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

**Ref:** Ad-hoc EDP visits 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)  
Our letter of 22 March 2018 (our ref. Ares(2018)1591095)  
Your letter of 29 March 2018 (your ref. KSH/1256-2/2018; our ref. Ares(2018)1758355)

Dear Ms Vukovich,

Thank you for your analysis on the sector classification of the Hungarian Central Bank's (MNB) foundations and their subsidiaries, provided in your letter of 29 March 2018. Please find below our reply to the various points you raise in your letter and our conclusion on the basis of the information at our disposal.

While it has some straightforward aspects to it (e.g. control over these entities), the case of the MNB's foundations and their subsidiaries, when seen in its entirety, is rather unconventional. The activities of the MNB regarding the creation of the foundations, their endowment with exceptionally large funds over a short time frame and, given the monetary financing prohibition of the Treaty<sup>1</sup>, the instructions given to them to acquire debt instruments issued by their own government are, in our view, unprecedented. While the activities of the foundations, which are clearly in line with their declared purpose, are not unusual in international comparison, they remain overshadowed by the size and frequency of the asset acquisitions and disposals carried out by them. In fact, as we will repeat in what follows, and as we have also mentioned in our initial advice letter, the entire issue is

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<sup>1</sup> Article 123 of the [Treaty on the Functioning of the European Union](#)

a typical case where the *substance-over-form*<sup>2</sup> principle must be applied. Moreover, considering all the above and the procedural aspects of this case, I hope you will appreciate the circumspect and gradual nature of our approach towards its resolution.

### ***Institutional unit and market/non-market analysis***

We welcome your agreement with our assessment that the subsidiaries of the MNB's foundations should be regarded as special purpose entities and should, therefore, be consolidated with their parents. However, you also state that such a consolidation would change the market/non-market character of the parents (foundations), even if the necessary test would be premature to carry out.

Eurostat does not share this view. First, the special purpose nature of these subsidiaries would seem to preclude this possibility. As we have written in our initial advice letter, the productive activity of the subsidiaries (in value terms) is disproportionately smaller than their combined balance sheet. Their whole purpose seems to be the holding of large value, investment-type fixed assets, the returns of which are intended to finance the activities of the foundations. While the transactions yielding those returns may be intended to be performed on a commercial basis, the ultimate goal of the subsidiaries is to be the subordinate financing vehicles of the foundations. In our judgment, they do not alter the non-market character of their respective parents. Partially consolidating their appropriately apportioned parts with their parents (the foundations), as described in our initial advice letter, would not change the nature of the resulting institutional units. Their declared purpose remains the same: funding education, research, conferences and other related interests, delivered free of charge or at a low price, activities that are either non-market or essentially governmental tasks. As such, the main activity of the unit, and thus the major part of the output, (i.e. that of the parent) being non-market, the institutional unit is non-market according to ESA 3.26.

That such a 'consolidation' would not modify the actual and real purpose of the resulting institutional units may find support with the fact that, after having initially used almost their entire endowment to purchase government debt securities, they thereafter redirected their investment strategy substantially. It would be somewhat strange that the activity classification (NACE<sup>3</sup>) or the non-market character of an institutional unit depends on the investing strategy. The NACE of the aggregated entities should not be "real estate activities" (NACE 68), as they would not have been "financial service activities" in the first place (NACE 64-66). In general, cases of private charitable foundations mostly funded through a rich portfolio of real estate assets (or holding a portfolio of productive assets to deliver services) would not lead to the recognition of the foundation as a market producer.

Second, and in relation to the previous point, we draw your attention to the fact that, even if the 50% test was to be applicable to the foundations, own capital formation and its costs should be removed from the test according to ESA 20.30 and 20.31. As a result, it is rather unlikely that the construction activities and associated costs of real estate subsidiaries would significantly influence

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<sup>2</sup> In the meaning of the principle foreseen under ESA paragraph 20.164, which is also known as the *substance-over-form* principle and where ESA stands for the [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.

<sup>3</sup> NACE is the acronym for "Nomenclature statistique des activités économiques dans la Communauté européenne" and is the statistical classification of economic activities in the European Community, as foreseen in [Council Regulation \(EEC\) No 3037/90](#) on the statistical classification of economic activities in the European Community.

the result of the 50% test, as long as the real estate entities concerned are not aiming at reselling or actively trading buildings on the market. By the same token, the earnings in the form of interest on government bonds do not enter the 50% test either (ESA 20.30 and MGDD<sup>4</sup> section I.2.4.3 paragraph 32). As a result, the means by which the foundations will actually generate the earnings required to cover the expense incurred to provide the intended services without charging commensurable prices, will, by and large, be neutral from the 50% test point of view.

Third, it however cannot be precluded that the real estate rentals eventually become so large as to constitute the main activity of the unit. It should however be noted that the rental income should be appropriately partitioned between a rent component (D.45) and an output component (P.11), with only the latter entering sales. Such a partitioning can be significant for rentals in big cities such as Budapest. However, in case such renting activity (of the P11 type) would become so large, compared to the education tasks, the notion that each foundation and its subsidiary would constitute one unique institutional unit may then have to be reconsidered – in a way to appropriately keep the non-market activity located inside government.

### ***MNB control over the foundations***

Regarding control over the foundations (in the ESA 2010 meaning of the term 'control'), we take note of your opinion that "*control is not a one-off measure at a certain time point but an existing ability to determine general policy or programme...*", which is intended to suggest that while public control of foundations would have existed at inception, this public control would not be establishable later on and would, therefore, have ceased. Aside from the fact that there are indications examined below to the contrary, we would however challenge the general pertinence of your assertion of the need to continuously test for control in the case of NPIs. Certainly, control of for-profit entities is generally to be assessed continuously, given that the ability to gain benefits from the entity in question and the associated control can be transferred at any point in time (e.g. through share sales). In contrast, control of an NPI can often be established at inception without further re-examination, i.e. as long as no change in status occurs. This is because NPIs are often designed to operate autonomously, having in mind that the beneficiaries of the NPI are neither the founder nor the parties engaged in running the NPI itself. As a result, control over an NPI can be established simply through its creation, as in fact implied by the ESA 20.15(b) reference to the "*enabling instrument*".

As we have written in our initial advice letter, according to the foundations' articles of association, 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 (a clause that may raise doubts as to their genuine NPI character). We find that these factual observations fully meet the requirements of ESA 2.39 and 20.15.

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<sup>4</sup> [Manual on Government Deficit and Debt](#) – Implementation of ESA 2010 – 2016 edition

As we have also stated in our initial advice letter, the founder (MNB) in fact chose to repeatedly amend (up to 10 times per entity, since their creation) said articles of association, which is further evidence, not only for control to have been exercised by the founder over the foundations at their creation, but also for the fact that the founder has retained control over time and it still keeps exercising it over them.

In summary, Eurostat considers that **the foundations of the Hungarian Central Bank were and remain under the control of the MNB.**

### *Direct versus indirect control*

Moreover, we cannot find paragraphs in the ESA that would support your argument that government control over non-profit institutions (NPIs) would have to only apply directly. In our opinion, none of the paragraphs from 20.13 through 20.16 would allow for such a conclusion. In contrast, ESA 2010 explicitly considers the distinction between direct and indirect control, ESA 20.306 being rather clear: "*All institutional units included in the public sector are resident units controlled by government, either directly or indirectly by public sector units in aggregate.*" Thus, Eurostat considers that if ESA 2010 had intended to restrict ESA 20.15 to cases of direct control, it would have done so explicitly. From this follows that even NPIs indirectly controlled by government are still controlled by government and should be considered public sector units for purposes of sector classification, and following ESA 20.15, to be classified inside general government.

As we have also written in our initial advice letter, 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, **the foundations are also, albeit indirectly, controlled by general government.**

### *Size of the units*

Your letter stresses that "*size and number of units are not and have never been decisive factors in their classification*". Although this assertion may sound right in concept, this is not at all the case in practice. The size of entities is relevant to Eurostat for determining whether an enhanced analysis of the case is required or not. In addition, while the number of the foundations is ultimately inconsequential, their combined size and, in particular, their combined endowment's flow rate, as well as their main activity in substance are quite unprecedented and, therefore, in our view, valid factors in the analysis of their sector classification.

Notwithstanding, given that the foundations are under the direct control of the Hungarian Central Bank and under the indirect control of general government and thus, ultimately shielded from

liquidation until their parent decides otherwise, the use of the so-called *endowment model*<sup>5</sup> in their case, as quite often done in the private sector and as was invoked by the MNB, is questionable. We remain hitherto unpersuaded that for the effective fulfilment of their declared scope, either the creation of the several foundations, or their endowment with such large funding would have been necessary. Moreover, considering also the initial lack of transparency regarding the foundations<sup>6</sup>, in our judgment, a thorough statistical analysis on the actual use of such funds would be both necessary and appropriate.

### ***Income and wealth redistribution***

Your letter argues that the Pallas Athena foundations are not redistributing wealth because this would imply carrying out capital transfers. A fundamental criterion for units to be classified inside government is when they "*redistribute income and wealth*" according to ESA 20.02(b), the same paragraph also explaining that this can be carried out "*by means of transfer payments such as taxes and social benefits*". The restriction that you would like to apply seems therefore unwarranted. In our understanding, the foundations under review are within the remit of ESA 20.02(b), being providers of social transfers in kind to households. In addition, a transfer of income and wealth is also *de facto* occurring when a public producer is non-market because it is not charging any price for the services provided or only low or very low prices (ESA 20.02(a) and 20.02(c)). This is also the case of the foundations.

Your letter indicates that the "*expenditures that can be attributed to redistributive activity amount to 0.01% of GDP annually*". First, as explained in the previous paragraph, the redistributive activity covers not only grants provided (research, educational, etc.), but more generally all the costs incurred that are not charged to the beneficiaries of the foundations' services (estimated to be 0.07% of GDP in 2016, according to the information available). Second, it is important to stress that the net lending/net borrowing (B.9) impact of the foundations could be even more significant given that it is influenced by the net purchases of real estate carried out by the foundations (0.1% of GDP over 2015 and 2016).

### ***Treatment of the lump sum***

Taking into account all the above, including (1) the repeated amendments of the articles of association, (2) the control still exercised directly by the MNB and indirectly by government, (3) the sunset clauses requiring ultimate return of the initial funding, as well as (4) the fact that the real purpose of the foundations seems to be the fulfilment of government policy, in our view, the endowment is closer in its nature to a financing transaction undertaken by the central bank on behalf of its government, and would, therefore, be more accurately portrayed in national accounts as a loan granted by the founder (MNB) to government in the context of the implementation of government policy.

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<sup>5</sup> A financing model for NPIs, whereby the founder endows the NPI with amounts large enough, that if invested, their return would finance the activity of the NPI in perpetuity, thereby ensuring a social impact lasting potentially longer than the life of the founder itself.

<sup>6</sup> As has been widely reported in the media, information on the foundations was not publicly available for a relatively long time period after their creation, until the Hungarian courts decided that the endowment they received from their founder (MNB) were public funds and that, therefore, the foundations would need to disclose said information to the public.

Your letter mentions your objection to imputing "*a non-removable loan granted by the Central Bank to the government*". We would like to clarify that the loan in question is deemed to have been incurred to finance the acquisition by the foundations of their government bond portfolios. Accordingly, the liquidation of that bond portfolio discussed above (its replacement by a real estate portfolio) would lead to a parallel reduction in the imputed loan against an entry in withdrawal in equity, which the Hungarian Central Statistical Office (KSH) should be very familiar with. We hereby take the opportunity to note that KSH has a long history of rerouting transactions through government accounts (by way of equity withdrawal), whenever KSH considered that a transaction is carried out by a public corporation at the request of government, and therefore on its behalf – an accounting policy that is fully supported by Eurostat.

### ***Conclusion***

In conclusion, while taking into account the arguments presented in your letter of 29 March 2018, for the reasons stated above, we reiterate what we have said in our initial advice letter.

**In view of the analysis carried out, 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, 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 as a loan extended by the central bank to general government, at zero interest, with an indeterminate maturity, to be gradually redeemed following the liquidation of the portfolio of government bonds.

Yours sincerely,

*(eSigned)*  
Luca Ascoli  
Acting Director