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TECHNICAL ASSISTANCE REPORT—OPERATIONAL ASPECTS OF ESTABLISHING AN ASSET MANAGEMENT COMPANY

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TECHNICAL ASSISTANCE REPORT

OPERATIONAL ASPECTS OF ESTABLISHING AN ASSET MANAGEMENT COMPANY

Atilla Arda (MCM, Mission Chief) and Arne Berggren (Short-Term Expert)

July 2015

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PREFACE

At the request of the Magyar Nemzeti Bank (MNB), a technical assistance (TA) mission from the Monetary and Capital Markets Department (MCM) of the International Monetary Fund (IMF) visited Budapest during June 2–4, 2015 to assist the MNB in further developing an operational framework for a recently created asset management company (AMC), the Magyar Reorganizációs és Követeléskezelő (MARK).[1] This mission followed one that was fielded during January 14–16, 2015

In carrying out its work, the mission met with Dr. Ádám Balog, MNB Deputy Governor; Dr. Csaba Kandrács, Chief Executive Officer of MARK; Mr. Márton Nagy and Mr. Dániel Palotai, both Executive Directors at the MNB; Mr. Gergely Fábián, Director at the MNB; and other MARK and MNB managers and staff.

The mission's main findings and recommendations were presented at a concluding meeting with Mr. Márton Nagy, Mr. Gergely Fábián, and officials of MARK, and were further elaborated in an aide-mémoire. Following further review at the MNB, MARK, and IMF headquarters, this finalized technical assistance report will be sent to the MNB and MARK.

The mission would like to express its gratitude to Mr. Gergely Fábián, Dr. Csaba Kandrács, and staffs of the MNB and MARK for their hospitality and for the fruitful discussions that underpin the mission's work, which greatly facilitated the work.

[1] The mission comprised Messrs. Atilla Arda (MCM, mission chief) and Arne Berggren (short-term expert).

Table 1. Hungary: Key Recommendations June 2015 Mission

Topic/Recommendation	Priority	Timeframe
Attract one or two international professional equity partners to bring MARK closer to the preferred private ownership model.	High	Near-term
Finance MARK's operations with bonds issued by MARK.	High	Start of operations
Ensure case-by-case valuations reflecting the characteristics of the assets without relying too much on average values on certain parameters.	High	Start of operations
Ensure that work processes create value for individual assets and improve the liquidity of its portfolio, including through clear 'deal flows.'	High	Start of operations
Restrict the powers of MARK's owner(s) (i) to formulate the mission statement and set the long-term objectives; and (ii) to appoint the Supervisory Board and the Board of Directors.	High	Immediate
Establish MARK's Board of Directors as its primary decision-making body to set policies and procedures, determine MARK's risk appetite, and appoint and hold accountable its executives (in particular, the Chief Executive Officer).	High	Immediate
Appoint to MARK's Board of Directors exclusively independent members (that is, members unrelated to MARK's owners) with backgrounds relevant to MARK's business (including real estate and distressed debt management) and the Board's responsibilities (audit, oversight, and risk management); alternatively, ensure that a majority of the Board members is independent and knowledgeable.	High	Immediate
Establish an Audit (& Compliance) Committee and a Remuneration Committee, and possibly also a Corporate Governance/Nomination Committee and an Investment/Credit Committee at the Board of Directors level.	High	Start of operations
Establish reporting lines to the Boards for the Audit Committee and the compliance function; and reporting lines to the Audit Committee for Internal Audit.	High	Start of operations
Include in MARK's by-laws, limited, objective grounds for dismissal for all members of the Supervisory Board and the Board of Directors, and the Chief Executive Officer.	High	Near-term
Establish a remuneration and compensation package that attracts qualified staff and rewards closing deals (that is, successful divestments).	High	Start of operations
Ensure that liability and legal representation insurances for MARK officials and staff in case of actions in good faith are adequate as to substance (that is, liability and legal representation) and the financial coverage (relative to possible liability claims and cost of legal representation).	High	Immediate

Table 2. Hungary: Summary of Progress January 2015 Recommendations

Topic/ Recommendation January 2015	Priority	Timeframe	Progress June 2015
Develop a clear mission statement focused on: - MNB's broad policy objective; - MARK-specific mandate to buy assets of specified nature with sole objective of maximizing value; - Mission to restructure and divest assets within maximum of 10 years; - Initial ownership and funding from MNB, not precluding private investment in future; - Aim to achieve a market-referenced long-term rate of return for the shareholder; and - MARK will operate entirely on commercial principles, meeting the highest international standards of business conduct and integrity.	High	Near-term	Agreed and ongoing
MNB to fully delegate asset management functions and operational decisions to MARK.	High	Immediate/start of operations	Agreed and ongoing
Ensure that no obstacles exist to sale of shares or private funding of MARK.	High	Near-term	Agreed, to be implemented
Establish a governance structure enabling MARK to meet its objectives and manage distressed assets without interference in business decisions.	High	Near-term	Agreed and ongoing
Reconsider the composition of MARK's Supervisory Board and Board of Directors to include a majority of well-qualified Directors without roles in MNB.	High	By start of operations	Under consideration
Separate the roles of Chairman of the Board of Directors and Chief Executive Officer, making the Chairman a non-Executive Director.	Medium	By start of operations	Under consideration
Consider refinancing with market-based funding or share sales in MARK.	Medium	Once positive cash flows established	Agreed, to be implemented

Hungary: Summary of Progress January 2015 Recommendations (concluded)

Topic/ Recommendation January 2015	Priority	Timeframe	Progress June 2015
Adjust the maturity structure and currency composition of MARK liabilities to mirror expected cash flows.	High	After internal evaluation of acquired assets	Agreed, to be implemented
Ensure adequate equity funding to absorb valuation adjustment and operating losses in initial years of operation.	High	Near-term	Agreed, to be implemented
Sale of assets to MARK should be voluntary on the part of the banks.	High	Continuous (policy is in place)	Agreed and implemented
MARK to offer prices consistent with an expectation of making a reasonable rate of return for its shareholder.	High	Near-term (policy under development)	Agreed, to be implemented
Develop criteria for internal valuation of real estate.	High	Near-term	Agreed and ongoing
Undertake an asset-by-asset valuation exercise in the first months of operations, and prepare a starting balance sheet reflecting these.	High	Start of operations	Agreed and ongoing
Put in place procedures enabling regular updating of valuations as new market information becomes available.	High	Medium-term	Agreed and ongoing
Consider seeking exceptional powers enabling MARK to circumvent delays in legal framework.	Low	Near-term	Disagreed
Develop remuneration policies for staff consistent with commercial focus and finite life of operations.	High	Medium-term	Agreed and ongoing
Consider legal protections for staff.	High	Before operations start	Agreed, to be implemented

I. Introduction

1. **In November 2014, the Magyar Nemzeti Bank (MNB) established the Magyar Reorganizációs és Követeléskezelő (MARK), an asset management company (AMC).** This was done to help restore monetary transmission, credit growth, and economic recovery. MARK is expected to remove the overhang of commercial real estate nonperforming loans (NPLs) from banks' balance sheets—freeing up capital and management time, and restoring the banks' capacity to make new loans. These NPLs stood at 27 percent at end-2014. The MNB considers banks solvent and generally well provisioned. It cites (a) reluctance to sell foreclosed collateral at low prices into a not effectively operating commercial real estate market and (b) inefficient foreclosure and insolvency processes, as the principal reasons why NPLs are not written off. MARK will buy commercial real estate loans and foreclosed collateral from the banks on the basis of voluntary sales.

2. **The MNB has established MARK on a sound foundation: banks' participation is voluntary, market prices determine valuations, and MARK's lifetime is 10 years.** It has a target of HUF 300 billion purchase value (US$1.2 billion, 1.3 percent of GDP) compared to a potential portfolio estimated to have a book value of HUF 800 billion. Purchasable loans must be secured by real estate and be underperforming (e.g., nonperforming loans) and minimum size limits on individual transactions apply. The latter implies relatively few loans (<500) are expected to account for the bulk of transactions. Discussions between the MNB and European regional institutions on the role and functions of MARK are ongoing.

3. **This provides a good basis for MARK to shape a sales pitch based on strategy and governance that will further improve MARK's credibility, marketability, and profitability.** This will require a clear strategy aimed at value creation and a governance structure that is consistent with best international practices. MARK's strategy comprises a clear mandate, an ambitious return on equity (ROE), a sound funding structure, a valuation methodology based on market prices, and work processes that create value for individual assets and improve the liquidity of MARK's portfolio. Its governance structure should limit MNB's role and provide MARK's directors and executives with a high degree of operational autonomy. Attracting from the outset one or two international professional investors would strengthen MARK's credibility and support both its strategy and governance structure.

4. **This aide-mémoire should be read in conjunction with the report of the January 2015 mission.**[2] This aide-mémoire is therefore brief, focuses on the authorities' progress in implementing the recommendations of the January mission, and elaborates on those recommendations in light of the progress made so far.

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[2] https://www.imf.org/external/pubs/ft/scr/2015/cr1599.pdf

II. Strategy

5. **MARK has a clear, well-defined mandate to focus on maximizing the value of its assets.** This is supported by an ambitious return on equity and a valuation methodology based on market prices. This will help to (i) establish clear criteria to measure the success of MARK, its management, and staff; (ii) insulate MARK and the MNB from political and interest groups' pressures; (iii) minimize financial risks for the public sector; (iv) provide clear direction for MARK's policies on sale or retention of assets, valuation, and restructuring, etc.; (v) provide a commercial focus and market-based incentive packages to attract staff with the right skills; and (vi) establish MARK as a credible market player.

6. **Other key components of MARK's strategy are as follows**:

Return on Equity—The MNB expects MARK to deliver an return on equity (ROE) of 15 percent, which sets the objectives against which MARK will assess bids for its portfolio.

Funding of MARK and its operations

- MARK is fully owned and funded by the MNB. While this has served to proceed quickly in establishing MARK, working toward market operations, the mission recommended that MARK's ownership be opened to international professional investors to bring MARK closer to the preferred ownership model.[3]

- Instead of the MNB fully financing MARK's operations, the mission recommended that acquisitions be (partly) paid with bonds issued by MARK—possibly with a government guarantee.

- Allowing equity partners and bond holders would introduce market discipline and helpdeliver on MARK's business strategy. A diversified ownership also would reduce the MNB's financial exposure and, arguably, dequalify MARK as a state-owned company, which would increase flexibility with respect to procurement and remuneration policies.[4]

Valuation methodology—In consultation with the European Commission, MARK is developing a methodology to set a ceiling for MARK's bids on assets that will be offered to it. The mission stressed that this methodology should be consistently in line with MARK's profitability target. This will require a case-by-case valuation reflecting the characteristics of

[3] Preferably, an AMC is not set-up as a unit within a central bank or a subsidiary thereof (Ingves, et al., "Issues in the Establishment of Asset Management Companies," IMF PDP/04/3).

[4] The authorities could also consider clarifying with Eurostat—the EU's statistical office—whether MARK qualifies as 'general government.'

the assets. The mission noted that reliance on average values on certain parameters—as is under consideration—may cause unattractive assets to be overvalued and attractive assets to be undervalued. The same risk lurks in too large a haircut on the market price.

Work processes—MARK's work processes should create value for individual assets and improve the liquidity of its portfolio.[5] The mission recommended that a culture be established that rewards value creation and drives toward closing deals (that is, successful divestments), through—amongst others—clear 'deal flows.'

III. Governance

7. **The mission reiterated the January mission's recommendation to reconsider the composition and mandate of MARK's corporate bodies.** The mission noted that while the MNB—as MARK's sole shareholder—has a legitimate interest in key decisions and appointments, the current corporate governance and decision-making structure is dominated by the MNB and its officials, who, at the same time also must serve broader policy objectives as central bank(ers) and exercise prudential supervision over MARK. This could undermine MARK's value-maximization mandate and jeopardize MNB's autonomy and credibility.

8. **The mission recommended that MARK's governance structure be consistent with best international practices, and that the composition of its decision-making bodies reflect their mandates**:

a. The *owner(s)* should be tasked only (i) to formulate the mission statement and set the long-term objectives; and (ii) to appoint the Supervisory Board and the Board of Directors. Currently, MNB's close involvement within MARK could create both policy and personal conflicts of interests, does not support MARK's sales pitch, and does not convey a good image to the outside world.

b. The *Supervisory Board* of MARK is intended to be a stand-in for and advisor to the owner(s) without decision-making powers. Although not ideal, based on its intended purpose, the Supervisory Board could consist of MNB representatives—currently all MNB Executive Directors—on condition that the Board of Directors is as advised below.

c. The *Board of Directors* should set MARK's policies and procedures, appoint and hold accountable its executives (in particular, the CEO), and determine MARK's risk

[5] Liquidity (i.e., improve the chances to sell an asset) could be improved by a number of actions: (a) buying assets from several banks and creating portfolios of a critical size; (b) addressing legal issues and uncertainty; (c) taking legal action and reaching agreement with borrowers; (d) restructuring companies to make these more viable; (e) negotiating for immediate repayments or amortizations for payments that seem impossible prior to negotiations.

appetite. This Board should be populated by persons with backgrounds relevant to MARK's business (including real estate and distressed debt management) and the Board's responsibilities (audit, oversight, and risk management). Ideally, the Board of Directors should exclusively consist of independent members (that is, non-MNB officials); alternatively, the independent members should be in the majority.[6]

9. **The mission shared the following considerations with the authorities regarding other aspects of MARK's governance structure:**

a. There should be a clear distinction between operational committees and Board committees. The latter should include committees that are recognized by best international practices, in particular, an Audit (& Compliance) Committee and a Remuneration/Compensation Committee; and, possibly, also a Corporate Governance/Nomination Committee and an Investment/Credit Committee.

b. Reporting lines to the Boards should be in place for the Audit Committee and the compliance function; and Internal Audit should report to the Audit Committee. The compliance function and Internal Audit would of course also report to the CEO.

c. If the authorities maintain that MNB should appoint and dismiss the CEO, the mission recommended that the Board of Directors should have an active involvement in the selection and dismissal of the CEO.

d. Relatedly, the mission recommended that limited, objective grounds for dismissal be enshrined in MARK's by-laws for all members of the Supervisory Board and the Board of Directors, as well as the CEO.

e. The mission reiterated the January mission's recommendation that the positions of Chair of the Board of Directors and Chief Executive Officer (CEO) be separated.[7]

f. The remuneration and compensation package should serve two goals: attract qualified staff, and reward closing deals. The first goal seems to be met; the second needs more attention.

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[6] Currently, the Executive Board comprises three external members of the MNB's Monetary Council. While the members may be 'external' from the MNB perspective, they cannot be considered 'independent' for MARK's purposes. The mission argued that the authorities' claim that, in Hungary, independent members are uncommon for single-ownership corporations does not hold because, in this particular case, the parent and the subsidiary operate with different objectives (that is, nonprofit vs. profit), and that MARK should aim to attract multiple equity partners.

[7] While a majority of independent members would diminish the need to separate the positions of CEO and Chair of the Board of Directors, the mission maintained that these two positions be separated to ensure that the Board's oversight over the CEO's executive team is not controlled or directly influenced by the CEO.

g. Legal protection for actions in good faith should remove a distracting concern for MARK's leadership and staff.[8] MARK is considering liability and legal representation insurances, which appears appropriate. The mission recommended that the scope of this insurance should be adequate as to substance (that is, liability and legal representation) and the financial coverage (relative to possible liability claims).

[8] The mission was informed that criminal liability for public officials would not apply to MARK's officers and staff, but they would be subject to civil liability without the protection that the MNB Act provides to MNB officers and staff.