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Supervision of the central bank on behalf of the owner

Domestic and international experience and trends

The amendment made on 27 July 2002 to Act LVIII of 2001 on the Magyar Nemzeti Bank through the insertion of Articles 52/A–52/D re-established the Supervisory Board as the body responsible for the continuous supervision of the Magyar Nemzeti Bank (MNB) on behalf of the owner after a year of suspension.

Pursuant to Article 52/A of Act on the MNB the members of the Supervisory Board are as follows:

- the Chairman, elected by the Parliament,
- three other members, elected by the Parliament,
- a representative of the Minister of Finance,
- a consultant commissioned by the Minister of Finance.

Under Article 52/B of Act on the MNB the membership of the Supervisory Board shall be for the duration of the mandate of the Parliament. The functions of the Supervisory Board shall cease when the new Parliament has elected the new membership of the Supervisory Board within three months of the inaugural session of the Parliament. In the event that the new Parliament fails to elect the members of the new Supervisory Board by the aforementioned deadline, the operation of the Supervisory Board shall continue until the new Parliament elects the membership of the Board. The three members of the Supervisory Board, elected by the Parliament and the Chairman were elected by the Parliament at their session of 24 October 2002 to be followed by two further members elected by the Minister of Finance. Subsequent to the general elections of 2006 the new members are to be elected at the autumn session.

Under Article 52/D the members of the Supervisory Board are obliged to report to the Parliament responsible for their election, or to the Minister of Finance responsible for their appointment. In accordance with the Rules of Procedure of the Supervisory Board: "The members of the Supervisory Board – in line with their commitments stipulated by Act on the MNB – jointly prepare a report on their activities and submit it to the Parliament and the Minister of Finance. Upon request the

* The authors of this article have been the Chairman and a member of the Supervisory Board of the Magyar Nemzeti Bank since October 2002. In our article we have relied on certain elements of general experience recorded in the reports prepared for the Parliament by the Supervisory Board and information obtained in exchanges of experience abroad. The factual statements are based on the consensual opinion of the reports of the Supervisory Board; however, actual wording is the responsibility of the authors, who hereby express their gratefulness to the other members of the Board – *dr. József Kajdi, dr. István Várfalvi, dr. Éva Várhegyi* and *dr. László Urbán* –, and the head and a staff member of the Board's Secretariat *(József Gungl, Ágnes Feigl–Sárvári)* for their cooperation.

members of the Supervisory Board should report to the Parliament responsible for their election, or the Minister of Finance responsible for their appointment." So far the Supervisory Board has submitted their report to the Parliament on four occasions, which was then discussed by the Parliament as part of the annual report of the central bank.

Under Act on the Magyar Nemzeti Bank the members of the Supervisory Board duly declare their wealth and report that they are not involved in any conflict of interest. The declarations of wealth were first reviewed by an ad hoc committee of the Parliament in autumn 2005 and in each case these were found appropriate.

As far as the operation (legal status, competence, tasks) of the Supervisory Board is concerned, the provisions of Act on the Magyar Nemzeti Bank and Act CXLIV of 1997 on Business Associations shall apply. (Pursuant to Article 70 of Act on the Magyar Nemzeti Bank the provisions of Act on Business Associations shall apply to the Supervisory Board of the MNB, with due consideration of the derogations set forth in the Act on the Magyar Nemzeti Bank.)

The principal task of the Supervisory Board, as stipulated by Act on the Magyar Nemzeti Bank, is the continuous supervision of the MNB as a company limited by shares on behalf of the owner; however, the basic tasks of the Magyar Nemzeti Bank, listed in Article 4. (1)–(7) and the impact thereof on the profit and loss of the Magyar Nemzeti Bank do not fall within their competence. Consequently, the Board does not review the following:

- defining and implementing the monetary policy,
- issuing banknotes and coins,
- holding and managing official reserves in foreign exchange and gold,
- foreign exchange operations in relation to the management of foreign exchange reserves and the implementation of the exchange rate policy,
- developing and monitoring domestic payment and settlement systems, including securities settlement systems and oversee their activities in order to achieve sound and efficient operation,
- collecting and publishing statistical information,
- promoting the stability of the financial system and the development and smooth conduct of policies related to the prudential supervision of the financial system.

The primary tasks of the Supervisory Board include the audit of the annual report and the profit and loss statement of the MNB – prepared in accordance with Act C of 2000 on Accounting and Government Decree 221/2000 on the Accounting Principles of the Central Bank implementing thereof, since the General Meeting of the MNB may approve them only when the written report of the Supervisory Board is received.

The Supervisory Board is required to audit (with the above limitations) all significant business policy related reports on the agenda of the MNB's General Meeting and all motions which fall within the exclusive competence of the MNB's General Meeting.

It is the statutory right of the Supervisory Board to control the MNB Audit Department, the body of internal audit. The head of the department may be appointed and recalled only with the consent of the Supervisory Board. Asserting its right of control and professional supervision, the Supervisory Board approves the internal audit working plan, and places the reports on the audits carried out by the Audit Department, which have been reconciled with the Board of Directors of the MNB, on the Supervisory Board's meeting agenda, discusses and approves them and initiates specific inspections, if necessary. Should the President of the MNB initiate "extraordinary" audits in addition to the working plan approved by the internal audit, the Chairman of the Supervisory Board adds these issues to the working plan of the Audit Department and provide information thereon at the next meeting of the Supervisory Board.

When the Supervisory Board started their operation, they wished to gain a general overview of the operation of the MNB, therefore placed all business areas falling within their competence on their agenda with the objective of getting a good insight into the most significant features, trends and peculiarities and make recommendations for the necessary changes.

AUDIT ACTIVITIES OF THE SUPERVISORY BOARD IN THE PAST

■ Satisfying their obligations prescribed by law, the Supervisory Board audited the parts of the annual report and the profit and loss statement of the Magyar Nemzeti Bank falling within the competence of the Supervisory Board each year, and made recommendations for the utilisation/settlement of the profit or loss and the payment of dividends when applicable. Due to the special settlement system between the central bank and the central budget, dividends were distributed only on one occasion.

■ During the general overview of the internal management, the Supervisory Board found that the financial control and the control environment were appropriate; however, some instructions on the implementation were prepared only with a delay in the first year of the supervisory cycle. The methodology and reliability of the financial planning, which were disapproved by the Supervisory Board, too, were then rectified by the central bank by issuing several new regulations, fine tuning the planning practice and introducing a new system of investment plans. As a result of the reduction of planning levels and the simplification of the procedures less time was required for reconciliation; however, the responsibility of the cost centres increased.

■ In the past years the Magyar Nemzeti Bank ensured a more cost-saving and efficient operation in an exemplary manner resulting in a significant reduction in the number of staff members as well as costs. However, costs decreased only compared to the planned figures, not the lowest basic value.

■ During the review of the human resources management of the MNB the Supervisory Board concluded that the redundancies due to the shrinking responsibilities of the central bank and the increasing efficiency were justified; notwithstanding the way of execution and the one-off costs of the redundancies were questionable in the first year of the Board's operating cycle. The Supervisory Board primarily took objections to that the organisational restructuring went on continuously for two years – between 2001 and 2003 – (certain areas were restructured several times) instead of implementing a pre-defined plan within a reasonable time frame. This caused constant insecurity in the operation of the organisation. According to the Supervisory Board the costs of the redundancies exceeded the necessary level, because during the restructuring the MNB did not rely on the existing, experienced professionals, but hired a high number of new staff members. The majority of the management was replaced and therefore the composition of the management significantly changed, which did not fit in the human resources stability practice of the European central banks.

The organisational structure has been continuously changing in the last four years due to changes in profile, establishment of new functions and optimisation of the operational procedures. Based on the assessment of the situation (the so-called benchmarking assessment prepared by the Swedish central bank), comparing the operational efficiency and features of the organisation the MNB started restructuring the organisational form and the structure in 2005. When the strategic objectives were set in 2004, the MNB's intention to become one of the most distinguished central banks by 2008, as far as professional and operational matters were concerned, was affirmed. During the planning phase it was understood that further opportunities for the improvement of efficiency should be seeked in view of the Swedish central bank, which is considered the most efficient among the central banks within the European Union. The Swedish central bank was chosen for benchmarking purposes for the following reasons:

- member of the ESCB, but not of the EMU;
- the total population of Sweden is only slightly lower than Hungary's;
- focuses on basic central bank tasks; in the last ten years it gradually cut back on other activities;
- does not supervise financial organisations;
- the number of staff members decreased by nearly 50 per cent, to 437.
- the MNB had already carried out several benchmarking studies in Sweden, which proved to be very useful and informative and the Swedish partner was very helpful.

The comparison covered three sections: functions, costs and the number of staff.

The cost-based comparison did not bring the expected result, since the costs of the Swedish central bank are only slightly more than 60 per cent of the costs of the MNB. A number of problems, different purchasing power parity and the level of wages and the whole structure of costs indicated that this was not viable.

As far as functions are concerned, we had to ascertain which tasks were identical and based on the knowledge of the legal environment what difference existed in the accomplishment of tasks. Then the staff had to be broken down so that these could compared taking the functions into account.

When the functions were contrasted, it was found that the Swedish bank performs no central bank supervision. As a result of the subsequent risk assessment the department focusing on this issue was dissolved in a way that the remaining central bank supervision tasks (together with the necessary staff) were assigned to the relevant areas. This was explained by that the commercial banks performed large-scale IT investments as a result of which on-site audits became unnecessary for the MNB receives the data electronically. As far as the statistical data supply is concerned, which is soon to be reformed totally, the security and reliability of data may be controlled in other ways, too. The MNB believes that the dissolution of the Bank Supervision Department does not infringe the fulfilment of the MNB's statutory supervision obligation. According to an investigation carried out by the State Audit Office regarding the operation of the MNB in 2005, this could be supported only by a detailed assessment. The Supervisory Board has supported such impact assessments.

The final conclusion of the comparative assessment indicated that the number of staff is appropriate for the basic functions; however, the MNB was operating less effectively. The problem lies fundamentally with the service function. While in Hungary the ratio of the service and the basic function is two to one, in Sweden these functions are equal with respect to the number of staff. With regard to the service activities it was seen that the Swedish central bank outsourced significantly more activities.

It was generally noted that the operational control and the control philosophy were different. The MNB applies far more and more detailed instructions and regulations, which cover almost all steps of implementation, while in Sweden policies are in place focusing on behaviours.

The management of the MNB – by business areas – discussed the results of the benchmarking assessment, and found that the necessity of each function, outsourcing certain activities and other opportunities improving the efficiency should be reviewed.

Taking into account a directorate proposal on the results of the benchmarking assessment and the necessary measures, a two-phase operation development programme was initiated. The first phase is scheduled by the end of 2006 and the second by the beginning of 2008, when the Logistics Centre is planned to start its operation. It is expected that in the first phase hundred staff members could be laid off followed by another hundred in the second phase.

A part of the planned measures (such as fully outsourcing IT application development, staff account management and lending, partially outsourcing legal tasks related to banking activities, security services, rationalising certain technical solutions and dissolving the Bank Supervision Department) were already implemented in 2005, which greatly contributed to the decrease in the number of staff members.

■ Besides improving the flexibility of the organisation and the operational efficiency the senior management of the MNB set the objective to restructure both the organisation and the management. In line with the above objectives, in early 2006 the directorate made a decision on the new organisational structure, which followed a differentiated management/control principle and was functionally structured. Due to the security of the operation, the organisational units that require a higher level of control, organisedness and task implementation continue to operate in a functional-hierarchic structure (unit/team/implementors), while problem-solving organisational units participating in decision-making (analysis, research, coordination, consulting, regulation) operate in a so-called team-oriented organisational form (without a departmental structure). As a result of the restructuring, the organisation has been significantly simplified both vertically and horizontally. The number of organisational units decreased: the former 17 departments and 48 sections were replaced by 7 plus 1 business areas, 20 functions and 17 sections. Consequently, the number of those in managerial positions significantly decreased (by 30 persons).

As a result of the various measures, the closing number of staff members in 2005, which was 1246, decreased by 437 persons to 809 by 31 December 2005. The Supervisory Board found the organisational development and the redundancies initiated on the basis of the international comparison favourable.

■ The Supervisory Board – in agreement with the auditor – considered the quick establishment of a geographically separated IT reserve capacity a priority, regarding which the Directorate made a decision in the spring of 2003. The capacity was implemented and put into operation a couple of months thereafter.

■ With regard to the status of the business associations owned by the MNB, the Supervisory Board has found that it is a rational solution if the Pénzjegynyomda Zrt. remained in the ownership of the MNB as long as HUF banknotes are produced, but a decision should be made as to the company's future at least 3 years prior to the planned introduction of the euro. As far as the strategic concepts related to the Diósgyőri Papírgyár are concerned, the Supervisory Board has agreed that in 2007 a decision should be made on the future of the paper-mill (in view of the future of the Pénzjegynyomda) and the investment policy should be shaped accordingly.

■ After reviewing the MNB's ownership interests and the reports on the existing legal disputes the Supervisory Board did not find any potential risks that would necessitate provisioning.

■ The Supervisory Board has controlled the internal audit for tasks falling within their competence in accordance with the provisions of the Act on MNB and the practice related to business associations. The Audit Department has carried out annually more than 50 investigations on average and revealed problems primarily in the IT area. In conclusion, the Board has found that the internal audits were carried out in an appropriate manner at the MNB in the past years and the Audit Department performed well at the central bank meeting demands, preparing reports in a timely manner and carrying out post audits adequately.

The Supervisory Board's connections

The Supervisory Board sends its yearly working plan to the Minister of Finance representing the shareholder, the State Audit Office and the Chairman of the Parliament for information. The Parliament is primarily informed about the results of the Board's activities through the report prepared by the members of the Supervisory Board.

The President of the State Audit Office participated in the statutory meeting of the Supervisory Board in person. An agreement was reached on the forms of cooperation. The President of the State Audit Office may attend the MNB Supervisory Board's meetings as a permanent invitee. The President of the State Audit Office receives the Board's Rules of Procedure, working plan and the minutes of the meetings for information. The State Audit Office regularly sends its own working plan and audit programme related to the MNB to the Supervisory Board of the MNB, which occasionally makes recommendations for their supplement. The Supervisory Board handles the findings and recommendations of the State Audit Office similarly to the observations of the internal audit, thus it monitors the implementation of the so-called rationalising measures. The Board occasionally consults the working team performing the SAO audits of the Magyar Nemzeti Bank.

Under Act on the MNB the members of the Supervisory Board commissioned by the Minister of Finance should report to the Minister of Finance. The Board's Rules of Procedure require that a report is prepared jointly by the members commissioned by the Parliament and the Minister of Finance. The report is to be submitted to both the Parliament and the Minister of Finance.

The Board – as the body responsible for the continuous supervision on behalf of the owner – occasionally provided the Minister of Finance with extra information.

On two occasions – on the request of the Minister – specific audits were carried out with regard to the independence of the MNB and a treasury transaction. The results were communicated to the owner.

The General Meeting is the main decision-making body of the MNB. Despite the fact that under the Act on the MNB the Magyar Nemzeti Bank is a legal entity operating as a company limited by shares, the members of the MNB's Supervisory Board – similarly to the Board's Chairman – are elected by the Parliament or commissioned by the Minister of Finance and not by the company itself (i.e. the General Meeting). The members of the Supervisory Board attend the General Meeting of the MNB with the right of consultation and may make statements. At the General Meeting of the MNB the Chairman of the Supervisory Board or a member commissioned by him presents the Board's position on the balance sheet, the profit and loss statement and any significant reports affecting the regular operation of the MNB. The General Meeting shall make a resolution on the annual report and the profit and loss statement only in the possession of the Supervisory Board's written report.

The Board of Directors, which comprises of the President and the Vice Presidents of the Bank, is the operative governing body of the MNB responsible for the management of the MNB's operations. The Supervisory Board's Chairman – or in his absence a member of the Supervisory Board attends the meetings of the Board of Directors, therefore is informed about matters and decisions affecting the Supervisory Board. The President of the MNB and the Supervisory Board coordinator are permanent invitees at the Supervisory Board's meetings. In addition to the above, the competent managing directors representing the directorates of the MNB participate in the discussion of the agenda.

The Supervisory Board may require information orally or in writing from the members of the MNB's Board of Directors or the managing directors of the MNB regarding issues falling within the supervisory competence of the Supervisory Board. Such information shall be provided by the petitioned person or a person commissioned by this person. This right of the Supervisory Board – considering that the Magyar Nemzeti Bank is a company limited by shares – is in line with Article 32(2) of Act CXLIV of 1997 on Business Associations. During the period between two meetings of the Supervisory Board, the Chairman of the Board maintains contacts with the President of the MNB, the management and the auditor and informs the Board subsequently.

The auditor of the MNB, who is elected by the General Meeting of the MNB on the recommendation of the State Audit Office, is a permanent invitee of the Supervisory Board's meetings. The Chairman of the Supervisory Board and the head of the Supervisory Board's Secretariat communicate directly with the auditor.

The Supervisory Board's connection with the internal audit is determined by the Board's statutory control function. Accordingly, the Supervisory Board approves the working plan of the internal audit, regularly receives the reports on audits based on which it can continuously monitor the audit activities, and when necessary, may request the Audit Department to carry out extraordinary investigations.

Control of the internal audit as a statutory function of the Supervisory Board

At the Magyar Nemzeti Bank the compliance with the requirement of independent internal audit – on the one hand – means that there is an audit department operating as an independent organisational unit under the supervision of the President of the MNB, the head of which is appointed and may be recalled by the President in agreement with the Supervisory Board.

On the other hand the independence of the internal audit also means that its head and managerial staff members, as well as the auditors, cannot be commissioned with tasks they can review afterwards or have others review these. The auditors commissioned to carry out audits should be personally and financially independent from the management of the organisational units under review; nonetheless, the auditors cannot be ordered to alter or exclude audit-related statements they make from the auditor's reports.

No person may participate in the audit regarding whom any reason for exclusion exists. For example, close relatives of staff members working at the audited organisational unit, persons who cannot be expected to carry out an audit in an objective manner, persons requested to perform a task they previously performed or managed or review an organisational unit they previously controlled cannot participate in the audit activities. In view of the conflict of interest requirement such reasons for exclusion should be reported by the auditor.

The Audit Department, as the independent central body of the internal audit, is controlled jointly by the Board of Directors and the Directorate. The department's primarily task is to support the bank's legal, regular, risk-managed and transparent operation and protect the bank's and its customers' assets and safeguard the owner's interests.

In order to perform its primary task, the department:

- shall examine whether all organisational units of the MNB and business associations, of which the majority owner is the MNB, comply with the provisions of legal acts and internal regulations;
- shall discover and investigate errors endangering the interests of the MNB, any possible misuses or recommends the investigation thereof and informs the management of the relevant banking area, the President of the MNB, the Vice President responsible for the professional management and the Chairman of the Supervisory Board on such issues;
- in connection with the investigations shall reveal situations, where MNB could implement cost-saving measures and improve the operational efficiency;
- during its investigations shall reveal risks inherent in the MNB's activities, and in order to manage such risks assess the control mechanisms built in the bank systems and make recommendations for their improvement;
- shall elaborate the mapping procedure for the operational risks of the MNB in order to establish the basis for systematic operational risk management;
- shall prepare internal regulations for a business continuity planning system and monitor its operation;
- having the reduction of risks in mind, shall express their opinion on the draft internal regulations and support important IT or other developments by making recommendations;
- shall make recommendations for the concept of external regulations to be published by the MNB;
- shall express an opinion on draft bills related to bank activities submitted to the Bank;
- shall cooperate with the auditor commissioned by the MNB and the State Audit Office.

As a fundamental tool in the control of the internal audit, the annual audit plan of the Audit Department and the annual report on its activities is approved by the Supervisory Board after the Directorate accepted them. The audit plan may be modified and extraordinary audits may be performed only when approved by the Supervisory Board.

The head of the Audit Department makes decisions on whether to implement audit tasks found in the working plan and the timing of the audits.

Should extraordinary audits (not scheduled in the audit plan) be performed on the request of the bank's employees or the management or for other reasons, the head of the department is required to make a proposal on such audits to the President of the MNB and inform the Supervisory Board. The Supervisory Board makes decisions as to the audits scheduled in the working plan as well as extraordinary audits.

The implementation of the audit plan is continuously monitored by the head of the department during the year, who prepares a report to the Supervisory Board on a monthly basis.

The independent internal audit procedure of the Magyar Nemzeti Bank is determined by a presidential instruction, regarding the modification of which related to the establishment of the Supervisory Board the MNB considered the findings and recommendations of the Supervisory Board. The currently effective presidential instruction includes the following:

- objective of the independent internal audit,
- legal status, independence, competence of the Audit Department and rules for conflicts of interest,
- commitments of the audited organisational units,
- work methods of the internal audit, audit methods,
- preparation and implementation of audits,
- rules for writing and reporting the findings of the audits, recipients of the internal audit reports and statements,
- implementation tasks resulting from the audit findings, persons responsible for implementation, monitoring the implementation of measures.

There is an Audit Committee at the Magyar Nemzeti Bank, the chairman of which is the President of the MNB. Its members are the Vice Presidents, the managing directors controlling the business areas and the Head of the Audit Department. The meetings of the Audit Committee are attended by the auditor of the MNB as a permanent invitee as well as the Chairman of the Supervisory Board or a representative appointed by him in case of items on the agenda falling within the competence of the Supervisory Board.

The Audit Committee discusses the audit strategy, monitors the implementation of former decisions and assesses their success.

The tasks of the Audit Committee include the discussion of the findings of the MNB's audit system (internal audit, auditor, Supervisory Board, State Audit Office), monitoring the preliminary approval of the annual audit plan. The Chairman of the Audit Committee makes decisions with regard to the following:

- further actions to be taken in connection with action plans not implemented in a timely manner;
- internal audit findings not accepted by the person in charge;
- internal audit recommendations affecting the whole bank and related measures;
- deficiencies experienced during projects and tender procedures and related measures;
- measures related to the findings of the auditor and the State Audit Office.

The internal audit reports, audit focusing on special purpose, minutes and the reports on the activities of the Audit Department are received by the President of the MNB, the Vice President managing the audited organisational unit and the Chairman of the Supervisory Board.

INTERNATIONAL EXPERIENCE

During its mandate, the Supervisory Board had the opportunity to make itself familiar with the control and supervisory practices of the Finnish, Swedish, Danish and Portuguese central banks.

The delegation of the Supervisory Board of the MNB visited the Parliamentary Supervisory Council of the Finnish central bank in 2004. In early 2006, based on the documentation of the Bank of International Settlements, they selected three further central banks for detailed study. Each of these seemed to welcome the idea, so the delegation of the Supervisory Board visited the Swedish, Danish and Portuguese central banks.

Finland

Preserving earlier Finnish traditions, the Finnish central bank (Suomen Pankki) is headed by – beside the Board of Directors – the Parliamentary Supervisory Council (PSC), elected by the Parliament, whose members are all members of parliament. The PSC is a multiparty body. As far as its tasks are concerned – when compared to the Hungarian solution –, it has the role of the General Meeting and partly the Supervisory Board, while its mandate has a wider scope (even exceeding that of the Budget or Economic Committees of the Hungarian Parliament.)

Thus, it is the PSC that makes recommendations concerning the members of the senior management (Board of Directors) of the Finnish central bank, determines their remunerations, and appoints the deputy of the Chairman of the Board of Directors (i.e. the Governor of the Bank). Also, the PSC makes recommendations concerning the central bank auditors (natural persons), also to be elected by the Parliament, which means the selection of five auditors. These auditors – when compared to the Hungarian solution – have the role of the State Audit Office and partly that of the Supervisory Board. (The Finnish State Audit Office does not deal with the central bank.)

The PSC regularly conducts hearings in order to be reported on the execution of the ECB monetary policy by the Board of Directors, and submits reports on that subject to the Parliament. They usually have meetings on a monthly basis, where, occasionally, with the participation of the members of the Board of Directors, they exchange views on the evaluation of the economic processes and the effects of the monetary policy of the ECB. At the same time, concerning the President, the requirement for independence (independence from the members of both the Board of Directors and the PSC) is fulfilled; however, occasional ex-post discussions on monetary processes are regarded compatible with that. Auditors' opinions are also jointly heard by the PSC and the senior management in charge of the central bank.

He competencies and tasks of the PSC

◗ Primarily, the organisation of efficient money supply and the review of nationally decided monetary matters, limited to the handling of adequate international reserves (much higher than the requirements of the ECB). Also, the members of the PSC exchange opinions on the effects of the monetary policy of the ECB (e.g. base rate) ex-post.

◗ Constant monitoring of the balance sheet and the profit and loss statement of the central bank with the help of the parliamentary auditors, and approval of these after closing the business year. Although, to supplement the work of the auditors, the PSC employs external auditors (Ernst & Young), it is only due to being urged by Brussels to do so as a result of the EU-membership. The auditors also rely on the activity of the internal audit.

◗ Outlining the business plan of the central bank, with special regard to ensuring the efficient and stable operation of the financial and capital markets. It is the task of the PSC to request the supervisory body to provide an account on their activity. The PSC evaluates the supervisory activity in its parliamentary report.

◗ Personnel issues, especially in relation to the senior management and the Board of Directors of the bank. The Finnish colleagues emphasised the importance of the principle of trust concerning personnel issues, thus especially in the case when, after its members had been elected, the PSC, together with the government, made recommendations concerning the person to become the Governor of the central bank. The approval of this recommendation is within the competence of the President of the Republic. It is also based on the recommendation of the PSC that the remunerations of the members of the Board of Directors are determined.

Outlining the framework of the operation of the central bank

◗ Within its budget, the Board of Directors manages its operation with quite independence, also based on the principle of trust. After joining the Economic and Monetary Union, the central bank halved the number of its organisational units. (Currently, apart from the headquarters, there are four regional offices.) This, however, did not originate from the direct consequences of the EMU accession, but from the bank's intentions to rationalise and the diminishing tasks concerning cash supply (disregarding the single occasion of currency replacement). (Electronic transactions have increased in volume and the role of the banking sector has become more dominant.) Although the earlier 800-900-strong staff have diminished in size by as many as 2-300 people, currently it is necessary to employ new colleagues. A reason for this is – among other things – that e.g. as many as 70-80 colleagues travel to the headquarters of the ECB in Frankfurt to attend meetings of different organisations and committees at least once a month. There is an even greater need for core economic tasks than before, not focussing on the Finnish context, but much rather on the processes of the whole of the EMU. EMU accession in itself can only slightly be expected to induce downsizing.

The co-operation of the Parliament, the PSC elected by it, and the Board of Directors formed on the basis of the recommendations of the PSC is characterised by constructive debating, a good example of which is that the PSC and the Board of Directors do not necessarily have to represent the same standpoint towards the Parliament. If they do, that standpoint may have been formulated at the joint meeting of the PSC and the Board of Directors, which the head of the Finnish Financial Supervision Authority is also entitled to attend, with a discussion right. The minutes of these meetings are secret, and only the resolution of the court of appeal may give exemption from this obligation.

The Financial Supervision Authority has an independent Board, and operates independently of the central bank. However, it is the central bank that provides it with the administrative conditions necessary for its operation, and it is supervised by the PSC. The inner organisation of the authority is determined by its core activities (regulation, financial institutions, financial and capital markets, and administration). It is an interesting solution that the internal auditing of the supervision authority is carried out by the internal audit unit of the central bank.

Sweden

The experience gathered at the Swedish central bank (Riksbank) is of special importance because the Board of Directors of MNB chose this bank as a so-called benchmarking model organisation, and the reorganisation of MNB was carried out based on this experience in early 2006. The choice was motivated by Sweden's being an EU Member State, but not a member of the euro-zone, and it was also due to the excellent reputation of the Riksbank.

The Swedish and the Hungarian regulatory frameworks and practices are identical in several respects.

- The monetary decision-making body is independent.
- The central bank has regular reporting obligation to the Parliament.
- The competent Standing Committee of the Parliament regularly conducts hearings with the Governor and the Deputy Governors of the central bank.
- The central bank is supervised by the Swedish National Audit Office.
- As soon as it is summoned, the Parliament elects the members of the Supervisory Board (called General Council in Sweden, which, functionally, is the equivalent of an Executive Board that can be deemed strong) with a mandate for the whole governmental term on the basis of a proposal list reflecting inter-party consent.
- The Supervisory Board holds regular meetings, usually on a monthly basis, it supervises

banking activities not relating to monetary policy, and it has self-controlled professional supervisory capacity. Its members usually seek to reach a consensus during the meetings.

◗ The remunerations of the members of the Supervisory Board are determined by the Parliament. They are obliged to declare their wealth.

◗ There are rules on the conflicts of interest.

The regulations and practice concerning control and supervision in Sweden and Hungary differ in respect of the following:

◗ Within the Swedish central bank, the monetary decision-making body and the body in control of the organisation is identical, it is the Executive Board, which has six members, and no "quasi external members".

◗ Each member of the Executive Board of the Swedish central bank (including the Governor) is appointed by the Supervisory Board, with a resolution passed with a simple majority, for six years. Usually, one mandate expires and one appointment decision is made each year. (There may be divergences from this system due to resignations.) Electing the first Deputy and establishing further details of the substitution order also fall under the competency of the Supervisory Board.

◗ The scope of the competency of the Supervisory Board is wider, complemented with the following tasks:

- approval of the Rules of Procedure,
- formal evaluation of the annual leadership performance of the members of the Executive Board based on its own audit, and the determination of their remunerations,
- exercising certain employer's rights in relation to the members of the Executive Board (recall someone, shorten the waiting period subsequent to appointment, etc.),
- approval of the design of banknotes and coins,
- expressing an opinion on statutory amendments concerning the status of the central bank; the Executive Board and the Management Committee discuss each such proposal,
- proposals on the allocation of the profit generated at the central bank,
- controlling the Audit Department of the Supervisory Board.

◗ The Supervisory Board of the Swedish central bank has 11 members and the same number of deputy members to back up each member. (A deputy member substitutes a board member if necessary, but may also be present at meetings in the presence of that board member.) The composition of the Supervisory Board reflects the composition of the Parliament, i.e. the proportion of parliamentary seats. The government or the finance minister cannot appoint members. Approximately half of those nominated by the individual parties are members of parliament, while the other half are not. (The Social Democratic faction tends to nominate members of parliament, while the other parties have shifted towards inviting non-MP experts). The Supervisory Board itself elects its Chairman, and also its Vice Chairman. The Chairman of the Supervisory Board is the candidate of the government, while the Vice Chairman of the opposition.

◗ Both the Chairman and the Vice Chairman of the Supervisory Board participate at the meetings of the Executive Board, including during the course of monetary decision making. They may not put forward proposals or vote concerning the issues on the agenda, but may contribute. Participation at the meetings facilitates the Supervisory Board's evaluation of performance and the decision on the prolongation of the six-year term as well. Usually, all the members of the Executive Board participate at the Supervisory Board meetings. They also inform the Supervisory Board on the inflation and stability reports, and answer queries concerning monetary decisions.

The Swedish central bank has no external auditors from among the internationally acclaimed big audit firms. External audit is conducted by the National Audit Office, and they also provide an auditor' opinion on the balance sheet.

Internal auditing at the Swedish central bank is controlled by the Executive Board. Short reports on each audit are only received by the members of the Executive Board. However, the Executive Board reviews the experience gathered through internal audits on the basis of separate motions approximately three times a year, which reviews are also communicated to the leaders of the Supervisory Board, who have the status of permanently invited members. Additionally, internal auditors periodically inform the Supervisory Board of their activity. They are to provide any information on the request of the Supervisory Board. In this respect they do not differentiate between subjects relating to and not relating to the core activity. At the same time, the Supervisory Board has its own audit department, the delivery of which task is commissioned through public procurement to a team of a renowned audit firm (currently Ernst & Young). This audit focuses on the enforcement of the Rules of Procedure, management procedures adopted by the members of the Executive Board (primarily in respect of being well-documented and compliant with regulations), the proposal concerning the allocation of the bank's profit and other issues determined annually. The three audit apparatuses (National Audit Office, Internal Audit Department, the audit unit of the Supervisory Board) harmonise their audit selections and keep each other informed.

◗ In the case of the Swedish central bank, the Parliament decides on the approval of the balance sheet and the allocation of the profit. The Supervisory Board makes a proposal relating to the latter. When the Parliament has approved the annual report, it separately votes on discharging the Executive Board and the Supervisory Board from any liability concerning their activity in the year covered by the report. (There has been a case when one minor party voted against it. Denying discharge would lead to the re-election of the Supervisory Board, but the Executive Board would not be re-called in this case, either.)

◗ Members' obligation to declare their wealth is narrower than in Hungary. The main purpose is to make interests within financial circles transparent and not to track accumulation of wealth. Annual income need not be reported. It is obligatory to report interests in businesses, financial assets owned, credit items, and agreements with earlier employers that are still in force but only over a certain limit of value (approx. a total of 50 thousand euros). These declarations of the members of the Executive Board and the leaders of Management Committee are public.

Denmark

The importance of the experience gathered at the Danish central bank (Danmarks Nationalbank) is underlined by the fact that Denmark is also a non-euro zone, old EU Member State.

The Danish and Hungarian regulatory frameworks and practices are identical in several instances:

◗ The monetary decision-making body is independent.

◗ The body with a supervisory mandate consists of external members, whose nomination is dependent partly on parliamentary decisions, and partly on appointments by a government minister.

◗ The body with a supervisory mandate has regular meetings, usually on a monthly basis. It supervises banking activities not relating to monetary policy, and controls internal audit.

Its members usually seek to reach a consensus during meetings.

◗ The head of the central bank is appointed by the head of state based on the prime minister's proposal.

In respect of control and supervision, the Danish and Hungarian regulatory frameworks and practices differ in the following:

◗ Within the Danish central bank, the monetary decision-making body and the body in control of the organisation is operatively identical, it is the Board of Governors of three members, which has no “quasi external” members.

◗ With the exception of the Chairman, the Governors of the Danish central bank are appointed by the Board of Directors, a body of supervisory character, with a majority vote. Governors (including the Chairman) are appointed for unlimited tenures; the tenure expires when the Governor turns 70 years of age.

◗ Additionally, the competencies of the Board of Directors, a body of supervisory character include:

- approval of the decree on the execution of the National Bank of Denmark Act (which also needs the endorsement of the Minister of Economic and Business Affairs),
- decisions on important organisational issues, such as branch opening and closing times, and the adoption of remunerational and pension regulations (relating to Governors as well),
- control of the whole activity of internal audit,
- approval of the annual balance sheet and the allocation of profits, which is to be reinforced by the Minister of Economic and Business Affairs.

◗ The Board of Directors of the Danish central bank has 25 members. Eight of them are elected by the Parliament. Two members are appointed by the minister appointed Royal Bank-Commissioner by the prime minister (the post is usually filled by the Minister of Economic and Business Affairs). The prime minister usually nominates his own permanent secretary of state and the permanent secretary of state of the Ministry of Justice. (The law requires that out of the two persons appointed by the prime minister, one be an economist and one a lawyer.) Further members are elected and recalled by the Committee of Directors in power in the following manner: each year three members' mandates expire, and new members are elected from among the notables of the business and the scientific communities and trade union leaders, always for a term of five years. The Board of Directors holds meetings quarterly and when there are vital issues on the agenda, the meeting is chaired by Minister of Economic and Business Affairs. At these meetings, they make important decisions within their competencies relating to the operation of the organisation, deal with internal audit reports, and, also, the Governors of the central bank and the members representing the political and business communities and trade unions exchange views on the Danish economic situation and the effects of worldwide processes. Each item on the agenda is negotiated after a preliminary discussion about it by the Committee of Directors.

◗ The operative body of the Board of Directors, usually meeting monthly, is the so-called Committee of Directors, formed of seven members of the Board of Directors. The two members of the Board of Directors appointed by the Royal Bank-Commissioner (i.e. the permanent secretaries of state of the Ministries of Economy and Legal Affairs) automatically become members of this body, whose competencies are the most similar to those of the MNB Supervisory Board, while further five members are elected by the Board of Directors each year. One of them is a representative of a ruling party, and one of an opposition party in the parliament, and three are other members of the Board. (Typically one represents the business, one the trade union, and one the professional community.) The members elected for one year can be and often are re-elected. The Chairman of the Board of Directors and the Chairman of the Committee of Directors is currently the same person (legally, it would be possible for two different persons to hold these posts), and has had this function for over a decade. (The current Chairman is a university professor.) A Vice President is also elected. (Currently, it is the state secretary of the Ministry of Economic and Business Affairs). The Minister of Economic and Business Affairs may be present at the meetings, crucial issues may only be decided on in his presence.

The Committee of Directors appoints the leaders of different ranks of the central bank based on the recommendations of the Board of Governors.

Usually, all the Governors participate at the meetings of the Board of Directors and Committee of Directors.

At the Danish central bank, external audit is executed by two auditors appointed by the Minister of Economic and Business Affairs. The National Audit Office is not entitled to audit the central bank.

At the Danish central bank, internal audit, currently engaging seven employees, operates under the control of the Board of Directors, a body of supervisory character. They inspect the whole activity of the central bank. The Board of Directors decides on selecting the head of internal audit, and exercises employer's rights in relation to this person. The Board of Directors approves the annual audit plan. The audit plan proposal is made on the basis of risk analysis, which the Committee may only supplement, at the most. The leaders involved receive reports on the audits that have been carried out. Internal audit prepares overall quarterly reports on the evaluation of the risk managing practice of the central bank, and the practical implementation of the procedural and control processes in consideration of the audits carried out. (There exists no annual report.) These reports are discussed by the Board of the Governors, then the Committee of the Directors, and finally, based on the recommendations of the latter, the Board of the Directors, which eventually approves them. Internal audit also audits the balance sheet and issues a declaration on it.

Within the organisational structure of the central bank, there is a currently eight-member audit organisation dealing with operative risk management and compliance with the rules, which is below the Board of the Governors in the hierarchy. One of the main tasks of this unit is risk assessment in the broader sense, and the preparation of a risk map and risk rankings on the basis of it. Risk management is supervised and evaluated by internal audit, and may be overruled by internal audit when it compiles its own audit plan.

Those responsible for the three different kinds of audit activity co-operate with each other, harmonising their activities.

◗ At the Danish central bank, decisions on approving the balance sheet and allocating the profit are made by the Board of Directors. Neither the Parliament, nor the National Audit Office plays a part in this. However, the decisions need to be endorsed by the Royal Bank-Commissioner.

◗ Members are not obliged to declare their wealth, there only exist regulations in relation to conflict of interests.

Portugal

The experience gathered at the Portuguese central bank (Banco de Portugal) is not only important because the circumstances of Portugal are similar to those of Hungary in several respects (e.g. territory, population and economy), but also because – unlike Sweden and Denmark – Portugal is a member of the European Monetary Union.

The bank that was established 160 years ago has only been operating in accordance with the current principles within its current legal framework since its nationalisation in 1974, even though the privately owned company limited by shares had functioned as the central bank of the Portuguese state since the early 20th century. The Republic of Portugal is a member of the European Monetary Union and thus the euro has replaced its earlier national currency, the escudo. Consequently, the Banco de Portugal no longer has tasks relating to monetary policy. However, it has euro notes produced by a privately owned company of a significant size, specialised in this field, within the framework of a joint venture, and puts them into circulation them together with the euro coins that are minted by order of the Treasury of Portugal. This and the fact that the supervision of the whole financial sphere is a task of the central bank (essentially corresponding to the authority of the Hungarian Financial Supervisory Authority, PSzÁF), justify that the staff include as many as 1600 people. For the same reason, the Banco de Portugal has agencies in six towns and has its own logistics centre.

Despite the similarities deriving from the role of central banks, the Portuguese and Hungarian regulatory frameworks and practices differ in several respects owing to the fact that Portugal is a member of the euro-zone:

◗ As a result of the EMU membership, no monetary decision-making body operates within the Portuguese central bank. Pursuant to the Organic Law of the Banco de Portugal, the main tasks of the bank are:

- the right to express an opinion and a de facto veto right when approving the balance sheet of the Banco de Portugal,
- safeguarding and management of the foreign currency stocks and the very significant gold stock,
- mediation of the international financial relations of the state,
- safeguarding of the stability of the payment system and, deriving from this, the function of final creditor (last resort),
- counselling provided for the government on economic and financial issues within its competency.

◗ The role of the Parliament is limited to legally defining the role of the central bank and the conditions of its operation, in other words, legislation does not supervise the activity of the central bank beyond passing and possibly amending the Organic Law of the Banco de Portugal.

◗ Even though the Parliament (or its competent committees) is entitled to conduct hearings with the Chairman, the Board of Directors, the Supervisory Board, and its members, it hardly ever exercises this right. Only hearings with the Chairman have been conducted. Thus, the central bank is not obliged to present regular reports to the Parliament, which usually seeks to be informed by the government or the Minister of Finance, or is possibly only informed by consulting the public annual report of the bank.

◗ Almost all supervisory, regulatory, and reporting tasks and obligations of the Banco de Portugal are concentrated at the Ministry of Finance. Thus, based on the recommendation of the Minister of Finance, it is the government that appoints the Chairman of the bank and the other members of the Board of Directors, the Supervisory Board and the so-called Advisory Board. As there is no organisation similar to the Hungarian State Audit Office in Portugal, the organisations of the central bank appointed by the government have reporting obligation to the Ministry of Finance.

◗ The Supervisory Board has three members appointed by the Minister of Finance, and one member elected by the staff of the bank. Pursuant to the appointment criteria, apart from the Chairman of the Supervisory Board, who has a veto right, one appointed member must be a chartered accountant, and another a renowned economist. Appointment is for three years, but as our hosts pointed out, the current Supervisory Board had only been the third in the past 30 years, and it had been functioning in its current set-up for more than 10 years.

The Supervisory Board holds regular, monthly meetings, and its Chairman also participates at the weekly meetings of the Board of Directors. In the course of their activity, they primarily rely on the work of the internal audit department, but the accounting department of the bank also directly reports to them in certain cases. Also, they closely cooperate with the independent external auditor, currently PWC. They chose the external auditor from a recommended list provided by the European Central Bank, and their appointment is for an undefined period. Another regular task of the Supervisory Board is to undertake physical checks of the assets of the bank, primarily its foreign currency and gold stocks, once a year. Apart from the tasks derived from the European Central Bank, the Supervisory Board has supervisory competence over any instances of the activities carried out at the Portuguese central bank (even including the inspection of excessive accumulation of wealth of staff members).

The remunerations of the members of the Supervisory Board are determined by the Minister of Finance appointing them, while the salaries of the Chairman of the bank and the members of the Board of Directors are determined by the Supervisory Board.

◗ The usual regulations in relation to conflict of interests apply to the members of the Supervisory Board (and naturally, to the members of the Board of Directors as well). They are obliged to declare their wealth to the Minister of Finance, but the declarations are not public.

The further Portuguese characteristics can be summarised as follows:

- when joining the euro zone, the Organic Law of the Banco de Portugal, which had been in effect virtually since the nationalisation in 1974, was amended, and consequently all the tasks related to the ESCB-membership were removed from the national supervisory system, thus the Supervisory Board has no competence whatsoever concerning these issues;
- as part of the supervisory tasks concerning the whole Portuguese financial system, the Supervisory Board of the Banco de Portugal supervises the operation of three state funds (Deposit Guarantee Fund, Integrated Mutual Agricultural Credit System, Agricultural Guarantee Fund) on the basis of government delegation; while the Chairpersons of these funds are members of the Board of Directors of the bank;
- generally, it can be stated that the Board of Directors and the Supervisory Board quite closely cooperate with the operative management of the Banco de Portugal, practically on a day-to-day basis, which is also indicated by the head of the Chairman's office managing the Secretariat to the Boards (i.e. the Board of Directors and the Supervisory Board) as well.

Formally, the Supervisory Board does not control the activity of internal audit. Internal audit does not have reporting obligation on the results of its activity to the Supervisory Board, but to the Board of Directors. Still, there are quite strong informal connection points between the Supervisory Board and internal audit, as the Supervisory Board mostly relies on internal audit reports when carrying out its activity.

The internal audit department has 16 auditors, besides whom two managers and two technical staff members belong to the thus 20-strong department. They prepare an annual plan to outline their activity, which usually stipulates 45 audits per year, divided into seven audit themes. Unlike at the MNB, no units of measurement are attached to any of the audit themes either in advance or in retrospect, (e.g. “auditor's days”). The classical risk approach is applied when audit tasks are determined. The general central bank audits are conducted in compliance with IAS, but the assessment of IT risks is treated separately, as a prominent area. (A separate IT committee operates within the bank).

As part of the supervisory tasks concerning the whole financial institutional system, central bank special purpose audits are conducted at financial institutions countrywide, even on authorities' or courts' requests on occasions.

Internal audit has formal reporting obligation only to the Chairman of the bank, but usually also sends the reports to the Supervisory Board, which, in turn, regularly calls upon internal audit to carry out different inspections.

One of the operative tasks of internal audit is to compile the annual report of the bank in co-operation with the accounting department. Our hosts explained that the reason for this was that they regarded the reputation of the bank and safeguarding it as the main risk factor. Naturally, the final draft of the annual report is approved by the Board of Directors, in agreement with the Supervisory Board, who submits it to the Minister of Finance, and thus to the government.

The internal audit department may also conduct special purpose audits based on special requests from the external auditor. Apart from the co-operation in compiling the annual report, they hold consultations in person once or twice annually.

Also, the European Central Bank may and occasionally does call upon internal audit to conduct different special purpose audits mainly relating to the circulation of euro notes and coins.

SUMMARY

Summarily, it can be stated that the regulatory frameworks of the central banks of the old EU Member States outside the euro zone (also considering the situation of the Bank of England, not mentioned above) are identical in the sense that firstly, they all have independent monetary decision-making bodies, and secondly, concerning non-monetary operation, separate – continuous and external – control is exerted through the activity of a monitoring, supervisory body which consists of people that are not employees of the central bank in each case. Consequently, the institution of the MNB Supervisory Board is definitely in harmony with the prevailing practice within the EU. However, it would be expedient to further refine the regulatory framework of its operation with regard to international experience and future requirements in the euro zone.