



EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

Luxembourg, 5 August 2014
ESTAT/D-2/EBC/LFO/CJ/mhd/D(2014)2852178

Ms Agnes Naarits
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15 Endla Street
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Estonia

Subject: Statistical treatment of the KredEx Fund and recording of the grants provided from the EU budget to KredEx

Ref: Your request for ex-ante advice No 1.2-4/14/621 dated 2 July 2014

Dear Mrs Naarits,

Thank you for the information provided to us by the Estonian statistical authorities on the recording of KredEx Fund in national accounts. After a careful examination of the issue by Eurostat, I am now in a position to provide an opinion on the statistical treatment in national accounts of KredEx Fund, as well as on the appropriate treatment of the so-called “repayable grants” provided from EU budget to KredEx.

The accounting issue

The issue for which an opinion is being sought is the statistical classification of the KredEx Fund and the statistical treatment of repayable grants provided from EU budget to KredEx under the current applicable rules of the ESA95 methodology and in the light of the forthcoming ESA 2010.

Documentation provided

The Estonian statistical authorities provided to Eurostat an exhaustive explanatory note on the KredEx Fund and on its activities as well as their proposal regarding the sector classification of KredEx. Statistics Estonia provided also proposals for the statistical recording of repayable grants provided from EU budget.

Description of the case

The KredEx Fund was founded in 2001 by the Ministry of Economic Affairs and Communications in order to carry out several activities which relates to the improvement of the financing possibilities for enterprises, management of credit risks associated with export as well as improvement of housing and energy efficiency. Before the creation of KredEx Fund, some of these activities were carried out by four different foundations. Currently, KredEx is mainly involved in the provision of loans and loan guarantees, as well as in the provision of direct grants, in the form of targeted financing for activities which relate to entrepreneurship (e.g. start-up loan guarantee, subordinated loan, including technology loan) or to housing and energy efficiency activities (e.g. housing loan guarantees, grants for apartment buildings, etc.).

Until 2013 KredEx was classified outside the general government sector. In the context of the 28.02.2013 EDP dialogue visit of Eurostat, the classification of KredEx was further discussed with the Estonian Statistical Authorities. Due to the fact that the predominant activities carried out by KredEx were concluded to be mainly on behalf of government and considering that the main financial resources of KredEx were grants provided from the State Budget, Eurostat and Statistics Estonia agreed that KredEx should be reclassified inside general government.

Nevertheless, as a result of their further analysis, Statistics Estonia reassessed the situation of KredEx, considering that actually the main activity of KredEx is the provision of financial services and therefore it was proposed to revert back its classification and to include the unit in the financial corporations sector (S.12). The reason for Statistics Estonia to consider it as a financial intermediary is due its assessment that more than half of the administrative costs are used for financial intermediation activities and that the unit is holding levels of financial assets and liabilities that exceed considerably the amount of direct grants provided each year from the State Budget.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

Paragraphs 2.26 about government control and 2.32 to 2.33 about Financial corporations of ESA95 chapter 2 and part I.5 of the ESA95 Manual on government deficit and debt (MGDD) about Units engaged in financial activities: 'general issues' are applicable in this case. From 1 September 2014, the equivalent paragraphs 2.35 and 2.38 on government control and paragraphs 2.56 and 2.57 of the ESA 2010, as well as part 2.57, Units engaged in financial activities: 'general issues' will be applicable. In addition, guidance provided by the MGDD in chapter I.6, 'Specific public entities' on Captive financial institutions will be relevant¹.

¹ The relevant MGDD sections are under revision, however it is not expected that the analysis below will be impacted.

Analysis

From the description given earlier, KredEx is entrusted with tasks in the context of public policy objectives, having a limited autonomy of decision in how to fulfil its main corporate objectives which are largely determined by government. For example, the *Support of Enterprise and State Loan Guarantees Act*, a legal act which sets out the bases, principles and organization of the state support of enterprise and the grant of state guarantees for business and housing loans, stipulates that the Minister of Economic Affairs and Communications shall decide which types of support are to be granted during each financial year². In the same document, it is also specified that the conditions for the state support of enterprise and for the grant of business loans shall be established in detail by the Minister of Economic Affairs and Communications. The approval of the council of KredEx is necessary for all projects, where the total amount of the guarantee or loans issued by KredEx exceeds one million euros per one company. Specific requirements related to the minimum limit of own funds as well as on guarantee limit are further specified. All these legal constraints show that KredEx is committed to conduct its interventions within a narrow framework defined by government; even if government would not necessarily have to approve or determine every single transaction with every single beneficiary, nevertheless standards of equity capital and limitations to investment are established in the legislation.

Moreover, KredEx has been established by government which exercises control over its activity. Its council predominantly consists of the representatives of ministries (Ministry of Economic Affairs and Communication) and Riigikoku (Parliament). In their main task the council is responsible for making strategic decisions regarding the operation of KredEx and the approval and amendment of the most important documents related to budget, strategy, risk management and principles of cooperation with credit institutions. The government, represented by the ministries and by the Parliament, exercises control over KredEx disposing of more than half of the voting rights in the council. As defined by ESA95 paragraph 2.26 (ESA 2010 paragraph 2.36), ‘government secures control over a corporation by owning more than half the voting shares or otherwise controlling more than half the shareholder’s voting power’.

Furthermore, as defined by the ESA95 paragraph 2.33 (ESA 2010 paragraph 2.57), ‘a financial intermediary does not simply act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account’. From the information available, it is clear that, for a predominant part of KredEx activities, it is the government which bears the final risk and covers the losses resulting from the provision of guarantees or loans. This argument is further emphasized by the fact that as specified in the *Support of Enterprise and State Loan Guarantees Act*, in case that KredEx cannot fulfil its obligations connected with sureties or guarantees, the state shall take over the relevant liabilities, as stipulated by the law. Furthermore, the loans and guarantees provided by KredEx to enterprises or housings are not funded by banking or financial markets at the prevailing conditions, but are funded from the State budget at low interest rates. Additionally, government must intervene if the level of own funds of KredEx falls below a minimum limit³. Furthermore, KredEx doesn’t behave as a

² See Chapter II§ 2 of the *Support of Enterprise and State Loan Guarantees Act*.

³ See Chapter II§ 19 of the *Support of Enterprise and State Loan Guarantees Act*.

“normal” commercial entity, trying to extend the scope of its activities, specialising itself in more profitable areas and looking to obtain a market rate of return. In this sense, KredEx acts as a government unit, giving priority to the fulfilment of public policy objectives without aiming for a market rate of return on the funds provided.⁴

Therefore, with respect to ESA 2010 guidance, KredEx seems to have the features of a captive financial institution, as defined in the ESA 2010 paragraphs 2.21 – 2.23 and as further developed in the MGDD. KredEx is not actually engaged in financial intermediation, but acquires a large majority of the financial resources for its activity from its ‘sponsor’, the government, by way of direct financing. By means of certain limitation of its decision making regarding the granting of loans or the selection of beneficiaries, the government executes a significant control over its assets. In this context, Eurostat considers that, with regard to the fact that KredEx does not comply with the definition of a financial intermediary and it is controlled by the government, with a limited autonomy of decision in main corporate policy, KredEx must be reclassified in the general government sector (S.13) according to ESA 2010 rules.

The second issue for which Statistics Estonia required a Eurostat view relates to the recording of EU grants from the EU Structural Assistance which are used to provide so called repayable support in the form of loans and guarantees for enterprises. Four joint initiatives were developed by the European Commission in co-operation with the European Investment Bank group and other financial institutions in the framework of the 2007-2013 programming period, in order to make cohesion policy more efficient and sustainable. Two of them refer to the promotion of financial engineering instruments (JEREMIE and JESSICA) and the other two (JASPERS and JASMINE) operate as technical assistance facilities. Until 2007, the EU Structural Assistance could have been used only for provision of direct grants. Starting from the year 2007, it became possible to use this financial assistance also for the provision of temporary support through financial engineering instruments (loans, guarantees, investment to own capital) which implies that there is a possibility to use EU Structural Assistance in a revolving way for setting up financial engineering instruments.

Regarding the treatment of such “repayable” grants provided from EU budget to KredEx, in the context of its classification in the general government sector, Eurostat considers that the most appropriate treatment would be to record the cash grants provided from the EU budget to KredEx as EU advance payments and therefore to treat them as financial advances (AF. 8) payable. The stock of payables toward the EU will fall over time as loans are not reimbursed or guarantees are called (i.e. the underlying funds provided by the EU are used up), through capital transfers from the EU to KredEx matched by capital transfers from KredEx to households/corporations. Due to the possible difficulties to identify every single transaction related to the repayment of loans by beneficiaries or for any single call of guarantees, it can be conceivable that the disappearance of payables could be recorded also at the level of group of transactions or that estimations (using a modelling method which could be further discussed on a bilateral basis) are made in order to assess the approximate reduction of payables. In case that the repayable grants are not fully used at the end of the programming period then the related stock of payables should be kept in government accounts until their full extinction as a result of other possible transactions.

⁴ See Chapter III.2 from MGDD.

Nevertheless, in case that identifying all the transactions related to the reduction in payables would be time consuming and information needed would be incomplete, a second-best possible treatment would be to record the cash amounts provided to KredEx immediately, as a capital transfer (D9) from the EU. And, at the same time, a capital transfer for the same amount from KredEx towards households or other units (enterprises) would be imputed in order to keep a neutral effect on B9 and in this way to be in line with the general rule on the recording of EU grants from chapter II.6.2 of the MGDD.

Conclusion

In view of the analysis above, Eurostat concludes that the KredEx is a government controlled entity and that it does not comply with the criteria of the financial intermediary, as defined in ESA 2010. KredEx has a limited management independence from the controlling unit as evidenced by a significant government control over its assets and liabilities. Consequently, Eurostat considers that KredEx has the characteristics of a captive financial institution controlled by government and, therefore, it should be classified in the general government sector (S. 13).

Eurostat believes that – in accordance with the general principles of recording of EU grants – the revenue from EU grants to KredEx should be recorded at the point at which the funds are used up through the call of guarantees or non-repayment of loans to KredEx.

Procedure

Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it is in possession of all of the necessary background information. The preliminary view is given in accordance with the guidelines for ex-ante advice published on the Eurostat web-site.

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

In this context, we would like to remind you that Eurostat is committed to adopting 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 advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat intends, therefore, to publish all future official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than **26 August 2014**.

Yours sincerely,

(eSigned)

Eduardo Barredo Capelot
Director