Strengthening Risk Management in Southeast Europe and Eurasia Banking Systems

Regional Initiative Implementation Plan

July 2011

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USAID PARTNERSHIP FOR FINANCIAL STABILITY (PFS) PROJECT

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DELOITTE CONSULTING, LLP

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Contents

Acronyms used

BSCEE	Banking Supervisors from Central and Eastern Europe
EBA	Europan Banking Authority
EBF	European Banking Federation
EBRD	European Bank for Reconstruction and Development
EBTN	European Bank Training Network
EU	European Union
IBFed	International Banking Federation
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
USAID	United States Agency for International Development
SDC	European Sovereign Debt Crisis
WB	World Bank
PFS	Partners for Financial Stability
SEE	South and East Europe

About PFS

The United States Agency for International Development (USAID) Partners for Financial Stability (PFS) Program is led by the Office of Economic Growth in the Europe and Eurasia Bureau (E&E). The project addresses the challenges facing the financial sector in 12 Partner Countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia (Southeastern Europe) as well as Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine (Eurasia). Other countries in the E&E region that are considered USAID 'graduates' serve as Mentor Countries in the PFS Program.

The PFS Program is designed to complement the work of the bilateral USAID missions' Economic Growth programs in the region by bringing together regional players to address regional challenges. PFS Program activities include benchmarking studies, conferences, knowledge sharing, research and technical assistance. The PFS Program addresses the challenges of the financial systems in these regions, working in a broad range of subject areas including anti-money laundering, banking and non-bank financial regulation, supervision and institutional rehabilitation, corporate governance, financial literacy, access to finance and implementation of international standards in financial sector reporting.

1. EXECUTIVE SUMMARY

Weak capacity by banks and regulators to manage risks, especially credit and liquidity risk, was brought to light in Southeast Europe and Eurasia by the global financial crisis. Today, lending to the private sector is subdued because banks are suffering from a heavy burden of problem loans and lack the skills to work out those loans. While banks and supervisory authorities have improved their ability to plan and manage bank liquidity after the debilitating bank runs that occurred throughout the region during the financial crisis, they need to further improve skills and adopt new international standards in liquidity risk management.

The Partners for Financial Stability Program (PFS) will undertake a series of regional activities to address weaknesses in risk management by banks and banking supervisors in Southeast Europe and Eurasia. The objective of the regional activities is to improve banks' and regulators' capacity to manage liquidity risks and resolve problem loans.

The regional activities will involve cost-share support for a number of training and knowledge sharing forums for banks and supervisory authorities on credit risk and liquidity risk management, a study and promoting best practices relating to collateral execution, and other demand driven activities. To the extent that opportunities arise, PFS will also support regional activities by other donors to deal with systemically high levels of non-performing loans and to support formal mechanisms for improving cross-border liquidity management during periods of economic stress.

PFS will monitor progress toward achieving the objectives and expected outcomes of the regional initiative by tracking a number of key performance indicators.

An overview of the regional initiative is provided in Table 1 below.

Table 1: Overview of Regional Initiative to Strengthen Risk Management in SEE and Eurasia banking systems

Objective	Partnerships	Activity	Outcome	Monitoring Indicators
Improve knowledge and capacity of banks and regulatory authorities to manage liquidity risk	• EBRD • IMF • World Bank / IFC • IBFed • EBF • EBTN • BSCEE • Domestic bank trade associations • EBA	1. Conduct technical workshops for bankers and banking supervisors on liquidity risk management	Strengthened capacity of regulatory authorities to monitor banks' liquidity risk.	Number of PFS Beneficiary Countries that participated in the workshops that have adopted formal methodology/tools for systemic liquidity surveillance, including cross-border trends and anomalies.
Improve knowledge and technical skills of banks and regulatory authorities to resolve problem loans	• EBRD • IMF • World Bank / IFC • IBFed • EBF • EBTN • BSCEE • Domestic bank trade associations • EBA	2. Conduct technical workshops for bankers and for banking supervisors on managing problem loans	Improved capacity and effectiveness of banks to work out and manage problem loans.	Number of PFS Beneficiary countries with 2% reduction in ratio of non-performing loans to total loans (on annual basis).
	• EBRD • Domestic bank trade associations	3. Conduct a study on legal impediments and leading practices in collateral execution, and support knowledge- and experience-sharing events	Improved efficiency of collateral execution procedures and subsequent increase in the flow of credit to the private sector.	Percent increase in credit flow to private sector Number of PFS Beneficiary countries that have improved their indicators for the length and cost of foreclosures.
	Partnerships and cost sharing for these activities will be determined on a case by case basis.	4. Support other demand-driven activities which contribute to improving risk management in banking in the PFS Beneficiary Countries	Improved risk management in banking in the PFS Beneficiary Countries	*Monitoring indicators for demand-driven activities will be designed and suggested for USAID approval when specific interventions are demanded*

2. THE DEVELOPMENT CHALLENGE RELATING TO RISK MANAGEMENT IN BANKING

The global financial crisis exposed not only the weak risk management policies and practices at commercial banks but also weaknesses in regulatory authorities' ability to supervise banks' risk management processes. The lack of adequate risk management over a number of years was a large factor in the financial crisis in SEE and Eurasian countries that resulted in economic turmoil. The resulting loss of confidence in the banking systems and steep declines in trade and remittances led in many countries to deep recession, threatening to undermine the social and economic gains of the last 15 years.

Since October 2008, stresses and shocks to the banking sectors in SEE and Eurasia have been introduced through two primary channels – ***liquidity risk and credit risk.*** It is expected that these two channels will continue to pose the most significant threat to the solvency of individual banks and banking systems. (See Appendix 1 for a brief overview of risk management in banking and Appendix 2 for details about the causes of bank insolvencies). There are an array of broad challenges relating to risk management in banking in SEE and Eurasia, particularly credit risk management practices when loans are underwritten on the front end. PFS will focus on a narrower set of achievable results relating to liquidity risk and problem loans within the timeframe and resources of the program.

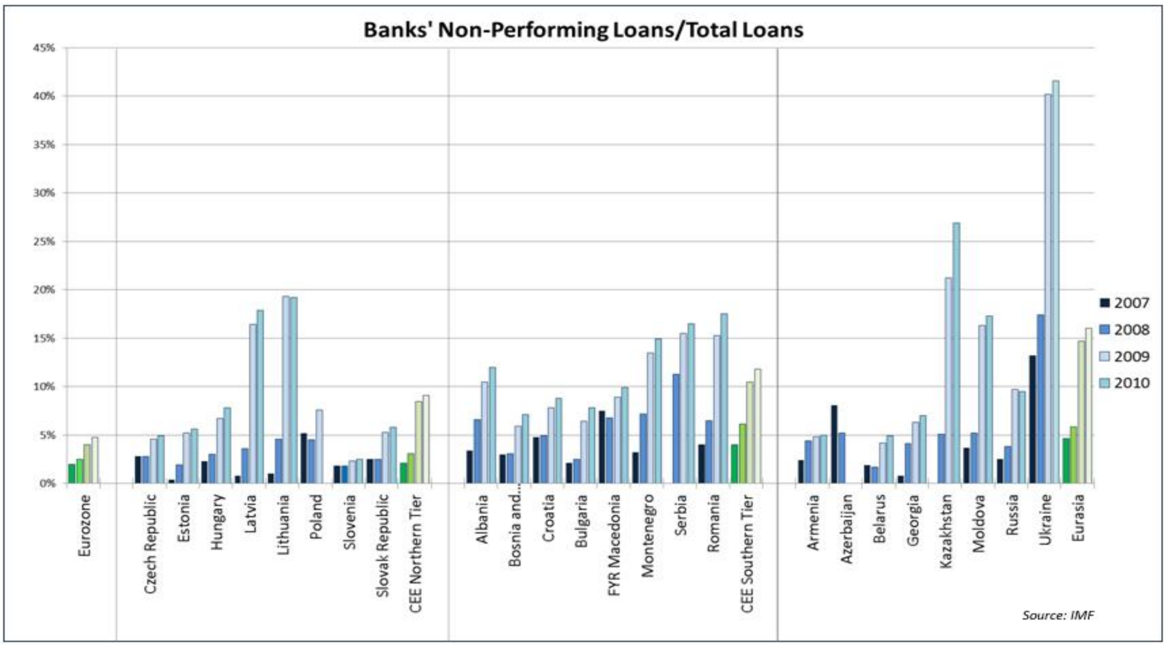
2.1 Improving and formalizing liquidity risk management practices

The initial shock to banking sectors in SEE and Eurasia was caused by gridlock in the EU and local inter-bank markets cutting off of the normal daily flow of funds between banks. These systemic liquidity stresses then prompted depositors to withdraw funds from banks, leading to full-scale systemic bank runs in some countries. Neither the banks nor the regulators were sufficiently prepared to deal with liquidity shocks of this magnitude. There were essentially no contingency plans that incorporated such scenarios. At this point (roughly, early 2009), the potential for panic and collapse of the banking sector was not out of the question in some countries.

The authorities quickly put together crisis management committees to take action. These committees and the individual central banks adopted a series of unprecedented ad-hoc responses, including informal cross-border facilities that were successful in restoring short term liquidity and stopping the panic withdrawal of deposits. Today, it is incumbent upon the authorities and commercial banks to put in place more formal arrangements and sustainable risk management policies and practices so that this does not happen again.

2.2 Dealing with the large overhang of problem loans

After the initial liquidity crisis in SEE and Eurasia, the global financial crisis impacted the real economy and the result has been a large volume of non-performing bank loans. Today many banks in the region have serious asset quality problems, constricting their solvency and their capacity to lend to viable businesses and individuals. The level of non-performing loans as a percentage of total loans has reached alarming levels in some countries and is seriously high throughout the region. In most countries, the proportion of NPLs has not yet peaked (see chart below). The advent of tighter monetary policy and higher interest rates in several countries due to growing inflationary pressures means that non-performing loans will remain a problem for some time.



Bankers and regulators in SEE and Eurasia have limited experience in working out and resolving problem loans to the private sector. In the SEE / Eurasia region, bankers' and regulators' experience in dealing with problem loans is limited to the early transition period when the economy was dominated by state-owned banks and enterprises. Better knowledge among banks and regulators about proactive approaches for restructuring and working out problem loans to private businesses while limiting the adverse impact on borrowers would help address the high level of problem loans.

A number of international financial institutions (IFI's) including the EBRD, EIB, World Bank / IFC are in the early planning stages of establishing one or more regional platforms to address problem loans, for instance, 'good bank/bad bank' mechanisms. These platforms, if successful, would also contribute to reducing the level of non-performing loans in SEE and Eurasia.

Legal systems in SEE and Eurasia, while reformed, are ill-equipped to deal with individual foreclosures and forced asset sales. Simpler, more efficient collateral execution (foreclosure) procedures could facilitate banks' clearing their books of problem loans and increase the flow of credit to the private sector.

3. PROPOSED OBJECTIVES AND OUTCOMES FOR THE REGIONAL INITIATIVE TO IMPROVE RISK MANAGEMENT IN BANKING SYSTEMS

In identifying and designing a proposal for a regional initiative, PFS has established a handful of guiding principles. The principles are:

- Potential activities should focus on the priority risks in SEE and Eurasian banking systems that have the potential to threaten financial stability.
- In the event external events (for instance, the European sovereign debt crisis) begin to negatively impact the banking markets in SEE and Eurasia, the potential activities should support authorities' and private financial sector institutions' abilities to react effectively and expeditiously to minimize the severity of the impact.
- Potential activities should strengthen communication and collaboration in the region and encourage the banking community (private and public) to sustain these gains in the future without donor involvement.

Overarching objective: To assist banks and regulators to introduce better practices to identify, measure, manage and mitigate liquidity risks and risks relating to non-performing loans, allowing for a return to more robust lending by the banks to support growth.

Intermediate objectives:

- To improve knowledge and capacity of banks and regulatory authorities to strengthen liquidity risk management.
- To improve knowledge and technical skills of banks and regulatory authorities to resolve problem loans.

Expected macro outcomes: Better risk management practices will contribute to enhanced financial stability through:

- Strengthened capacity of regulatory authorities to monitor banks' liquidity risk.
- Improved capacity and effectiveness of banks to work out and manage problem loans.
- Improved efficiency of collateral execution procedures and subsequent increase in the flow of credit to the private sector.
- Improved risk management in banking in the PFS Beneficiary Countries.

4. PROPOSED REGIONAL ACTIVITIES TO IMPROVE RISK MANAGEMENT IN PFS BANKING SYSTEMS

The PFS approach focuses on leveraging and sharing experiences and best practices between mentor countries and partner countries. Sharing knowledge and experience in targeted areas can be especially effective in advancing financial stability. The targeted activities listed below will strengthen the ability of banks to manage key risks that pose the greatest threat to financial stability and enhance regulatory capabilities to be an effective advocate for stronger risk management practices in the banks and to address potential systemic problems from the key risks.

Activity 1: Technical workshops for bankers and banking supervisors on liquidity planning, stress testing, and liquidity management in stressed environments.

1.1 Bankers – Through existing regional venues for bankers or PFS-organized technical workshops, promote knowledge and experience sharing amongst Beneficiary and Mentor countries on managing liquidity in stressed environments, including liquidity gap measurement tools, liquidity stress testing, and/or successful strategies to balance or hedge unmatched gap positions. In addition, an example of a comprehensive, detailed contingency funding plan – consistent with Basel Core Principles and Principles for Sound Liquidity Risk Management and Supervision– should be shared with bankers. Further, by coordinating with the macro prudential regional initiative, enhance bankers' understanding of the new Basel III requirements for liquidity.

Proposed Timing: Fourth quarter 2011 through third quarter of 2012. Participate in or support participation by Mentor country bankers in up to six existing venues organized for bankers in the region; and/or organize through cost-sharing one to two 2-day regional technical workshops. The priority will be to participate in venues sponsored by organizations or trade associations attracting bankers from multiple PFS countries. The alternative approach will be to organize through cost sharing regional or country specific venues for countries which have higher liquidity risks.

Estimated PFS Costs: Up to 30 days LOE. Leverage the LOE from Activity 1 for organizing participation in identified venues. Five to ten days are designated for preparing materials to be presented in the venues. Approximately 20 days are designated for the PFS advisor and/or mentor country bankers to participate in venues in the region (the number of days will likely be lower to the extent that credit and liquidity issues can be addressed in a single venue). PFS costs will be comprised of the advisors' and/or mentor country bankers' time and travel expenses for participation in the events and cost-share support for the organization of the events.

1.2 Regulatory Authorities – Through existing regional venues for banking supervisors, share knowledge and experience about enhanced liquidity supervision during the crisis which improved the regulator's capacity to identify and respond to liquidity concerns at individual banks and to identify vulnerabilities in the domestic inter-bank market. Provide examples of methodologies for host-country supervisor's surveillance of cross-border liquidity relevant for the domestic banking market (e.g. developments in Greek, Austrian, Italian funding markets for banks which own banks in Southeast Europe and Eurasia). Also, provide an example of a comprehensive, detailed contingency plan that is consistent with Basel Core Principles. Share successful examples where successful policy responses were introduced to address systemic liquidity stresses in late 2008 and early 2009.

If the opportunity arises, PFS will also support initiatives by other donors (for instance, EBRD or IMF) to promote formal arrangements for cross-border liquidity management for pan-European banks.

Proposed Timing: Second-half 2011 through early 2012. Participate in the meeting of banking supervisors from Southeast Europe (same meeting as noted in Activity 1.2) to share knowledge about successful approaches employed by regulators in other regions to improve the quality of liquidity supervision and reporting received from banks to detect trends or emerging problems in systemic liquidity. Also, share information about the newly developed Basel III requirements covering liquidity. While there is no formal structure for supervisors in the Eurasia PFS countries, they periodically meet on an as-needed basis. PFS will encourage a meeting among supervisors in the Eurasia area (same meeting as noted in Activity 1.2) to engage in knowledge-sharing and have the PFS topic on liquidity included in the agenda.

Estimated PFS Costs: Up to 12 days LOE. The three days from Activity 2 are leveraged for: (a) having the PFS topic included on the agenda for the meeting of the supervisors from Southeast Europe and (b) working with Eurasia PFS supervisors to organize a meeting in the second-half of 2011 which would be hosted by one of the supervisory authorities. Eight days are designated for preparing materials to be presented in the venues. Four days are designated for the PFS advisor to participate in two venues (Southeast Europe and Eurasia) of banking regulators to share knowledge about successful approaches for enhanced supervision of liquidity, improved regulatory reporting from the banks on liquidity and the newly developed requirements in Basel III for liquidity. PFS would cover the costs for the PFS advisor and his/her travel to the two meetings. Costs for PFS regulators and the meeting would be incurred by the respective regulatory body and the hosting regulatory authority for each of the meetings.

Activity 2: Technical workshops for bankers and for banking supervisors on managing problem loans.

2.1 Banks – Participate in up to six existing venues and host one or two 3-day technical workshops for bankers in the region. Share knowledge and experience on managing defaults and loan work-outs with viable borrowers. Experience will include successful methodologies for liquidating classes of collateral while avoiding further depressing asset prices. Priority will be given to attendance by bankers from the countries with the highest delinquency and default rates.

Proposed Timing: Third quarter 2011 through second quarter of 2012. The priority will be to participate in venues sponsored by organizations or trade associations attracting bankers from multiple PFS countries and to host targeted technical workshops attracting a wide audience of (lending / workout) bankers from Southeast Europe, Eurasia, and the mentor countries. An alternative approach will be to participate in country specific venues targeted on countries with the most serious NPL loans problems.

Estimated PFS Costs: Approximately 50 days LOE. PFS costs will be comprised of the advisors' and/or mentors' time and travel expenses for participation in the events and cost-share support for event organization costs.

2.2 Regulatory Authorities – During or just before/after two existing regional venues for banking supervisors, support 1.5 day technical workshops to strengthen understanding and capacity about successful measures (temporary or permanent) and approaches to address sharp increases in defaults and problem loans. [Note: Measures that do not impair the integrity of prudential standards or financial solvency.]

If the opportunity arises, PFS will also support initiatives by other donors (for instance, EBRD or IMF) to develop regional arrangements for dealing with problem loans.

Proposed Timing: Second-half 2011 through first half 2012. Request PFS participation in the meeting of banking supervisors from Southeast Europe to cost-share a technical workshop on successful approaches employed by regulators in other regions to manage NPLs during periods of a systemic credit stress. While there is no formal structure for supervisors in the Eurasia PFS countries, they periodically meet on an as-needed basis. PFS will encourage a meeting among supervisors in the Eurasia area to engage in knowledge-sharing and have the PFS topic included on the agenda.

Estimated PFS Costs: Up to 20 days. Three days are identified for: (a) having the PFS topic included on the agenda for the meeting of the supervisors from Southeast Europe and (b) working with Eurasia PFS supervisors to organize a meeting in the second-half of 2011 which would be hosted by one of the supervisory authorities. Four to six days are designated for preparing materials to be presented in the venues. Four days are designated for the PFS advisor and/or bankers from mentor countries to participate in two venues (Southeast Europe and Eurasia) of banking regulators to share knowledge about successful approaches employed by regulators that are consistent with prudential standards. PFS would cover the costs for the PFS advisor and/or mentor country banker(s) and their travel to the two meetings and cost-share part of the organization expenses. Costs for PFS regulators and for hosting the meeting would be incurred by the respective regulatory body and the hosting regulatory authority for each of the meetings.

Activity 3: Conduct a study on legal impediments and best practices and support knowledge and experience sharing events to facilitate more efficient collateral execution

As a cross-cutting activity in connection with PFS' regional initiatives on Access to Finance, carry out a high level study of the legal frameworks for collateral execution in Southeast Europe and Eurasia to identify important impediments and best practices. Include in the study a survey about the length and cost of foreclosures (and incorporate the data into the PFS benchmarking methodology as an indicator of the strength of countries' enabling environment for financial services). Publish the study and present it at regional forums on banking and access to finance in order to promote and facilitate changes in the legal environment to enable more efficient collection of problem loans.

Proposed Timing: Conduct the study in the third quarter of 2011. Publish the study and present it to at least four banking and access to finance events in Southeast Europe during the period of Q4-2011 through Q4-2012.

Estimated PFS Costs: Approximately 20 days LOE to conduct the study. An additional 15 days to present the study and facilitate knowledge and experience sharing at banking and access to finance forums where PFS is already participating.

Activity 4: Support other demand-driven activities which contribute to improving risk management in banking in the PFS countries.

To the extent that resources are available, PFS will continue to support demand driven regional activities such as the following:

Supporting Other Regional Efforts to Reduce Problem Loans – PFS will follow the plans of the IFI's or other donors and may decide to collaborate in regional efforts to reduce problem loans, for instance, 'good bank/bad bank' mechanisms.

April 2011 study tour to Croatia on implementation of Consolidated Supervision consistent with the Basel Core Principles. This study tour was an outgrowth of a request from the Azerbaijan central bank (sovereign bank regulator) and is open to financial supervisors from the PFS countries. PFS cost-share contribution was matched by the participants' paying their own travel expenses and the host covering some of the costs.

Study tour in June 2011 to the Czech Republic covering risk-based supervision. The Czech supervisor shared knowledge and experience about its approach and methodology for implementing and conducting risk-based supervision and examinations. The study tour was an outgrowth of a request from the Azerbaijan central bank (sovereign bank regulator). PFS cost-share contribution was matched by the participants' paying their own travel expenses and the host covering some of the costs.

April 2011 Bankers Forum sponsored by the Azerbaijan Training Center. The regional Forum addressed timely risk management topics in the post-crisis environment and was attended by bankers from the Eurasia region. PFS contributed to the forum by covering the costs of a banker from a mentor country, Hungary, to attend the event and speak about risk management developments in the new EU member countries.

5. PARTNERSHIPS AND COST SHARING

PFS will seek to achieve its objectives by partnering with other donors, international bodies, and organizations in the mentor countries and by leveraging on regional conferences or activities already taking place.

Table: Partnerships for activities

<table>
<tr><th>Activity</th><th>Potential Partner</th></tr>
<tr><td>1. Technical workshops for bankers and banking supervisors on liquidity planning, stress testing, and liquidity management in stressed environments</td><td rowspan="2">• EBRD
• IMF
• World Bank / IFC
• IBFed
• EBF
• EBTN
• BSCEE
• Domestic bank trade associations
• EBA</td></tr>
<tr><td>2. Technical workshops for bankers and for banking supervisors on managing problem loans</td></tr>
<tr><td>3. Conduct study on legal impediments and best practices in collateral execution, support knowledge and experience sharing events</td><td>• EBRD
• Domestic bank trade associations</td></tr>
<tr><td>4. Support other demand-driven activities which contribute to improving risk management in banking in the PFS countries</td><td>Partnerships and cost sharing for these activities will be determined on a case by case basis.</td></tr>
</table>

6. MONITORING PLAN

This section of the Regional Initiative Implementation Plan outlines how PFS will measure and monitor whether PFS activities are on track and contribute to the achievement of Regional Initiative Outcomes.

PFS will track the results of this Regional Initiative as part of its PFS PMP, using various data sources, such as PFS assessments and benchmarking studies, international institutions data reporting, counterpart self-assessments and reporting. PFS will also use surveys to measure overall satisfaction with PFS events amongst stakeholders (for example, after study tours or knowledge-sharing events), and thereby also gauge future demand for PFS initiatives/interventions. PFS will track cost-sharing amounts and percentages by the beneficiaries of the activities and by other co-financing organizations. Beneficiaries' and other organizations' willingness to share in the costs of PFS activities is a strong indicator of the usefulness of the events.

The Monitoring Plan below highlights the existing PMP indicators to which this Regional Initiative will contribute; as well as specific indicators at the Regional Initiative's Objective level (outcome-type indicators), and Activity level (output-type indicators). Recognizing that some of the activities may be demand-driven, appropriate indicators will be removed or added based on activity status during our regular quarterly reporting process to USAID.

E&E/EG Office Level	**AO: Broad-based, inclusive and sustainable economic growth and integration in the E&E region**			
	IR: Increased Financial Sector Stability, Growth and Inclusion			
	IR Indicators:	Credit to the private sector as of GDP (FA Framework)		
		Interest rate spread percentage (FA Framework)		
		Capital adequacy		
		NPL as a % of total lending		
	Sub IR 1.1: Increased financial sector integration	**Sub IR 1.2:** Increased harmonization of policies and practices with intl standards	**Sub IR 1.3:** Increased institutional capacity of financial sector actors	**Sub IR 1.4:** Increased access to financial services for historically underserved groups
PFS Program PMP-Level	**Sub IR Indicators:**			
	Number of formal partnerships developed with regional and international standard organizations, donor organizations, and research organizations in PFS areas	Number of Financial Sector Professionals trained on international standards with PFS assistance (PPR)	Number of Financial Sector Supervisors or Regulators trained with PFS assistance (PPR)	Number of financial institutions supported by PFS technical assistance in the area of SME lending
	Number of networks established between PFS financial sector stakeholders across PFS technical areas across E&E region	Number of internationally recognized financial sector standards adopted as a result of PFS assistance	Number of material improvements in the infrastructure institutions that reduce market risks made with PFS assistance (PPR)	Positive change in utilization of donor credit lines or guaranty facilities for onlending to SMEs by those financial institutions supported by PFS technical assistance
		Number of financial sector training and/or certification programs established or supported that meet international standards (PPR)	Increase in revenue of PFS partners associations, training institutions or other organizations for provision of training or other services to financial sector stakeholders.	Number of financial sector training and/or certification programs established or supported that meet international standards (PPR)

Project Initiative (RIIP) Level	Regional Initiative Implementation Plan – Risk Management	
	Notional Budget: $700,000	
	RIIP Primary Objective: To assist banks and regulators to introduce and implement international risk management standards and practices to identify, measure, manage and mitigate the risks and vulnerabilities in the region's banking systems	
	RIIP Intermediate Objective 1: Improve knowledge and capacity of banks and regulatory authorities to manage liquidity risks.	**RIIP Intermediate Objective 2:** Improve knowledge and technical skills of banks and regulatory authorities to resolve problem loans.
	Number of PFS Beneficiary Countries that participated in the workshops that have adopted systematic liquidity surveillance methodologies and tools. Unit of measure: Based on the survey of PFS Beneficiary Country workshop participants 6 months after attending the workshops.	Number of PFS Beneficiary countries with 2% reduction in ratio of non-performing loans to total loans (on annual basis). Unit of measure: Ratio of non-performing loans to total loans for each Beneficiary country is calculated first. Number of countries that show 2% reduction in the ratio, on annual basis, is counted.
		Percent increase in credit flow to private sector. Unit of measure: measures flow of credit on year-to-year basis.
		Number of PFS Beneficiary countries that have improved their indicators for the length and cost of foreclosures. Unit of measure: Baselines will be collected as the part of the study. Annually, the survey will be repeated and the number of countries that show reduction in length and cost of foreclosures will be counted.

<table>
<tr><th></th><th>Activity</th><th>Activity Indicator(s)</th><th>Related RIIP Objective(s)</th><th>Related PMP Objective(s)</th></tr>
<tr><td rowspan="7">Activity Implementation Level</td><td rowspan="2">Activity 1: Conduct technical workshops for bankers and banking supervisors on liquidity risk management</td><td>Number of technical workshops for bankers on liquidity planning and liquidity management in stressed environments</td><td rowspan="2">RIIP Intermediate Objective 1: Improve knowledge and capacity of banks and regulatory authorities to manage liquidity risk</td><td rowspan="2">Sub IR 1.3: Increased institutional capacity of financial sector actors

Sub IR 1.1. Increased financial sector integration</td></tr>
<tr><td>Number of technical workshops for banking supervisors on liquidity planning and liquidity management in stressed environments</td></tr>
<tr><td rowspan="2">Activity 2: Conduct technical workshops for bankers and for banking supervisors on managing problem loans</td><td>Number of technical workshops for bankers on managing problem loans</td><td rowspan="5">RIIP Intermediate Objective 2: Improve knowledge and technical skills of banks and regulatory authorities to resolve problem loan</td><td rowspan="5">Sub IR 1.3: Increased institutional capacity of financial sector actors
Sub IR 1.1. Increased financial sector integration</td></tr>
<tr><td>Number of technical workshops for banking supervisors on managing problem loans</td></tr>
<tr><td rowspan="2">Activity 3: Conduct study on legal impediments and leading practices in collateral execution, support knowledge and experience sharing events</td><td>A study completed that (1) includes a thorough analysis of legal impediments in collateral execution in the PFS Beneficiary countries; and (2) presents the leading international practices</td></tr>
<tr><td>Number of technical workshops for bankers or access to finance groups on improving collateral execution</td></tr>
<tr><td>Activity 4: Support other demand-driven activities which contribute to improving risk management in banking in the PFS Beneficiary countries</td><td>TBD when specific interventions are demanded</td></tr>
</table>

Appendix 1: Overview of Risk Management in Banking

Banks are in the business of taking and managing risk

Banks assume a variety of risks as they engage in financial intermediation, mobilizing deposits and other capital in order to provide credit. The most obvious risks are credit risk (arising from lending and investing funds) and liquidity risk (arising from depositors' rights to withdraw their money). Banks generally have the ability to identify, price and manage risks because of their knowledge of local markets and clients and their ability to obtain funding from a variety of sources.

Banks can reduce risk in a number of ways, for example, requiring collateral for loans or obtaining 'backup' lines of credit from other financial institutions. In other cases they can shift risk to other parties through a combination of pricing and product design. The practice of lending in foreign currencies is an example of transferring foreign currency risk to the borrower through product design.

Definitions of "risk management" in the banking context

Risk management can broadly be defined as management's ability to adequately identify, measure, select, price, monitor and control the explicit and implicit risks embedded in the bank's various products, operations, lines of business and business relationships.

Types of risks in banking

The Basel Committee for Banking Supervision identifies four categories of risks:

- Credit risk (including counterparty exposures);
- Liquidity risk.
- Market risks (including price risk, interest rate risk and foreign exchange risks);
- Operational risk (including such things as IT, reputation and legal risks); and

Appendix 2: Why individual banks fail and how financial distress at an individual bank can lead to systemic risk

Why a bank fails

In situations where a bank incurs losses that exceed the buffers provided by its, earnings, capital and reserves, the bank's financial solvency is impaired. When a bank's capital declines to zero or near zero, authorities generally step in and declare the bank insolvent or undertake other measures to prevent the bank's collapse.

Losses can occur from numerous sources. The most typical cause of bank failures is loan losses resulting from imprudent lending. Changes in the market prices of a bank's investments can also lead to losses and insolvency. Losses can also be caused by events such as IT systems problems, recessions, interest rate shocks, natural disasters, etc,

Banks can also fail for liquidity reasons. When a bank is unable to meet its obligations to depositors or credits, the bank is said to be insolvent. Again, the authorities generally step in to either close the bank or temporarily boost its liquidity (typically through loans from the central bank) until the bank can be resolved.

Financial distress at an individual bank can translate into systemic risk in four ways.

First, there is a classic domino effect. For example, a number of a bank's customers do not meet their obligations to repay loans in a timely manner. If these problems are severe, the bank itself will not be able to meet its own obligations toward other banks, and so on through the financial system.

Second is a fire-sale effect in asset markets, when large numbers of holders of financial assets engage in distressed sales of assets to obtain needed liquidity. The sudden increase in market supply of the assets (for instance, stocks or mortgage backed securities) drives down prices, often substantially. As we saw in the recent crisis, this effect transmits not only to banks and other firms that must sell assets to meet immediate liquidity needs but, because of margin calls and fair-value accounting requirements, to all other banks as well. The result is a vicious cycle, as these sales force still more sales.

Third is a contagion effect, whereby market participants (domestic and cross-border) conclude from a bank's distress that other banks holding similar assets or following similar business models are likely to also be facing similarly serious problems. Interbank lending then dries up, adversely affecting even the healthiest of banks.

Fourth is the discontinuation of a critical function -- for instance, clearing of credit or debit card payments -- played by a failing bank in the financial markets when other firms lack the expertise or capacity to provide ready substitutes.

The first two effects are largely a function of the interconnectedness of the distressed financial firm with other large firms, either through direct counterparty exposures or through common exposures of the bank's balance sheet with those of other firms. These effects are directly relevant to concerns about the 'too-big-to-fail' doctrine which have animated the reform debate and heightened concerns about moral hazard.

In contrast with the first two effects, the contagion effect is not necessarily a function of size. The events over the past few years have demonstrated that contagion risks were introduced when depositors, investors and counterparties became concerned with developments in a particular institution and assumed similar concerns existed in other banks. The systemic stresses arose not from the direct effects on the financial system played by an individual institution, but rather, by the perception of problems in the entire marketplace. Contagion risk is important, since the failure of almost any bank could bring about systemic problems if markets believe that the failure reveals problems with one or more significant classes of assets held by many financial institutions.

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