



Hungarian Central Statistical Office
President

KSH/1528-2/2018.

Budapest, 24 July 2018

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

Ms Mariana Kotzeva
General Director
European Commission

Luxemburg

Dear Ms Kotzeva,

Statistical classification of the Hungarian Central Bank's foundations and their subsidiaries resulted in recurrent discussions between Eurostat and the Hungarian Central Statistical Office (Ares(2017)4809788); Ares(2018)1591095); Ares(2018)1758355)).

The last Eurostat document (16 April 2018) concluded in a reservation on Hungarian EDP data in the EDP April Press release. I would like to summarize our standpoint in connection with the conclusion of the letter.

Eurostat's advice is based on two assumptions:

- The real purpose of the central bank by the establishment of the foundations is different from the one formulated in the founding documents.
- The foundations are directly controlled by the central bank and indirectly controlled by the government.

Based on these assumptions Eurostat experts apply two accounting tools: the rearrangement of a transaction and the reclassification of units. In addition to our objections to these assumptions we would like to point out that the application of these rules are not in line with the national accounts methodology.

The purpose of the establishment of the foundations

„...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“ (Eurostat letter of 16 April 2018). The supposition is paraphrased in detail in the Summary and conclusions of ad-hoc EDP visit in Hungary (22 September 2016): „...from actual events it could be considered that the foundations have a main function which is different from the one that is declared. It seems that they are not implementing the public policy they were supposedly created for (mainly educational scope)

but replacing government debt held by non-residents with debt held by residents, which is allegedly one element of government policy at present.” This presumption is not underpinned by any evidence. On the other hand, there was no need to create separate institutions for financing the government debt, because all existing institutional units including the central bank can purchase government securities on the secondary market. Furthermore, the central bank could even reduce the government debt by paying the profit into the central budget as dividend. It means that the establishment of the units for financing purpose would have been a redundant action from the part of the central bank. It should be added that buying Hungarian government bonds is an obvious decision from the part of any foundation, because it is a safe investment with relatively high return.

Eurostat experts try to underpin their view that the bank’s veritable purpose was different from what is declared by claiming that reaching the bank’s declared purpose there was no need for such huge donations: “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” (Eurostat letter of 16 April 2018). At this point they disregard the fact that the bank’s purpose was not only financing education and research but doing it in a long run and in an independent way. The annual income of the investments shall ensure the long-term financing of the core activity. That is why the bank chose the “endowment model” for these foundations.

Rearranging of the transaction

As Eurostat experts assume that the foundations were established for acquiring government bonds on behalf of the central bank, they apply a kind of rearrangement. But this rearrangement is not in line with the ESA 2010 rules. If the foundations were only agents for purchasing government securities, the purchase transaction and its financing should be recorded solely in the central bank’s accounts. The government securities would be recorded as central bank’s assets and would be eliminated from the foundations’ balance sheet. This accounting method is called principal party recognition. Instead of applying this method Eurostat experts advise to keep recording the acquisition of the government securities by the foundations and counterbalance it by a loan. In reality there was no need to incur a liability because the foundations had their own financing resources. The 16 April 2018 letter explains the role of the loan: “the loan in question is deemed to have been incurred to finance the acquisition by the foundations of their government bond portfolios.” The explanation reveals that this is a kind of distorted rearrangement. The substance of this special rearrangement is that the transaction is recorded in the accounts of the actual actor, but the financing is attributed to somebody else, the “principal party”. This kind of treatment is irregular. During the principal party recognition, the transaction and its financing should be together rearranged. The bank was either the principal party of transaction or not. If it was, the transaction should be recorded in its accounts. If it wasn’t, the transaction should be recorded in the foundations accounts and there is no reason to attribute the financing to a third party. The advice is not in line with the rearranging rules in the national accounts. We can accept neither the presumption Eurostat experts use nor the accounting method, they advise.

The direct control of the foundations

Eurostat experts suggest that the foundations should be classified into the general government because they are controlled by the central bank and this way they are indirectly controlled by the government. In the letter of 22 March 2018, it is explained that requirements of ESA 2010 paragraphs 2.39 and 20.15 (a), (b) and (d) are met.

ESA 2010 2.39 (a) states that the first indicator of the control is the “appointments of officers”. Appointment of officers is a control indicator because it means that the controller unit can influence the behavior of a NPI by changing the officers directing the unit. If the

founder is not able to remove the officers at its own will it cannot practice its control over the unit. When we examine this indicator, it should be taken into account that the Civil Code strongly protects the foundations' interests even against their founders. Although the members of the board are appointed by the founder at the moment of establishment, and also later provided the board member dies, retires and so on, but it cannot initiate the change of the board members at its own will. The withdrawal of an appointment can take place only in the case the advisory body member undoubtedly jeopardizes the achievement of founder goals. This fact should be proved by the founder, and if the advisory body's member rejects the fact of the violation a court case takes place. The law keeps in mind the foundation's and not the founder's interest. If the founder should tolerate that it cannot change the decision-making body on its own will the founder does not control the unit. The requirement paragraph 2.39(a) is not met.

ESA 2010 2.39 (b) states that the second indicator of control is "other provisions of the enabling instrument". Eurostat experts explain that „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." None of the listed provisions are control indicators. They are only the necessary parts of the founding documents. The purpose of the activity, the use of the funds or the sunset clauses should be precisely defined by the founder. Instead of the commonly needed provisions paragraph 2.39(b) speaks about specific provisions which limit the decision-making ability of the NPI and transfer it to the controller units. Examples are the right of veto or the preliminary agreement of the controller unit. We haven't found such specific provisions in the founding documents. The documents do not give to the founder any additional tool for influencing the fund's operations. The requirement of paragraph 2.39(b) is not met.

ESA 2010 2.39 (d) states that the fourth indicator of control is the "degree of financing". Financing is a control indicator because the behavior of a NPI can be influenced by the financial means it receives. This is why the financing model is important. The decisions of a NPI can only be influenced by financing if it is financed by the founder in a continuous way. If the NPI is financed by property income, the degree of financing – the ability to control the NPI over the financing means – by the founder is zero. Eurostat experts wrote that "virtually the entire funding of the foundations was provided by the founder" meaning that the degree of financing is 100%. It is incorrect. Financing means in this context that the foundations year by year have to apply for donations to be able to provide their services. The initial endowment does not create a financial link between the two partners. The requirement of 2.39(d) is not met.

Classification of non-profit institutions controlled by non-government public units

Parallel with the rerouting Eurostat experts advise classifying the foundations created by the central bank into the general government. The reclassification would improve the general government net lending/net borrowing if we applied the national accounts rules literally. ESA 2010 4.165 (e) declares that D.99 includes "donations between units belonging to different sectors, including legacies or large gifts to non-profit institutions (NPIs)". As there are no special rules in the methodology for non-profit institutions classified into general government the general rule should be applied. It proves that ESA 2010 is not prepared to situations, where a non-government unit gives large capital transfers to a non-profit

institution classified into general government. Otherwise ESA would make an exception to this rule because the government net lending /net borrowing could be easily artificially modified by this rule. In the advice this contradiction is covert because with a different explanation the capital transfer is exchanged for financial transactions and this way the improvement of the government deficit is avoided. Thus the advice does not raise this problem explicitly. However, the reclassification of NPIS into the general government sector triggers this problem and no solution can be found in the national accounts methodology.

Eurostat experts deem that the reclassification is inevitable because in their opinion all non-market non-profit institutions controlled directly or indirectly by the government should be classified into general government. For justifying this view, they cite ESA 2010 20.306: "*All institutional units included in the public sector are resident units controlled by government, either directly or indirectly by public sector units in aggregate.*" The paragraph in fact states that all the units considered as public are controlled units, which is correct, but does not say anything about the indirect control of non-profit institution. The question is whether the indirect control is an applicable notion in the case of non-profit institutions in the national accounts framework. Control of a NPI is defined as the ability to determine the general policy or program of the NPI. As there is no equity link between the government and the non-profit institutions in question it is not evident that this ability exists for the government units. For instance, if the appointment of officers or the content of the enabling instrument is decided by one unit, the founder, it is not possible to attribute these decisions to another entity, a government unit. If the government is not able to make the decisions on the units it is not justified to classify them into the government sector.

MGDD gives an interpretation on the problem. While describing the criteria of control, paragraph I.2.3.17 notes that "in ESA 2010 (like in 2008 SNA) these criteria are applied only to the case of a controlling government unit. However, they may also be relevant for market producers NPIS controlled by public units not part of the government sector" (Footnote 15). It means that MGDD rejects classifying non-profit institutions controlled by non-government public units into the government sector but supports classifying market ones into the non-government public sector. If the possibility of classification of these units into the government sector is excluded, the problem of manipulating the government deficit through non-profit institutions established by public corporation is solved. The public corporations can establish and finance non-profit institutions without impacting the general government deficit.

One can assume that there are many such non-profit institutions in the European Union. Eurostat experts wrote in the letter of 22 March 2018 that when the central banks create non-profit institutions "...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." However, if the problem is placed into the broader context of public corporations, one cannot say that „it is negligible for the purpose of any analysis relevant for national accounts". In our opinion this phenomenon is not negligible, but it was not discussed because it is solved in national accounts: non-profit institutions controlled by public corporations should not be, and in the European Union are not classified into the general government. When we classify the Pallas Athene foundations into the NPISHs sector we follow the rules of national accounts.

Classification of non-profit institutions controlled by central banks

One can object that central banks are special public units thus the classification NPISHs funded by them needs further analysis. We agree with that objection. In our opinion the non-profit institutions funded by central banks are even more separated from government than that of other public corporations. Central banks are and must be independent from government, in their case the indirect control of the government is even more out of question

than in the case of other public companies. Article 130 of THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION clearly prohibits control over central banks: “When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.” This fact be considered in the statistical treatment. If the direct control over the central bank is prohibited in the European Union, there is no basis to suppose indirect control over the bodies established by the central bank.

In the Hungarian case this is not the owner but the bank which decides on the dividends payment of the bank by the Hungarian law developed in close consultation with EU organs. The bank decided on creating the foundations itself, the government did not have right to influence the decision.

In the European Union we know about eleven central banks having non-profit institution: Danmarks Nationalbank, Deutsche Bundesbank, Banco de España, Banque de France, Banca d’Italia, Banque centrale du Luxembourg, Central Bank of Malta, Oesterreichische Nationalbank, Narodowy Bank Polski, Banco de Portugal, Sveriges Riksbank. In some cases (for example the German, French, Swedish central banks’ foundations) the classification needs circumspection, because part of the governing body of the foundations is appointed by ministries or by the parliament, so some government institutions may have direct control to some extent. As we argued above the appointment of officers does not generate automatically control. It follows there is a need for a twofold examination. First, it should be determined whether the right of appointment is coupled with the right of withdrawal to grant control over the foundation. If the existence of the control is proved it should be decided which body disposes with stronger influence. If it is government, it may create a possibility to classify the foundation into government. Please, note that in the Hungarian case none of these conditions are met.

Most of the EU countries’ foundations are financed by current annual transfers from the bank, which means that the central bank itself exercise control over the non-profit institutions. This fact does not have an impact on their classification, because non-profit institutions – with the exception of the government-controlled ones – are classified by their activity rather than by the control exercised over them. The activity in this context means serving the corporations or serving the households. As the central banks’ foundation serve the households, they should be classified into the NPISHs sector.

There is at least one foundation which follows the “endowment model”. This is the Riksbankens Jubileumsfond, a foundation of the Swedish central bank. By now the total assets due to the initial payments and the accumulated profit exceed 10 billion SEK, more than 0,2% of the Swedish GDP. This amount is in absolute terms larger than the total assets of the Pallas Athene foundations together. This amount is not “clearly negligible for the purpose of any analysis relevant for national accounts” (Eurostat letter of 22 March 2018).” Due to the endowment model this foundation is totally independent from the founders financially; its classification may still need further examination because the governing body is appointed by the parliament. The process described above should be pursued.

Summary

In summary, some EU central banks’ foundations are directly controlled to some extent by government units. In this case the need for further examination can be raised to decide on

the sector classification of the units. In any other cases they should be unambiguously classified into the NPISHs sector. In the case of the Pallas Athene foundations direct government control is not detected, therefore they should be classified into the NPISHs sector. Both the treatment of the transactions and the sector classification of the Pallas Athene foundations are in line with the provisions of the national accounts in ESA 2010.

Yours sincerely,



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