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Directorate C: National and European Accounts

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Subject: Classification of the Housing Finance Agency and the Irish Rail

Dear Mr Keating,

During our EDP dialogue visit to Ireland on 4-5 July 2006, we promised to come back to you with our views concerning two classification issues, the Housing Finance Agency and Irish Rail. After receiving the additional requested information and your analysis, we would like to share our views with you.

1. Classification of the Housing Finance Agency

The case

The Housing Finance Agency (HFA) was established in 1982 by a legal act, for the purpose of providing loans for the acquisition or construction of houses. Initially, the Agency raised funds on the market by way of index-linked bonds and lent these funds to individual borrowers. Changes to the founding act in 1986, 1992 and 2002 altered the role of the Agency, by broadening the purpose of loans but basically restricting the circle of borrowers to local governments, which themselves can on-lend to individuals. Currently, as reported by the Central Statistics Office (CSO), only 1% of the existing loans is to individual borrowers.

The HFA is a public limited company, 100% owned by the government (Ministry for Finance). Directors are appointed by the Minister for the Environment, Heritage and Local Government, with the consent of the Minister for Finance.

The Irish authorities seek advice on the classification of this unit. The HFA is currently classified as financial intermediary to the financial corporations (S.12) sector, but the CSO studies a possible reclassification in general government.

Eurostat asked further clarification from the CSO after the dialogue visit, notably questions concerning the autonomy of decision as well as the profitability and risks taken by the HFA.

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Analysis

The CSO, in its analysis, concluded that the HFA should be reclassified into general government, because of the "limited nature of HFA's activities and the fact that in most instances it can not refuse to provide loans when requested by Local Authorities and approved by the Department of the Environment."

It is recalled that ESA 95 par. 2.33 states that a financial intermediary "*places itself at risk by acquiring financial assets and incurring liabilities on its own account.*" It is debatable whether the HFA places itself genuinely at risk, in view of the fact that the total liabilities of HFA are guaranteed by government and, that, although there is no explicit guarantee on the lendings (assets of HFA), it is argued that "*there is an implicit understanding that in the event that a Local Authority cannot repay, the government would grant aid to the Local Authority to make up the shortfall*". Thus it would be questionable if the HFA places itself at risk, notably bearing any credit risk, and whether it can be seen therefore as a financial intermediary according to national accounts rules.

Par. 2.37 of ESA 95 states that financial intermediation implies that: "*acquiring assets and incurring liabilities should be with the general public or specified and relatively large sub-groups thereof*". In case the unit provides financial intermediation only to a certain group, the unit should be allocated "*according to the predominant function of the company group*", unless the unit is subject to financial supervision. However, the HFA is currently not supervised by the Bank of Ireland, and according to the information provided, the HFA is currently lending almost only to local authorities (95% of total assets), which might not represent a general public or a large subgroup thereof.

In addition, it is noted that the HFA does not seem to act genuinely as a financial intermediary because the Agency does not assess the risk of the borrower and in fact does not seek profits (it is just required to break-even but not to be profitable). Moreover, the HFA cannot lend to parties not within the act founding the Agency, and, conversely, cannot refuse lending to local governments if they fulfil the requirements set down by the HFA act. Thus the HFA has no autonomy of decision with respect to its main activity.

From the information provided, we consider that the HFA is rather to be considered an instrument of government policy, ensuring local governments' possibility to borrow at low cost, as its main activity, instead of being a genuine financial intermediary.

Advice

Considering the reasoning above, Eurostat agrees with the conclusion of the CSO, and recommends the reclassification of the Housing Finance Agency into general government.

2. Classification of the Irish Rail

The case

In the Irish National Accounts, the state owned road and rail transport company Coras Iompair Eireann (CIE) and its three transport operating subsidiary companies (Irish Rail, Dublin Bus and Bus Eireann) are classified outside general government. All three subsidiaries make operating losses (before public service obligation payments are made to the companies by Government) but historically all three had sufficient sales revenues to be considered as market producers, based on the standard 50% test for market production, and were classified in the public non-financial corporations sector (S.11001).

In recent years, Irish Rail has become a borderline classification case. Sales revenues have declined relative to its operating expenses and now represent approximately 50% of costs. Its classification was last examined in 2004 when CSO proposed that it should continue to be classified in the non-financial corporations sector. At the time, CSO discussed the issue of the sectorization of the holding company (CIE) with Eurostat, who agreed with their proposal, provided that the holding company exercised real control over the subsidiary companies and was not simply a legal construct through which the Government controlled the individual companies.

During the EDP dialogue visit in July 2006, the issue was raised again and Eurostat requested more information. Upon the receipt of the new information, Eurostat analyzed the issue. There were two main issues to be analysed:

1. Can a non-market subsidiary of a market holding company be recognized and reclassified in general government?

2. If yes, is it necessary to reclassify the Irish Rail into the general government sector?

Analysis

1. Classification of the holding companies and its subsidiaries

It is recalled that ESA 95 par. 2.13 (c) states that "*entities forming a part of a group of units engaged in production and keeping complete set of accounts are deemed to be institutional units even if they have partially surrendered their autonomy of decision to the central body (the holding corporation) responsible for the general direction of the group; the holding corporation itself is deemed to be an institutional unit distinct from the units which it controls*", meaning that each subsidiary and holding company itself should be assessed individually when deciding about the classification of the unit, if the company is deemed to be an institutional unit. If the holding corporation is not an institutional unit, its accounts should be combined and integrated within the controlling institutional unit (ESA 95 par. 2.13. (b)).

One can usefully distinguish three cases. If the holding company would purely be a "shell" (case 1), with no autonomy of decision and no effective exercise of control over the group, it should be classified into the general government sector even if the subsidiaries are market. If the holding company is a real holding (case 2), exercising purely the management of the group, the market criterion shall be assessed on a group level, to obviate the difficulty that the holding might not bill subsidiaries for its service and might predominantly cover its costs from dividend payments with the result of distorting the application of the 50% criterion. If the holding company is rather a "mother" company (case 3), not only exercising effective control over the subsidiaries, but having own profit seeking activities, as we understand is the case for CIE, the market / non-market criterion must be tested normally.

2. Classification of the Irish Rail

According to a table sent by the CSO to Eurostat, showing information on revenues and costs of CIE and its subsidiaries, the Irish Rail seemed to comply with the 50% rule. The assessment must be made over a number of years. As the figures (of 2003-2005) suggest, the

Irish Rail seemed to be market and has never gone under the 50% threshold. Moreover, we cannot observe any trend from these figures.

Nevertheless it was also noticed that some of the costs might be underestimated. A short investigation of the profit and loss account of the company reveals several contentious issues, which should be taken into account when measuring operating costs:

a. Consumption of fixed capital. As indicated by the CSO in its analysis, instead of calculating consumption of fixed capital in national accounts terms (depreciation based on market value), the CSO used the figures reported in the profit and loss account of the company, based on historical value. The adjustment of these amounts would imply a noticeable increase in costs.

b. Amortisation of capital grants. Among the costs of Irish Rail, a negative amount for "Amortisation of capital grants" is reported (deducted from costs).

c. Own work capitalised. Similarly to the amortisation of capital grants, there is a negative entry among payroll and related costs to reflect own fixed capital formation, which should be investigated closer by the CSO.

Concerning the sales revenue, we note that CSO did not include grants by government within sales when assessing the 50% criterion, seemingly following on ESA 95 par. 3.33 (a) "*all payments made by the general government or the Institutions of the European Union and granted to any kind of producer in this type of activity, i.e. all payments linked to the volume or value of output are included, but payments to cover an overall deficit are excluded*". However, the treatment of EU grants needs further clarification. The CSO is invited to clarify and comment on these issues.

Therefore before Eurostat formulates a final conclusion on the sectorization of the Irish Rail, it would like the CSO to provide its opinion as well as the possibly amended set of figures.

Advice

Based upon the above analysis, Eurostat concludes that the Irish Rail might be reclassified into general government even if the holding company (CIE) and other subsidiaries are classified into the non-financial corporations sector, depending on the analysis and findings which will be carried out by the CSO. In particular, when testing the 50% criterion, Eurostat would like to ask the CSO to re-examine the figures along the lines mentioned above.

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 the amended Council Regulation 3605/93 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 15 March 2007.

Yours sincerely,

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Director