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Subject: Statistical classification of the Hungarian Central Bank's foundations and their subsidiaries

Ref: Ad-hoc EDP visit discussions of 22 September 2016 and 12 September 2017
Bilateral clarifications under the EDP notifications of October 2016, April and October 2017, respectively
Your e-mail from 2 October 2017 (our ref. Ares(2017)4809788)

Dear Ms Vukovich,

thank you for the information provided during the ad-hoc visits and bilateral clarification rounds mentioned above. After careful examination of the issue by Eurostat, I am now in a position to provide an opinion on the statistical treatment of the Hungarian Central Bank's (MNB) foundations and their subsidiaries in national accounts.

The accounting issue

The issue for which an opinion is being provided is the statistical classification of the MNB's foundations and their subsidiaries in national accounts and in EDP reporting¹ under the currently applicable rules of the European System of Accounts (ESA)² and of Eurostat's Manual on Government Deficit and Debt (MGDD)³.

The sector classification of the MNB's foundations and their subsidiaries was first raised by Eurostat during the 2016 ad-hoc EDP visit to Hungary and repeatedly brought up during the subsequent EDP notification periods and during the last ad-hoc visit.

¹ As foreseen in [Council Regulation \(EC\) No 479/2009](#) on the application of the Protocol on the excessive deficit procedure (EDP) annexed to the Treaty establishing the European Community

² ESA2010 – [European System of Accounts 2010](#), as foreseen in [Regulation \(EU\) No 549/2013](#) of the European Parliament and of the Council on the European system of national and regional accounts in the European Union

³ [Manual on Government Deficit and Debt](#) – Implementation of ESA 2010 – 2016 edition

Description of the case

Late 2013 and during 2014, the MNB established 6 foundations, with separate legal personality. Later, in two waves (mid-2015 and mid-2016) the foundations have established under their (in some cases joint) control 5 limited liability companies and one of these, another 5, under its own.

According to their articles of association, all foundations have been established to both perform and support education (in a broad sense), research, knowledge sharing (nationally and internationally) and related activities in several fields, but mainly in economics.

In several steps, happening in relatively short succession, mainly during 2014, the MNB has endowed the foundations with a significant amount of funds, totalling 863 millions of euro by the end of 2015 (roughly 0.8% of Hungarian GDP at the time). In line with the instructions of their founder⁴, a little over $\frac{3}{4}$ of this amount was initially invested by the foundations into debt securities issued by the Hungarian Government, prompting the “close monitoring” of the MNB’s related operations by the European Central Bank (ECB), as documented in the ECB’s annual reports⁵ and several response letters to questions raised in this regard by Members of the European Parliament.⁶ The remaining amounts were used (in roughly equal shares) to launch the subsidiaries mentioned above (serving as their equity), to acquire property where the foundations can reside and to set aside liquid assets (cash and deposits).

In the subsequent years, several changes happened both to the institutional structure of these entities and to their consolidated asset portfolio. Two pairs of the 6 foundations have merged, with 4 foundations remaining. Some of the subsidiaries have acquired and/or absorbed additional entities. By year-end 2016, while the MNB increased the total endowment with relatively small amounts, the foundations have transformed about $\frac{1}{3}$ of their government bond investments into real estate (buildings and land), by using the proceeds of the bond selling to extend corporate loans to their subsidiaries, with which the latter ones acquired the real estate. While detailed data are not yet available for 2017, the trend to further reduce the government bond holdings and acquire more real estate, reportedly continued.

All the while, even though representing only a very small portion (about 2%)⁷ of their entire endowment, the foundations have performed their declared activities as well: extended grants for a multitude of educational purposes, funded research and related mobility, the organisation of conferences, as well as the publication of books; continued constructing their university campus in the town of Kecskemét.

⁴ As foreseen in the foundations’ articles of association (<http://www.pallasalapitvanyok.hu>) and as declared in the interview given by the President of the MNB (<https://vs.hu/mind/osszes/matolcsy-elarulta-sajat-kozgazkepzes-epit-az-mnb-200-milliardbol-0828>). (The referred sources are in Hungarian language.)

⁵ Please refer to the 2015 and 2016 annual reports of the ECB, which can be consulted under <https://www.ecb.europa.eu/pub/pdf/annrep/ar2015en.pdf> and <https://www.ecb.europa.eu/pub/pdf/annrep/ar2016en.pdf>, respectively.

⁶ Please refer to the letters given in response by ECB President Mario Draghi to questions raised by MEPs:

- Csaba Molnár (https://www.ecb.europa.eu/pub/pdf/other/160422letter_molnar.en.pdf),
- Benedek Jávor (https://www.ecb.europa.eu/pub/pdf/other/160707letter_javor.en.pdf),
- Udo Bullmann (https://www.ecb.europa.eu/pub/pdf/other/161021_bullmann.en.pdf) and
- Sophia in ’t Veld (https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter170830_intVeld.en.pdf).

⁷ In terms of operating expenses over total endowment.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

ESA chapters 2 and 20 on the classification of units and, in particular, paragraphs: 2.12 on institutional units, 2.17-2.19 on special purpose entities, 2.24-2.26 on artificial subsidiaries, 2.27-2.28 on special purpose entities of general government, 2.31-2.34 on the general sector classification logic, 2.39 and 20.15 on the indicators of (government) control over non-profit institutions and 20.311-20.313 on central banks are applicable.

Chapter I.2.3. of the MGDD gives further guidance on the concept of government controlled institutional units.

Analysis

Institutional units

In line with the general sector classification logic (see in particular ESA 2.34) it needs to be determined first, whether any entity under analysis qualifies as *institutional unit* under ESA (see in particular paragraph 2.12).

In Eurostat's judgment, none of the foundations, just as well as none of their subsidiaries, exhibits features that would justify individual treatment for sector classification purposes and, therefore, part of the analysis on whether they do qualify as institutional units is to be carried out at an aggregate level.

The foundations are entitled to own assets and incur liabilities in their own right, they are able to exchange these assets and liabilities (e.g. they significantly changed their asset portfolio over time), they are able to take economic decisions and to draw up complete sets of accounts. The foundations have separate legal personality from their founder, reside at a different address, have several employees, the size and regular (systematic) nature of their activity is, by and large, in line with their declared scope. While there is an overlap of functions amongst the foundations and between them and their founder, due to several positions being held by some of the same persons and, thus, from a personnel perspective a clear isolation is not given, the criteria of ESA 2.12 would seem to be satisfied and therefore **the foundations would qualify as institutional units.**

The subsidiaries of the foundations are, however, different. While at a first glance they may be seen to also satisfy the requirements of ESA 2.12, in fact virtually all of them share the same physical address with their respective parent, several of them share employees or e-mail addresses and some of them do not even have one full-time equivalent employee over the year. The yearly average number of the employees, as well as the size and scope of the operations of these subsidiaries are clearly disproportionate with the size of their balance sheets. Moreover, in light of the declared purpose of their parent foundations, the existence of the subsidiaries, especially considering their relative size and numbers, does not seem to be justified at all. In sum, **the subsidiaries** do not satisfy the conditions set out in ESA 2.18 (in particular points (a)-(c) and (e) thereof), as well as ESA 2.24 and **should, thus, be regarded**

as artificially created special purpose entities of the foundations, and not as separate institutional units.

In general, entities not qualifying as institutional units themselves, need to be consolidated with their immediate parents which do qualify as such. Since most of the subsidiaries are jointly controlled by some of the foundations, at the individual unit/entity level they would need to be split and follow partial consolidation, in line with ESA 20.320. However, as said before, because this analysis is performed at the aggregate level, the consolidation can also be carried out in the aggregate. In what follows for the purposes of this analysis, Eurostat will refer only to the MNB's foundations and will consider each of them as institutional units incorporating the appropriately apportioned and partially consolidated subsidiaries.

Next steps of the classification process

In line with the decision tree referred to by ESA 2.34, all foundations are resident in Hungary, none of them is a household and given their declared purpose (as described above), all are non-market producers. Eurostat notes that these observations were shared by the Hungarian statistical authorities and considers, therefore, that no further clarifications on them would be necessary.

Control

In the long-standing discussions on this sector classification issue, the position consistently held by the Hungarian statistical authorities was that the MNB's foundations are created in such a way that they are not controlled by any other institutional unit, which is why they were (and still remain) classified in the sector of non-profit institutions serving households (NPISH, S.15).

Eurostat does not share this view. In Eurostat's experience, in the overwhelming majority of cases, it can be assumed without further investigation, that the founder/creator of an entity controls that entity. While the case of the MNB's foundations is unique in many of its facets, under the aspect of *control* it seems to be rather common.

According to ESA 1.36, "*Control is defined as the ability to determine the general policy or programme of an institutional unit.*" In line with ESA 2.39 and 20.15, control over non-profit institutions (NPIs) is indicated by any of the following points: "*(a) the appointment of officers; (b) the provisions of enabling instruments (such as the obligations in the statute of the NPI); (c) contractual agreements; (d) the degree of financing; (e) the degree of government risk exposure. As with corporations, a single indicator may be sufficient to establish control in some cases, but, in other cases, a number of separate indicators may collectively indicate control.*"

According to the foundations' articles of association (see footnote no.4) the founder (MNB) determines the members of the boards of trustees and those of the oversight boards (by way of nomination), the authority (rights and obligations) of these members, as well as the purpose and activity of the foundations themselves. Furthermore, virtually the entire funding of the

foundations was provided by the founder, with particular limits and requirements regarding the use of these funds, as well as related sunset clauses, requiring the return of funds remaining after discharging all liabilities to the founder itself. These observations alone would meet the requirements of ESA 2.39 and 20.15 (and in particular points (a), (b) and (d) thereof) in full.

Nonetheless, considering also the repeated amendments of these articles of association by their founder (of up to 10 times since their creation), affecting both their financing and scope of activity, Eurostat considers that **the foundations of the Hungarian Central Bank were and remain under the direct control of the MNB.**

According to ESA paragraphs 20.311-20.313, the central bank is "*generally assumed to be [a] public financial corporation*" that is "*placed under general control of government*" and where, in national accounts, the economic ownership exercised by government is recognised "*even in circumstances where it has no legal ownership*". In short, for national accounts purposes, the central bank is considered to be under the control of general government. By extension, following the chain of control, as it was described earlier, **the foundations are also, albeit indirectly, controlled by general government.**

Additionally, from a national accounting perspective, the main function and activity of a central bank is to manage the nation's reserve assets, to issue the national currency and to conduct the monetary policy (see ESA 20.312). The MNB's foundations, however, with their declared and performed activity of funding education, research, conferences and other related interests, as described earlier, fall outside this scope. Moreover, in line with the substance-over-form principle (ESA 20.164), by performing said activities, the foundations are essentially redistributing national wealth and, in doing so, they seem to be implementing exclusively policy usually reserved for units of general government (see ESA 2.111).

In international comparison, some of these aspects – related to either the organisation or the activity of the MNB's foundations – are not entirely unusual. Most, if not all central banks do perform educational or research activities, they collect art for decorative purposes or for exhibition, maintain their own archives and libraries, may have a coin and banknote collection and in some cases, a related museum. Some central banks, in order to foster research, education and debate in their own field of interest, create separate non-profit entities to perform this activity.

The two features of the MNB's foundations, which set them apart from the international mainstream, are their size and numbers. Usually, the central banks do carry out all those enumerated activities directly themselves. But even in those cases where they create a separate legal vehicle, they usually create only one and that is bound to remain so small in comparison to the size of the bank, as to make it clearly negligible for the purpose of any analysis relevant for national accounts. In the Hungarian case, as at year-end 2016, the 6 initially created foundations and their 13 subsidiaries hold total endowments received equal to 2.7% of the MNB's total assets and 0.8% of Hungarian GDP.

Conclusion

In view of the analysis above, Eurostat concludes that for the purposes of statistical classification under ESA, the MNB's foundations are government controlled non-profit units and non-market producers and should, therefore, be classified in the general government sector (S.13). Likewise, all subsidiaries established or later acquired by the foundations are deemed to be artificial subsidiaries and should, therefore, be consolidated with their immediate parent(s).

Eurostat would like to draw attention to the fact that since, in line with national accounting practice, it would be manifestly inappropriate to record transactions showing a central bank redistributing national wealth, the endowment of the foundations should be accounted for at reclassification as a loan extended by the central bank to general government, at zero interest and with an indeterminate maturity.

Procedure

Eurostat is prepared to give a preliminary view on the statistical classification of such operations provided that it has received all 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 at its disposal. 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 would 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 30 March 2018.

Yours sincerely,

(eSigned)
Luca Ascoli
Acting Director