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Mr Petr Musil  
Director, Macroeconomic Statistics Section  
Czech Statistical Office  
Na padesátém 81, 100 82 Prague 10  
Czech Republic

**Subject: Advice on the sector classification of the 2021 established National Development Fund (NRF, or Národní Rozvojový Fond)**

**Reference:** Your letter csu-004425/2021-4 from 5/5/2021 (Ares(2021)3020877)  
Your e-mail dated 18/06/2021 and attached documents (Ares(2021)3984471)  
Video-conference on 16/09/2021 to discuss NRF's classification  
Your e-mail dated 15/11/2021 including replies to questions asked during the video-conference (Ares(2022)969277)  
Discussions on the topic during the EDP dialogue visit held on 22-23/11/2021 (Ares(2021)7458495)  
Eurostat's letter to CZSO from 7/2/2022 (Ares(2022)893700)  
CZSO's comments on the classification from 7/2/2022 (Ares(2022)904955)

Dear Mr Musil,

Thank you for your request for an advice on the sector classification of the 2021-established **NRF** (National Development Fund / *Národní Rozvojový Fond*, or "the Fund"). After having closely examined the arguments and the documents provided, Eurostat is now in a position to express a view on this matter.

## **1. THE ACCOUNTING ISSUE**

NRF obtained a licence to operate as a financial intermediary from the Czech Central Bank in November 2020, and was established in February 2021 as a resident development financial institution.

With your letter of 5 May 2021 you requested an advice on NRF's sector classification, which was followed by an intensive exchange of information on, among other things, the organisational structure of NRF, the investment processes, its financing, the 'buyers' of the investment units (shares) followed by several iterations of questions and answers. Some changes to NRF's statutes

also took place in the meantime, like for example expanding the Board of Directors (“BoD”) from two to three seats, as well as forming a clear majority vote within the BoD.

### *1.1. Documentation provided*

- A document describing the main features and activities of NRF (‘Case Study’) by the Czech National Statistical Office (CZSO);
- A memorandum among the founder, the National Development Bank (“**NRB**”, formerly called CMZRB or “the Bank”)<sup>1</sup>, the Czech Ministry of Industry and Trade, and four commercial Czech banks, the latter intending to subscribe to investment shares (‘investment units’, as per ESA 2010) in NRF’s sub-funds;
- NRF’s articles of association;
- NRF’s statute determining the management of the Fund, the establishment of sub-funds, and the principles for conducting day-to-day operations, among others;
- On 18 June 2021 the CZSO sent replies to a number of clarification questions asked by Eurostat.
- On 15 November 2021, Eurostat received a service contract, updated Fund’s statute, as well as remuneration agreement, in Czech language, elaborating on which administrative activities of the Fund are performed by NRB and which are performed by NRF.
- On 15 November 2021, Eurostat also received an updated investment/ divestment decision making cascade.

### *1.2. Description of NRF*

NRF has been in planning for several years, and was established in 2021 as a way to promote long term investment and involve private financing in the construction of public infrastructure.

The goal of the Fund is to provide riskier layers of project financing (e.g. subordinated, or mezzanine loan tranches), especially for infrastructure projects (initial projects are planned in the public transport sector and municipal buildings for the general public). Investments will be realized through sub-funds, whereas each sub-fund will be an accounting, asset-separated part of NRF, and will have its own investment strategy, focusing on a specific sector (e.g. transport, healthcare, etc.), but will not have own decision-making autonomy (separate from that of NRF).

Sub-funds are banned from cross-subsidizing each other’s losses. Investment shares will not be guaranteed by the government. Potential losses in the sub-funds will result in a decrease in net asset value of the sub-fund, and thereby decrease in the value of investment shares. Investment shares are not expected to be widely tradeable, and can be exchanged only at bilateral seller-buyer transactions.

NRB owns 100% of the founders’ shares in the Fund, and NRF is considered a wholly owned subsidiary of NRB (NRInvestiční). For national accounts purposes, NRB is classified in the central

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<sup>1</sup> Formerly called Czech-Moravian Development Bank or “CMZRB”. CMZRB was also the name used by CZSO in the original request.

government subsector (S.1311), which has been confirmed during EDP dialogue visits<sup>2</sup>. NRB committed CZK 2 million to pay for the founders' shares. However, the main financing is expected to be raised by issuing investor shares for NRF's sub-funds. The Fund's investments are projected to reach CZK 7 billion over the next few years (EUR 270m, or appr. 0.1% of Czechia's GDP).

NRF has signed memorandum of understanding with four private commercial banks, as private investors, who expressed intention to acquire investment shares in future NRF *sub-funds*, once sub-funds are established: Česká spořitelna, Komerční banka, Československá obchodní banka and UniCredit Bank (all of which are S.12 private financial corporations). Other private investors can join NRF in future. The Fund is targeting to attract other commercial banks and institutional investors, such as pension funds, insurance companies or even finance subsidiaries of large industrial companies.

According to information provided by CZSO, investment in the Fund may also be a way for commercial banks to finance a certain project, both on the senior loan side (by providing a direct loan to the project company), and on the subordinated instruments side (indirectly through a sub-fund of NRF). Banks may also prefer the portfolio approach of NRF for risk-sharing with other investors, as well as to hold investment shares rather than subordinated loans, for accounting and reporting purposes.

NRF's BoD, together with the four commercial banks, has already started to identify and assess potential infrastructure projects for financing. The BoD comprises three directors, all appointed by the General Meeting of the NRF — two directors, who currently also serve on the board of an NRB subsidiary (S.1311) and one director has neither an existing employment relationship with the general government, nor a political mandate. According to the information sent to Eurostat, initially NRF's BoD comprised 2 directors (1:1 government/ NRB: non-government/ commercial banks), but was later expanded and currently comprises 3 directors (2:1 government/ NRB: non-government/ commercial banks).

Private company projects can be co-financed by NRF's sub-funds, but the projects must be in the public interest (e.g. public infrastructure, buildings in service to the public, healthcare, etc). Such public interest projects are expected to produce a risk/return profiles commensurate with the expectations for the subordinated loan financial instruments to be used by NRF. Whether projects meet the criterion of public interest will be decided by NRF's BoD, in consultation with the National Investment Council (NIC).

NRF's Supervisory Board (SB) also comprises three members, all of whom appointed by the General Meeting of the NRF. SB will have only supervisory functions, with no executive powers. Currently, one of the SB representatives is a government/ NRB official and the other two have neither an existing employment relationship with general government, nor a political mandate. According to article 20.7 of the Fund's articles of association, investment share majority approval will be required, alongside majority approval by the founders' shares, for many cases concerning the administration of NRF and its sub-funds.

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<sup>2</sup> Ares(2015)2997328, //ec.europa.eu/eurostat/documents/1015035/3991219/Final-findings-EDP-dialogue-visit-CZ-19-20-Nov-2014.pdf

All major documents and statutes establishing the Fund have already been approved by the General Meeting of shareholders. Since no sub-fund has been established yet, these documents and statutes have been *approved by the holder of the founders' shares only* (no existing investment shares). Any future changes to the establishing documents and statutes will require majority approval of the founders' shares (currently 100% held by NRB), which gives a de facto veto right to NRB (in cases where future changes are proposed by the holders of the investment shares). Likewise, investment shares holders will have a veto right as per article 20.7 of the Fund's articles of association (once sub-funds are established and any investment shares are issued).

The National Investment Council (NIC) is a newly created body specifically with the goal of promoting long term investment in public infrastructure. NIC comprises nine members, of which four government representatives, four representatives of the four private banks signatory to NRF's Memorandum of Understanding, and one independent member. Two potential investment projects are currently being considered, whereby sub-fund(s) of NRF will lend to a municipality (S.1313) for the construction of a public building and to a public transport corporation classified outside government.

Each sub-fund will have its own investment committee and a portfolio manager. The portfolio manager will be one of the three members of NRF's BoD, at least for the first few sub-funds. However, the investment committee has only advisory functions and all investment decisions are taken at the level of NRF's BoD. As of the time of writing this advice, no sub-fund of NRF has been established.

As informed in November 2021, NRF would charge a management fee to its sub-funds for management and (partial) administration services, instead of reallocating its costs to individual sub-funds, as was the original setup (informed in May 2021). This amendment in the Fund's statute is in order to re-align its setup with the usual market investment company remunerations (discussed further in point 2.3e below).

## **2. METHODOLOGICAL ANALYSIS**

### ***2.1. Applicable accounting rules***

Eurostat carried out its analysis based on ESA 2010 and the Manual on Government Deficit and Debt (MGDD) 2019, in particular:

- ESA 2010, Chapter 2: in particular, ESA 2.12-2.13 dealing with the definition of an institutional unit, as well as MGDD section 1.2.2;
- ESA 2010, paragraphs 2.21-2.23 and 2.61, as well as MGDD 1.6.6 on captive financial institutions;

## **2.2. National accounts analysis**

In the analysis provided to Eurostat, CZSO described in detail the investment decision making cascade, the control over the main executive body (the BoD of NRF), as well as an explanation of why sub-funds are not considered separate institutional entities. Further information was provided on financial resources and lending conditions and some data were disclosed on assets and liabilities of NRF. The analysis concluded (in May 2021, based on the initial the BoD composition) that NRF should be classified in S.12 public financial corporations classified outside of government. The BoD now comprises three directors (2:1 government/NRB: non-government/commercial banks), vs two in May 2021 (the ratio was 1:1 government/NRB: non-government/commercial banks).

## **2.3. Methodological analysis and clarification by Eurostat**

### *a) NRF governance, Board of Directors (“BoD”) composition*

Following the MGDD, the control criteria is an important step in deciding on the sector classification. Broadly speaking, control over an entity could be seen as “control of people who are taking decisions for the concerned entity”. The BoD is the main executive body of NRF, which takes all the decisions concerning the Fund’s management, including, among others, investment or divestment decisions by sub-funds, decisions to set up or wind-up sub-funds, decisions to issue investment shares in sub-funds, etc.

In May 2021, CZSO informed Eurostat that the BoD would comprise two directors, one of which a representative of NRB. In June 2021, however, CZSO informed of a change in the structure of NRF’s BoD. One more director was added, and the additional director would also be a representative of NRB. Both NRB directors in NRF’s BoD are simultaneously also serving as directors in a wholly owned investment subsidiary of NRB. The BoD decisions are taken with a simple two thirds majority. Considering the above, it can be concluded that NRF is controlled by NRB (S.13), and therefore it is to be considered a public entity.

Furthermore, all major documents and statutes establishing the Fund have already been approved by the General Meeting of shareholders, before any sub-fund has been established. In other words, these documents and statutes have been approved by the holder of the founders’ shares only, i.e. by NRB only (no existing investment shares yet). Any future changes to the establishing documents and statutes will require majority approval of the owners of the founders’ shares, which gives a de facto veto right to NRB (in cases where future changes are proposed by the holders of the investment shares). Likewise, investment shares holders will have a veto right at the level of the General Meeting of shareholders in the future (once sub-funds are established and any investment shares are issued).

### *b) Institutional unit nature of NRF*

*The ESA 2.12-2.13 and MGDD 1.2.2* foresee that the entity is not deemed to be an institutional unit, if it does not exercise autonomy of decision over its principal function. The lack of autonomy of decision could be seen in cases when entities are acting within pre-defined contractual or legal provisions. In the case of NRF, the main investment decisions, i.e. investments into projects, are taken by the BoD. The latter is deciding on whether the project will be implemented, and whether a particular sub-fund will be established. The BoD is signing the financing agreement with the

investors on behalf of NRF. Further decisions in relation to the management of temporary liquid assets are taken by the portfolio manager of the sub-fund (who is also a member of the BoD).

Considering the above, it is therefore questionable whether NRF can be considered a separate institutional unit. This is especially based on the fact that all major operating decisions in NRF and its sub-funds can be taken with a two thirds majority at NRF BoD level, whereas two of the NRF director posts are occupied by existing NRB subsidiary directors and the founders' shares in the Fund are 100% owned by NRB.

NRF could therefore be deemed not to have decision making autonomy from NRB. Following the latter, for GFS/EDP statistical purposes, NRF could be considered as an ancillary entity, or an artificial subsidiary of NRB (ESA 2.13 (c) "entities which, while keeping a complete set of accounts, have no autonomy of decision, are part of the units which control them").

*c) Institutional unit nature of NRF's sub-funds*

Eurostat concurs with the CZSO analysis and conclusion that the future NRF's sub-funds cannot be considered as separate institutional units due to lack of decision-making autonomy. NRF's sub-funds are therefore considered ancillary entities forming parts of the Fund itself. Sub-funds serve NRF by issuing investment shares and carrying the principal asset management activity of the Fund. Different sub-funds are needed to differentiate between different projects, sectors and their specificities, e.g. transport vs healthcare.

*d) Captive unit considerations, in case NRF might be deemed an institutional unit*

The MGDD foresees that individual entities forming part of a group structure, for which a complete set of accounts can be drawn up, are considered institutional units even if they have partially surrendered their autonomy of decision to the central body.

If this could be applied to NRF, then further analysis should focus on MGDD 1.6.6 provisions, as regards captive financial institutions. Captive financial institutions are entities which have "*limited capacity of decision as regards their current management and are very much dependant on their parent (controlling unit) as regards the conduct of their activity*".

*MGDD 1.6.6. paragraph 40 on decision making* would be relevant, in this case: NRF "has a limited capacity of decision as regards [its] current management and [is] very much dependent on [its] parent [NRB] as regards the conduct of [its] activity", which would imply that even if NRF would be considered an institutional unit, its sector classification will be the same as NRB's.

*The MGDD* explains that government captive institutions carry out financial tasks, almost exclusively in the context of the public policy. The NRF was established by the development bank to finance infrastructure projects (possibly mainly public infrastructure).

*ESA 20.24 on expected beneficiaries of NRF financing*: Two potential NRF projects were given as an example: one was lending to a municipality (S.1313) for the construction of a public building and the second was lending to a public transport corporation classified outside government. The beneficiaries of projects financed by NRF are expected to be either classified in government, or are public corporations.

Taking into account the fact that there is no obligation/ implicit guarantee by the Bank to cover any obligations of NRF and its sub-funds and that the losses of any sub-fund will only affect this

particular sub-fund's investors, an open question remains, on what incentivises investors to participate in NRF's sub-funds. It is not excluded that, as the role of NRF is in the context of important government policies (e.g. revamping public infrastructure), the investors would be sure that government will provide support if needed and would price/ take into account this situation.

*MGDD 1.6.6. paragraph 44 on constraints on the assets of NRF:* Sub-fund loans (the main assets of NRF) need an ex-ante authorization from NRF's BoD, which is in turn controlled by NRB (S.1311). This points towards the same classification as NRB's.

*MGDD 1.6.6. paragraph 47 on constraints on the liabilities of NRF:* Both borrowing and issuance of investment shares need an ex-ante authorization from NRF's BoD (as confirmed by NRF's establishing acts and replies to Eurostat questions), which is in turn controlled by NRB. This points towards the same classification as NRB's.

*e) Management fee/ remuneration paid by sub-funds to NRF*

Eurostat took note that another typical market practice, when it comes to remuneration, was missing in NRF, namely that fund managers typically also have profit participation, in the form of a carry interest, that gives them the right to share in the sub-funds' profits after original investments are repaid with a certain hurdle rate of return. This shows that NRB's investment in NRF does not necessarily bring an equity-like profit, while NRB will effectively take all investment/ divestment decision through its representatives on NRF's BoD. If NRF were operating on market principles, then NRB would have been expected to share in the Fund's potential profits (profits realised after repaying debt-like hurdle rates of return to investment shares, akin to loan interest costs).

*f) Founders' shares vs investment shares*

Founders' shares represent NRF's equity because the holder of these shares (NRB) controls NRF's BoD (the BoD being the main executive body and with 2 out of 3 directors simultaneously serving as directors of another wholly-owned NRB subsidiary). Eurostat questioned the nature of the investment shares as they had limited voting rights (in fact, all the founding legal documents of NRF have been enacted only with the vote of the founders' shares, as no investment shares have existed at that time). Investment shares can also be seen as having the character of subordinated loans/ mezzanine bonds from their holders to the respective sub-fund. This is because investment shares produce equity-like returns only after a pre-set hurdle (threshold) rate of return is achieved, and this hurdle rate is similar to an interest rate on a loan. Since sub-funds lack the characteristics of being institutional units (lack of decision-making autonomy at sub-fund level), the question was whether investment shares represent subordinated loans/ mezzanine bonds to NRF itself.

At the same time, the Czech statistical authorities however reasoned that investment shares cannot be seen as F.3 bonds, because of the ESA 5.97 requirement that subordinated instruments cannot be considered debt if they have any participation in the profit, as is the case of the future sub-funds' investment shares.

Investment shares are expected to provide the majority of the financing for the Fund, up to CZK 7 billion, while the issuance of founders' shares has provided only CZK 2 million of capital, mainly for the purposes of set-up and administrative costs of the Fund.

### 3. CONCLUSIONS

Based on the analysis presented in point 2.3 above, Eurostat considers that NRF is either (i) an ancillary unit to NRB, or (ii) complies with the definition of an entity having the features of a captive financial institution controlled by government. In either case, its sector classification would be in central government (S.1311).

### 4. PROCEDURE

This view of Eurostat is based on the information provided by the Czech authorities. If this information turns out to be incomplete, or the implementation of the new development unit differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

Eurostat would also like to recall that there is an on-going CMFB Task Force on Development Banks and Development Financial Institutions. Upon conclusion of the task force, in the future, there might be changes to existing rules for sector classification of development financial institutions, which might necessitate changes to the current advice.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advices, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

*(e-Signed)*

Luca Ascoli  
Director