EUR-0014-1057-00
Delivery Order #25
January 31, 1994

October - December 1993

Hungary: Redeployment of Financial Assets, Restructuring, and Privatization

KPMG Peat Marwick
Policy Economics Group
January 31, 1994

Summary of Activities and Deliverable

During the fourth quarter of calendar year 1993, the KPMG project team worked with the Office of the Resident Adviser/Budapest and the U.S. Treasury advisors to define terms of reference and gain Government of Hungary approval for a mission to investigate weaknesses in corporate governance in banks, and to prepare a paper to make recommendations to the Government, in the form of the State Holding Company (the AV Rt.) as owner of the banks, on specific steps that can be taken by the AV Rt. to strengthen its ownership role and the functioning of banks' boards, in general.

As delineated in the terms of reference, which is incorporated as an appendix to our attached report "Bank Corporate Governance in Hungary," the project was designed to address perceived (and in our view, quite real) weaknesses in the management and oversight of banks, which weaknesses are founded to a large degree on the absence of local experience and sound guidance about the substance of governance. Therefore, while the report represents our summary analysis and recommendations, the team also met extensively with senior management of the AV Rt., the Ministry of Finance, the banks themselves (including management and board members), and other interested parties. Throughout, the team coordinated closely with the U.S. Treasury advisors and the OAR staff, including delivery of a detailed briefing at the conclusion of the mission.

The USAID funded work benefitted enormously from the detailed knowledge of the banks gained by certain team members who participated in a separate but related top-down bank review, which due to funding limitations and flexibility constraints under this delivetry order, and the necessity for quick response, was funded directly by the Government of Hungary.

Next Steps

No other activity was recorded during the quarter. However, some funding remains under the delivery order, and KPMG project management have been discussing with OAR/Budapest and the U.S. Treasury advisors the possibility of assisting in carrying out one of the recommendations of the report, in particular the establishment of a bank directors' institute. KPMG has received approval of a no-cost extension through March 14, 1994, and hope to get this work approved in time.

Attachment:

"Bank Corporate Governance in Hungary"
December 1993

BANK CORPORATE GOVERNANCE IN HUNGARY

Prepared for the
Bank Privatization Working Group
Budapest

Prepared by
KPMG Peat Marwick
Policy Economics Group
Washington, D.C.

December 20, 1993

2

TABLE OF CONTENTS

i. INTRODUCTION

1. FRAMEWORK OF LAW.

Hungarian legislation, the Companies Act, the Banking Act. Application in practice.

2. OBJECTIVES AND CONDUCT OF THE BANK.

Functions of the boards, duty of care, duty of fair dealing, remedies, structural bias.

3. BOARD OF DIRECTORS : EXERCISE OF BUSINESS JUDGMENT.

Duty of care in context. Elements of business judgment, process due care, subjective good faith, disinterest, independence, waste, egregious conduct, illegality, fraud, ultra vires conduct, undue influence.

4. THE SUPERVISORY BOARD : COMPLIANCE AND PERFORMANCE MEASUREMENT.

Duty of inquiry, duty to comply with laws, compliance programs, process vs. supervisory performance. Improved quality of information.

5. CONFLICTS OF INTEREST.

Manager/Director/Supervisor conflicts. Self dealing. Dominating shareholder transactions. Ratification of decisions in conflict situations. Judicial review.

6. SHAPE OF FUTURE BOARDS.

Boards' role in corporate governance. Role of management and management information. Role of corporate directors/supervisors. Selection of Supervisory Board members. Selection of Directors. Elements in the Appointment of

Directors. Nominating Committee of the Board of Directors. Appointment of International Bankers as Directors or Advisors. Role of Corporate Directors. Role of Continuing Professional Education : Creation of an Institute of Directors. Role of shareholders. Role of regulators.

7. PERFORMANCE MEASUREMENT CRITERIA.

Application of standardized objective financial ratios to assess bank performance. Adherence to Business Plan. Performance related compensation schemes.

8. SUMMARY OF RECOMMENDATIONS IN FORM OF DRAFT RESOLUTION.

Consideration by Bank General Meetings.

9. APPENDICES

I: Checklist for Assessment of Boards

II: Checklist for Board Members Exercising Their Duties

III: USAID Phase 1b Terms of Reference

INTRODUCTION

The purpose of this paper is to offer some suggestions that can be implemented by the AV Rt. and other state owners of banks. Some of the principles covered are also applicable to the operation of non-state owned enterprises and should be considered in the process of making any changes to the laws relating to corporate governance.

This paper outlines broad principles of corporate governance as currently understood and applied by law or practice in the United States and elsewhere. It should be stressed that even in the U.S. the definition of the roles and duties of directors is not precise and guidelines produced in this paper are a general indication of the principles as they are applied rather than a definitive interpretation of the law. A comparison is made with the existing system of corporate governance in the Hungarian banking sector. The paper is concerned with the development of a workable system which may be applied by the owners, supervisors, directors and management in Hungary on an expedited basis. This paper has been prepared based on the knowledge, experience and analysis of the KPMG Policy Economics Group team. In matters of Hungarian law, banking and accounting practice we rely on information provided to us by the Hungarian authorities and on certain published sources. Whilst every effort has been made to check the accuracy of facts appearing here we are dependent to a considerable degree on informal translations and personal interviews to identify problems within the existing Hungarian system.

Having said that, we are satisfied that this paper represents an important basis for changing bank governance in Hungary substantially and for the better.

Its specific application will be -

(a) for use in the Bank Governance Project commissioned by USAID for the Bank Privatization Committee under Phase 1B of "Hungarian Redeployment of Financial Assets: Restructuring and Privatization". Terms of Reference attached as Appendix III; and

(b) for use in improved bank governance by providing measurable performance standards for banking institutions owned or controlled by the Government of Hungary or instrumentality's under its auspices.

Having regard to the terms of reference of the above mentioned contract special mention was asked in two areas-

(a) the development of performance measurement criteria for management especially quantitative goals and performance related compensation, and

(b) the upgrading of Supervisory Boards with particular emphasis on board membership selection and the accountability of supervisors/directors.

In Chapter Seven we outline proposed quantitative performance criteria and appropriate management incentive programs. Although we have made suggestions for improvements at Supervisory Board level, in particular in Chapter Four, it is the Board of Directors which is key to good bank governance. Accordingly, we have paid significant attention to the duties of directors, their exercise of business judgment, conflicts of interest and, of course, performance measurement. We have provided checklists to assist in assessment together with a draft resolution incorporating good governance principles which Bank Annual General Meetings may wish to consider. We have been informed by bank owners that such a format would be extremely helpful in efforts to improve bank performance.

1: FRAMEWORK OF LAW

Corporate Governance in Hungary is framed by the laws enacted by Parliament in recent years, principally by Act VI of 1988 On Business Organizations (hereinafter the "Companies Act") and Act LXIX of 1991 On Financial Institutions and Financial Institutional Activities (hereinafter the "Banking Act").

The first aim of the Companies Act is to enhance, by the establishment of a modern legal framework, the improvement of the income generating capability of the economy. The framework it establishes allows for a variety of different companies including "a joint stock company" which, according to the Banking Act is the corporate form that a Bank (other than a savings or credit cooperative) must adopt. In the case of a public company limited by shares or a limited liability company having capital of over HUF 20 million or more than 25 members or any company having more than 200 employees a two tier governance structure is mandated. Most banks meet more than one of these criteria.

The structure consists of a Board of Directors and a Supervisory Board which "shall determine its own method of operation, and this shall be endorsed by the principal body of the company" (the General Meeting). The Supervisory Board shall monitor the management of the company and may request books and files from management and have experts examine them. Senior Officers and their next of kin are prohibited from acting as members of the Supervisory Board [A. 31(2)]. Furthermore, the supervisory Board is charged with the examination of all major reports submitted to the principal body of the company, and further to examine the balance sheet and the assets register.

The report of the Supervisory Board is mandatory before the General Meeting can adopt a balance sheet and apportion profits. One third of the members of the Supervisory Board shall be employees elected to serve. In the case of large companies the Auditor (who must be a member of the Hungarian Chamber of Auditors) has a statutory role to work with the Supervisors in monitoring the management of the company. Article 42 of the Companies Act requires an auditor who detects a significant reduction in the assets of the company or becomes aware of a fact that affects the liability of senior officers or supervisors is obliged to inform the Supervisory Board or, failing that, the

General Meeting, or in default, the Court of Registration. The Board of Supervisors represent the company in suits involving judicial review of a company's actions. According to law, where there is an internal control body this must report to the Supervisory Board.

In summary, the responsibilities of the Supervisory Board are legal, formal in nature, concerned with process rather than management or business judgment. For the purposes of drawing up effective guidelines for shareholders we have assumed that the powers of the Supervisory Board and those of the Board of Directors remain unchanged. While we may have suggestions for changes in the law, we are advised that such a step is unlikely anytime soon. In addition, substantial steps towards better bank governance can be made without awaiting such changes. Accordingly, we are recommending improvements within the existing legal framework.

The Board of Directors (referred to as the directorate in the Companies Act) is the executive body of the company and represents the company at law in relation to third parties. It supervises company personnel and exercises employer rights. There are between 3 and 11 board members. It is the duty of the board of directors draw up the balance sheet and statement of assets and propose the apportionment of profits. It is also charged with drawing up a report, at least annually, on the management of the business, the financial situation and the business policy of the company. They are supposed to keep financial records as regulated. It is possible for the charter of the company to provide that the Board of Supervisors should represent the company at law rather than the Board of Directors.

In practice, the executive authority of the company rests with the Board of Directors and while they are responsible for the day to day management of business affairs they generally delegate this to management. This is often provided for in the Charter and Articles of Association where the powers of the Chief Executive Officer and senior management may be enumerated. The legal responsibility rests with the senior officers who are in this case the members of the Board of Directors.

Most banks are Public Companies limited by Shares and are governed by the relevant provisions of the Companies Act. We are informed that there is little Hungarian case law dealing with the relative responsibilities of supervisors and directors.

RECOMMENDATION:

In view of the unlikelihood of any early change in the law of corporate governance we recommend that separate performance and conduct standards be set for members of the Supervisory Board and the Board of Directors. The standards should reflect their function, supervision and process in the first case and executive competence and achievement in the second. These standards should be adopted by the shareholders at a General Meeting.

2: OBJECTIVES AND CONDUCT OF THE BANK

As an incorporated entity enjoying limited liability the bank has the objectives outlined in its charter as its sphere of activity. In many instances these objectives are defined as a "Bank", a reserved term with a specific definition in the Banking Act, which enables it to carry out a range of financial activities. What is missing are the essential components of corporate objectives and conduct common to commercial ventures in the United States and elsewhere:

1. The conduct of business activities, with due regard to its fiduciary duties as a Bank, with a view to enhancing corporate profit and shareholder gain. This is the principal objective of the bank.

2. To act within the law.

3. Act within an ethical framework appropriate to the responsible conduct of business.

The powers given to directors (and in this context, supervisory board members/supervisors) are given for the purpose of enhancing the principal objective and not for any other reason even if they are allowed to take into account other factors in pursuit of this objective. These objectives, and others, can be established by the shareholders of a bank as part of the mission statement or strategic plan, and can then govern the activities of directors.

As is the case in Hungary it is generally recognized that the Board of Directors does not operate the business. It is responsible for management and in practice this is delegated to the management. In exercising responsibility the Board of Directors needs to observe certain rules or duties which will ensure that management acts as it should.

Duty of Care

As applied in the United States, a director or officer has a duty to perform his functions in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that a reasonable and prudent person would be expected to exercise in a like position and under similar circumstances. This is essentially a "negligence" standard, which means that a director could

be found negligent in performing his duties if the director's behavior did not measure up to that expected of a hypothetical bank director of ordinary diligence acting under the same facts and circumstances.

An analogous provision exists in Hungary, in Article 32 of the Companies Act, where senior officers, supervisory board members and auditors are "obliged to act with the care generally expected from persons in such positions". In Hungary, this is probably a lesser standard at law than in the United States. However, if a reasonable standard is established by the shareholders at the Company Meeting then it becomes what is expected of such persons and may turn out to be enforceable at law and in practice.

Duty of Loyalty

In America, directors, senior executives and shareholders are obliged to deal fairly with the company when their pecuniary self interest is involved. This duty is tested by two principles, substantive fairness and full disclosure. Briefly, the transaction must be fair to the company in essential matters and the person or entity having the duty must disclose fully its interest in the transaction. Even if the transaction is judged to be substantially fair to the company the duty will be breached if there was not full disclosure, and the transaction may be voided. The concept here is not mere compliance with a law requiring disclosure such as in the Banking Act, Article 41 but is an affirmative duty on the director or supervisor to act fairly as a matter of practice. To some extent, this is a moral concept and is likely to be reinforced through discussion at every level of the company. In general, a director/supervisor will keep his duty by recusing himself from involvement in decisions where he has an interest or where his judgment may be affected by relations with others having an interest. Procedures can be established to assess the fairness of any transaction by the board. The test here is what a disinterested director would conclude is fair to the company.

Bank regulators typically go farther by imposing additional limits on transactions with affiliates even where there is full disclosure and a disinterested vote.

Remedies

It is clear that under Article 32 of the Companies Act, the director/supervisor/auditor is personally liable for breaches of duties. There are administrative remedies available such as removal of the entire board by

the shareholders at the General Meeting. Article 44 of the Companies Act permits judicial review but it is unclear as to how effective this remedy would be in the current circumstances. A possible future remedy is a derivative action by shareholders which would allow them to force the board into a certain course after making a demand in accordance with the charter and company resolutions for breaches of duty. In the event of criminal wrongdoing there must be appropriate remedies and enforcement. This area represents an exception to our view that, despite its shortcomings, the existing banking and companies laws provide a framework upon which progress can be made soon. In reality, it appears to be not board members but middle and lower level managers who are most susceptible to criminal fraud and embezzlement. Board members need an effective criminal justice system to investigate matters referred to it by directors/supervisors in the course of their duties. The likelihood of detection (and subsequent punishment) is the best remedy for fraud.

Structural Bias

In Hungary, the structure of the banks is fundamentally sectoral i.e. their original objective was the financing of certain industries represented in their client portfolio. This objective can be inconsistent with good bank governance and the achievement of shareholder objectives such as making a profit. From our examination of bank lending and policies governing enforcement of security interests in collateral, it seems that there is a great reluctance to take the appropriate commercial decisions at both the management and the board level. In order to overcome structural bias, shareholders of banks must insist that the banks be run in accordance with commercially reasonable standards. To do that, operating policies must be put in place and they must be followed. Shareholders must select qualified, independent board members. Directors/supervisors must be acquainted with what is expected of them through the implementation of performance standards and the following of the bank's objectives, and if those expectations are not met, they should be replaced.

RECOMMENDATION

We recommend that each bank prepare a Mission Statement and operating policies which record its objectives and the means to achieve them. We recommend that all candidates being considered for appointment as directors/supervisors/auditors be acquainted with the duties expected of them in their particular role.

3: BOARD OF DIRECTORS: EXERCISE OF BUSINESS JUDGMENT

The standards of care described in the following sections are based on the view that there can be different expectations of directors and management, depending on their responsibilities in relation to the bank. For example, a director who is part of operating management might be held to a higher standard of care than an "outside" director who has no other connection with the bank. The management director has access to more information and, thus, may be held to a higher standard.

In Hungary there are three levels of responsibility:

- The supervisory board;
- The board of directors; and
- Operating management.

The supervisory board does not make operating decisions. It serves in more of an oversight capacity. Directors have policymaking responsibilities. Operating management is the closest to the bank's operations and consequently are the most knowledgeable.

All directors must:

- Make sure they understand the business; how does it work, what is the business and regulatory environment in which it operates;
- Be diligent;
- Attend meetings, read materials, ask questions, insist on explanations and be familiar with internal control systems and their results, as well as information received from outside auditors and internal control processes;
- Exercise independent judgment; and
- Be loyal to the bank's interests.

Duty of Care in a Decision Making Context

There is a distinction to be made in the duty of care as it applies to directors and to supervisory board members. Supervisory board members have a duty of care in a non decision making or oversight context. By contrast, directors

have a duty in a decision making context and a results oriented standard may measure their performance.

In the U.S. a director's duty of care is linked to the so-called "business judgment rule" which limits the liability of a director at law if he acts in good faith and with due care in a decision making capacity. Even if a director acts in a manner in which an ordinarily prudent person would not, he will still be protected. What matters here is whether the decision making process was in order. Here, the directors should take appropriate steps to inform themselves before coming to a decision. If they do this and follow due process at the board then their business decision will enjoy the protection of the business judgment rule. There are exceptions, of course. Egregious or irrational conduct may constitute a breach of good faith and thereby negate the protection.

Duty of Care in a Non Decision Making Context

This duty which would apply to supervisory board members in the Hungarian context, may be less than that which an ordinarily prudent person would reasonably be expected to exercise. In general, persons would only be found liable in a non decision making context upon an express abdication of responsibility or upon other obvious and prolonged failure to exercise oversight or supervision. From our observation, it seems that Supervisory Boards exercise their duties with some care in Hungary.

Elements of Business Judgment

The so called "business judgment rule" has three elements: that the director acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company. If the process employed in decision making allowed for these elements to be present then the rule may apply. This rule is often tested in hostile takeovers in the U.S. where management might be expected to lose their jobs. The other elements are:

a. Process Due Care

This may be defined as : did the director take appropriate steps to be informed before making the decision?

b. Subjective Good Faith

The action must be taken in the honest belief that it is in the best interests of the company.

c. Disinterest

A director seeking to rely on business judgment must be disinterested in the result e.g. no pecuniary or other interest for self dealing.

d. Independence

A director must be independent. This means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences which convert an otherwise valid business decision into a tainted act.

e. Waste

Business judgment does not include corporate waste. An example is where there is a gross disparity in value between what the corporation received and the consideration transferred. It would require a unanimous vote of shareholders to overcome the suggestion of waste in these circumstances.

f. Egregious Conduct

This may be defined as "so unwise or unreasonable conduct as to fall outside the bounds of the director's discretion".

g. Illegality

Board action that is illegal cannot be protected by a claim of the exercise of business judgment. Thus, an illegal act which directors themselves have agreed to undertake will make them liable.

h. Fraud

Again, if there is any evidence of fraud on the part of any director this will vitiate any protection which may exist on the grounds of exercising business judgment.

i. Ultra Vires Conduct

Similarly, if directors act beyond the powers or purposes of the company they cannot be exercising business judgment and will be liable.

j. Undue Influence

It is a fundamental principle that a fiduciary who is dominated by another, and who is therefore so lacking in independence that he cannot freely exercise judgment on behalf of the company cannot therefore be considered to be acting in subjective good faith.

Undue influence has two obvious contexts in Hungary. Firstly, the aforementioned close relationship between the bank and its sectoral borrowers. Evidence suggests that this influence is exercised chiefly at middle management (branch) level. However, it may taint the options which senior management and the board are given and thus have a profound effect on the decisions of the company. There is also the institutional connection between bank boards and borrowers which reflect the connected ownership of many major institutions in Hungary. Another example is the tendency towards the making of unqualified appointments to the boards of individual banks. Of necessity, such appointees bear a presumption of other influence which if exercised may prove damaging to the commercial interests of the bank and to its shareholders.

A second situation of undue influence has yet to arise in any major way. This would involve the influence exercised by the State Asset Holding Company (AV Rt.) in situations where it is the controlling but not sole shareholder. It may be that there will be conflicts between different shareholders, albethey in the state sector, and steps should be taken to ensure a disinterested review of any proposals which may fall in to this category.

RECOMMENDATION

Shareholders should agree on and set out the principles under which a bank will operate. Until the law is amended, shareholders can establish these principles (with remedies for violation being removal and personal liability). Each appointee to the Board of Directors should be made aware of the above principles, orally and in writing, and that adhering to them will be regarded as

a test of board effectiveness by the shareholder. Failure to adhere to the principles will be regarded as grounds for removal of directors. Supervisors should be acquainted with the principles so as to know what to look for by way of standards from members of the Board of Directors. In this case, they will be able to exercise their oversight function more effectively.

To assist the directors in understanding and meeting their obligations, they may wish to avail themselves of independent counsel as needed. In addition, a Directors' Institute could be established to provide directors with information and continuing education.

4: SUPERVISORY BOARD: COMPLIANCE & PERFORMANCE MEASUREMENT

This section addresses certain other duties which may be expected in an oversight or process context and may therefore serve as a performance measure for the effectiveness of Supervisory Boards.

Duty of Inquiry

In general, a director/supervisor has no duty to investigate except to the extent necessary to become informed before making a decision. This implies the absence of suspicious circumstances. Where there are indications of wrongdoing the presumption that directors/supervisors are entitled to rely on the honesty and integrity of their subordinates is overturned. Here, they will be under a duty of inquiry. In Hungary, certain indications of misappropriation of bank funds would seem to raise this duty especially for supervisors. The extent of the inquiry depends upon the seriousness of the problem and the resources available to the board. However, it may be that the duty would not be eliminated merely by saying that the board or other investigatory authorities lack the capacity to enquire effectively. If resources are available elsewhere, the board has a duty to employ them in pursuit of its legitimate inquiry.

Duty to Comply with Laws

Except as provided in the Companies and Banking Acts where there are certain affirmative duties, it is arguable that the duty of directors/supervisors is to refrain from knowingly causing or permitting the bank to violate any laws. This presupposes that directors/supervisors will have knowledge of the law. However, directors are for the most part not lawyers, and should not be expected to know the law in detail. What they do need to do is assure themselves that someone who does know the law is assuring the bank's compliance. To help meet this duty, directors/supervisors may wish to make use of independent counsel and independent auditors.

Compliance Programs

In Hungary, there has been no duty upon directors/supervisors to establish or maintain compliance programs. Where there is an internal control function in the bank, it is responsible to the supervisors. There are also compliance measures required by State Banking Supervision, although these requirements are quite limited. Provided that there is some form of acceptable internal review process, we do not feel that the development of compliance programs is an early priority with the exception of programs designed to detect and deter unlawful misappropriation of bank funds through client scams or illegal actions by bank employees.

Improved Quality of Information

A critical factor here is improving the quality of information available to supervisors in the oversight context and to directors in the decision making or business judgment context. This will be achieved following the upgrade of systems and the improved staff and management training in the banks.

RECOMMENDATION

We recommend that supervisors be acquainted with the aforementioned principles both orally and in writing prior to nomination at bank annual general meetings. In the alternative, directors should receive a full briefing about those principles after they are elected, but before they take office (or as soon as possible thereafter).

5: CONFLICTS OF INTEREST

Manager/Director/Supervisor Conflicts

The basic principle in defining conflict of interest is that duty must prevail over personal interests. A well run bank will have procedures for dealing with such conflict situations. In Hungary, certain transactions are governed by provisions of the Banking Act. These laws require a declaration of interest by directors or supervisors who retain a significant relationship with a bank customer or where they stand to personally profit from any deal. In certain cases a two thirds majority of the Board of Directors is required.

Self Dealing

We have observed differences in the procedures adopted by banks to deal with conflict and compensation issues. In one case, the Board of Directors and the Supervisory Board are the approving authority for the other's conflict transactions and compensation contracts. In another case, the Board concerned (chiefly, the Board of Directors as the executive body) adopts the proposed transaction. Some procedures require that the board record numbers of votes for and against a decision and do not require a quorum of disinterested directors to be present. In addition, there does not appear to be any requirement to name the directors voting for or against a particular action. There is a right for a board member in most instances to record his dissent in the minutes. As far as conflict transactions are concerned Article 290 of the Companies Act governs the activity of directors including rights of recovery for the company. This restricts the company's right of recovery to one year after the violation or three months after its discovery whichever is earlier.

In time, some attention needs to be paid to improving the civil right of recovery in conflict situations. In the meantime, managers, directors and supervisors should be acquainted with the principles behind conflicts of interest. One way to do this is to have each bank adopt its own code of conduct, together with operating procedures that specify how to deal with conflict situations.

Dominating Shareholder Transactions

This is an issue which may seem moot in the Hungarian context given that the state, directly or indirectly, owns the great majority of shares in the banks. However, there are large numbers of entities holding small numbers of shares. They enjoy considerable institutional independence and presumably, regard their investment as a balance sheet asset which will produce dividend income or is otherwise valuable. In the context of restructuring the state owned banks measures may be necessary which will have the effect of reducing or eliminating the investment of such shareholders. Care must be taken to ensure that each organ of the company in exercising its functions is acting in the best interests of the company and that it treats each class of shareholder fairly. Acting solely at the behest of the dominating stockholder will leave directors or supervisors open to liability claims.

Ratification

A very important part of the process for dealing with conflict transactions is ratification by disinterested directors after full disclosure of all relevant facts. This is why on the face of it, the idea that the Supervisory Board should approve all Board of Directors' conflicts and vice versa is appealing. Given the separate functions the likelihood of undue influence is lessened. It is easier for a board charged with a separate function to say no to a director than it is for his fellow directors to do so. Having said that, caution still needs to be taken to ensure that the consideration is by persons who are truly disinterested. In addition, the process should insist that approval can only take place if such disinterested directors constituting a majority also constitute sufficient numbers to meet other statutory requirements such as a quorum.

Judicial Review

It is worth bearing in mind that Article 44 of the Companies Act can be used as a tool in effective governance. This permits any shareholder to apply for judicial review of decisions of the company or any of its bodies that the shareholder believes violates the provisions of any law, the articles of association or the charter. In circumstances where the AV Rt. or other instrumentality's of the Government of Hungary are able to amend the articles of association it can impose appropriate standards of conduct on supervisors\ directors with the aid of the courts.

RECOMMENDATION

A Code of Conduct should be established for directors/supervisors/managers incorporating the following questions-

1. Has the transaction been authorized by a sufficient number of disinterested members to constitute action by the board where a quorum was present?

2. Has the attendance of an interested member been counted in ascertaining the presence of a quorum?

3. Has the transaction been authorized or ratified by the shareholders?

4. Was the interested member in a position to control or dominate the shareholders action?

5. Was the interested member's vote necessary to constitute such authorization of the action? For all actions, conflict or not, the minutes should reflect the text of the resolution, the discussion, the existence of supporting documents and the names of those voting for, against, abstaining or absent.

6. Has there been adequate disclosure of his conflicts to the directors, supervisors or shareholders prior to their actions?

7. Was the contract fair to the company? In other words, was the transaction on terms no less favorable to the company than could have been obtained from an unaffiliated third person?

6: SHAPE OF FUTURE BOARDS

Role of Boards in Corporate Governance

Corporate governance is a system for operating a corporation for the benefit of the owners (shareholders), and for establishing and maintaining accountability between all of the different players in the corporate structure. Shareholders hold the supervisory board accountable for its actions and, through the supervisory board, monitor and hold the board of directors accountable. They, in turn, hold management accountable. If a company is to be an efficient profit making enterprise good corporate governance is necessary. The certain knowledge of being subject to review improves responsibility and performance at every level of an organization. It is important to recognize that even in the two tier Hungarian system, the board of directors is at the core of effective corporate governance. They retain responsibility for executive action and make the decisions which will determine the bank's progress. [For test see Appendix I]

Role of Management & Management Information

Currently, directors and supervisors are heavily dependent on information provided by management. This is the case in any corporate environment. However, there are steps which will improve their ability to make decisions. An Audit Committee composed of non executive members of the Board of Directors and the Supervisory Board should be established to which the internal Auditor and the external auditors report directly.

Role of Corporate Directors & Supervisors

Boards of directors and supervisory boards should set the goals and objectives for the bank, select management that can carry out those goals and objectives, and, working with that management, establish internal operating policies. Consequently, boards should be composed of the most credible people available. For directors this means an understanding that their principal role is to evaluate the Chief Executive Officer, and if he is not performing to replace him in a timely manner. To be able to do this directors must have the necessary stature and lack of relationship to the CEO and the company to be believable. Conversely, the CEO should be urged to provide complete information, in a form that can be readily digested by the board.

In the Hungarian context this requires some reform of the way boards operate. Firstly, as presently constituted neither directors nor supervisors, with the possible exception of the President of the Supervisory Board, are in a position to be sufficiently independent of management. This lack of independence relates to the qualifications, experience, training of board members and their access to independent sources of information. Secondly, we have observed that bank boards receive volumes of information which would demand a great deal of time even from a full time board member. Furthermore, they are often asked not to approve a specific course of action but merely to adopt a report. Two reforms suggest themselves. One, each item for consideration by a board should be accompanied by an executive summary laying out the salient points. The accompanying material should be tabulated for easy reference. Two, the Board should be asked to adopt a clear resolution endorsing a proposed course of action, discussion upon which should be recorded as should the votes of individual members on the adoption of the proposal.

Selection of Supervisory Board Members

The factors determining an appointment to the Supervisory Board are not the same as those which come into play for a member of the Board of Directors. Supervisors' functions are essentially concerned with oversight and compliance. Those duties are laid out more fully in Chapter 4 of this paper. Their role is not one of management nor responsibility for management. Accordingly, the sort of things one looks for in a supervisor are the following:

- independence
- understanding of the role of supervisor
- honesty and integrity
- general knowledge of the bank's business
- willingness to back up board decisions.

Specialist qualifications are not as important for members of the Supervisory Board as for directors. Accordingly, certain occupations such as lawyers, auditors and accountants are generally valuable in an oversight context. However, any reasonable person who is independent of outside influences may prove to be a satisfactory supervisor.

Selection of Directors

In the case of directors the situation is different. They fall into two categories, executive and non executive or outside directors. Despite the distinction their liability as directors remains the same at law. In general, executive directors form part of the management and their role in the company should be defined by contracts negotiated by the company.

For an outside director the following should be borne in mind:

- he is not part of management
- he is present only for limited periods of time
- he usually has other substantial business responsibilities
- he is heavily dependent on management and auditors for information.

Bearing these points in mind, if we require outside directors to act as corporate policeman, we may impose on them duties that they lack the time and staff resources to perform well. It also runs the risk of drawing them deeper into management responsibility and may erode their independence. [Appendix II is a checklist of factors which apply to the appointment of board members.] Within these constraints it is in the shareholders' interest to have the best qualified directors. We understand a consulting firm is currently drawing up a list of potentially qualified directors for use in nominations at Annual General Meetings. The list is rated according to a points system which, we believe, rates training, experience and other factors. Although we have not seen this system we believe it represents a starting point for the appointment of effective directors.

Elements in the Appointment of Directors

The following items are relevant in the selection of outside directors for bank boards:

- independence
- commercial banking experience
- educational background
- judgment
- continuing professional education
- standing and character
- professional or business background

Identification of other factors and the relative weighting of particular skills needs to be assessed by professionally qualified human resource consultants.

Nominating Committee of the Board of Directors

A nominating committee could be established with the purpose of advising the shareholders at the general meeting as to the qualifications of any name to be proposed, and could help ensure that only qualified people are proposed as directors. It would be the function of the committee to apply the criteria outlined here and to make recommendations on that basis.

We are aware that AV Rt. as a major bank shareholder has drawn up certain performance indicators for the operation of boards of directors. It includes information which may be readily obtained within the constraints of current Hungarian accounting and banking practice.

Appointment of International Bankers as Directors or Advisors

In order to supplement the number of qualified persons available to serve as directors, with appropriate commercial or international experience, consideration should be given to the appointment of qualified foreign directors to sit on bank boards. Such persons would bring market orientation and banking experience and would provide a valid alternative voice to that of management. Their presence also could have the positive effect of inspiring other non-executive directors into a more active role on the board. In the alternative, the bank could appoint qualified foreign bankers as Advisory Board Members, who would attend board meetings with all rights of directors except the right to vote. They would also be available to advise management. As an example, we are aware of at least one bank in Poland that has a British banker on its board.

Role of Corporate Directors

We are aware that various government bodies including AV Rt. are corporately represented on a number of boards of directors. In some ways this seems logical for an owner. However, the potential disadvantage is the lack of institutional memory which a director *in personam* would bring to the deliberations of the board. This problem may be alleviated to some extent by sending the same corporate representative to each board meeting. On balance though, we recommend the appointment of qualified individual directors upon whose judgment the owner can rely. It is important to have directors

who are not only the "eyes and ears" of the owner, but who can make substantive contributions to the operation of the bank.

Role of Continuing Professional Education : Creation of an Institute of Directors

In many countries, professional people are required throughout their career to attend courses organized in their specialist field to ensure that they are up to date with current practice in the profession. In banks as well, directors are often given training to enable them to better carry out their responsibilities. We recommend that this be done with bank directors.

We also recommend the establishment of an Institute of Directors, membership in which would be required by owners in the selection of members of the board of directors and the supervisory board. The Institute would organize courses of short duration covering areas of importance for directors in carrying out their responsibilities. The Institute could also conduct refresher courses each year. Such an Institute need not be a large organization or an expensive undertaking. It could be staffed for the most part by part time or visiting experts, e.g. bank directors with international experience, experienced banking teachers and corporate law experts. Panels of directors could be organized for question and answer sessions with potential Hungarian directors.

For the new director this would involve periodic attendance at a continuing professional education seminar. The purpose of this training would be to acquaint directors with the duties of a bank director. It also would provide an opportunity to discuss the duties of directors who are experienced in commercial banking. Attendance at such a program would be among the criteria used by the nominating committee in recommending persons to be elected to the board of directors or the supervisory board at the Bank's general meeting.

Role of Shareholders

It is the responsibility of shareholders to ensure that proper steps are taken to appoint an effective board. This helps achieve the shareholders' objectives of corporate profit and the regulators' objectives of sound banking.

Role of Regulators

This is one area where substantial improvements can be made, which would support reforms in corporate governance. As we noted in our report "Hungary Financial Sector: Study of Preliminary Strategic Options", dated September 10, 1993, clear leadership is required from State Banking Supervision.

Typically, when a bank fails or is subject to a costly government rescue, a number of questions are asked in an attempt to assign responsibility, such as:

- Where was the board of directors?
- Where was the supervisory board?
- Where were the lawyers?
- Where were the auditors? and
- Where were the regulators?

This paper discusses and recommends a number of steps that shareholders can take towards good corporate governance of banks in Hungary within the existing system. In our view, those steps are necessary whether there exists a strong banking supervision authority or not.

However, at the same time, we believe that the limited role which SBS has given itself in the regulatory process poses risks to the integrity of the system. Its apparent excessive focus on "bank secrecy," combined with the paucity of useful information which it collects from banks, make its activities of limited value in good bank governance. The lack of regular and full scope on-site examination by SBS represents an important gap in the enforcement of law and regulation, and effectively leaves the entire burden for ensuring substantive compliance on the boards of directors and supervisors, who are not always well equipped to deal with such situations.

Elsewhere, we have recommended that SBS consider subcontracting on-site examination to qualified specialists whose fees would be paid by the bank being examined. We also recommend that the SBS expand its bank examination and reporting requirements so as to provide additional information which will assist in making the right decisions when it comes to restructuring the banks. This may include loan classification. Should SBS decide not to do this, Boards of Directors would be wise to consider this option themselves. Again, the need for clear leadership should be stressed.

RECOMMENDATION

A mechanism should be established to coordinate the implementation of the factors mentioned here, the performance measurement criteria in the next chapter and the development of a list of persons who are qualified to be directors. This would involve selection, assessment, qualifications and training for supervisors and directors as appropriate. Its aim would be to bring persons elected to board membership up to speed in a short period of time. It should also involve monitoring of individual director performance.

7: PERFORMANCE MEASUREMENT CRITERIA

There are many ways to define and measure the "performance" of a bank or other enterprise. The appropriate way depends on the role and objectives of the observer. In this section, we discuss the types of information that would be appropriate to measure performance:

o from the perspective of an owner of shares (as an investor seeking to maximize his total return by means of adjusting his financial exposure), and

o from the perspective of a control owner (one whose shareholding is fixed by market conditions or by statute (e.g., the AV Rt.) who is motivated to exercise, and has the possibility of exercising, direct influence over management).

We take the view that an owner in either capacity could reasonably judge performance on the basis of a combination of (i) standard objective indicators (such as financial ratios) applicable to all banks, and (ii) customized indicators applicable to each bank separately. At the same time, in this discussion we propose that the former are more useful to an owner/investor, while the latter are more appropriate for a control owner. At this time, of course, the AV Rt. fits more closely the category of control owner.

Application of Standardized Objective Financial Ratios to Assess Bank Performance

An owner of/investor in bank shares is interested in a bank's condition and performance for different reasons than is a bank supervisor (as maker and enforcer of prudential rules) or a central bank (as lender of last resort and overseer of the payments system). It is not the role of the owner/investor to act as the state's policeman, nor is it his responsibility to provide emergency liquidity support. (This does not mean that a bank's board should not take responsibility for legal compliance and risk management.) Because the owner's interests are different, his information needs are different.

Briefly stated, the owner's interest is to monitor his investment for the purpose of making decisions about how to improve his expected return (which also can mean, minimize his loss) on that investment. An

owner/investor needs information which will permit him to make investment decisions:

1. How much and in what form is he invested (common stock, preferred stock, debt)?

2. What are his actual and target total returns (absolute and relative to alternatives)? This basically requires knowing weighted average cost of shares (in the case of the AV Rt., this likely is initial book value), past and expected share price performance (including indicia of liquidity, eventual privatization sale price), and actual and expected dividends.

3. How is the bank performing, and what is its condition, relative to expectations about that bank, the industry as a whole, and alternative investments?

4. What events are on the horizon which could affect his return expectations (e.g., new share issuance, change in ownership, loan consolidation, revisions to tax law, change in market interest rates, share demand-creation schemes)?

5. What steps can he take (e.g., buy more shares, hold, sell, buy/sell options) to improve his expected return?

Until such time as there develops an active market in bank shares, the focus must be on monitoring the financial condition and performance of the bank as the only available information, both "as reported" by the bank according to accounting standards, and as may be adjusted by the owner/investor.

As a general point, we note the following about the type and form of information an owner/investor ought to collect for the purpose of monitoring the bank's condition and performance:

- In collecting data for the purpose of monitoring financial performance, the law of diminishing marginal returns applies. There is little incremental value in collecting dozens of financial ratios when a smaller number will provide effectively as much information.

- At the same time, such information can quickly lose value by becoming "stale," so it is important to receive that information in a timely manner and with some reasonable frequency, normally quarterly (most

information can be expressed in annualized terms).

- That information should be comprehensive, covering earnings, capital adequacy, asset quality, liquidity, etc.

- Later, once trading in bank shares becomes common, it will be necessary to shift focus from performance as measured by accounting rules, to performance as measured by market information. We reserve discussion of the latter since there is as yet no market activity to observe (except perhaps as expressed in a bank's cost of uninsured funds).

- Current period information for each bank should be compared against its own seasonally-adjusted past performance (time series) to provide information on trends. It also should be compared against the performance of other, similarly-situated banks (cross section) to provide an industry benchmark. For the time being, the latter should be composed only of domestic banks, with information based on international benchmarks included as a "compass."

- Care should be taken to ensure period-to-period and cross-sectional comparability of data, for example by making adjustments as accounting practices change (e.g., bank-only vs. consolidated), as mergers or spin-offs occur, to reflect the effects of inflation (where applicable), etc.

Keeping in mind these general points, we would suggest that the following types of information would meet current needs:

a. Earnings

- Net interest income/Net interest margin. Purpose: To track the efficiency with which the bank intermediates funds. Form: Expressed in absolute amounts, and relative to a common denominator such as average total assets (ratios). It is essential that, in calculating these figures, adjustments be made to ensure that no interest income is being recognized on loans or other assets where timely payment of interest is in doubt.

- Non interest income. Purpose: To track the bank's success in providing non credit services. Form: Absolute, and relative to average total assets. Loan fees should be adjusted so that they are recognized over the life of the loan.

- Non interest expense. Purpose: To track the ability of the bank to control regular expenses. Form: Absolute, and relative to average total assets.

- Extraordinary income and expense. Purpose: To record unusual events such as loan consolidation. Form: Absolute, and relative to average total assets.

- Net income. Form: Absolute, and relative to (i) average total assets, and to (ii) shareholders' equity outstanding at the beginning of the measurement period.

- Net income per share. Form: Absolute, based on shares outstanding, and fully diluted.

b. Capital

- Common equity and total shareholders' equity. Form: Relative to period-end total assets.

- Risk-based capital. Form: Tier 1, Tier 2, and Total, relative to period-end risk-weighted assets and includable off-balance sheet items (following Bank for International Settlements guidelines, or as adopted by SBS).

- Internal capital generation rate. Purpose: Tracks capacity of bank to generate and retain capital to support future growth without calling on potentially-dilutive new share issues. Form: Expressed as (i) return on shareholders' equity (net income as a percentage of shareholders' equity at the beginning of the year), multiplied by (ii) the earnings retention rate (percentage of net income retained after dividends).

- Adjusted common equity. Period-end common equity, minus the sum of (i) any statutory valuation reserve deficiency, plus (ii) any unrealized losses as may be reasonably estimated by the owner/investor. Expressed as absolute amount, and relative to period-end total assets.

c. Asset Quality

- Portfolio Concentration Indicator. Purpose: Tracks systematic risk that the bank should be consider reducing through diversification of borrowers/industries. Form: Sum of (i) the aggregate exposure of the bank to (a) borrowers which exceed, say, 10 percent of shareholders'

equity, and to (b) industries which exceed, say, 100 percent of shareholders' equity, divided by (ii) total shareholders' equity.

- Non performing assets and "Watch List" assets. Form: Absolute, and relative to average total assets.

- Classified (qualified) loans and other assets. Form: Absolute, and relative to shareholders' equity.

- Risk-weighted classified assets (e.g., the sum of 20 percent of Substandard, 50 percent of Doubtful, and 100 percent of Bad/Loss). Form: Absolute, and relative to shareholders' equity.

- Reserve adequacy. Form: Valuation reserves relative to (i) statutory requirement and (ii) the sum of weighted classified assets plus 2 percent of unclassified assets. Also calculate any shortage, and compare against (i) current period earnings and (ii) period-end common equity.

d. Liquidity

- Net purchased funds. Form: Short term liabilities (excluding insured deposits) minus short term assets (those which can be liquidated immediately at face value). Absolute, and relative to net assets (total assets minus short term assets).

- Unused funding capacity. Form: Total tested market capacity relative to outstanding bank obligations.

e. Share/Debt Performance (if applicable)

- Book value per share. Form: Book value of common equity relative to number of shares outstanding, and also only a fully diluted basis.

- Market price per share. Note: Discount recent sales if the market is illiquid (e.g., large bid-ask spreads, low turnover)

- Market value of bank's own debt. Form: In the absence of such data, use Debt rating, or proxy assigned by owner/investor based on rating agency or other methodology. If the bank's debt trades at a large discount to face, the shares may be worthless.

Bank-Specific Performance: Adherence to Business Plan

While such standardized objective indicators of performance are important, from the perspective of a control owner it is more important to establish and monitor performance against goals customized to each bank. Certainly, for purposes of performance based compensation schemes, the greatest weight should be given to performance against the approved business plan. A business plan is bank-specific, and includes both quantitative and qualitative targets. A good business plan will include only targets which are reasonably achievable for the particular bank at that particular time.

Having said that, there is no reason why a business plan should not include some of the performance indicators discussed above. For example, through an approved business plan, a board could establish as a management goal to reduce overhead costs to the industry average, where that average is expressed in the form of a standardized ratio.

Examples of such performance measurement criteria which can be made part of an approved business plan follow.

o For the CEO:

Earnings targets, which normally would be to meet or exceed rates of return earned by competing institutions, since that is an important determinant of future growth. However, we note that, in the current environment, those targets can be to reduce losses, rather than to make profits. Earnings can be expressed also as earnings per share and growth rate in earnings per share. Other indicators are growth rate of dividends, change in stock price, etc. Other criteria might include achieving and maintaining a high level of regulatory compliance, as reflected in SBS reports, and demonstrated responsiveness to regulatory criticisms.

o For a business unit:

Goals should be equally specific, but based to a greater degree on the performance of the individual unit. For particular units these might include:

o For Credit

Asset quality targets, such as reducing qualified assets by some amount/percent within a given time frame, reducing the portfolio concentration indicator by some amount, reducing the inflow of new qualified assets, achieving a given collection/recovery rate on problem assets, etc.

o For Treasury

Asset/liability management goals (e.g., reduce "income at risk" posed by interest rate risk from the current figure to a reduced figure). Trading goals (e.g., trading profits achieved without violating risk limits). Can also use spread income and margin goals.

o For Internal Control

Success in meeting annual audit plan as set forth by the supervisory board. Maintenance of current knowledge and skills through training. Low error rate in back office. Low incidence of fraud.

o For Automation

Introduction of new MIS according to budget plan (this is an example of a goal that explicitly recognizes that some essential activities involve upfront costs that are really investments which will yield lower costs in the future).

In sum, the board should use as its benchmark the approved business plan/budget. In that plan, overall corporate goals and objectives should be the responsibility of the CEO, and business unit-level goals and objectives should be the responsibility of the unit heads.

Performance Related Compensation Schemes

From our observation of compensation practices in Hungarian banks we note that although bonuses exist they do so in name only; these are a common feature of compensation for all senior management because of their tax advantaged status. They are not awarded on a discretionary basis having regard to an individual's job performance.

Of course, any performance based compensation scheme presupposes the

existence of an acceptable performance evaluation system. This in turn presupposes the existence of information systems capable of tracking individual or business unit/profit center performance, according to pre-established cost and revenue allocation rules. Those rules must address such topics as:

- What is the appropriate performance evaluation period (e.g., one quarter, one year, two years), which may vary as a function of the individual or business unit's activities. For example, a trader might receive a bonus once a year because most of his positions are closed out, and the profit and loss recognized, within one year. In contrast, a lending officer should not receive a bonus simply for making new loans; he should be rewarded for that loan only once that loan has been "seasoned" -- demonstrated to be a good loan -- which may take two years or so. For the CEO, who must make decisions which in the short run are costly -- "investments" which may lower reported profits today but are expected to produce lower costs/higher profits in the future -- the appropriate time frame may be longer still.

- How should (direct and overhead) costs and revenues be allocated among the units? This is particularly difficult with respect to "staff" functions such as legal, economics, internal control, etc., which on the surface generate only costs and no revenues, and properly understood no less difficult for "line" functions such as credit and treasury, which appear to generate most of the revenues.

- What other performance indicators are appropriate, in particular what weight should be given to "soft" qualitative performance indicators which might be worth rewarding, such as low staff turnover (high turnover is costly to the bank), dedication to training (reduces the risk that the staff will make mistakes), or good marks on internal control reviews (noncompliance with policies and procedures may indicate higher risk).

It is possible that the banks will not be able to reach internal consensus on these issues for some time; measuring and rewarding one's contribution or "worth" to an organization is obviously more than a simple technical exercise. In any case, the current underdeveloped state of information systems will permit only the most crude performance evaluation system to be put in place in the short run. As these challenges are met, performance evaluations and performance based compensation can become sharper tools, and therefore more effective in rewarding or punishing behavior.

Separate from the question of how to measure performance is the question of the form in which compensation is to be made. At present, those options are limited in Hungary. Ideally, management should participate in a bonus scheme as if they were owners of the bank's shares. In other words, rather than reward them exclusively with additional cash (an expense item which arguably reduces the amount of dividends payable to shareholders), the scheme should be payable at least partly in, for example, (i) (newly-issued) shares, (ii) bargain options to purchase shares in the market at a price equal to, say, 110% of the average trade price over the 12 months prior to taking office, or (iii) in cash where the amount of cash is a function of the increase over time in the shareholders' total return (roughly defined as the sum of share price appreciation plus dividends paid).

Of course, at present, there is either no active trading, or no trading whatsoever, in bank shares, so in the short run performance based compensation can be paid only in cash.

RECOMMENDATION

Therefore, we would recommend that the board of directors, or the control owner acting through the board, establish annually through the business plan reasonably-achievable quantitative and qualitative goals for the bank's overall performance (e.g., earnings, earnings growth rate), and separately for the key business units, and base performance compensation on those goals. Those goals should be a combination of the internal targets (business plan) and external targets (the bank's performance relative to all banks, as measured by standardized ratios). Base compensation should be sufficient to attract and retain qualified staff (having reference to what competitors offer), with material potential additional compensation based on these pre-determined internal and external goals, as set forth in the board-approved business plan.

At a later stage of reorganization and market development it may be possible to establish a stable share price for bank stock. In an efficient market, the stock price captures and reflects all available information about the bank's past and expected future condition and performance, and clearly is the proper point of reference for rewarding senior management, arguably far superior to any complicated system of formulas based on attributed value-added. Awards would take the form of, for example, bank stock and/or options on bank stock, or cash compensation based on the total return on the bank's stock during a defined period.

In the short run, there is little alternative to simply paying cash, with awards based on success or failure in meeting the goals in the business plan. A fixed compensation pool equal to, say, 20% of the total annual compensation of the senior management as defined could be set aside for wholly discretionary payments to eligible officers who assist in meeting the performance criteria outlined above. The responsibility for awarding performance related pay should be given to the Compensation Committee of the Board of Directors. That committee should be composed exclusively of outside directors. In particular:

- The Committee acting independently should award the compensation to be received by the Chief Executive Officer, which in the short run should be based largely on the performance of the bank relative to the overall bank goals set forth in the approved business plan.

- In consultation with the CEO, the Committee should decide on the awards to other senior management, where the allocation of that portion of the pool would be based primarily on the performance of their business units relative to their approved budgets and other approved management goals and objectives, and to a lesser extent on the overall bank goals.

While the entire pool would be available to the Compensation Committee, it would be under no requirement to make any payment at all if performance did not justify it. The pool should be viewed as shareholder money, to be awarded to key management if, and in proportion to, their perceived contribution to producing that value for the shareholders.

The Committee may award the pool as it sees fit. If only one officer performed adequately, the committee could award all or part of the pool to that person. There would be no established differentials with respect to performance related compensation.

8: SUMMARY OF RECOMMENDATIONS IN FORM OF DRAFT RESOLUTION

Text to be considered by Bank General Meetings

"A proposal to adopt a policy (and/or amend the Articles of association or by-laws) to improve corporate governance within the Bank.

The meeting hereby adopts the following statements, codes of practice or conduct:

- The Mission Statement of the Bank {outlines the objectives of the bank, drawn from principles in Chapter 2}
- Statement of the Duties of Members of the Board of Directors and the Exercise of Business Judgment. It shall be required that each nominee for appointment as a director shall understand the duties and undertake to apply them in board deliberations. {Duties as enumerated in Chapter 3}
- Statement of the Duties of Members of the Supervisory Board. {Duties as enumerated in Chapter 4}
- Code of Conduct for Transactions Involving Conflicts of Interest. {Code questions as outlined in Chapter 5}
- Statement of Qualification Criteria for Membership of the Board of Directors. {Appointment of Nominating Committee, Details of Criteria, Application as in Chapter 6}
- Statement of Requirements for Continuing Professional Education of Directors. {As provided in Chapter 6}
- Statement of Performance Measurement Standards and Performance Related Compensation for Senior Officers. {As provided in Chapter 7}"

The actual text of the resolution will have to be prepared by appropriately qualified Hungarian personnel who can advise on the particular requirements of the bank charter, articles of association or by-laws.

APPENDIX I

CHECKLIST FOR ASSESSMENT OF BOARD PERFORMANCE

Currently, management experts in the U.S. are examining the credibility of board performance. Arising out of this is a checklist based upon questions answered by the Chief Executive Officer. These questions and answers will provide a useful guide for shareholders in assessing the performance of the board.

1. If you had a choice, would you even have a board? Would it include the same directors you have now?

2. Is your board strong enough to say "no" to you?

3. If you were suddenly unable to serve (due to death, incapacity, or other causes), is your board sufficiently informed to pick your successor?

4. Do you and your officers listen more than talk before your board?

5. Have you taught the board members enough about the bank and the industry so that they can be thoughtful critics of your business strategy?

6. Do your directors know how to evaluate your performance?

7. Are your compensation, nominating and auditing structures independent?

8. Do you seek board advice and counsel before making important decisions?

9. Do you keep your board informed about significant differences of opinion within your management team?

10. Would an outside observer of a board meeting conclude that you were a corporate employee performing under the independent oversight of your board?

These questions embody the principles which lead to good corporate governance. In general, it is a good idea for the board to be able to evaluate and to remove the CEO where necessary. To do this it may need to establish procedures, including the appointment of one of their number to be the person, where necessary, to convene the board in times of crisis. The Hungarian system offers a possible role here for the President of the Supervisory Board who also attends Board of Directors meetings. Boards should also ensure that adequate information is provided to major shareholders whether or not management does so adequately.

{A note on sources. This checklist is based upon material which appears in an article by Ira M. Millstein, The Evolution of the Certifying Board, The Business Lawyer, August 1993, Volume 48, Number 4}

APPENDIX II

CHECKLIST FOR BOARD MEMBERS IN EXERCISING THEIR DUTIES

The following points are ones which should be considered by any potential appointee as a director of a bank.

1. Do not accept a directorship unless you have the time to do the work.

2. Understand the company's business. Nothing is more dangerous to a bank than a board of directors that does not understand the complexity of the operation and its risks. Know and understand the bank's basic business strategies and make certain the board has a process for assessing progress along the charted course, and for managing risks.

3. Nothing is more important than selecting good management and assessing their performance. Directors are often on a board because of a relationship with a senior officer or a major shareholder, or because of their other connections. Deference to such loyalties is no substitute for hardheaded assessment of management's competence.

4. Be wary of business transactions with the company. A director is entitled to significant compensation for participating on the board. That compensation should be explicit and not in the form of special business favors. Do business with the company only on arm's length terms and make certain that the company has policies and procedures that require the other directors and senior officers to do the same.

5. Participate. Look, listen, ask and speak. Ask for information, read what you receive, and then ask the questions that occur to you. Listen to and respond to your fellow directors. Write as well as talk. Make sure that directors' decisions are well documented. If you want to write down the reason for a decision, you need to consider whether the decision is the right one.

6. Pay attention to auditors and lawyers who are paid to provide information and advice. They may not always be right and it may be a good business decision to reject their advice. The board should have an understandable reason for rejecting professional advice. It is important to document those decisions while preserving appropriate confidentiality.

7. Pay attention to regulatory criticism. Challenge management either to cure the basis of the criticism or to provide a cogent explanation of the regulator's errors. Regulators are not always right.

8. Be alert to signs of serious trouble - financial, operational or personnel trouble. In such circumstances, outside directors need to have the greatest concern about their own responsibilities for overseeing and changing management.

9. Have insurance or a meaningful indemnity arrangement.

10. From time to time, evaluate the board's processes and look for ways to improve them.

11. Be informed about the laws and regulations to which the bank is subject. Stay informed. Make sure management has a process in place for insuring compliance.

APPENDIX III

USAID PHASE 1B TERMS OF REFERENCE

M E M O R A N D U M

DATE: October 20, 1993

TO: Richard Burns

CC: David Cowles, Mitzi Likar, William Dewey, Louis Stettler

FROM: Alexandra Hendrickson, Office of the AIDREP

SUBJECT: Terms of Reference for "Hungarian Redeployment of Financial Assets: Restructuring and Privatization, Phase 1B."

The purpose of this memo is to describe the second assignment for KPMG under its contract to provide policy advice on financial sector reform to the Government of Hungary. Under this contract, "Hungarian Redeployment of Financial Assets: Restructuring and Privatization, Phase 1B," terms of reference are assigned based on on-going direction given by the client, the Bank Privatization Work Group, an interagency body of Hungarian officials charged with executing tasks to expedite the privatization of the state-owned Hungarian banks.

Under the contract, the Bank Privatization Work Group delineates the terms of reference for KPMG including defining the subject and contents of the deliverables. The U.S. Treasury Advisor who represents the Minister of Privatization in the Work Group, Bill Dewey, serves as the conduit for the terms of reference. He submits them to OAR Budapest for our approval and we communicate them to you in AID/Washington.

The World Bank on its latest mission, stated that establishing guidelines for bank corporate governance was a key condition for extending an EFSAL to the GOH. The Bank Privatization Work Group delegated responsibility to the State Asset Holding Company (the AVRt.) for setting standards for corporate governance. Therefore KPMG will execute these terms of reference jointly for the AVRt. and the Bank Privatization Work Group. Both parties think that this is appropriate work for KPMG and will draw on the firm's strengths.

For your information, the contract was effective July 1. It was originally budgeted at $250,000 and has about $160,000 in work left under it after KPMG's trip out here in September to work on bank regulatory issues. It runs through February 1.

TERMS OF REFERENCE: BANK CORPORATE GOVERNANCE

Participants in the dialogue on financial sector reform in Hungary have consistently identified improved governance in the banks as a crucial component of the reform process. There is universal agreement that privatization of the banks is the ultimate solution to this requirement. The debilitated financial condition of the

banks suggests that the introduction of effective ownership supervision cannot wait until the banks are privatized. Rather this process must begin now with the stringent supervision of weaker institutions and radical changes in the governance structures of the banks system-wide.

Efforts to reform governance structures should be concentrated in two areas:

a. **Development of Performance Measurement Criteria:** Currently executive managements are not subject to specific criteria by which their performance is evaluated by the owner.

i. It is first necessary to define specific (quantitative) criteria for evaluating management's performance and how they are derived from an overall corporate strategic plan.

ii. New compensation schemes which link remuneration to achievement of financial and other management goals cited in the plans as well as progress towards privatization should be developed and put in place. (For example, this could be done through a system of cash bonuses, profit sharing and stock options linked with privatization.)

iii. Additional measures to ensure that the supervisory boards monitor management's performance should also be established.

b. **Upgrading the Supervisory Boards:** When the banks are privatized, private owners will assure that they operate in a prudent and commercially motivated manner. In the meantime, or until the banks are fully privatized, the state owner must be able to delegate responsibility for this function to the boards. To date, however, supervisory boards have not acted on behalf of the owner either to establish performance goals or to assure adherence to sound banking practices. This can only occur when the board is empowered to compensate and retain or dismiss management in accordance with clearly established performance criteria as described above.

In order to upgrade the supervisory boards, the role of the supervisory board members or the members of the board of directors should be redefined in the following areas:

Board Membership: The owner must be ensure that the composition of the supervisory boards reflect a level of experience and technical competence which is missing today. In order to address this, develop and recommend steps for the selection, roles and liability of board members who are experienced in banking or bank regulation in market based systems.

Develop a Culture of Accountability: Prepare draft criteria setting forth the revised roles and liabilities for board members in the light of laws governing board functions. If existing law is inadequate, revisions should be recommended in

order to ensure that board members acknowledge personal liability for willful misconduct and gross negligence in the performance of their duties.

The efforts described above should be keyed to the roles and responsibilities set forth in the general provisions of the draft Bank Recapitalization Agreements, currently being developed as part of the 1993 Bank Recapitalization and Loan Consolidation Plan, especially those provisions relating to performance by the owners, boards of directors and management.

DELIVERABLES

KPMG will provide the deliverables set out in Article IV of the current contract, including providing technical reports, documents and presentations written to meet the recommendations required in these terms of reference and as directed by the Bank Privatization Work Group and the AVRt.

TIMING

The AVRt. has requested that the work begin as soon as is practical.

Please let me know if you have any questions about this assignment. If the terms of reference seem acceptable to you, one of us should give KPMG the go-ahead to proceed with the work. Don Billings is the project manager for this contract and Ed Nolan is his back up if he is not available. Thank you for your help on this.

u:\aidrep\memos\torkpmgr.akh