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**Subject: Note on the sector classification of the Bulgarian Deposit Insurance Fund**

Dear Ms Atanasova,

Please find below Eurostat's view of the classification of the Bulgarian Deposit Insurance Fund. Eurostat expects the Bulgarian Statistical Authorities to implement this classification already in the forthcoming October EDP notification.

## 1. BACKGROUND

This note provides Eurostat's view on the appropriate sector classification of the Bulgarian Deposit Insurance Fund (DIF), in the light of ESA 2010 rules and the further elaboration thereof in the Manual on Government Deficit and Debt (MGDD).

DIF is a legal entity, set up in January 1999 under the specific Law on Bank Deposit Guarantee, which aims at "*maintaining financial stability and ensuring public confidence in the Bulgarian banking system. Its major functions include:*

- *repaying in full the insured deposit amounts of physical persons and legal entities up to BGN 196 000 (EUR 100 000);*
- *determining and collecting initial and annual contributions from all banks participating in the deposit insurance system;*
- *investing its funds in securities issued or guaranteed by the state, short-term deposits with banks, and deposits with the Bulgarian National Bank (BNB);*
- *protecting creditors' interests and controlling trustees' activities under the terms of the Law on Bank Bankruptcy".*

DIF is "*managed by a Management Board consisting of five members, who are designated for a four-year term of office, as follows:*

- *the Chairman of the Management Board – by the Council of Ministers;*
- *the Vice Chairman of the Management Board – by the BNB Governing Council;*
- *one member – by the Association of Banks in Bulgaria;*
- *two members – jointly by the Chairman and the Vice Chairman of the fund's Management Board."*

## **2. THE CASE**

The Bulgarian Statistical Office currently classifies DIF in the financial corporations sector (S.12). However, Eurostat considers that DIF must be instead classified inside general government given, amongst other, its lack of autonomy of decision from government as regards its principal function.

The fund was activated at the end of 2014 for considerable amounts, after the BNB's decision to withdraw the banking licence of the Corporate Commercial Bank. Guaranteed deposits in the Corporate Commercial Bank amounted to BGN 3.692 billion (4.5% of GDP in 2014). As of 31 March 2015, DIF had repaid BGN 3.554 billion to depositors. Being short of funds, and because the BNB's could not provide a loan in an amount required to cover the additional shortfall, government took steps to make available to the fund a significant line of credit from the central budget. Central government thus emerged as the lender of last resort.

The accounting issue is thus firstly to determine whether DIF constitutes an institutional unit under ESA2010, and if not, which entity should be regarded as the parent unit. The decision influences the delimitation of general government. Secondly, a further issue is the appropriate recording of the transactions, for the amounts called in 2014 and for the proceeds DIF will recover later on.

## **3. APPLICABLE RULES**

The following rules are relevant for the statistical analysis of the sector classification of DIF:

- Paragraph 2.12 of ESA 2010 on autonomy of decision;
- Paragraph 2.38 of ESA 2010 on government control;
- Chapter 20 of ESA 2010, in particular paragraphs 20.05, 20.08-20.10, 20.17-2.18, and 20.57-20.62, as well as 20.309-20.310 (public sector control);
- Chapter I.5 of the MGDD, Units engaged in financial activities, which includes a separate section on the sector classification of 'protection funds' (called here deposit insurance funds).

The following rules are relevant for the recording of the repayment of the guaranteed deposits:

- Paragraphs 20.240 and 20.243-20.248 of ESA 2010 on defeasances and bailouts, and in particular paragraph 20.245 on recording expected loss in the case of government guarantees during a bailout;
- Paragraphs 20.233 (debt assumption) and 20.257-20.259 (guarantees) of ESA 2010.
- Chapter IV.5 of the MGDD, Financial defeasance; • Chapter VII.4 of the MGDD on government guarantees.

#### 4. STATISTICAL ANALYSIS OF SECTORISATION

Chapter 20 of ESA 2010 describes the delimitation of the general government sector, which comprises government units, non-market NPIs controlled by government as well as other non-market producers controlled by government (ESA 20.05).

Being a special purpose entity created by special legislation to carry public policies, DIF may at first sight be assimilated to a government agency, either to be recognized as part of the core central government unit (ESA 20.08, part of 'budgetary central government' – ESA 20.62) or as a separate central government unit (ESA 20.10, part of 'other central government bodies' – ESA 20.62). To the extent that BNB has significant involvement in DIF management and activities, there could be, however, a question as to whether this public agency may not be instead classified in the central bank sub-sector.

One feature of the DIF balance sheet is the absence of any registered equity/capital (account 05100), the shareholder equity being composed of the sole accumulated earnings (account 05510). This suggests that DIF is a specially created entity and puts a question mark on the ownership of DIF. In this context, contributions of banks are not repayable in any circumstances (for instance when a bank decides to stop operating). However, the liquidation value of DIF is returned to banks rather than government.

Chapter 20 of ESA 2010 also provides guidance on the sector classification of (other) 'producers of goods and services that operate under the influence of government units'. In particular, diagram 20.1 under par 20.17 presents the classic decision tree for determining the sector classification of such other producers of goods and services.

Thus, the first step in this decision tree is to determine whether such an entity is an institutional unit or not. If it is not an institutional unit, it should be viewed as part of its controlling/parent unit. If it fulfils the criteria for being an institutional unit, the decision tree carries on by exploring other questions, namely whether the institutional unit is public or not, and whether it is market or nonmarket.

In the case of DIF, Eurostat considers that there is sufficient evidence to conclude that this entity has no genuine autonomy of decision with regard to its main activity or function. Therefore, it is not an institutional unit and it should be allocated to the sector of its controlling unit.

## 1. Autonomy of decision

Par. 2.12 of ESA 2010 defines an institutional unit as "*an economic entity characterised by decision-making autonomy in the exercise of its principal function*" (underlined added). Par. 2.12 further reads that "*to have autonomy of decision in respect of its principal function, an entity must be:*

(a) *entitled to own goods and assets in its own right; ...*

(b) *able to take economic decisions and engage in economic activities for which it is responsible and accountable at law;*

(c) *able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts; and (d) able to draw up a complete set of accounts...*"

Through the ad-hoc Law on Bank Deposit Guarantee, legislation (i.e. government) de facto imposes a very rigid framework to the activities and actions carried out by DIF<sup>1</sup>. To a large extent, DIF seems to operate as an 'autopilot' in the sense that the main activities or actions of the fund are explicitly defined through legislation, with little room for autonomous decisions taken by the Management Board.

In this context, point (b) above is particularly important as it enquires on the question of who decides or controls the actions of the entity with respect to its main activity or principal function, and thus whether this entity is able to take economic decisions independently from any other institution.

In this respect, Chapter I.5 of the MGDD includes a section on sector classification of deposit insurance funds ('protection fund'). The MGDD stresses that such entities often act much as 'auto-pilots', reminding that the sector classification of a deposit insurance fund would depend on its autonomy of decision, or the lack of it. The MGDD principally lists three relevant criteria to assess the autonomy of decision in the ESA sense – as opposed to autonomy of actions with respect to mere administrative tasks – or lack thereof: (1) who decides on fund activation? (2) who sets the levels of contribution? (3) who has the final say on the exceptional financing needs (in case financial call would exceed fund resources)? More specifically, the MGDD explicitly says that the ability to take decisions related to placements/investment of the accumulated funds (4) is not a relevant criterion to consider in this context.

With respect to (1)-who decides on activation-, the MGDD further says that this criterion is de facto frequently irrelevant, as activation is often made by another institutional unit - as this is the case in Bulgaria given that it is the BNB which takes the decision.

With respect to (2)-who sets the level of contribution?, the MGDD also states that protection funds generally do not fix the global amount of contributions to be raised and that the room of manoeuvre as concerns the modulation of individual contributions is generally rather limited. This suggests that the criterion is often de facto irrelevant.

While the MGDD seems to be calling for a multi-criteria approach ("*If for most of these crucial decisions...*"), it nonetheless indicates that the most important criterion of the three listed above is the exceptional financing criterion. Thus, the important point to consider is the power of the fund to decide on how to fill in the gap in case of insufficient resources.

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<sup>1</sup> This rigid framework is more generally imposed by Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, although, as each Member State has to transpose the directive into its national legislation, differences in legislations which might affect the classification of national deposits guarantees funds might emerge in this respect between different Member States

As already discussed above, the existing Law on Bank Deposit Guarantee defines the framework of the DIF exceptional financing in a strict way. In addition, while, according to the law, the Management Board seems to decide on how to fill in the gap in case of insufficient resources in the fund, it was observed in practice that the Bulgarian government was de facto strongly involved in the discussions on how to finance the gap in the fund in 2014. There was no credible alternative to Treasury funding, the BNB being unable to do it. In a sense, the 2014 financial call and other events thus provide concrete evidence for judging the exceptional financing criteria.

Having established that DIF is not an institutional unit according to ESA 2010, the next step is to identify which entity is the parent entity, i.e. the controlling or owing unit.

## **2. Notion of control**

Control is defined in paragraph 20.18 of ESA 2010 as "*the ability to determine the general policy or programme of that entity*", with further criteria listed in 20.309-20.310. Financing is listed as an indicator of control in ESA 2.32h or ESA 20.309g.

It should however be noted that control of an institutional unit is not necessarily the same thing as control of an entity without autonomy of decision in the ESA sense, or, even more so, as control of an asset. Given that 20.18 is the first paragraph of the 'public control' section, it may be argued that this paragraph in fact concerns entities that are already found to be institutional units.

After having closely examined the provisions of the Law on Bank Deposit Guarantee, and in view of the concrete developments observed in 2014, Eurostat can make the following observations as regards the ability of government to exercise control over DIF.

As regards the Management Board itself, given that DIF operates as an auto-pilot, the decision power of the Management Board is not a decisive factor for the sector classification of the fund. Nevertheless, the involvement of government in the Management Board (and in the fund itself) seems de facto superior to that of the BNB - the government appointing the Chairman who then appoints two further members. In addition, art.9, paragraphs 8 and 9 of the Law give extended powers to the Chairman. The ability to remove 'key personnel' is a criterion for control under ESA 2.32c.

Another noticeable aspect is that DIF has limited possibility to raise the premiums paid by the banks (art.18, par.3 of the Law).

Finally, government and not the Central Bank or a banking association (as it can be sometimes seen in other Member States) is, de facto, the last resort financier in the case of insufficient resources in the fund (art.18, par.4 of the Law). From a risk perspective, the government bears the negative consequences of the activation of the fund. Thus, it is government that is exposed to the risk of financing in the case of insufficient resources in the fund, while the BNB is not exposed to such a risk.

To summarise, government secures control over DIF as a result of the rigid legal framework as well as the exposure of government to the risk of financing in the case of insufficient resources in the fund (see also par. 2.38 of ESA 2010). DIF was (and still is) dependent on government borrowing, and this was clearly seen in practice when the fund was activated and a decision was taken to fill in the resources gap in the fund with a government loan.

Therefore, DIF itself is not able to take economic decisions and engage in economic activities for which it is responsible and accountable at law. Such decisions are taken instead by the controlling (parent) unit.

### **3. Parent (controlling) unit**

When deciding on which is the parent unit, one issue is to decide on the ownership of DIF equity. As mentioned below, no registered capital exists, in such a manner that no obvious owner emerges (shareholder). Banks could be thought as implicitly equity holders, if banks could have their stake returned when they decide to stop activity or earn some income on their stakes – which is not the case here. The fact that the liquidation value of DIF returns to banks in case of DIF disbanding can be seen as a borderline case. It would seem insufficient to establish an equity link in national account, given that a guarantee fund is required under EU law at all times. We also assume that, under IFRS, banks charge annual contributions as expenses, and not as acquisition of assets.

Clearly, the parent unit is therefore not a private entity or the banking association. Two potential parent remains: BNB or budgetary central government.

As explained above, government secures control over the decision-making power of the fund in the following ways:

- through legislation;
- through superior involvement of government in the Management Board;
- through the exposure of government to the risk of financing of the fund.

It is therefore Eurostat's view that government and not BNB must be considered as the controlling (parent) unit of DIF.

### **5. STATISTICAL RECORDING OF THE TRANSACTIONS**

The reclassification of DIF inside general government would have a sizeable impact on government deficit. Two options for recording can a-priori be envisaged. One option consists in recording financial calls as government expenditure (capital transfer) and recoveries as government revenue (capital transfer), in line with certain financial guarantees or debt assumptions recording (ESA 20.257-20.259, or 20.223b). Another option is to record, at time of activation, government expenditure for the expected loss only, as is the case for debt defeasance, or some cases of debt assumptions (ESA 20.240-20.245, 20.223a). Recoveries then enter the financial accounts.

The second option, which is preferable, supposes sufficiently good estimate of expected recoveries. It has the advantage of being consistent with defeasance structures/bailout recording (which, arguably, are closely associated events) and with economic substance avoiding larges entries in government accounts that are hard to justify both in the context of EDP monitoring but also from a public accounting (IPSAS) point of view. There is also a concern with respect to the unclear potential of government to control the timing of recoveries.

Under ESA2010, the second option is preferred whenever a reliable estimate of recoveries (or of loss) exists, as is explicit in ESA para 20.245 or implicit in 20.223b. We observe in the balance sheet of DIF as of December 2014 (established on 18 March 2015) an amount of BGN 855 million (account 02360), which we interpret as being the expected recovery. We

nonetheless understand that this estimate may be conservative, and a revised estimate as of December 2015 may well prove more realistic. We consider that national institutes have a period of a few semesters after the event to establish the more realistic expected loss applicable in national accounts. This implies that a preliminary first estimate would be booked in EDP tables for the April or even October notifications of the year following the event.

For these reasons, Eurostat believes that for the recording of the repayments of the guaranteed deposits the second option should be followed. The expected loss approach is also applicable to some government guarantee schemes.

The following statistical recordings should be made in this case:

- a capital transfer for the expected loss (repayment of the guaranteed deposits reduced by the expected proceeds from the liquidation of the Corporate Commercial Bank) in 2014;
- recording of the expected recovery in the financial accounts in 2014;
- recording recoveries in the financial accounts, the excess between actual and expected recoveries entering the revaluation accounts;
- the loan granted by government to DIF will be consolidated within general government.

## 6. CONCLUSION

- DIF acts as an 'autopilot' under a restrictive framework defined by government through legislation;
- As a result, DIF lacks autonomy of decision-making power as regards its principal activity;
- Government bears the risk of financing in the case of insufficient resources in the fund (and this was clearly seen in practice) and is the parent (controlling unit).

First, DIF could be considered as a government agency, set up by special legislation to conduct public policies, to be classified generally in general government.

Second, based on the general decision tree presented in diagram 20.1, if an entity lacks decision-making power, because it rather functions as an 'auto-pilot', the entity should not be recognised in national accounts as an institutional unit but included in its controlling/parent unit. In the case of DIF, the entity functions as an 'autopilot', it lacks decision making autonomy and the parent (controlling) unit is government.

Therefore, Eurostat considers that DIF should be classified in the general government sector.

Eurostat also observes that deposit insurance funds in other Member States that have similar features to DIF, have been classified inside general government. Eurostat is committed to ensure consistent treatment of similar cases across Member States.

Finally, the transactions to be recorded would involve a capital transfer expenditure in 2014 for the expected loss (i.e. the payment for the guaranteed deposits reduced by the expected proceeds from the liquidation of the Corporate Commercial Bank), the remainder entering the financial accounts. Recoveries later on would enter the financial accounts, implying that the excess of actual over expected recoveries would enter the revaluation accounts.

I thank you for your co-operation and remain.

Yours sincerely,

*(e-Signed)*

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