as holding companies the appropriate sub sector is “captive financial institution and money lenders”.

If they will be classified as head offices, then IDB Holding and IDB Development will be classified as financial auxiliaries (because they hold other holding companies). Clal Industries will be classified as non financial corporations. Clal Insurance Enterprises Holdings will be classified either as financial auxiliaries (because they hold financial corporations), or as insurance corporations. Koor Industries and Discount investments hold both financial and non financial corporations and needs to be examined to decide which type of activity is the principal one.

**Currently these kind of companies have been classified as Holding companies, because their main activity is to hold other companies and engage in some financial activities, although it seems that the owner of the Group controls, and makes the decision for many of the subsidiaries. There are only a few companies which have been classified as head offices. All of the holding companies have been classified under the financial sector, in the “other financial intermediaries” subsector. In our opinion, it would be preferable to split the holding companies into two subgroups: those holding financial subsidiaries and those holding non financial subsidiaries.**

It should be mentioned that during the last month the conclusions of “the committee on market concentration” (set up by the Israeli government) have been published, recommending to separate financial and non financial holdings by prohibiting companies controlling large non financial corporations from controlling large financial institutions and to regulate holding companies with a pyramid structure through the tools of corporate governance. This means, among other things, that data on the nature of the holding companies with a distinction between financial and non-financial subsidiaries is important for policy makers.

A few numbers from the balance sheets of Israel - refers to the total financial assets:

year	Financial sector as part of the total economy S12/S1	Other financial intermediaries subsector as part of the financial sector S123/S12	Other financial intermediaries subsector excluding mutual funds, provident funds and training funds as part of the total financial sector	Holding companies as part of the Other financial intermediaries subsector excluding mutual funds and provident funds	Holding companies as part of the total economy
2003	40%	24%	9%	80%	2.8%
2008	39%	30%	18%	n.a.	n.a.

## 5. Conclusions

Companies which mainly hold subsidiaries and engage in some financial activity (issuing bonds and giving loans to the subsidiaries) have been classified in the financial sector, the “captive financial institution and money lenders” subsector, although the owner of the Group controls, sets the policy and makes the decision for many of the subsidiaries. The decision was not unequivocal, and in our opinion it is not clear, if another statistical agency would have classified these corporations in the same way. This ambiguity could lead to differences in classification in the statistics of various institutions and countries and make it difficult to compare data between agencies and countries. Therefore more specific guidance on classification of holding companies and head offices seems important.

In our opinion it would also be useful to make a sub-classification of the holding companies into two types: those holding mainly financial corporations and those holding mainly non financial corporations.