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Directorate D: Government Finance Statistics (GFS) and quality

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Dr Konrad Pesendorfer
Director General
Statistics Austria
Guglgasse 13
A-1110 Vienna
AUSTRIA

Subject: Sector classification of KA Finanz AG under ESA 2010

Dear Mr Pesendorfer,

Following the discussion during the Financial Accounts Working Group of 16-18 June 2014 devoted to the sector classification of financial defeasance structures in the Monetary Financial Institutions (MFIs) list (agenda item C.1.g), we would like to explain and confirm our view on the statistical classification of KA Finanz AG.

The accounting issue

KA Finanz AG was established in November 2009 as a result of the demerger of Kommunalkredit Austria AG. KA Finanz AG is owned by the Austrian federal government; its shares are held under trusteeship by FIMBAG, a subsidiary of the Austrian Industrial Holding.

The purpose of KA Finanz AG it is to wind down non-strategic assets of the former Kommunalkredit Austria AG and it is not engaged in any new asset-side business.

In 2011, the sector classification of KA Finanz was examined and discussed with the Austrian statistical authorities, also with a view to clarify the methodological guidance on financial defeasance structures under ESA95. As a consequence, the unit remained classified to the sector of financial corporations (S.12).

Considering the upcoming changeover, as of 1 September 2014, to the revised conceptual framework for the compilation of national accounts, ESA 2010, the results of the analysis must be revisited.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

The ESA 2010's chapters 2 and 20 set out the rules for sector classification of institutional units. The guidance on financial defeasance structures is further specified in Section IV.5 of the Manual on Government Deficit and Debt (Implementation of ESA 2010).

Analysis

As a rescue measure for a financial institution in distress, its impaired and/or illiquid assets (referred to as ‘problematic assets’ in the MGDD) might be paired with its liabilities of equivalent value and allocated to a separate unit. This has a positive impact on the liquidity and capital structure of the financial institution, decreasing its need for additional own funds, required under the banking supervision framework, and allowing it to re-focus its activities on standard banking operations, involving transformation of maturity, scale and risk of financial assets and liabilities remaining on its balance sheet.

This practice was in place in several EU Member States in the wake of the recent financial crisis. In all cases where government was involved in the process, the issue was also analysed by the European Commission in respect of its implications for the competition on financial markets (‘state aid procedure’), specifically as an impaired asset measure.

The problematic, and, hence, not regarded as strategic, assets, are to be governed by a separate unit, frequently a spun-off entity, whose main purpose is to run down the portfolio of financial assets until their maturity or until a point of time when they could be sold minimising the related losses, or even at a profit should a market situation change considerably. The unit commonly is closed to any new business, and, consequently, does not actively compete with other financial institutions and does not distort the competition on the financial market.

Kommunalkredit AG, nationalised by the Federal Republic of Austria in 2008, was also subject to the above described procedure of a decoupling of certain assets and liabilities of the whole of its balance sheet. The Kommunalkredit AG balance sheet was split into strategic and non-strategic assets in 2009, and the parts were attributed to the new entities - Kommunalkredit AG (new) and KA Finanz AG. The rescue measure was analysed by the European Commission, DG Competition (cf. State aid SA. 32745 (2011/NN) – Austria Restructuring of Kommunalkredit Austria of 31 march 2011).

The distinction between the two new units, between a potentially profitable, vital business model (Kommunalkredit AG (new)) and a risky wind-down loss-making entity (KA Finanz AG) was in fact recognised in the outcome of statistical analysis of government capital injections into the units by the Statistics Austria. Whilst a capital injection into Kommunalkredit AG (new) was considered in national accounts as an acquisition of equity in the entity, all capital injections into KA Finanz AG were recorded as capital transfers.

We consider that, carrying on its balance sheet a significant share of illiquid assets, aiming at their wind-down and being closed to a new business, KA Finanz AG at the moment of its creation in 2009 had the features of a defeasance structure as defined in MGDD, section IV.5. Taking into account the nature of assets on its balance sheet and the need for their refinancing, it might have been essential for this type of unit to hold a banking licence, usually in its limited scope as in the case of KA Finanz, or a special authorisation by the Central Bank. This has enabled to orderly wind down the assets, not losing the access to the direct financing from financial markets.

Hence, KA Finanz AG might still indirectly be involved in the process of a financial intermediation at a macro level, as a participant of money markets and being partly open to customer deposits. Nevertheless, we believe that the entity manages in this way its risk exposure arising from the past transactions of Kommunalkredit AG (old), and the past experience shows that the ultimate risks of its wind-down activities are borne by government. Likewise, KA Finanz AG is able to comply with the statutory minimum capital requirements solely as a result of the government financial support through various recapitalisation measures, including direct capital injections and guarantees on assets and its liabilities.

Consequently, we consider that KA Finanz AG’s case satisfies the major characteristics of financial defeasance defined in the MGDD (cf. Section IV.5.1) and must be classified as such.

Eurostat notes that KA Finanz has been included in the Monetary Financial Institutions (MFI) list, which is compiled by Central Bank authorities, since its creation. As you are aware, this issue was

discussed during the Financial Accounts Working Group meeting on 16-18 June 2014 and there Eurostat reaffirmed its opinion that ESA 2010 shows a change as regards the content of the sub-sector S.122 (Monetary Financial Institutions) compared to ESA95. Therefore, wherever a unit had the features to be classified within the general government, in accordance with the relevant statistical rules as described above, Eurostat believes that such a classification must take place, independently of any administrative arrangements which may have led to the inclusion of such a unit in the MFI list.

Conclusion

In order to implement the relevant guidance of the MGDD and ensure the comparable and equal treatment of similar cases across EU Member States, Eurostat considers that KA Finanz AG must, under the revised conceptual framework ESA 2010, be classified in national accounts into the general government sector since its creation in 2009. The respective revision should be undertaken as of 1 September 2014, when ESA 2010 becomes applicable to national accounts data submitted to Eurostat under the ESA transmission programme and the excessive deficit procedure (EDP).

Procedure

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. Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on the Eurostat website. In case you have objections concerning the publication of this specific case, please let us know *before 18 July 2014*.

Yours sincerely,

Eduardo Barredo-Capelot
Director
(*e-signed*)