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Directorate D: Government Finance Statistics (GFS) and quality

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Ms Gabriella Vukovich
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Subject: **Statistical classification of Eximbank**

Ref: Dialogue visit discussion of 10-11 June 2014
Your note provided on the classification of MFB and Eximbank on 29 August 2014
Further information provided on 15 January 2016
Your note on 5 February 2016
Your e-mail on 9 February 2016
Dialogue visit discussion of 16 February 2016

Dear Ms Vukovich,

Thank you for the information provided during the dialogue visit of 15-16 February 2016 and in the previous correspondence. After a careful examination of the issue by Eurostat, I am now in a position to provide an opinion on the statistical treatment of Eximbank in national accounts.

The accounting issue

The issue for which an opinion is being sought is the statistical classification of Eximbank in national accounts and in EDP reporting under the currently applicable rules of ESA2010 and of the ESA2010 Manual on Government Deficit and Debt.

Documentation provided

The statistical issue of classification regarding potential captive financial institutions was raised by Eurostat during the 2014 EDP dialogue visit to Hungary, in the light of the approaching introduction of ESA2010. At the request of Eurostat, the Hungarian statistical authorities provided a note with the description of Eximbank and the description of its national accounts classification. Eurostat requested further information on the activities and features of the bank and also proposed to discuss the issue during the dialogue visit in 2016. After an extensive discussion during the last dialogue visit, Eurostat promised to provide its opinion before the April 2016 EDP notification.

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Description of the case

Eximbank is established according to the Act XLII of 1994 on Eximbank: Eximbank’s core function is the public policy objective of promotion and funding of Hungarian exports.

With a view to this, the bank provides financial and investment services linked to the export of Hungarian goods and services, to supplier transactions, to export oriented investments, to investments and working capital needs enhancing the international competitiveness of resident enterprises, to international aid, to foreign investments of Hungarian investors, alongside to imports and investments in Hungary by non-residents.

Eximbank is 100% owned by the Hungarian government and its liabilities are fully guaranteed by the government. Eximbank does not collect deposits and is not member of the Deposit Guarantee Scheme.

In support of its mandate, Eximbank may lend directly to exporters of Hungarian products and services, and, as well as indirectly, through the refinancing of domestic commercial banks export finance. This last way of lending is prevalent and constitutes the majority of the loans provided. The majority (over 90% of the total stock) of Eximbank´s assets are in the form of subsidized loans, providing loans at the rate set in the OECD "*Arrangement of officially supported export credit*", for which the government provides compensation as laid down in the Act on Eximbank. This compensation is based on the difference between the concessional lending rates and the sum of Eximbanks´s funding costs, operating expenses and the applicable risk premium.

The Hungarian Export Credit Insurance Plc. (MEHIB) is also part of Eximbank and provides export credit insurance to exporters and their banks.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

ESA2010 Chapter 2 on the classification of units, especially paragraphs 2.21-2.23 (Captive financial institutions), paragraph 2.27 (SPEs of general government), paragraph 2.56 and 2.57 (financial intermediation), 2.98-2.99 (Captive financial institutions and money lenders) are applicable.

ESA2010 Manual on Government Deficit and Debt 2016 edition, chapter I.6.6. gives further guidance (mostly unchanged compared to the MGDD 2014 edition) on the classification of entities having the features of captive financial institutions.

Analysis

Eximbank as a public entity

Eximbank is an incorporated entity created by government and fully owned by government in order to carry out a defined public policy objective.

The Board of Directors of Eximbank consists of 7 persons, 3 from investment agencies, 2 of the internal members of the bank and 2 civil servants. In the Supervisory Board, among 5 persons, there is one delegate from government. The ownership rights are exercised by the minister of Foreign Affairs and Trade, who is also appointing all the board members for 5 years.

Eximbank is clearly a public unit. At the same time, although government has established Eximbank with many of the attributes of incorporated commercial entities, some features may raise a question mark as to whether Eximbank should be considered as an institutional unit, in the meaning of ESA2010, or not.

If it is not an institutional unit, Eximbank must be consolidated with the accounts of its parent – the State – and accordingly classified within general government. If it is an institutional unit, one has to establish whether Eximbank is a market producer either delivering financial intermediation services or other financial services (and to whom), or alternatively whether its activity is essentially market or non-market. This analysis is based on the hypothesis that Eximbank is an institutional unit.

In case Eximbank would be considered a financial corporation (as currently is the case), only four possible subsectors are in fact applicable for the case: Deposit-taking corporations S.122, Other financial intermediaries S.125, Financial auxiliaries S.126 or Captive financial institutions S.127.

Eximbank cannot be classified as a financial intermediary or a financial auxiliary

ESA2010 Chapter 2 defines the rules on the classification of institutional units. The financial corporation (S.12) sector, where Eximbank is currently classified, includes institutional units, which are independent entities and market producers, whose principal activity is the production of financial services. They are principally engaged in financial intermediation or in auxiliary financial services.

Eximbank does not have the feature of financial intermediary because it fails to meet certain technical criteria that would allow classifying it within S.122 or S.125, and also because it does not convincingly fulfil the financial intermediary criteria.

As defined by ESA2010 paragraph 2.56 *´Financial intermediation is the activity in which an institutional units acquires financial assets and incurs liabilities on its own account by engaging in financial transactions on the markets. The assets and liabilities of financial intermediaries are transformed or repackaged in relation to, for example, maturity, scale, risk, etc in the intermediation process´*, moreover, ESA2010 paragraph 2.57 clarifies that, *'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 provided by the Hungarian authorities, it is government which bears the risks and covers the losses resulting from the export public policy, through the provision of loans at interest rates below market rates (the predominant part of the Eximbank´s activities is related to the subsidized export financing), and through the fact that the liabilities of the Eximbank are explicitly guaranteed by government, as stipulated by the Act on Eximbank. This seems to preclude from classifying Eximbank in sectors S.122-S.125.

Further to this, because Eximbank does not collect deposits and is not actively seeking to collect deposits, it cannot be considered a deposit-taking corporation, and cannot be classified in the sector S.122, as according to ESA2010 paragraph 2.75 *´the deposit-taking corporations except the central bank subsector (S.122) includes all financial corporations and quasi-corporations, except those classified in the central bank and in the MMF subsectors, which are principally engaged in financial intermediation and whose business is to receive deposits and/or close substitutes for deposits from institutional units, hence not only from MFIs, and, for their own account, to grant loans and/or to make investments in securities.´*

Moreover, Eximbank cannot be convincingly classified in either S.122 or S.125 subsectors because its 'production', as measured in national accounts, is likely to be negative. The interest rates charged on loans are set in accordance with the OECD *´Arrangement of officially supported export credit´* and at a level much lower than the funding and administrative costs. To make up for the loss incurred on these loans, Eximbank receives under the so-called *´interest equalisation program´*

payments from government, which are calculated as the difference between the interest rate paid by the borrower and the *´sum of Eximbanks´s funding costs, operating expenses and the applicable risk premium´* (as mentioned in the Annual Report of Eximbank 2014). This means, in practical terms, that the government is not subsidizing individual loans, but the production process itself, as the subsidy is clearly aimed at covering costs (to be treated as a subsidy on production). As Eximbank is financing itself from the interbank market and from bonds (with no FISIM earned from the liability side), and, provides loans on a low and subsidized interest rate (negative FISIM on the asset side), its production in the national accounts sense is likely to be negative. With FISIM exhibiting negative amounts, Eximbank´s overall production – FISIM together with fees collected – is likely to be negative too.

This seemingly strange result is in fact merely the manifestation of the non-commercial nature of Eximbank´s portfolio. This points, concretely, at the fact that Eximbank cannot plausibly be classified as a market producer selling intermediation services.

Eximbank cannot be classified in the S.126 subsector either. Financial auxiliaries (S.126) do not put themselves at risk, generally by avoiding acquiring financial assets or incurring liabilities on their own, and acting more as brokers between parties – which is not the Eximbank case. More importantly, given that the largest share of its income comes from subsidies on production, it will fail the 50% market test which is applicable to financial auxiliaries. Here again, Eximbank´s main production is not purchased by clients (being negative), but is de facto purchased by government.

As a result, Eximbank conceived as a financial entity should be considered as a captive. However captives of government have to be classified in government.

Another line of reasoning is to directly verify if Eximbank meets the criteria of captive.

Eximbank meets the criteria for captive of government

Although Eximbank might not seem at first sight to be a typical captive, a close analysis suggests that it has, in fact, virtually all of the typical attributes of captives. Although captives might be typically seen as legal shells with nearly no physical presence, certain entities with the feature of captive do have however significant actual activity and notably a significant number of employees. Whilst these entities perform numerous processing or other administrative tasks, they are captive to the extent that they do not have enough effective control over their assets and liabilities (somebody does: government) to be genuinely exposed to the risks and rewards on them (as reasoned in ESA2010 paragraph 2.22).

According to the ***MGDD Chapter I.6.6*** paragraph 47, four criteria must be simultaneously analysed in order to conclude whether a government controlled financial institution seemingly engaged in financial intermediation would have to be classified in the S.12 (genuine financial intermediary) or S.13 sector (de facto captive).

´47. To summarise, a unit engaged in financial activities and controlled by government would have the features of a captive financial institution and thus would be classified in the government sector, and not in the financial corporations sector (S.12), if at the same time the following conditions would be met:
1. the unit would carry out a limited range of activities in narrow conditions set by government (in the framework of public policy objectives),
2. government influence or constraints would be evidenced simultaneously on both:
- assets side and
- liabilities side of the unit, and
3. the unit would not behave like a "normal" commercial entity (e.g. no expectation of a market rate of return on equity).´

The following analysis summarizes the examination of these criteria for Eximbank.

1) Carrying out a limited range of activities in narrow conditions set by government

Eximbank´s range of activities are clearly limited, as its tasks are defined in the law regulating its operations. The Hungarian authorities explain in their note sent to Eurostat on 5 February 2016 that decisions concerning the strategy are taken by the owner (such as the expansion of activities in 2012), and this is done in a regulated way, where the government instructs the minister exercising the ownership rights.

Eximbank´s core function is the funding of exports. Most loans provided by the bank (more than 93% of the stock of loans in 2014) are granted with interest subsidy provided by the state. Without the interest equalisation system, Eximbank would make large losses. Thus Eximbank doesn't behave as a "normal" commercial entity, trying to extend the scope of its activities, specialising in more profitable areas and looking to obtain a market rate of return. In this sense, Eximbank acts as a government agency, giving priority to fulfilling public policy objectives without aiming for a market rate of return on the funds provided. This is also confirmed by the bank´s Annual Statement of 2014, where it is mentioned that *´the level of interest equalisation and support provided by the Hungarian State is also intended to hold Eximbank´s profit at or near zero for loans covered by these [interest equalisation] programmes, reflecting Eximbank´s role as an instrument of economic policy for the Hungarian State rather than as a traditional profit-oriented bank.´*

Eximbank also has explicit derogations from the Hungarian Act on financial institutions, regarding capital adequacy requirements, size of large exposure and size of client risk.

2) Government influence or constraints of the liabilities side

Eximbank does not collect deposits, and is not actively seeking to collect deposits. Eximbank is financing itself from the interbank market and from financial markets. The Hungarian government provides a statutory guarantee to the bank. The bank pays no guarantee fee for this statutory guarantee. The Act on Eximbank defines that the Act on the Central Budget of Hungary includes the upper limits of the total volume of deposits accepted or other debts incurred.

All these factors lead to the conclusion that, on the liability side, there is clear influence and constraints which result in control on the funding of the bank´s operations.

3) Government´s influence on the asset side

Eximbank is a government controlled entity, which has been entrusted by government to carry out activities in the context of a public policy, namely the support of export-oriented lending, by granting loans under more favourable conditions than the markets.

MGDD Chapter I.6.6 paragraph 45 mentions that *´the government controlled unit would be obliged to conduct its interventions within a narrow framework defined by government, even if government would not necessarily have to formally approve/determine every single allocation of assets to every single beneficiary, which however may be frequently the case for operations of a significant size´*.

Not only are Eximbank´s loans related to the pro-export policy of government but a significant portion of Eximbank´s buyer´s credit loans are mandated by the Hungarian State to provide buyer´s credit through a system of tied-aid credits based on intergovernmental agreement. Further constraint is set by the Act on Eximbank on the upper limit of guarantees that Eximbank is permitted to undertake (which is also to be included in the Act on the central budget of Hungary as approved by government). As a result, part of the Eximbank's assets is explicitly guaranteed by government. Moreover, the total amount of loans that can be provided by Eximbank is also limited given that the Act on the Central budget of Hungary sets an upper limit for the appropriation of funds to cover the amounts that may be settled between the bank and the government in the interest-equalisation system.

In Eximbank, the decision making level depends on the amount of the individual loan: if the risk exposure is above 20bn HUF, the shareholder (the government) is taking the decision, between 5bn and 20bn HUF, the Board, and below 5bn the Credit committee, which consist of the risk manager and the relationship manager. As explained during the dialogue visit, the proportions of outstanding lending in 2014 by type of approval were 0.3%-9.9%-89.8% (government-board-committee), and in 2015:0%, 10%, 90%.

So, while the government may not have a direct influence on everyday business, it exercises control due to its presence in the Board of Directors and the Supervisory Board, due to its power as a shareholder to change the strategy of the bank and due to the constraints and mechanisms laid down in the Act on Eximbank.

4) *The unit would not behave like a "normal" commercial entity (e.g. no expectation of a market rate of return on equity).*

Eximbank´s core function is the support of Hungarian export through the provision of subsidized loans.

It is evident, that the government is not expecting a high market rate of return from the bank, but rather that the entity fulfils best its main aim: the pro-export policy of government, which is in accordance with the economic policy of the government. This is confirmed by the fact that, without the subsidy provided by government, Eximbank would be loss making in each year.

Eximbank is a captive financial institution to be reclassified in the general government sector

Taking into account the reasoning above, with respect to both ESA2010 and MGDD guidance, Eximbank seems to have the features of a captive financial institution, as defined in the ESA2010 paragraphs 2.21 – 2.23 and as further developed in the MGDD Chapter I.6.6. Eximbank is not actually engaged in financial intermediation, but acquires a large majority of the financial resources for its activity with the help of its ‘sponsor’, government, by receiving subsidies to cover the difference between the funding costs and the low lending rates, and also by receiving from government a full statutory guarantee on all its liabilities that allows the bank to borrow on the financial market at more favourable terms.

In this context, Eurostat considers that Eximbank does not comply with the definition of a financial intermediary and is controlled by the government, with a limited autonomy of decision in main corporate policy. As such, Eximbank must be classified in the general government sector (S.13) according to ESA2010 rules.

Conclusion

In view of the analysis above, Eurostat concludes that Eximbank is a government controlled entity and does not comply with the criteria of financial intermediary, as defined in ESA2010. Eximbank has limited independence from the controlling unit as evidenced by the significant government control over the general policy, and also constraints on the assets and liabilities. Consequently, Eurostat considers that Eximbank has the characteristics of a captive financial institution controlled by government and, therefore, should be classified in the general government sector (S. 13).

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 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 1 April 2016.

Yours sincerely,

(eSigned)

Eduardo Barredo Capelot
Director