PD-ACA-613

BearingPoint

Ukraine Bank Supervision Development
Contract #PCE-I-00-99-00006-00 TO#827
Quarterly Report
July 1, 2003 to June 30, 2004

I. The NBU Bank Supervision Department evolves its processes so that risk-based supervision becomes the basis for both its inspection and enforcement. The following aspects of bank supervision are modified to reflect the new emphasis on risk-based supervision.

1. On-site Inspection: GDBS staff is expert, not only in financial analysis (as is presently the case), but also in analysis of how adequate the banks' risk management systems are, in light of current and foreseeable risks that the bank faces with its current and prospective range of services. Written examination procedures place greater emphasis for the risk-management system. The "CAMELS" and "report of examination" -- for each bank examined – reflect the NBU's evaluation and recommendations for correction of any weaknesses found in the bank's risk management system.

By September 30, 2003

Working with the Risk Based Supervision Task Force (Task Force), assist in the development of courses, implementation and delivery of the RBS training plan (a subset of the RBS implementation plan). The RBS training plan covers the remainder of the calendar year 2003 and all of 2004. Advisors: Antonova, All; NBU Counterpart: Task Force

According to the RBS training plan, we will develop and deliver technical training for trainers (who will deliver regional RBS training throughout 2004) starting on November 10 and continued for two weeks. The pilot seminar for GDBS Central Office personnel is scheduled for February 2004. BearingPoint RBS training was coordinated with Dutch Grant training events, and as a result potential RBS trainers from the NBU will be scheduled to attend Train-the-Trainers courses organized and delivered by Dutch Grant.

In the meanwhile, BearingPoint continued course development efforts, and assigned advisors and counterparts responsible for the development of particular course components and topics. This effort will continue throughout our project duration. We envision different instructors to participate in each of the training seminars, thus organizational efforts will be an ongoing aspect of this project. We coordinated course delivery and logistics with the NBU's Personnel Department and the GDBS Training Unit Manager, Ms. Tatyana Khimich.

Working with the Task Force, implement the recommended schedule (developed in September 2002) to review chapters of the Onsite Manual to focus and emphasize the evaluation of banks' risk management system and results of the Risk Assessment System (RAS). Begin the review of chapters based on an approved (by Task Force) schedule. This

process will continue through 2004 and into 2005. Advisors: Ladokhina, Baranovich, Blimling; NBU Counterpart: Task Force

Since the Risk Assessment System (RAS) is to be officially approved in early 2004, the Task Force (primarily the Small Working Group) has focused its work on further developing the RAS. Thus, the implementation of the review schedule for the Onsite Manual is postponed until the beginning of 2004. In the meantime, both Ukrainian and English versions of the Manual were reviewed and adjusted in order to properly mirror each other.

By December 31, 2003

Finalize changes to the Report of Examination, CAMELS Policy, Supervisory Strategies and other communication tools to reflect the results of RAS. Advisors: Kutsenko, Blimling, Wilson; NBU Counterpart: Task Force

The final draft of the Risk Assessment System was completed after the Train-the-Trainers session held in November. Per NBU's decision, the RAS will be introduced as a separate section of Onsite Manual in early 2004. Such section will be mandatory for examiners to use, but will have limited effect on banks in case a deficiency is found, as this remains a pilot program. In addition, before October 2004, the regional examiners will have to submit to the Task Force their comments and suggestions to fine-tune the RAS and support it full implementation in 2005.

The Report of Examination format will remain unchanged until the pilot program nears its completion. After every risk-based exam the examiners will produce separate memos for each risk category, together with assessment factors and risk matrices supporting the conclusions. The reason for such decision is that the NBU has not had a chance to test the proposed Report of Examination format at any examination. Such tests will be done during training and follow-up examinations. Only after NBU has collected practical experience in using RAS will the amendments to Report of Examination will come into effect.

Continue to assist the Task Force in the implementation of RBS training plan. Advisors: Antonova, All; NBU Counterpart: Task Force

The technical training for the potential instructors of RBS seminars was held November 10 through November 21, 2003. Twenty participants successfully completed the seminar. Course materials included brief presentations on Risk Based Supervision, Risk Management Systems, Corporate Governance and included completion of an extensive case study covering all nine banking risk areas. Using the course material and feedback form the participants in this two-week seminar, we are developing an abbreviated, three-day seminar to be held in various NBU locations in 2004 and 2005. The abbreviated seminar will address the nine banking risks in a more limited fashion and specifically focus on the risk assessment system.

Continue development of the Onsite Manual and other supervisory tools. Assist in the issuance of revised Chapters of the Onsite Manual. Advisors: Ladokhina, Baranovich, Blimling; NBU Counterpart: Task Force

We presented a set of recommendations to the NBU regarding the Onsite Manual review, including the following: 1) to publish and practically implement the chapters developed earlier, used informally, but not officially adopted; 2) to expand the Onsite Manual and

Banking Supervision Manual, specifically, by including a chapter on Offsite Analysis; 3) to review the Manual in order to make the terminology consistent with the Risk Assessment System and Policy Guidelines for Comprehensive Risk Management Systems in Banks; and, 4) to make sure that corporate governance principles are adequately reflected in the Manual.

By March 31, 2004

Continue to assist the Task Force in the implementation of RBS training plan. Advisors: Antonova, All; NBU Counterpart: Task Force

Our project is in constant contact with the Task Force. In our discussions during each of the risk-based supervision seminars, we are assisting the members of the Task Force with areas of possible improvement in the risk-based supervision plan. We have carefully emphasized to the participants of risk-based supervision seminars conducted in Kyiv and in regions that the risk-based assessment system and risk-based supervision plan is a working document, to be viewed as a living document. The seminar participants have expressed a desire for more detail with the risk assessment system and we are exploring ways to assist the NBU to give more detail, without making the document too cumbersome and unusable.

Continue the development of the Onsite Manual and other supervisory tools. Assist in the issuance of revised Chapters of the Onsite Manual. Advisors: Ladokhina, Baranovich, Blimling; NBU Counterpart: Task Force

We delivered recommendations for a quality assurance function within the Banking Supervision Department. We continued to discuss the role and function of the off-site analysts. Although the on-site inspectors have a detailed manual to follow in their inspection process, the off-site analysts do not have a policy guide for their goals and general responsibilities. This is critical for risk-based supervision to develop properly.

By June 30, 2004

Continue to assist the Task Force in the implementation of RBS training plan. Advisors: Antonova, All; NBU Counterpart: Task Force

Our project continued to assist the members of the Task Force in the implementation of RBS plan. By June 2004 BearingPoint consultants together with the NBU conducted 11 (eleven) risk-based supervision seminars in Kiyv and in regions with 225 people attending. Based on the feedback received from the participants, BearingPoint consultants together with Task Force members are designing modifications to the course for the next year, e.g., focus on individual risk categories, measurement tools, etc.

Continue the development of the Onsite Manual and other supervisory tools. Assist in the issuance of revised Chapters of the Onsite Manual. Advisors: Ladokhina, Baranovich, Blimling; NBU Counterpart: Task Force

We have discussed the format of the On-Site Manual and various supervisory tools at each of our risk-based supervision seminars. We also plan to visit commercial bank inspections in the third quarter of 2004 to discuss the Manual further. All examiners have read the Manual and claim to use the Manual at on-site inspections. We have received many comments to amend the Manual further to more closely match the risk assessment matrix. We will develop new chapters of the Manual and amend certain previously completed chapter in the final year of our project.

2. **Offsite Analysis: MIS reports modified, based on the risk-assessment methodology. External audit results incorporated into the supervisory strategy of banks.**

By September 30, 2003

Continue to assist the GDBS in developing their supervisory strategies for banks to include results of the internal/external audits. Advisors: Kutsenko; NBU Counterpart: Ivanenko, Faber

We did not perform activities in this area during this quarter.

By March 31, 2004

Make recommendations and assist in implementation of changes and additions to reporting requirements subsequent to finalizing the RAS. Advisors: Kutsenko, All; NBU Counterpart: Task Force

The NBU Board of Directors approved the risk assessment system on March 15, 2004. Connected to this approval process, our advisors have assisted the GDBS with various reporting and information changes for MIS, including the supervisory strategy document and the Bank Dossier. These changes are being discussed in connection with our risk-based supervision seminars in the regions. We will continue to assist the GDBS with recommendations for other management information reports throughout the year.

3. **Licensing: Requirements for both renewal and new bank licenses are changed to require risk management systems that meet NBU standards.**

By September 30, 2003 – June 30, 2004

Continue work with the Legal Department in the development of a licensing framework needed to ensure commercial banks appropriately address the Risk Management System functions at the time of licensing. Advisors: Gegenheimer, Telychko; NBU Counterpart: NBU Legal Department, Parkhomenko

Draft amendments to the Law on Banks and Banking Activity (Banking Law) have been developed. Articles 17-20 address issues related to licensing. The amendments are to be considered during round table discussions with the Legal Department by December 31, 2003. Due to reasons beyond our control, working group on amendments to Banking Law related to issues of risk management systems (including addressing the risk-management functions at the time of licensing) was not formed in a timely manner. It should commence activity only in early 2004. Please see comments in Section 5 "Legal Issues".

Our legal advisors advised the NBU working groups on the banking law and implementing regulations, primarily in the area of related parties to banking operations. The principal items of concern are amendments to the banking law as it pertains to: "essential participants" in banks, the concept of "beneficial ownership," and related parties. Advisors have met with Ms.

Ivanenko, Ms. Farber and Mr. Novikov to present ideas and suggestions for provisions that we believe the NBU should advocate in the amendments. Advisors have also attended working group sessions with NBU representatives and representatives from the Bankers Association to discuss the proposed amendments. We are continuing to work on these items, as well as preparing for discussions later on audit requirements, bank corporate governance, and consolidated supervision.

Our legal advisors continue to advise the NBU working groups on the Banking Law and its implementing regulations, including requirements for licensing activities and risk management. At present, Article 19 of the Banking Law requires that members of the bank's supervisory board and management board have appropriate education and experience necessary to manage a bank. This is a good concept, but more is needed. This threshold should be much higher to include a proper internal audit function and risk management capabilities. We delivered a comprehensive set of recommendations to the Banking Law regarding licensing activity in May 2003 and have continued to push this area further. The Banking Law (proposed Article 44) would have considerable more detail regarding the expectation of risk management and audit functions than in the current edition.

The proposed Article 44 of the Banking Law contains much stronger and more detailed language regarding risk management and internal controls and audit activities of banks, including the following:

- Each bank must have a comprehensive and adequate system for determination, evaluation, monitoring and control of all risks.
- Each bank must have a system of internal controls and management information systems that are appropriate for the bank's size and complexity.
- Each bank should have committees for risk management, internal audit and conduct review, which should report to the Supervisory Board.
- Each bank must submit an annual report to the NBU concerning evaluation of its own risk management and internal audit units.

We are continuing to work on these items, as well as preparing for discussions later on bank corporate governance and risk management, capital of banks, purchasing by banks of their own shares, transactions with connected parties, and consolidated supervision of "banking groups".

4. Organization and Staffing: Supervisory personnel are trained in risk-based management. The organizational structure of the Bank Supervision Department will be reviewed and changed to reflect the evolution of risk-based management.

By September 30, 2003

Work with the Task Force, NBU Personnel, and World Bank/Dutch Grant project in developing and implementing RBS training to begin in late 2003 and continue throughout 2004. Advisors: Antonova, All; NBU Counterpart: Task Force, NBU Personnel Department

Organization of course delivery and logistics was coordinated and discussed with the Personnel Department and GDBS Training Unit. The NBU Personnel Department and [illegible] assisted BearingPoint in selecting RBS instructors from the NBU. The persons selected [illegible] also be expected to attend Dutch Grant's Train-the-Trainers course (Presentation Skills). Technical training for the RBS trainers was completed in November 2003.

Continue efforts to organize and deliver various work/study and training opportunities in Poland and the United States. Advisors: Antonova; NBU Counterpart: Ivanenko, NBU Personnel Department

We provided a proposal to Mr. Pushkariov on the selection of GDBS personnel members for study tours abroad.

With BearingPoint advisory assistance, Ms. Ivanenko, Deputy Director of the General Department of Banking Supervision, participated in the course development of a seminar ("Best Practices of On-Site Examinations: Regional Experience and Challenges" for CEE and former Soviet Union countries) organized by the Training Initiatives for Banking Supervision ("TIBS") of the National Bank of Poland. This seminar was held during the week of November 17, 2003. Ms. Ivanenko made presentations on the Ukrainian bank supervision experiences and challenges. Three other persons from the GDBS also attended this forum.

BearingPoint advisors continue to work closely with the NBU and TIBS on future topics for seminars and cooperation avenues between the NBU and TIBS. We are also considering a future trip for the GDBS Training Unit Manager to visit TIBS for the purpose of discussing best practices, policies and approaches to organizing a self-sufficient and effective training function for the NBU bank supervision area.

Finalize proposal to provide English lessons for future participants in U.S.-based work/study program. Advisors: Ladokhina; NBU Counterpart: Faber, Ivanenko, Pushkayov

This issue has proven to be politically sensitive, and it was decided to postpone English classes until the GDBS management specifically requests assistance for the participants of the study tour. The candidates are to be selected by the GDBS management and in compliance with criteria stipulated in the proposal mentioned above.

By December 31, 2003

Continue the development and implementation of RBS training program. Advisors: Antonova, All; NBU Counterpart: Task Force, NBU Personnel Department

We developed training materials and delivered a "training-of-trainers" ("TOT") session for risk-based supervision in November 2003. A group of instructors from Kyiv and regions was selected by the NBU and BearingPoint to assist in the future implementation of risk-based supervision training. During the next quarter, BearingPoint will focus on formatting training materials and on the development of the best delivery mechanisms – combination of distance and classroom training. Selected individuals from TOT group will be heavily involved in the development and then in the delivery of the risk-based supervision training.

Continue efforts to organize and deliver various work/study and training opportunities in Poland and the United States. Advisors: Antonova; NBU Counterpart: Ivanenko, NBU Personnel Department

In November 2003 several senior managers of the General Department of Banking Supervision participated in the seminar "Best Practices of On-Site Examinations: Regional Experience and Challenges" for CEE and former Soviet Union countries organized by the Training Initiatives for Banking Supervision (TIBS) of the National Bank of Poland. Ms. Ivanenko, Deputy Director of GDBS, delivered a training session on the Ukrainian bank supervision experience and challenges. GDBS used this opportunity to discuss future cooperation between TIBS and the NBU. BearingPoint will continue to facilitate cooperation between the NBU and the NBP in the area of delivery of the joint training programs. According to the NBU 2004 training plan, TIBS instructors plan to deliver a seminar on the Polish experience of risk-based and consolidated supervision.

BearingPoint presented to the NBU the list of international training courses organized by OCC for bank supervision experts for 2004. If desired by the NBU or the GDBS, BearingPoint will facilitate participation of experts in these US-based training sessions. In the meanwhile, BearingPoint will continue to look into opportunities and possibilities to organize and deliver a study tour/internship program for GDBS examiners in the United States.

Assist and facilitate the organization of English lessons for future participants in U.S.-based work/study program. Advisors: Ladokhina; NBU Counterpart: Faber, Ivanenko, Pushkayov

Please see above (September 30, 2003) for comments in this area.

By March 31, 2004

Continue the development and implementation of RBS training program. Advisors: Antonova, All; NBU Counterpart: Task Force, NBU Personnel Department

During the first quarter of 2004, we have assisted the RBS Task Force with delivery of five risk-based supervision seminars. The seminars were held in Kyiv (2); and Zaporizhzhya, Cherkassy, and Dnipropetrovsk. Over the five courses, we had an estimated 70 participants. The participants were active in discussions and have voiced their concerns, positive and negative about the new system. The participants are mostly cautious about the amount of subjectivity in the new risk-based supervision system and their resultant ability to deal with the commercial banks armed only with opinion. All participants say more training and experience is necessary to fully implement this program. A more detailed summary of participant concerns is attached to this report as Appendix A. An additional six seminars are planned for the second quarter of this year. By the end of 2004, the NBU plans to have as many as 16 seminars on the new system covering the majority of the regions.

Continue efforts to organize and deliver various work/study and training opportunities in Poland and the United States. Advisors: Antonova; NBU Counterpart: Ivanenko, NBU Personnel Department

BearingPoint advisors have coordinated a one-week discussion between the National Bank of Poland and the National Bank of Ukraine on the topic of risk-based supervision. General agreement has been reached on the agenda items and the persons to be involved; however, timing remains an issue. The National Bank of Poland will cover all costs of materials preparation and speakers. The National Bank of Ukraine will cover housing costs. USAID through BearingPoint, will cover transportation and interpretation. This study visit was originally scheduled for the last week of May; however, this date interfered with preparations for the next TIBS course to be delivered during the first week of June. As a result, we have tentatively agreed that this study visit will take place in September of this year, with persons from Poland visiting Ukraine.

By June 30, 2004

Continue the development and implementation of RBS training program. Advisors: Antonova, All; NBU Counterpart: Task Force, NBU Personnel Department

During the second quarter of 2004, we have assisted the GDBS in the delivery of six risk based supervision seminars. These seminars were conducted in Kyiv, Donetsk, Lviv, Kharkiv, Simferopil and Odessa, with over 150 people participating. Over the eleven courses conducted in the first and the second quarter, we had an estimate of 227 participants. The participants were active in discussions and made positive comments about the new system and voiced their concerns. The issue of subjectivity in the new risk-based supervision system continues to be voiced. All participants as well as GDBS management say more training and experience is necessary to fully implement this program. After 11 seminars that were conducted, it became clear that the NBU needed to develop training materials and conduct training in specific risk categories, as well as measurement tools. An additional five seminars are planned for the second half of this year. We are not planning to make significant changes to the format of this course. The schedule of courses conducted is attached, as well as the schedule of course planned for the second half of 2004.

Including the train-the-trainer seminar conducted in November 2003, the number of banking supervision employees trained in risk based supervision totals 247 people, or approximately 35% of all supervision employees of the NBU. Of note, over 80% of seminar participants were women. Our initial, overall target coverage was higher, but after the RBS training plan was developed, over 150 employees from the foreign exchange control function were added to the GDBS. With five seminars scheduled for the second half of 2004, we plan to cover over 50% of all BS employees by the end of 2004.

The participation of the NBU instructors in the delivery of RBS course significantly increased over these three months. Whereas during the first seminars approximately 20-30% of the course was delivered by the NBU instructors and the rest by BearingPoint consultants, by the end of the second quarter of 2004, 60-70% of the material was delivered by the NBU staff from various functions of GDBS. Currently the GDBS has approximately 10 instructors (in Kyiv and in regions) who are able to deliver various parts of risk-based supervision course. BearingPoint will continue to assist the NBU in the delivery of risk-based supervision training, as well as in the development of the cadre of instructors to support self-sustainability of the GDBS training function in the future.

It is envisaged that in the third and the fourth quarter of 2004 the NBU instructors, under BearingPoint supervision and coordination, will deliver the majority of the risk-based supervision course topics. Then BearingPoint advisors will assist the NBU in the development of the new course format and content for 2005 risk-based supervision training. Changes to existing course format will be discussed later after 2004 risk-based supervision training is completed in its existing format. It is expected that BearingPoint advisors will assist the NBU in the delivery of risk-based supervision training throughout the project duration. Our vision of how assistance to the GDBS training function could be organized is attached.

On June 29, our project team crossed a milestone with respect to risk-based supervision implementation. BearingPoint advisors delivered a half-day, risk-based supervision case study to the NBU's senior management (Deputy Governors) and GDBS senior management (all Directors). This case study highlighted many issues relating to a bank's deteriorating condition, which were not apparent by merely studying the bank's financial ratios. The case study described the pro-active nature of concepts of risk-based supervision, as a method of addressing the root cause of bank problem before these issues appear in the form of deteriorating financial statements. In addition, the case study highlighted short-, medium- and long-term recommendations for full and effective implementation of risk-based supervision. Certain members of the NBU's senior management were skeptical of the subjectivity of risk-based supervision prior to this case study; however, many indicated they saw risk-based supervision in a new light after this exercise. Our team immediately followed this case study exercise with a comprehensive action plan (attached) for implementation of risk-based supervision to build on the momentum and understanding of this concept at the senior-most levels of the NBU. This action plan is now being used as a basis for several working groups at the NBU focused on implementation of risk-based supervision.

Continue efforts to organize and deliver various work/study and training opportunities in Poland and the United States. Advisors: Antonova; NBU Counterpart: Ivanenko, NBU Personnel Department

BearingPoint advisors together with GDBS and Personnel Department of the NBU continued to coordinate a one-week discussion between the National Bank of Poland and the National Bank of Ukraine on the topic of risk-based supervision, focusing on the issues of credit risk assessment, measurement, on-site examination planning, etc. General agreement has been reached on the agenda items and the persons to be involved. This seminar is scheduled for the week of September 6-10, 2004 and will be conducted at the premises of the Training Academy of the NBU in Kyiv. Currently the NBU, the NBP and BearingPoint are coordination cost sharing schemes for the delivery of this course. The National Bank of Poland will cover all costs of materials preparation and speakers.

On May 31 – June 4, 2004 three representatives of the GDBS participated in the course delivered by TIBS of the NBP. This course was dedicated to the issues of Credit Risk Management. Mr. Oleg Kostiushko, Head of Large Bank Monitoring Division of the GDBS, made a presentation on credit risk management practices in Ukraine. Our advisors assisted with preparation for this presentation. All representatives of the NBU who participated in this course commented on the excellent quality of instruction and organization. This course was conducted in Russian and was attended by representatives of central banks of the former Soviet Union and Eastern and Central European countries.

Ongoing

As risk-based supervision is developed within the GDBS, make recommendations to management concerning potential changes in organizational structure. (Continuation from year I. Advisors: Blimling, Wilson; NBU Counterpart: Shlapak, Pushkayov

We have provided assistance in the formation of a new department within the GDBS. The department combines the Methodology, the Economic Analysis, the Strategic Planning, and the Enforcement Actions Units into one department called the Department of Methodology and Strategic Planning. Ms. Svitlana Faber heads the new department, and the previous units are now divisions with slight name changes. This reorganization results in having four departments reporting to Mr. Pushkayov rather than three departments and four units. Additionally, a new unit within the Methodology Division, called the Risk Based Supervision Unit, has been formed. We are working closely with this new unit in the development of the supervisory manual and other RBS tools. Ms. Farber is our primary counterpart for the overall banking supervision development project.

Building upon information we have ascertained from our risk-based supervision seminars and from many discussions with NBU senior management and senior management of the GDBS, we have developed an "action plan" for full implementation of risk- based supervision at the NBU. The action plan is attached to this report. Certain actions within the plan are of a short-term nature, but much of the plan is oriented toward the next five years of development. Deputy Governor Shlapak has accepted this plan, and asked each of the major units within the banking supervision function to develop their own action plans to meet these longer-term goals. We expect the NBU to form various working groups in the third quarter of 2004. We will assist the various working groups in their formation, organization and coordination.

5. **Legal Issues: Elements of the legal framework are further elaborated which deal with different aspects of the banks' required systems of risk management. In particular new implementing regulations are developed requiring risk-management units and board-approved risk limits within banks. An amendment to the Law on Banks and Banking is developed to require the internal auditors of commercial banks to report to the Supervisory Council of their bank (rather than, as currently required, to their Board of Management.)[1]**

<u>**By September 30, 2003**</u>

Working with the GDBS and NBU Legal Department, assist in the development of amendments to the Law on Banks and Banking (and related laws) in order to improve the legal framework for implementing risk-based supervision and corporate governance in banks, using as a basis the areas identified in Year 1. Advisors: Telychko, Gegenheimer; NBU Counterpart: Ivanenko, NBU Legal Department

Since the NBU has decided to submit their proposed amendments to the Banking Law in segments divided into defined topics, extensive working group meetings dedicated to specific issues have been conducted and will be conducted throughout this year and ext year.

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[1] This section calls for the implementation of new laws and regulations, and amending current legislation. We feel that a thorough review of all pertinent laws and regulations, along with full agreement and cooperation from NBU Bank Supervision and Legal Departments are necessary before implementation can take place. Therefore, the actual implementation phase may only be accomplished after considerable research and consultation with NBU management and staff, and the banking industry. Our assistance in the development of Laws and Regulations will coincide with the NBU Comprehensive Program of the Development of the Ukrainian Banking System.

The first two working groups that took place in July-August were dedicated to external audit and beneficial ownership concepts. Participants of the working groups have accepted many of our recommendations. Even though the language has been considerably changed, approximately 80% of the underlying concepts were taken into consideration. The proposed amendments are to be approved by the NBU Council some time in mid-October and submitted to the Rada.

By December 31, 2003

Continue to assist in the development of amendments to the Law on Banks and Banking (and other laws). (This is in line with the "Comprehensive Program for the Development of the Banking Industry," which states the NBU will submit suggested amendments to the Rada by 12/31/03.) Advisors: Telychko, Gegenheimer; NBU Counterpart: Ivanenko, NBU Legal Department

We developed and distributed to all concerned parties within the NBU further recommendations on amendments to Banking Law in area of corporate governance and risk-management systems as well as in area of consolidated supervision.

Mr. Gegenheimer and Mr. Telychko held meetings with Ms. Faber, Mr. Novikov, Mr. Uvarov and other key personnel to discuss necessary amendments to Banking Law and reasons for so a slow process of making amendments. The major problems displayed are: 1) political reasons; 2) internal conflict between the Legal Department and General Department of Bank Supervision; 3) overload of the NBU legal department with other work while human resources are insufficient; 4) structural changes within the NBU; 4) intention to involve commercial banks in the process of discussing proposed amendments to the law (though, it is necessary since interests of banking community are strongly presented and lobbied in the Parliament); 5) changes in approaches related to forming package(s) of amendments. Due to above reasons, the work on amendments related to beneficial ownership concept and external audit is not finished yet, though relevant working groups started their activities in summer 2003. Working groups on other issues were not formed yet.

As of late December 2003, the NBU decided to provide recommendations on amendments to Banking Law in one comprehensive package that would incorporate recommendations related to beneficial ownership, audit, corporate governance, risk-management systems (including addressing RMS issues at the time of licensing and reinforcing the NBU authorities) and possibly consolidated supervision. The working group dedicated to those issues is supposed to start operation in early 2004. It is expected that actual amendments to Banking Law will not take place until end of 2004.

By March 31, 2004

Identify NBU regulations that need updating as a result of passage by the Rada the package of law amendments submitted in December 2003. (Of course, this assumes that the package actually is submitted by 12/31/03, and that the Rada actually passes it or passes something that reasonably resembles the package.) Advisors: Telychko, Gegenheimer, Burlaka; NBU Counterpart: Ivanenko, NBU Legal Department

The amendments to the Banking Law have not yet been finalized for submission to the Rada. See above for a discussion of the remaining contentious items concerning related parties.

banking operations. Nonetheless, our legal advisors have identified several regulations that may need to be amended once the law has been passed, assuming it will contain the suggested amendments.

By June 30, 2004

Provide specific suggestions for amendments to existing NBU regulations, or for new regulations, to implement suggestions in connection with findings of previous quarters. Advisors: Telychko, Gegenheimer; NBU Counterpart: Ivanenko, NBU Legal Department

A set of draft amendments to the Banking Law was recently submitted to Parliament. Our advisors assisted with the submitting amendments to the Banking Law as it pertains to: ownership structure of banking organizations, submission of information by "essential" and controlling participants, strengthening enforcement measures regarding violators of prior notification procedure for purchasing of such participation, banks' registration, and external audit requirements.

Our advisors worked with the NBU and its critical counterparts in discussing these amendments and readying Parliament for their submission. Advisors have attended working group sessions with the NBU representatives and representatives from the Bankers Association to discuss the proposed amendments. Advisors have met with Ms. Ivanenko, Ms. Farber and Mr. Novikov to present ideas and suggestions for provisions that we believe the NBU should advocate in the amendments.

II. The banking community understands and accepts risk-based supervision. The contractor will advise and assist the National Bank in the elaboration of regulatory standards and an action plan for implementation of risk-based supervision at the commercial banks.

1. Compliance: NBU GDBS develops a plan for compliance with the new regulations on risk-based supervision.

By September 30, 2003

Work with the Task Force to fully implement the compliance plan (part of RBS implementation plan developed in May 2003) by December 31, 2004. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

Discussions were held with key members of the Task Force on how to proceed with the implementation of the compliance plan. More specific details and recommendations will be forthcoming in the next quarter.

By December 31, 2003

Continue Working with the Task Force to fully implement the compliance plan by December 31, 2004. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

Discussions were held with Ms. Faber concerning implementation of the Risk Based Supervision initiative. However, due to continued personnel changes within the [illegible] supervision area and extensive holiday leave for major contributors to the initiative, little was formally decided. Ms. Faber intends to begin the use of the Risk Based Supervision approach in 2004, but will not be able to work out all the details until early in January.

By March 31, 2004

Continue working with the Task Force to fully implement the compliance plan by December 31, 2004. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

On March 15, 2004, the NBU's Board of Governors passed the "Resolution On the Approval of the Methodological Guidelines for Bank Examinations, "Risk Assessment System." Several members of NBU senior management were wavering on their support of the new system; however, the NBU Chairman fully supported the concept. Our most critical counterpart in this effort is Ms. Svitlana Farber, and our project has devoted considerable resources to assisting her with developing proper arguments in favor of risk-based supervision. We continue to participate in banker's meetings regarding the recommendations for risk management for commercial banks. This document is also nearing its completion, and will provide a higher level of transparency of expectations to the commercial banks. During 2004, inspectors will officially continue to inspect banks under the CAMELS system; however, they will also assess the bank under the risk assessment system. After each inspection, an internal report will be developed showing the risk assessment of the bank being inspected. These "practice" reviews will ensure a deeper understanding of risk-based supervision before the program becomes effective in 2005.

By June 30, 2004

Continue working with the Task Force to fully implement the compliance plan by December 31, 2004. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

The compliance plan for implementing risk management in commercial banks is a combination of three areas of our project: the risk assessment system being implemented by the NBU, risk management guidelines and banker roundtable discussions. The risk assessment system allows inspectors and bankers to discuss the various concepts of risk management and the expectations of the NBU. The risk management recommendations are being drafted and edited by a working group of NBU personnel and the commercial banks. This higher form of transparency and inclusion will bring about a better document and more accountability by the commercial banks. The banker roundtable discussions allow a free forum for suggestions and recommendations. See part six of this section for a more complete discussion of the banker roundtable discussions.

2. **Diagnostic: NBU Bank Supervision Department (GDBS) reviews the main products and services of a sample of the two tiers of larger banks (about 25 banks, accounting for over three-fourths of banking system assets) and assesses the types of risks relevant for each.**

By March 31, 2004

Assist Task Force in developing a process that will allow the GDBS to maintain timely information on existing and new products that commercial banks offer. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

We have developed a risk matrix for use in our RBS training seminars that categorizes banking risks by risk category and by product category. This will be used as a guide for the GDBS describing new products and services, and the risks inherent in each. We will also incorporate amendments to the On-Site Manual for new products and services risks.

By June 30, 2004

Assist Task Force in the implementation of a process that will allow the GDBS to maintain timely information on existing and new products that commercial banks offer. Advisors: Blimling, Wilson; NBU Counterpart: Task Force

The task force was heavily concentrated on implementation of risk-based supervision concepts in general, as well as delivering the training seminars. A matrix of risks applicable to various products and services will be developed in the third quarter of 2004. The most effective "process" for maintaining timely information about new products and services in using the Methodology Unit as an apex for information from supervisory strategies and inspections and continued meetings with banks on an informal basis. The NBU has committed to both of these concepts through acceptance of the action plan for implementing risk-based supervision. Additionally, in 2005, we expect the risk management "recommendations" given to commercial banks will transform into a regulation and become "requirements."

3. **Template: NBU BS develops a template covering the panoply of risks, and describes the key elements needed for an effective risk management system.**

By September 30, 2003

Assist the Task Force in finalizing the testing of the Risk Assessment System (RAS) and provide a draft of policy guidelines for Risk Management Systems in Banks. Advisors: Blimling, Wilson, Vance, Ladokhina; NBU Counterpart: Task Force

The Risk Assessment System (RAS) was finalized by the Small Working Group of the RBS Task Force, based on the results of its pilot bank testing and further discussion by the Task Force, as well as taking into consideration comments and proposals of NBU branches and commercial banks. The RAS is ready to be approved by the Task Force and the NBU Board of Governors. A major change is the merging of the Operational and IT Risks into an Operations and Technology Risk category.

BearingPoint advisors drafted and submitted to the GDBS "Policy Guidelines to Risk Management Systems in Commercial Banks" based on best international practices. The Guidelines are to be finalized by the GDBS and officially issued by the end of 2003. To facilitate this, the GDBS established a Working Group that includes seven representatives of the NBU, seven representatives of commercial banks, and BearingPoint advisors. The objective of this Working Group is to finalize the Guidelines, taking into consideration comments and proposals of all interested parties (NBU units and branches, and commercial banks), and prepare a final official issuance.

By December 31, 2003

Assist the Task Force in finalizing the policy guidelines for Risk Management Systems in Banks. Advisors: Blimling, Wilson, Vance, Ladokhina; NBU Counterpart: Task Force

The policy guidelines remain in the final development stage. The working group made up of Task Force members and commercial bankers has been established and they are currently working to revise the initial draft. It is anticipated a final draft that will be sent to all commercial banks will be issued early in the first quarter of 2004.

The working group met twice in the fourth quarter of 2003. At the second meeting in November, the inputs and comments of bankers were discussed. In particular, there were questions on the functions and responsibilities of the Risk Management Committee, the roles of the Supervisory Council, the Board of Managers, the ALCO, and internal audit. The NBU and BearingPoint position on these issues was presented to banks based on the principles of Corporate Governance. It was also suggested that for the next meeting the banks would present their ideas on the management of specific risks. The input of the banks has been received and is being summarized by the NBU and BearingPoint. The final discussion of this input and the meeting with the banks are scheduled for the middle of December and early January, respectively. After that it is planned that the Guidelines will be distributed for all banks and then in early 2004 passed as an official NBU document.

4. **Tools: NBU BS develops tools for the commercial banks in implementing "risk based" systems, such as examples of policies, audits programs, MIS software for implementation by individual banks.**

By March 31, 2004

Working with the Task Force, assist in the development of tools for commercial banks in implementing risk management systems. Advisors: Kutsenko, All; NBU Counterpart: Task Force

The "Policy Guidelines to Risk Management Systems in Commercial Banks" contains a myriad of examples of policies and audit considerations for bank management to follow in developing a comprehensive risk management system, applicable to any particular bank. These recommendations continue to be discussed with commercial banks and the bankers association, with expected approval in the second quarter of 2004. Our project is also considering development of a second document specifically covering minimum requirements for management information systems, both at a senior management and a board of directors' level.

By June 30, 2004

Working with the Task Force, assist in the development of tools for commercial banks in implementing risk management systems. Advisors: Kutsenko, All; NBU Counterpart: Task Force

As mentioned above, the risk management recommendations document – still not finalized – has a myriad of suggestions for risk management tools in commercial banks. From our banker roundtable discussions, it is obvious that bankers have read this document, even though in draft form, and are already developing measures to comply with the recommendations presented. We will develop a comprehensive document in the next twelve months that will specifically address the issues brought forth by bankers in the various roundtable discussions.

5. **Risk-based Supervision Director and Committee: The NBU designate a small group of examiners to be responsible for risk management implementation ("Risk-Based Supervision Committee") and senior Bank Supervision Department Official ("Risk-Based Supervision Director"), who will be the NBU's primary liaison with the banks in the implementation of the new methodology. This group is responsible for training other NBU examiners in risk management, for reviewing implementation plans and policies, and for evaluating and providing on-site assistance regarding the procedures developed by individual banks.**[2]

   The Risk Based Supervision Task Force is established and fully functioning. This illustrative task is complete. Additionally, the NBU restructured the banking supervision area to have a separate risk-based supervision focus, including a methodology unit, which is our primary counterpart for this project.

6. **Communication: NBU's "Risk-based Supervision Committee" develops seminars and prepares training materials to be made available to the banks as guidance on implementation of risk-based systems and the new NBU regulations in this area. (A policy manual should be given to the bankers by the NBU early in the process to provide this guidance and as a basis for discussion at meetings with senior bankers.)**

   By September 30, 2003

   Assist the Task Force in the development and delivery of training, outreach activities, and guidelines in their efforts to inform and assist commercial banks in their development of risk management systems (part of implementation plan developed in May 2003). Advisors: All; NBU Counterpart: Task Force

   The NBU initiated an outreach session in late October for bank internal auditors. During this two-day session various issues were discussed, including the role of internal auditors in risk management and supervision-by-risk processes. BearingPoint participated in this outreach session by making a presentation covering "Basle Committee Requirements to Internal Auditors."

   By December 31, 2003

   Assist the Task Force in the development and delivery of training, outreach activities, and guidelines in their efforts to inform and assist commercial banks in their development of risk management systems. Advisors: All; NBU Counterpart: Task Force

[2] Note: We have determined that a separate Director and Committee is not necessary since "Risk-based Supervision" is to become an integral part of all supervisory efforts. Instead, we are proposing that a task force be established that will guide the GDBS through the implementation of "Risk-based Supervision".

BearingPoint advisors participated during the first two weeks of October in an NBU sponsored Risk Management Outreach initiative and two industry sponsored Internal and External Audit workshops.

By March 31, 2004

Assist the Task Force in the development and delivery of training, outreach activities, and guidelines to inform and assist commercial banks in their development of risk management systems. Advisors: All; NBU Counterpart: Task Force

Our advisors participated in two outreach sessions, the first in Zaporizhzhya and the second in Dnipropetrovsk. These "banker's roundtable discussions" were highly informative and interactive. Commercial bankers are generally supportive of risk management guidelines and recommendations. However, bankers are quite hesitant about the degree of subjectivity that accompanies risk management, much like the hesitancy of the inspectors from the NBU. The commercial bankers have, like the NBU inspectors, recommended more training be offered for risk management principles to ensure this concept is understood.

Our advisors have also actively participated in working groups associated with the risk management guidelines of the NBU.

By June 30, 2004

Assist the Task Force in the development and delivery of training, outreach activities, and guidelines to inform and assist commercial banks in the development of risk management systems. Advisors: All; NBU Counterpart: Task Force

BearingPoint advisors continued to participate in outreach sessions – "banker's roundtable discussions" – where the GDBS is presenting two documents to the banking community – "Risk Assessment Systems" document and "Recommendation on Comprehensive Risk Management Systems."

In the second quarter of 2004, five banker roundtable discussions were conducted with bankers representing Donetsk, Crimea, Odessa, Kharkiv (including Poltava and Cherhigiv) and Lviv (including Ivano-Frankivsk, Uzhgorod and Lutsk) regions. Nearly 120 bankers from 52 regional banks participated in these roundtable discussions. Overall, in 2004, seven roundtables were conducted in seven different regions of Ukraine. This format allowed the NBU to reach practically all of the regional banks (68 out of 72), with total assets of approximately 50 billion UAH, or roughly 40% of total assets of the banking system (as of June 30, 2004).

These meetings have been very informative and demonstrated that different banks are at a different level of understanding of risk management concept and advantages. It must be stressed that no banks has openly questioned the need for risk management systems. Bankers comments have been relatively consistent in this area, and relate to the following topics: the degree of subjectivity in risk management and risk-based supervision, the general lack of available training in this area, the cost of information technology that is necessary to construct risk management systems, the difficulty of implementing corporate governance principles particularly of supervisory board members. We can divide the banking industry (ex[illegible] foreign-owned entities) into three groups for risk management and corporate gov[illegible] principles. The first group has grasped risk management and corporate governance concepts and want assistance in implementation. The second group has not fully accepted risk management and corporate governance principles, yet have reluctantly agreed to the concept and is generally willing to listen to recommendations. The third group consists primarily of small banks, which are simply overwhelmed by these concepts and want the NBU to tell them what to do and supply all technology and know-how to get it done.

In July, the NBU plans to finish this outreach program by conducting two roundtables for banks of Kyiv and Kyiv region. We will summarize the roundtable discussions in our next quarterly report, dated September 30.

7. **Role of external and internal auditors: The NBU, through its regulations and its *inspection procedures, focus on getting the management and bank boards to* more rigorously incorporate, in a systematic way, analyses and recommendations of the internal and their external auditors. (Substantial work is needed in this area. Regulation, certification, and actual practices of internal and external audit in Ukraine are very weak.)**

<u>By September 30, 2003</u>

Assist the NBU, by making recommendations to changes in laws, regulations, methodologies and/or practices, in strengthening commercial banks' internal and external audit function. Advisors: Kutsenko, Telychko; NBU Counterpart: Ivanenko, Faber

During the quarter, the NBU continued to work on issues related to external auditors. In particular, the Audit Certification Committee Policy has been adopted and the Committee established (based upon recommendations from Mr. Chuck Canfield, WB/DG Advisor). The Committee includes nine member: five representing NBU, four from the Audit Chamber, and one from the non-bank financial regulator agency. Mr. Pushkayov was named Chairman and Mr. Faber Deputy Chairman.

It is expected that one of the immediate decisions to be made by the Committee is how and when to start issuing new bank audit certificates and what to do with the ones that expire. This issue becomes extremely important since the majority of External Auditor certificates expire before May 2004, i.e. before the deadline for presentation of year-end audited financial statements to NBU and the general public. If the issue remains unresolved, many national audit companies will loose the authority to conduct audits, which may have an adverse impact on the quality of the remaining audits (remaining audit companies may not have sufficient resources to accommodate the clients previously serviced by formerly authorized audit companies).

The NBU is fully aware of this situation and has formed a Task Force with NBU experts, representatives of audit companies (both domestic and the Big Four), and BearingPoint advisors.

<u>By December 31, 2003</u>

Finalize assistance to the NBU in strengthening commercial banks' internal and external audit function. Advisors: Kutsenko, Telychko; NBU Counterpart: Ivanenko, Faber

The Certification Committee of the National Bank has established procedures for renewing expired and existing external audit certificates, as well as for granting certificates to new auditors (entry requirements). Both procedures require eligible candidates to be able to show knowledge of International Accounting Standards (IAS) by completing the process for trusted accounting certificates (i.e. CCA, CPA, or its Russian language equivalent – CIPA). In this respect, we cooperated closely with other USAID-funded project – Accounting Certification administered by Chemonics – to the mutual benefit of both projects.

It is expected that the work will be continued in mid-2004, once banks would submit their audited financial statements and the NBU will start checking their quality.

III. The NBU Bank Supervision Department implements an institutionalized program for training, career advancement and certification of bank supervision officials. The NBU Bank Supervision Department, USAID advisors, and World Bank advisors and instructors will work together to develop an integrated approach to establish a consistent and sustainable program for improved training and for "certification" of bank supervision personnel.

By September 30, 2003

Continue working with the GDBS and the NBU Personnel Department (and Dutch Grant/World Bank Project) in the development of a curriculum for core courses, including RBS. Advisors: Antonova; NBU Counterpart: Ivanenko, Personnel Department

A series of meetings were conducted with Dutch Grant/BankWorld representatives and BearingPoint on many issues related to the development of core course curriculum, including RBS course as one of the fundamental courses. All training initiatives of BearingPoint and BankWorld were coordinated to avoid overlapping situations. It was initially agreed that the Risk-Based Supervision course will be considered as one of the fundamental courses of the formal training program developed by the Dutch Grant in close cooperation with BearingPoint, who will be responsible for the delivery of this course in 2004/5 for the bank supervision staff of the NBU. Potential participation of BearingPoint staff in the delivery of BankWorld Train-the-Trainer course was discussed. As it was mentioned earlier, BearingPoint local RBS instructors (from the staff of the GDBS) will attend Dutch Grant/World Bank Train-the-Trainers courses offered at three different locations of the NBU.

By December 31, 2003

Assist in finalizing a curriculum for core courses, including RBS. Advisors: Antonova; NBU Counterpart: Ivanenko, Personnel Department

BearingPoint participated in all Train-the-Trainers courses organized by Dutch Grant representatives at three different locations of the NBU, and selected a group of potential instructors for its RBS training program. Then in November 2003 these instructors attended technical Train-the-Trainer RBS seminars organized by BearingPoint.

BearingPoint consultants participated in meetings of Dutch Grant consultants and Training Unit management and discussed issues related to finalizing core course curriculum, including RBS courses, organizing and implementing an efficient training function, developing unit's policies and procedures, job descriptions, organizational structure, training needs analysis processes, etc. We agreed that BearingPoint would look into an opportunity to expose Training Unit manager to the Polish experience of organizing an efficient training function for banking supervision area.

2. **Trainers: A group of its seasoned bank supervisors become classroom trainers, as part of their regular duties.**

By September 30, 2003

Assist the GDBS and NBU Personnel Department (and Dutch Grant/World Bank Project) in developing a Train-the-Trainer program as part of the formal training program. Advisors: Antonova; NBU Counterpart: Ivanenko, Personnel Department

We provided assistance to Dutch Grant/BankWorld. Potential participation of BearingPoint staff in the delivery of Train-the-Trainers course was discussed.

By December 31, 2003

Assist the GDBS and NBU Personnel Department (Dutch Grant/World Bank Project) in finalizing a Train-the-Trainer program as part of the formal training program. Advisors: Antonova; NBU Counterpart: Ivanenko, Personnel Department

BearingPoint continued to provide assistance to Dutch Grant/Bankworld in this sphere. BearingPoint participated in all three TOT courses delivered by BankWorld and contributed to course development and delivery. As mentioned above, several instructors have been trained and are now actively involved in the training process.

3. **Certification: The NBU develops minimum qualifications for certification of fully qualified bank supervisors. The certification process should include: satisfactory completion of a set of core courses, normally to be taken by GDBS bank supervision staff (from Kiev and regions) during their first three years in the Department; successful ratings by supervisors for the candidate's experience of having worked for certain periods of time in specified fields of responsibility of the Department (e.g. on-site exams, off-site supervision, licensing, registration); a passing score on an objective Certification Test that the GDBS will administer from time to time.**

By December 31, 2003 / March 31, 2004

Develop concept paper to provide guidance in the development of an appropriate regulation to institutionalize an accreditation process. Assist in the development of the regulation. Advisors: Ladokhina, Telychko; NBU Counterpart: Ivanenko, NBU Personnel Department

Due to conflicting schedules, we postponed this activity until the March quarter. Our advisors have met with visiting Dutch Grant instructors to coordinate assistance and coordinate advise on the formation of an accreditation plan and career development program for banking supervisors. The training coordinator for banking supervision is in general agreement with these concepts; however, the NBU's Personnel Department would like to form an overall career development plan for the entire NBU rather than for each department.

This is a positive development for staff members, however this also causes a delay in our implementation schedule.

By June 30, 2004

Present to the GDBS and the NBU Personnel Department a detailed proposed accreditation program based on the newly created regulation. Advisors: Ladokhina; NBU Counterpart: Ivanenko, NBU Personnel Department.

The development of the detailed accreditation program will be a major focus in the third year of the contract. As it was mentioned earlier, accreditation program is included in the Comprehensive Program for the development of the banking system of Ukraine for 2003 - 2005. BearingPoint advisors discussed accreditation with management of GDBS and agreed on the preliminary action plan. However, this effort requires extensive cooperation with Personnel Department of the NBU that currently is working on the development of general human resource management policy for the entire NBU, not just banking supervision. On a positive note, a Deputy Governor Shlapak stressed the need for emphasis of personnel development issues in our discussion of the action plan for risk-based supervision. Upon the development of the implementation plan for accreditation program and of a set of deliverables, the GDBS with BearingPoint advisors will present them to Personnel Department. Since accreditation program is closely tied to career development and compensation, our project will continue to insist on the comprehensive approach to accreditation that, on one side, builds on the existing NBU's personnel management policies, and on the other side, proposes changes that will bring up the status of bank examiners to appropriate level, recognizing their critical role in ensuring stability of the banking system.

IV. Surveys and Assessments.

1. Survey of Gender Composition of staff, with indications of supervisory and non-supervisory personnel.

Complete - Survey officially submitted in September 2002 to USAID in Kiev. (A similar survey is to be repeated by June 30, 2005.)

2. Assessment of the NBU's operational implementation of Basle Core Principles, subject to agreement by the NBU.

Complete – Assessment officially submitted in July 2003 to USAID. (A similar assessment is to be completed in by June 30, 2005.)

3. Obtain an average examination rating of the "M" component of CAMELS for Tier I and Tier 2 banks.

Complete – Information officially submitted in July 2003 to USAID. A similar determination is to be conducted by June 30, 2005.

Outside Contacts (for quarter ending March 31, 2004)

Advisor	Organization	Contact Name	Time
Bryan Stirewalt	USAID	Victor Verhun	5 hours
	U.S. Treasury	Mel Brown	40 hours
	FMI	Ann Wallace	4 hours

Advisor	Organization	Contact Name	Time
Alex Kutsenko	USAID	Victor Verhun	4 hours
	Donor Task Force on Audit Issues	Yevgeniya Malikova (USAID)	2 hours
	Chemonics	Barry Pitts	1 hour

Advisor	Organization	Contact Name	Time
Maryna Antonova	USAID	Victor Verhun	24 hours

Other Work Requested By the NBU

Our legal advisors assisted Mrs. Farber in her understanding of the functions of a credit bureau. The NBU was concerned with regulation and supervision of a credit bureau, in addition to usage of information from the credit bureau. We advised the NBU that regulation and supervision of a credit bureau is generally left to consumer protection rules, and safety and soundness is not a general concern. We also advised the NBU to exercise caution on using information from a credit bureau for supervisory purposes. It is preferable to design internal data collection mechanisms through the bank's financial report, rather than using a credit bureau for this purpose.

Attachment A

BearingPoint.
Formerly KPMG Consulting

МЕМОРАНДУМ

To: Faber
Pozharskaya
Khimich

From: BearingPoint

Date: July XX, 2004

Topic: DRAFT MEMO on Training activities from June 2004 to June 2005

Risk-based supervision seminars

In 2004, we delivered **eleven** risk-based supervision seminars for the GDBS *(insert coverage data)*. By the end of 2004, we plan to assist with delivery of additional **five** risk-based supervision seminars. We are contemplating certain changes to the format of the seminars; however the changes will only be slight.

Over six months of 2004, several instructors from the GDBS and NBU regional offices and persons from BearingPoint delivered these seminars *(insert names of people, subjects taught)*. Iryna Pozharskaya, in particular, has proven to be a critical person to the deliver of these seminars. We believe that the presentation skills, and general confidence in public speaking, that Iryna has gained through these seminars will be invaluable to her long-term career at the NBU. People obviously become more effective in their presentations after the first delivery. Several people from the regional offices have expressed continued interest, and demonstrated competence, in the delivery of this seminar. We want to encourage participation by as many Ukrainian speakers as possible for this seminar, and in preparation for many internal seminars and courses at the NBU in years to come.

We expect that the majority of the risk-based supervision seminar will be delivered by NBU personnel in the second half of 2004. Our project will continue to assist with certain topics and with preparing new instructors for their portion of the seminar. We hope that by 2005 we will have a core group of risk-based supervision instructors – many from regional offices – who could be used for this and many other seminars and courses in their respective offices (*see section on core instructors group*). Bearing Point together with the RBS Methodology Unit will continue to coordinate course refinement/development, and dissemination of training materials.

BearingPoint (Alex Kutsenko) put all the materials from two RBS courses (two week train -the-trainers course and three day risk-based supervision course) on a CD that was distributed to all seminar participants. This material may serve as a foundation for a distance-learning course that could be developed and administered by the Training Unit / Risk-based Supervision Methodology Unit. Our project might also develop a list of test questions for this seminar for the accreditation program, as the risk-based supervision seminar is one of the core (fundamental) courses. In addition, on-the-job training for risk-based supervision program will be extremely important as NBU gains experience of RBS exams. Our project can provide the NBU with recommendations of how to organize this training. As first results of risk-based supervision exams are ready, BearingPoint will also assist in the review and dissemination of relevant information and lessons learned. (*Note that this depends on how much RBS is done in the exams that are planned for the nearest future, on the involvement of BearingPoint, and on the willingness of the NBU to share experience gained through these exams*).

For 2005, seven RBS seminars are planned (attached is the schedule of seminars for 2005). Five of the seven seminars are planned for the period of BearingPoint project, through June 30, 20005. Therefore, we need to consider the format of these future courses. One suggestion was to focus more detail on the specific risks that have been identified as the most difficult (i.e. market-related risks or operational risk). We might also focus more on written communication tools if a new format of the report on examination is introduced. We might also bring together the trainers for an update of the train-the-trainers course, as we have more experience in this topic and we know more about problem areas of RBS implementation. We might also suggest another approach, to invite examiners in charge for the exams scheduled for the nearest future, and use these training events as an opportunity to conduct management training (how to plan and conduct a RBS exam, allocate resources, etc).

Deliverables:

1. Update the basic RBS seminar, by September 2004.
2. Provide a current list of the NBU instructors and subjects taught.
3. Provide statistics on the number of GDBS employees in Kyiv and in regions who have completed training by July 2004.
4. Finalize a course schedule for September – December 2004.
5. Finalize a course schedule for 2005.
6. Update the general format for 2005 RBS seminar, by January 2005.
7. Develop list of test questions for RBS seminar for accreditation program, by January 2005.
8. Update and finalize CD with all training materials.
9. Develop a plan for delivering RBS through a distance-learning format.

Core instructors group

As was suggested by Karen Wilson, in order to provide for continuity training efforts and consistency of knowledge and skills dissemination throughout the regional offices of the NBU, the NBU should ensure that every regional office of the NBU has its own instructors and monitors the training needs of its staff.

We would suggest two persons from every region with five or more banks (legal entities) and one person from every other region to act as core instructors for RBS, and maybe other topics. This scheme will bring a total of approximately 40 people who will be training contact persons in regions and through whom the NBU will disseminate new materials, etc. They will conduct training in their respective regions and communicate with RBS Methodology Unit on the issues of RBS program implementation. Certain of these people might need to attend a train-the-trainers session. We also hope that in the future these regional trainers will be a source of information on real training needs of regional GDBS staff, in terms of formal and on-the-job training.

The NBU desperately needs to develop experts in such areas as capital markets, foreign exchange, credit, and information technology. These people should be offered chances to attend specialized courses to gain deeper knowledge in these areas. Then they can be used as consultants during examinations and as teachers at the NBU training facilities, and should have input to the RBS Methodology Unit on supervisory tools. We can assist the NBU in putting together such a list based on our experience. An individual development plan should be developed for every individual who fits into this category.

Deliverable:

1. Together wit the GDBS training coordinator, compile a list of potential trainers from all the regions (by the end of 2004).

Outreach programs for the banking community

The outreach programs have become a very successful form of communication with the banking community. We strongly encourage continuance of the same or similar programs in the future. We will assist with organization and delivery of further roundtables and conferences with the banking community, as necessary.

Accreditation

This is the most challenging part of our assignment, even though accreditation is in the comprehensive program for the development of the banking system of Ukraine for 2003-2005. Based on discussions with Ms. Faber, we have tentatively concluded that the NBU Personnel Department might be more opposed to the word "accreditation", than to the concept itself. In addition, "attestation" practices may give us additional arguments that certifying knowledge and skills of people is not a totally new concept for the NBU.

We believe Mrs. Farber is a willing to take a leadership role in pressing ahead with the accreditation program, including a level of coordination with the NBU Personnel Department. We will support Mrs. Farber is in terms of the development of actions plan for implementation of an accreditation program. Certain steps are already addressed in the action plan for risk-based supervision and will be discussed in the various working groups dealing with implementation of risk-based supervision. We also discussed the fact that accreditation is closely tied to career development and compensation. Compensation issues are one of the most difficult aspects of accreditation implementation.

We believe the following items are necessary to move forward with a viable "attestation" process at the NBU:

1. Review all existing NBU policies and procedures on attestation and human resource management to ensure knowledge of the opportunities and threats that current legislation presents for our accreditation program.

2. Review a draft policy on training and accreditation, developed by Tatiana Khimich, Head of the Training Unit of the GDBS, that was delivered to NBU Personnel Department and in still in the process of approval. Currently Personnel Department is working on the general human resource management and training policy that will cover all functions of the NBU.

3. Study experience of other countries in terms of accreditation implementation, particularly Poland and the United States.

4. Review the NBU Regulation # 153 from April 25, 2002 on "Comprehensive Program of Bank Supervision Personnel Training." This regulation includes a list of fundamental and advanced courses that are recommended for bank supervision personnel. The document mentions two types of tests, at the end of each course and an integral test that may be conducted once a year and based on which promotion and reward decision will be made. We need to review these lists of courses to make sure that they encompass the most relevant subjects for banking supervision staff.

5. Develop sample test questions for both types of tests and to make recommendations about the administration of these tests. These tests in the future will become a critical part of the accreditation program.

6. Test these questions with a pilot group to ensure the questions are understandable and feasible.

7. Transfer test administration function to the Training Unit that will also administer other aspects of accreditation once it is approved.

8. Develop ***a comprehensive document on accreditation*** that will encompass all the abovementioned components with specific recommendation on how the NBU may launch the fist pilot accreditation program.

9. Based on this document, assist the NBU in drafting a **regulation on accreditation** that eventually will get approval from the Board of the NBU.

All these may be deliverables for this part of the project. A lot of aspects in this list have already been developed or prepared, at least partially.

Internship Programs and Cooperation with Other Supervisors

We will continue to look for the training and internship opportunities in the USA and In Poland. It has become a tradition to send 3-4 people every quarter to the training events that TIBS hosts. In addition to attending courses, GDBS employees to take part in course development and delivery at TIBS. TIBS seminars and internship programs can also be used as a way to develop core instructors group.

A seminar on risk-based supervision with emphasis on credit risk is scheduled for September 6-9, 2004. Personnel from the National Bank of Poland will deliver this seminar. BearingPoint will assist in course development and coordinate course delivery efforts in Kyiv.

The GDBS is actively looking for opportunities to organize short-term (one week) internship programs at central banks of other countries. Funding for these initiatives comes from Dutch Grant.

Deliverables:

1. Assist with organization of a risk-based supervision seminar to be delivered by TIBS in Kyiv in September 2004.
2. Memo on potential cooperation between TIBS and the NBU before the end of the project.
3. Develop a list of "best" training courses offered by TIBS, Toronto Center, OCC and other supervisory agencies.

Summary

The ultimate goal is to make ensure that GDBS training function is self-sufficient and sustainable, and relies on its own resources for professional development of employees. Training should become a mandatory, constituent part of professional duties of all banking supervision staff. It shall be duly considered in annual work plans and development plans for each staff member, and sufficient time should be allocated to training. We strongly encourage more interaction, formally or informally, between the head office and regional offices.

Attachment B

BearingPoint.
Formerly KPMG Consulting

Date: June 30, 2004

To: Mr. Schlapak, Deputy Governor
National Bank of Ukraine

CC: Konstantin Uvarov, Natalya Ivanenko, Svitlana Farber,

From: Bryan Stirewalt

Re: Action Plan for Risk-Based Supervision

Dear Mr. Schlapak:

I am sorry for the delay in sending this letter to you, but the issues surrounding implementation of risk-based supervision are, as you know, quite complex. The attached "action plan" lists the areas of needed emphasis in implementing risk-based supervision in Ukraine. We are also suggesting a broad timetable for implementation of risk-based supervision, which deviates slightly from the existing plan of the NBU. Any change of this magnitude in a large organization involves not only difficult changes in legislation and the NBU's internal policies and procedures, but also necessitates large changes in the overall culture of supervision and further development of supervisors. While various changes to the infrastructure supporting banking supervision can be accomplished in the short-term, changes with recruiting, compensating, training and efficiently organizing supervisors will only be possible over a longer time period.

We obviously cannot afford to wait five to seven years to implement risk-based supervision. Chairman Tihipko has correctly emphasized that time is of the essence in this transformation, and we certainly agree. We will need to implement risk-based supervision and develop supervision staff on parallel tracks. We suggest implementing a program of risk-based supervision, on a step-by-step basis, within the next 18 months while realistically envisioning a fully effective program in five to seven years. During out risk-based supervision seminars this year, we have had the ability to meet and discuss these concepts with many supervisors across the country. This has given us a much greater depth of understanding of strengths and weaknesses of the supervision processes. From this vantage point, we are better able to refine the risk assessment system and provide recommendations for full implementation of risk-based supervision.

The risk assessment system is the "front office" of risk-based supervision, and is supported by a wide range of "back office" functions and processes. Supervisors seem to accept the concept of the risk assessment system; however, the matrices used in the document need to be amended to provide inspectors with more detail and explanation and to match the experience level of staff and developments in the banking industry. As a result, we believe that all inspections should include each of the "evaluation factors" in the risk assessment system by January 2005. However, the full implementation of this document, including the matrices, would only begin in January 2006. The only exception to this rule is in the area of credit risk, where supervisors are most comfortable making subjective judgments. Additionally, credit risk is the highest risk in the banking industry of Ukraine. This change in implementation strategy would allow the inspectors to gain a higher level of comfort with the evaluation criteria and a better knowledge of how the risk matrices would apply to these evaluation factors. This will also allow amendments to be made to the risk matrices based on feedback from our seminars.

Our recommendations in this action plan center on the following topics, divided into short-term (within 18 months) and medium-term (18 months to three years) goals. While these goals have short- and medium-term time lines, we expect full implementation of certain items, particularly implementing a program to attract, train and retain banking supervision staff, to cover a five to seven year time horizon.

SHORT-TERM GOALS

- Enhance the Supervisory Cycle / Supervisory Strategy Document
- Amend the Report of Inspection
- Review and Enhance Management Information Systems
- Enhance Banking Legislation for Risk Management Principles

MEDIUM-TERM GOALS

- Update Risk-Assessment System and the Inspection Manual
- Improve Inspection Planning Processes and Better Allocate Supervision Resources
- Improve the Off-Site Supervision Processes
- Develop a Program to Attract, Train and Retain Bank Supervision Staff
- Develop a Quality Assurance Program

The following document explains each of the above items in detail. The BSD should form a working group to deal with each of these issues. It is our opinion that forming one working group to deal with the concept of risk-based supervision would be better than several working groups dealing with each sub-topic, as the areas are often interconnected. I look forward to discussing each of these items with you, at a time that is convenient for you.

Sincerely,

Bryan D. Stirewalt, Project Manager
USAID Banking Supervision Development Project
National Bank of Ukraine

ACTION PLAN FOR IMPLEMENTATION OF RISK-BASED SUPERVISION

Enhance the Supervisory Cycle / Supervisory Strategy Document

The Banking Supervision Department ("BSD") should amend the policy defining the ***supervisory cycle*** for banks in Ukraine. The supervisory cycle is defined as the time between the ending date of a full scope, on-site inspection and the start date of the next inspection. The supervisory cycle should be primarily related to two factors. First, the supervisory cycle should be related to the amount of risk that an individual bank or banking group poses to the entire banking system in Ukraine (systemic risk). This systemic risk generally refers to banks with the largest market shares of assets, loans and deposits, and those banks that have the most complex product lines. Secondly, the supervisory cycle should be related to the individual risk in a bank. This is most closely related to the institution's CAMELS rating and its risk assessment. We should note that the supervisory cycle refers to a full-scope, on-site inspection of the bank, as a whole, not individual branches within the banking organization. Branches should be inspected on an as-needed basis, not based on any cycle. Also, the supervisory cycle is considered the maximum amount of time between inspections, not the minimum amount of time. If a bank with systemic risk implications for Ukraine is also showing a severe financial weakness, it might be prudent to inspect the bank using a six-month supervisory cycle.

Institutions with high levels of system risk and those with high individual risks should have shorter supervisory cycles than institutions with lower levels of risk. For instance, all banks in groups one and two in Ukraine and all banks with a CAMELS rating of 3, 4 or 5 might be assigned to a category requiring a full-scope, on-site inspection every 12 months. All banks with a CAMELS rating of 1 or 2 and with a "high" aggregate credit risk or a "high" aggregate liquidity risk assessment might be assigned to a category requiring a targeted, on-site inspection every 12 months. Finally, all remaining banks might be assigned to a category requiring a full-scope, on-site inspection every 24 months. After approving a policy statement defining the supervisory cycle for each bank in Ukraine, each bank in Ukraine should be assigned to one of these three supervisory cycle categories. As the banking system stabilizes, and risk management systems and financial reporting improve, the BSD might consider a 36-month supervisory cycle for banks in groups three and four with CAMELS ratings of 1 or 2.

The BSD will next need to develop a supervisory strategy document for each bank. The initial format of this document has already been developed the BSD Methodology Unit. This document must detail all planned supervisory actions (including an estimate of the amount of estimated human resources for these actions) for each bank through, and including, the next full-scope, on-site inspection. Once assigned to a supervisory cycle, the BSD should complete a supervisory strategy for each bank. The first set of strategies will need to be completed at one point in time, meaning thee overall accuracy of estimates will be less than perfect. On an ongoing basis, the on-site inspectors should develop this document with cooperation from the assigned off-site analysts, at the conclusion of each inspection.

The supervisory strategy should include, at a minimum: the number of inspectors to be involved at the next comprehensive on-site inspection, the time estimate for the next inspection, the number and location of branches to be reviewed, the number of persons needed (including any necessary risk area specialists), timing for the head office review, and the overall scope of the inspection by risk category. It is not necessary tol list personnel by name, only by levels of expertise and specialty. We realize that given the volume of turnover in the BSD inspection unit at the present time, it is difficult to plan for the next inspection. The strategy should also include any targeted on-site inspections in between full-scope inspections.

The off-site analysts should confirm the accuracy of the strategy document each quarter relative to the bank's actions taken in response to the previous inspection as well as the current trends and risks noted from analysis. This process may necessitate that the off-site analysts attend each on-site inspection to more completely understand the bank's conditions and expectations that the on-site inspectors have for the bank in the interim period between full-scope inspections.

The supervisory strategies will form the basis for allocating resources and for general planning in the banking supervision area. By compiling all supervisory strategies, the BSD can more easily determine the number of inspectors and analysts needed for inspections and follow-up analysis. For staff size planning purposes, the BSD should also consider vacations, sick leave, and training opportunities for all supervisory staff.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve policy statement for supervisory cycle.			
2. Approve supervisory strategy document format.			
3. Develop instructions for use of supervisory strategy document.			
4. Assign all banks to a supervisory cycle category.			
5. Develop a supervisory strategy for every bank.			

Improve Inspection Planning Processes / Allocation of Resources

The BSD seems to have an adequate number of staff to perform the role of banking supervision. However, the staff does not seem to be mobile and are not located in the geographic areas of highest need. Additionally, the inclusion of certain persons with the on-site inspection team, who may not be performing work directly related to risk-based supervision, detracts from the inspection team's efficiency. These issues are creating inefficiencies in supervision operations, which impact the BSD's ability to conduct effective risk-based supervision.

One of the causes of these inefficiencies seems to lie in the policy of inspecting branches. The geographic location of bank supervision staff seems to drive the inspection process, rather than the risk profile of the commercial banks to be inspected. Further, the regional offices of the NBU seem to be somewhat independent in their inspection processes, rather than driven by a single, supervisory strategy regarding the effected bank.

Branches of commercial banks should only be inspected if they pose a significant risk to the bank's risk profile and should have a much more limited inspection scope than that of the head office location. Inspections of branches should only occur in the branches having the most active loan portfolios, or branches with certain risk exposures that could affect the entire banking group. The most important risks in branch offices are credit risk, operational risk and, to a more limited extent, reputation and legal risks. Branch reviews might also include testing the implementation effectiveness of policies issued by the bank's head office or for significant internal or external audit weaknesses. All market-related risks (liquidity risk, interest rate risk, foreign exchange risk, price risk) and legal and strategic risks should be managed at the commercial bank's head office and therefore inspected there as well. Decentralized risk management of market risks is generally not a good risk management practice for banks. Nonetheless, if risk management of market risk is decentralized, more work will be necessary in branch locations. Regardless of general branch inspection methodology, it is important to follow the approved supervisory strategy for the individual bank. A branch inspection is not justified simply because the National Bank has bank supervision staff nearby.

The inspection process should start with a small team in the head office learning the bank's strategic direction and overall risk profile. This team will be comprised of the team leaders for risk areas and will be responsible for developing the plan for inspection of branches. After the head office team has determined the risks to be addressed and the inspection plan for addressing those risks, the branch teams should commence their inspections according to this plan. The branch inspection findings will then be discussed with the bank's branch manager, and sent to the head office location in a format determined by the inspector-in-charge. The full review of the head office will only begin near the conclusion of the branch offices reviews. Key personnel from the inspections of branches might be useful as part of the head office inspection team as well. The most significant conclusions of the branch reviews will be consolidated into the report of inspection for the head office.

It is important to appropriately staff the head office locations for inspections, particularly of the more complex banks, with an appropriate number of inspectors and with inspectors that have the proper expertise to deal with the most complex risks. In this realm, the BSD will likely need to "borrow" the best persons from regional offices to work at the

head office locations on a temporary basis from time to time. It is not economically feasible, in the short term, to ask people to relocate on a permanent basis from the regions to Kyiv. However, in the long term, the National Bank should consider a program to provide more incentives (monetary or otherwise) to attract more people to the BSD Head Office and Kyiv Regional Office. A critical issue to the long-term viability of banking supervision function is the ability to attract and retain quality employees, stopping the curtain outflow of experienced and well-trained inspectors to the banking industry. This issue is discussed more fully in a later section of this document.
The National Bank should review the geographic locations of inspectors, and determine where the inspectors are needed most. The National Bank should question the wisdom of keeping inspectors in an office where no bank head offices is located. The National Bank might consider creating a more limited regional offices structure, and assign persons to be regional inspection coordinators. The regional coordinators would coordinate the on-site inspection planning process, starting with the banks in the highest risk category and moving through the banks in the lower risk category. The planning process would necessarily improve in accuracy and efficiency as more historical information is obtained and inspectors gain more experience with the inspection process.

The BSD should review the size and composition of on-site inspection teams. Currently, the staff includes persons who are reviewing the bank for compliance with foreign exchange control and cash settlements operations. We certainly would not object to inclusion of these persons on the inspection team; however, their role in the inspection process needs to be directed by the inspector-in-charge. If their work is not specifically directed by the inspector-in-charge, the size of the inspection team performing work directly related to risk-based supervision should not be affected by their inclusion.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Develop policy statement for branch inspections.			
2. Analyze the feasibility of all bank supervision office locations, particularly questioning the need for inspectors in regions where no bank head offices are located.			
3. Develop a more centralized inspection planning process, including appointment of regional coordinators.			
4. Develop a program to provide an incentive for qualified persons from regions to inspection of complex banks.			
5. Develop a long-term program to increase the size of the banking			

supervision staff of the Kyiv Regional Office and Head Office of the National Bank.			

Update Risk-Assessment System and the Inspection Manual

The BSD should compile feedback from the risk assessment seminars and update the risk assessment system. Inspectors, in virtually every seminar location, have expressed their desire for more concrete, numerical targets to judge the quantity of risk and more detail in terms of planning and expectations for reviewing the quality of risk management. The risk assessment system will only become truly effective after several years of experience in its usage and application on bank inspections in evaluation bank risk management systems and following employee accreditation through a systematic career development program.

Numerical targets should not become a permanent addition to the risk assessment system. However, we acknowledge that banking supervision personnel need additional guidance and more formal benchmarks to form their judgments in the early stages of risk-based supervision implementation. Banking supervision personnel should clearly see the weaknesses of numerical targets, which is one of the main reasons for moving away from compliance-based supervision. The following is a miniature case study illustrating the weaknesses of relying too heavily on numerical indicators for each bank.

Case Study on Numerical Indicators

From off-site analysis, we see two banks. Bank A has problem loans totaling 25% of their regulatory capital. Bank B has problem loans totaling 60% of their regulatory capital. Which bank has the most risk? Given this information, we can easily say that Bank B has the most risk. After an on-site inspections and adjustments, we find that Bank A has insufficient and inaccurate problem loan recognition policies and practices, resulting in problem loans totaling 45% of regulatory capital (rather than 25%) while Bank B has an accurate loan review system showing problem loans at 60% of regulatory capital. Further, nearly half of Bank A's problem loans are classified "doubtful" while all of Bank B's problem loans are classified "substandard." After looking at risk management systems, we can safely say that Bank A has a higher level of risk and weaker risk management systems, even though it still has a lower total amount problem loans. Banking supervision cannot rely on off-site reports from Bank A because their risk management systems are weak, causing widespread reporting errors.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Compile participant feedback			

from risk assessment seminars and develop a document with recommendations for amendments to the risk assessment system.			
2. Develop numerical targets or ranges for quantity of risk in each of the six financial risk categories.			
3. Review, and amend the on-site inspection manual to include a discussion of each of the evaluation factors from the risk assessment system and develop or amend discussions in the inspection manual that will lead to conclusions on each factor.			

It is critically important of obtain feedback from the regional office locations regarding the initial numerical targets for the quantity of risk and amendments to the on-site inspection manual for quality of risk management. While feasible in the first version of the risk assessment system, persons from the head office cannot simply develop these future items in a vacuum and hold others accountable for compliance and consistency. Also, in establishing numeral targets to assist inspectors in judging the quantity of risk, peer information should be considered. However, frequently peer informative is reflective of a higher level of risk in the system as a whole. Therefore, we recommend that the "low" risk category for quantity of risk be set based on developed country ratios, not based on peer group information from Ukraine alone. The moderate- and high-risk categories can be more reflective of the Ukrainian situation, which should improve over time.

Amend the Report of Inspection

The standard Report of Inspection ("Report") should be amended to be consistent with the risk assessment system. The standard Report should include comments for each of the nine risk categories and the inspectors should be required to include a comment regarding each of the general evaluation factors listed in the risk assessment system. The comments should clearly lead the reader to the determination of the bank's level of risk and its quality of risk management. An executive summary section at the beginning of the Report should include, at a minimum, a comment regarding any risk area considered to be a "high aggregate risk" and an "increasing direction of risk." The Report should also include a standard set of financial tables so that numerical information does not clutter the message to the bank's management.

The BSD needs to also consider the issue of the audience of the Report. In other words, to whom is the National Bank writing this Report? This issue is causing certain problems in the regions as off-site analysts criticize the inspectors for not including certain information that the analyst wanted to know form the inspection process, yet the inspector did not consider material for the commercial bank. In international practice, some regulators adopt the attitude that the Report is written from the National Bank to the commercial bank, while other regulators feel the Report is an internal document that is simply shared with, or copied to, the commercial bank. For the most effective message, particularly with regard to risk management, we recommend that the audience of the Report should be the commercial bank. If the BSD head office wishes certain information to be included from each inspection, this might be included as a standard appendix to the Report or as part of a confidential memorandum (or placed within a management information system) that is separate from Report and treated as an internal document.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve the revised Report of Inspection to be consistent with the risk assessment system.			
2. Develop instructions for completion of the Report of Inspection.			
3. Include a professional writing course as part of the courses available for bank supervision personnel.			
4. Develop a confidential memorandum or management information system that would capture all necessary information from bank inspections that might not always be included in the Report of Inspection.			

<u>Develop a Program to Attract, Train and Retain Bank Supervision Staff</u>

The National Bank needs to develop a program to attract talented persons from the banking industry and from universities to the banking supervision function. Sadly, the role of a civil servant has diminished in value from previous days. Young educated people are interested in remuneration and possibilities of rapid advancement in an organization by means of merit, not longevity. The National Bank needs to turn its attention to meeting those needs.

United States regulators perform a survey periodically on the entry-level salaries of professional staff in the banking industry. The average entry-level salary is used to determine the entry-level salaries of the banking supervisors. Obviously, salaries at mid-sized commercial banks have a much higher realm of possibility that government service; however, a competitive entry-level salary ensures that supervisors are attracting talented persons from universities. Likewise, people are rewarded and promoted on a merit basis to higher levels in the supervisory organization. Rewards are given for teaching courses, for managing difficult inspections of problem banks, for developing new methods of inspections or analysis that helps the organization, etc. When a person is applying for a higher-level position, these factors are considered in addition to the person's longevity in the agency and their general experience.

In Poland, a rather strange phenomenon occurred with development of bank supervision staff. At first, Poland experienced the same problem that Ukraine is experiencing now, with exodus of quality staff members to the commercial banking industry for higher salaries. However, as Poland opened its banking system to more foreign banks, and the foreign banks reduced the staff size of the banks purchased, the number of bankers needed in the industry declined considerably. As a result, the National Bank of Poland's Banking Supervision Department was able to hire many experienced bankers as inspectors. In addition, the National Bank of Poland also realigned the salaries of banking supervision personnel to make careers more attractive to bankers looking for work.

During our training sessions, banking supervisors have confided serious concerns that they are not yet comfortable in judging whether a bank's risk management systems are good or bad, with the possible exception of credit risk. Moving toward a risk-based supervisory approach is a long-term process that should be managed cautiously. The series of risk assessment seminars are setting the basics requirements of the risk assessment system. However, all bank supervision personnel, including management levels, need to have more training on the individual risk areas within risk-based supervision. This training program should be developed and delivered in a systematic manner throughout the department. Training all effected staff on the individual risk areas will consume several years, yet this should not hold back the risk-based supervision program. It is important to start risk-based supervision as soon as possible, and develop a long-term, comprehensive training program to augment the supervisor's expertise and improve their confidence in risk management analysis.

The BSD needs to identify persons as instructors for certain core courses and provide them with the time necessary to prepare to deliver these seminars. This is often a difficult decision, as the best inspectors and analysts are often the best instructors yet have the least time to spare for this process. However, formal and informal training is not an "extra" item to development of banking supervisors. Training is not simply an item that is obtained externally. Training materials need to developed and delivered by existing employees, not simply through attending external courses. We certainly recognize a need for certain external courses on complex topics, such as derivative instruments or strategic planning; however, "core" courses should be internally managed to be most effective. Providing people with adequate training is critical to development of risk-based supervision.

The National Bank should consider creating positions of "risk experts" within the BSD Methodology Unit. These persons would have the responsibility of organizing course materials for core courses, updating the on-site inspection manual for specific risk areas, and keeping management and staff informed of current banking trends in their risk areas. These persons might also assist with inspections of the largest, most complex banks in Ukraine. While working in Poland, we recommended that the banking supervision methodology unit be organized along the following six lines of "expertise": credit risk expert, operational risk expert, market risks expert (foreign exchange risk, interest rate risk, liquidity risk, and price risk), non-financial risk expert (strategic risk, legal risk, and reputation risk), accounting expert, and supervisory processes expert (on-site and off-site processes, report of inspection, off-site analysis reports, management information systems, etc.).

The BSD should also develop an accreditation process for all staff members, which includes basic knowledge in all risk areas. This accreditation process would include certain core courses, on-the-job assignment or seminars that must be successfully completed by every staff member in order to reach a certain level in the organization to be "accredited." Employees should follow a pre-set development plan for the first several years of employment to be accredited, and then develop their own career development plan based on their expertise from that point forward. This would also be an important marketing tool to the banking industry, showing the competence of supervision staff to judge risk management. An effective accreditation process can also help in the judicial process by demonstrating the level of expertise of banking supervisors in making their judgments.

The BSD should also consider the concept of a normal "career path" for bank supervision employees. Ideally a training program would match the career path. The concept of hiring people directly into the head office of the BSD creates some tensions between regional offices and the head office, as quite often neither party fully understands the other's role. As an example, if the BSD hires people directly as off-site analysts without any experience as an on-site inspector, the inspector and the analyst will not be able to understand each other's needs. This results in the situation we have now, whereby analysts do not participate in an inspection, rather they are writing exhaustively detailed and often overly critical letters to inspectors following their receipt of a report of inspection. Answering these letters detracts from the already scarce time of inspectors and adds minimal value to the supervisory process. The career path should serve to significantly improve the level of communication between on-site, off-site and head office supervision functions, as each function would better understand each other's role in banking supervision in addition to the strengths and limitations of each type of supervision.

Task	Time Frame	Resource	Person(s)

	for Completion of Task	Allocation for Task	Responsible for Task
1. Develop and implement a long-term career development plan for banking supervision staff, including a long-term plan to train all staff in risk-based supervision and individual risk categories.			
2. Identify, from within the BSD nation-wide, instructors for core courses and develop all core courses.			
3. Develop a tracking mechanism to identify the core courses and on-the-job experiences that a person needs to reach an "accreditation" level.			
4. Ensure that the time allocation for training and career development is viewed as part of someone's job, not as an "extra item" if time allows. The BSD needs to provide incentives (merit recognition, bonuses, promotions, etc.) for persons to become trainers and for persons to desire the goal of reaching an accreditation level.			

Improve the Off-Site Supervision Process

The BSD's off-site analysts play a critical role in the supervisory process for banks. The off-site analysts need to ensure each bank is taking appropriate steps to correct deficiencies noted in the previous inspection and to monitor the future effects of bank's actions in between inspections, including risk that might affect the entire banking system.

To perform the first role above, the analysts need to have in-depth knowledge of the findings from the most recent on-site inspection, including the areas of highest risk and the bank's proposed corrective actions. The expectations for the analysts should be included in the supervisory strategy of each bank. We recommend that the off-site analysts visit the on-site inspections during the initial planning phase and at the end of this inspection as findings are communicated to bank management. The analysts may wish to participate in the individual risk assessment areas of the on-site inspection process for career development, as time permits. This will allow the analysts to have more in-depth knowledge of the bank's conditions and problematic areas. Attending the on-site inspections, even if only briefly, will also allow the analysts to better judge the bank's corrective actions as it submits information between on-site inspections who to contact if questions arise. Currently, it seems the analysts are not involved in the on-site inspection process. The analysts are drafting detailed letters of criticism to the on-site inspectors, only after receiving the final report of inspection in the head office. This seems to be a rather bureaucratic process, is not a productive use of time for the analyst or for the inspectors, and significantly detracts from the overall supervisory process. The supervisory process needs to be more cooperative and interactive to be effective.

To perform the second basic role from above, the analysts should continue to develop new and refine existing early warning systems for banks, and used analysis models for analyzing individual banks and the banking industry. We recommend that the BSD produce a report on an annual basis describing the financial trends and the areas of highest risks in the banking system, including broad recommendations for supervisory actions in the coming year. This will complement the existing quarterly analyses that are already being prepared, but are mostly factual and historical information. This knowledge will be critical for overall supervision planning. Saying this, the BSD should keep in mind that certain misconceptions may exist regarding the use of early warning models. First the models are only as good as the data the model is fed. If banks are submitting inaccurate financial reports, models will not be effective. Second, models rarely, if ever, provide the final answer to any real or potential problem. Models can only show symptoms of problems, not causes. It is important to treat model outputs as a source for more questions, rather than as a final solution. Relative to the issue of systemic risks, senior management of the BSD and the National Bank should look closely at management information systems to ensure that available data is circulated to the proper persons and is sufficient in detail and useful in decision making processes.

Off-site analysts should follow the same accreditation process as on-site inspectors, and attend the same core courses for banking risk. Analysts do need more training in how to analyze bank reports and policies that will be submitted between inspections. We also encourage BSD to consider hire analysts from the existing pool of inspectors, rather than independently hiring analysts from outside the National Bank system. This will encourage more career development and foster a career path for employees, and will break down many of the communication walls that exist between inspectors and analysts.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve the off-site analysis summary document.			
2. Develop a requirement for analysts to attend on-site inspections.			
3. Ensure that analysts are also			

included in the BSD accreditation program and are able to attend core courses in banking risk.			
4. Develop and refine early warning analysis models.			
5. Prepare an internal, annual report on the condition of the banking industry, banking risks and banking trends, and recommendations for supervisory actions.			

Enhance Banking Legislation for Risk Management Principles

Licensing requirements in Ukraine already contain certain provisions related to risk-management systems. In order to improve existing legislation and implement the recommendations of the World Bank/IMF Financial Sector Adjustment Team, a significant number of changes to the Banking Law will be necessary. Some of these items may also necessitate corresponding changes to other legislation. The changes include the following[1].

Risk management systems and internal controls. There should be affirmative requirements for banks to have adequate *systems* of risk management and internal controls, both as a condition of registration or licensing and on an ongoing basis. The current version of the Banking Law requires a risk management "unit" and internal audit "service" but does not require risk management or internal control *systems* that, in the judgment of the NBU, are adequate and appropriate for the given bank's activities and profile. We have received a draft from the NBU Legal Department which would require "availability of internal policies to regulate the carrying out of banking operations according to the requirements of [the Banking] law, rules and regulations of the NBU, and the bank's statute" as a condition for receiving a banking license. This is a good start, but more is necessary.

Enforcement measures. Article 73 should clarify that the NBU has the authority to require improvement in the risk management and/or internal control systems in a bank when, in the judgment of the NBU, these items are inadequate. Also, the NBU should be able to require more capital depending on level of risk in bank's activities, as determined by the NBU based on its analysis and evaluation of the bank's situation. We have received a proposed amendment drafted by the Law Department, which would eliminate the performance of "risky operations that would endanger depositors' interests" as a basis for enforcement action. In our view, this would be a mistake. The NBU should have the legal authority to require correction of *any* situation that, in its judgment, could be detrimental to the stability of a bank or endanger the interests of its depositors.

[1] Communicated in a memo dated May 28, 2003.

Strengthening the responsibilities of Supervisory Councils. Additional emphasis should be placed on making the supervisory council responsible for approving/overseeing the implementation of the bank's strategy, risk management, internal controls, etc., as well as ensuring the bank's compliance with all applicable legal requirements and fulfilling their fiduciary duties.

The "Revision Commission" concept should be eliminated. Enterprises (including banks) in most western countries do not use a "revision commission," but rather an audit committee, which is a committee of the supervisory council, and the function of which is to assist the supervisory council with the more technical financial matters and oversight of the internal controls and internal audit function. The audit committee is one of the most important committees in a bank.

Strengthening licensing/registration requirements. The law should require information on business reputation of all proposed holders of essential participation. Article 18 says the NBU can refuse registration if a proposed essential participant does not have an impeccable business reputation, but Article 17 does not require submission of such information in the first place. Also, the Article 17 requirements should be tied to Article 34, which requires all essential participants to have an impeccable business reputation. Information on professional skills and experience of all proposed supervisory council members should also have to be submitted at the registration stage.

Transparency of ownership/control. Article 34 does not require approval for "control," but 50% ownership. Addition of a "beneficial owner" concept may be helpful, but the critical issue is the NBU should be able to approve any *de facto* "control" situation in a bank, regardless of the amount of share ownership (if any). The NBU should also have the legal ability to assess the complete ownership structure of proposed bank or banking group, both at the registration/licensing stage and as a result of change in control or significant ownership – and reject applications if proposed or resulting ownership structure is not sufficiently transparent.

Consolidated supervision. The NBU needs the legal ability to review structure, corporate governance provisions, internal controls and risk management, and suitability of management in any "group" of companies that includes a bank. This is an extremely important concept: failure to practice effective consolidated supervision (Basle Core Principle 20) results in non-compliance with many of the other Core Principles. There is a new European Union Directive (December 2002) on Supplemental Supervision of Financial Conglomerates. While some of this directive is probably more complex and detailed than is necessary for Ukraine presently, much of it is highly relevant and should be implemented as soon as possible. This is the case, in particular, with requirements for group-wide risk management systems, internal controls, and appropriate skills and business reputation for managers of companies that control banks.

Treasury stock purchases (banks buying back their own shares). The NBU should have the authority to approve *any* purchase by a bank of its own shares, and the bank should have to demonstrate to the NBU's satisfaction that such a transaction would be for a legitimate business purpose which is beneficial to the bank (not necessarily to the shareholders who wish to sell their shares back to the bank).

Transactions with related parties. The provisions in the Law need to be strengthened, in accordance with the FSAP Team's recommendations.

External audits. The Banking Law does not require auditors' reports to be furnished to the NBU, or that auditors inform NBU about violations or conditions discovered during audits that could detrimentally affect banks. We have received a draft provision from the NBU Law Department, which would require the submission of audit reports, but does not require the auditors to provide other information as described above. There should also be a requirement for bank management to implement recommendations of internal/external auditors.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. See above for a listing of items to include in the Banking Law.			

Review and Enhance Management Information Systems

The BSD and National Bank senior management groups need to review all management information systems, such as the "Bank Dossier", emanating from banking supervisory personnel. Senior management should consider what is "critical" information for periodic reports, and what is "extra" information to be used as support. Management information should be both concise and descriptive. The general discussion of management information systems should also be covered in the strategic plan.

The BSD should develop a series of new management information charts to show the aggregate risk assessments of banks in Ukraine. We suggest the following information to be displayed: the percentage of banking assets having high, moderate and low risk in each risk category; the percentage of banks having high, moderate and low risk in each risk category; the percentage of banking assets with increasing risk in each risk category; and the percentage of banks with increasing risk in each risk category. These charts should be updated quarterly or semi-annually – more frequent updates would be not useful as information would not be changing significantly on a monthly basis. The BSD may have other useful suggestions to illustrate the overall risk and risk trend in the banking system. Additionally, the NBU senior management team should also provide input to the information they would like to receive on a regular basis.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task

1. Review management information systems for sufficiency and conciseness.			
2. Develop new management information systems to illustrate risk assessments and trends in the banking sector.			

As a note, the new management information systems need to incorporate relevant information from other National Bank departments, including violations of law or regulation, so that this information can be incorporated into the overall risk assessment.

Develop a Quality Assurance Program

An effective quality assurance program is necessary for implementation of risk-based supervision due to the subjectivity of decisions to be taken. However, it is important to take a proper attitude toward a quality assurance program. Quality assurance is not intended to be a "re-inspection" of a bank to show what someone else would have done given the same circumstances. Rather, quality assurance should be process-oriented, looking at the inspection and analysis procedures used and the documented support for inspection and analysis findings. The persons performing quality assurance should not adopt a punitive attitude toward inspectors and analysts, yet should be simply be ensuring that all supervisory decisions and information are based on and supported by facts. Where supervisory processes need improvement, the quality assurance function should make recommendations to BSD management on changes to improve the process.

The BSD should develop a team of persons to form quality assurance reviews. The banks selected for review should be selected randomly, and preferably be geographically dispersed. The primary areas of review could be the following:

Continuous Supervision of the Bank and the Bank's Risk Profile: Were the CAMELS and RAS consistent with examination findings? Were any interim changes to CAMELS and RAS properly documented? Were quarterly off-site analyses conducted to specifically address any changed in CAMELS, RAS and bank activities? Do quarterly analyses include bank management's responses to recommendations in report of inspection and compliance with any applicable enforcement actions?

Full-Scope Safety and Soundness Supervision Activities: Did the full-scope review address each of the nine banking risks and assess the risk to earnings and capital in each of the risk areas? Did the on-site examination team support their conclusions of the aggregate risk profile for each risk area and the direction of risk per the risk assessment system? Did the examining team address the accuracy of the bank's internal loan review system and the bank's ability to determine an adequate level of loan loss reserves?

Supervisory Strategies: Do supervisory strategies reflect all significant supervisory concerns identified at the most recent inspection? Were strategies amended when there are changes to the risk profile of the bank? Did strategies result in correction of significant deficiencies at the bank? Did subsequent supervisory activities reflect the scope and resources indicated in the strategy?

Communications: Did the formal communications to the bank address major risks and supervisory concerns? Were interim changes to CAMELS and RAS are communicated to the appropriate persons in the Banking Supervision Department of the NBU?

Examination policies and procedures: Were the minimum inspection procedures are used properly? Were inspection procedures expanded, when appropriate? Was the resource usage is consistent with findings and risk profiles.

Documentation: Do examination working papers properly support findings in the Report of Examination? Do analyst's working papers properly support communication with the bank and quarterly monitoring and analysis of the bank?

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Develop and approve a quality assurance program.			
2. Identify qualified persons to perform quality assurance reviews – might be handled as a temporary assignment to get more participation.			
3. Develop a schedule of quality assurance reviews and implement this schedule.			
4. Prepare an annual summary of quality assurance reviews with recommendations for BSD and National Bank senior management.			

Attachment B

(Letterhead)

Date: June 30, 2004

To: Mr. Schlapak, Deputy Governor
National Bank of Ukraine

CC: Konstantin Uvarov, Natalya Ivanenko, Svitlana Farber,

From: Bryan Stirewalt

Re: Action Plan for Risk-Based Supervision

Dear Mr. Schlapak:

I am sorry for the delay in sending this letter to you, but the issues surrounding implementation of risk-based supervision are, as you know, quite complex. The attached "action plan" lists the areas of needed emphasis in implementing risk-based supervision in Ukraine. We are also suggesting a broad timetable for implementation of risk-based supervision, which deviates slightly from the existing plan of the NBU. Any change of this magnitude in a large organization involves not only difficult changes in legislation and the NBU's internal policies and procedures, but also necessitates large changes in the overall culture of supervision and further development of supervisors. While various changes to the infrastructure supporting banking supervision can be accomplished in the short-term, changes with recruiting, compensating, training and efficiently organizing supervisors will only be possible over a longer time period.

We obviously cannot afford to wait five to seven years to implement risk-based supervision. Chairman Tihipko has correctly emphasized that time is of the essence in this transformation, and we certainly agree. We will need to implement risk-based supervision and develop supervision staff on parallel tracks. We suggest implementing a program of risk-based supervision, on a step-by-step basis, within the next 18 months while realistically envisioning a fully effective program in five to seven years. During out risk-based supervision seminars this year, we have had the ability to meet and discuss these concepts with many supervisors across the country. This has given us a much greater depth of understanding of strengths and weaknesses of the supervision processes. From this vantage point, we are better able to refine the risk assessment system and provide recommendations for full implementation of risk-based supervision.

The risk assessment system is the "front office" of risk-based supervision, and is supported by a wide range of "back office" functions and processes. Supervisors seem to accept the concept of the risk assessment system; however, the matrices used in the document need to be amended to provide inspectors with more detail and explanation and to match the experience level of staff and developments in the banking industry. As a result, we believe that all inspections should include each of the "evaluation factors" in