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UKRAINE DEPOSIT GUARANTEE FUND

UKRAINE IP-FSS BUY-IN

REGIONAL ECONOMIC GROWTH PROJECT

Recommendations to Self-Assessment of Compliance with Core Principles of Effective Deposit Insurance Systems

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DISCLAIMER

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KEY FINDINGS

During the period of April 23-30, 2016, an assessment of compliance of the deposit insurance framework in Ukraine with Core Principles for Effective Deposit Insurance Systems by Basel Committee on Banking Supervision and International Association of Deposit Insurance Systems (BCBS – IADI Core Principles or Core Principles) was carried out. The self-assessment was performed by the Deposit Guaranty Fund of Ukraine together with a team of experts funded by USAID, in cooperation with the Office of Technical Assistance of the US Treasury Department[1]. The most recent Financial System Stability Assessment was carried out in 2003 by the IMF and World Bank.

Ratings are assigned for each Core Principle[2] based on an assessment of the current legal framework, including those requirements coming into effect as of July 1, 2016, and on the current practices at the Deposit Guaranty Fund (DGF). The assessment also included a review of the legal framework for early detection and timely intervention by the bank supervisory authority but did not encompass an overall assessment of the effectiveness of the framework for banking supervision. In early 2016 the National Bank of Ukraine (NBU) performed a self-assessment of conformance with the Basel Core Principles for Effective Banking Supervision, and the report is expected to be released in June of this year, after consultations with World Bank.

This report does not contain a detailed evaluation of the operating environment for the deposit insurance system. However, the current macroeconomic, business, and banking environment have been taken into account. Ukraine's macroeconomic situation is currently very weak in the context of military conflict in the eastern part of Ukraine since 2014 and the annexation of the Crimean region by Russia in 2014. GDP growth was -7% in 2014 and -12% in 2015. The hryvnia (UAH) has lost about 70% of its value against the U.S. dollar (USD) in the past two years. The business environment is difficult, as illustrated by difficulties enforcing contracts and registering property and a high level of corruption.[3]

The banking system is in crisis with more than seventy banks accounting for approximately one-third of all banks, having been declared insolvent and put into liquidation or resolution since 2014. The DGF expects that more banks will fail during 2016. The magnitude of the banking crisis is significant: public funding to the deposit insurance system totaled more than UAH 60 billion (USD 2.4 billion) since 2014, or 2% of 2014 GDP; the DGF has paid out UAH 76 billion (USD 2.9 billion) of insured deposits of seventy-four banks (two significant banks, Delta Bank and Finance and Credit Bank, accounted for UAH 25 billion in 2015).

The Law "On Households Deposit Guarantee System" has been reformed several times to enhance the scheme's effectiveness for contributing to the stability of the country's

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[1] The expert team was comprised of Leslie Sulenta and Oleksiy Kutsenko (both USAID IP-FSS Project), and Vilma Rosa Leon-York (Office of Technical Assistance, US Treasury).

[2] Rating scale used:

- Compliant (C): When the essential criteria are met without any significant deficiencies.
- Largely compliant (LC): When only minor shortcomings are observed and the authorities are able to achieve full compliance within a prescribed time frame.
- Materially non-compliant (MNC): Severe shortcomings which cannot be rectified easily.
- Non-compliant (NC): No substantive implementation of the Core Principle.
- Not applicable (NA): Not considered given the structural, legal and institutional features of the deposit insurance system.

[3] See World Bank Doing Business and WEF Global Competitiveness reports.

financial sector and economy and to alleviate the public's fears of bank failures in times of stress or crisis. DGF has evolved from a pay-box mandate in 1998 to a loss minimizer in 2012. In 2012, DGF's mandate was expanded to be the resolution authority, charged with determining the resolution strategy and responsible for carrying out least-cost resolution of banks declared failed by the NBU as the supervisory authority.

Some of the design features of the deposit insurance and resolution framework can lead to moral hazard. Moral hazard arises when parties have incentives to accept more risk because the costs are born, in whole or in part, by others. Although driven by the crisis situation, DGF's access to unlimited funding from the government could put the system in a position where the remaining banks are unable to ultimately repay the costs of the deposit insurance system, undermining the key concept that the banking industry should finance deposit insurance. Additional reforms are needed to minimize the costs of the deposit insurance system, including addressing flaws in the framework for timely intervention and resolution. Furthermore, good corporate governance and sound risk management at individual banks does not appear to be properly embedded, and parties at fault in bank failures are not yet held accountable despite DGF's attempts, as explained in this report.

The governance structure of the DGF does not conform to the Core Principles. The DGF is not fully independent because the NBU, as chair, and the government have the majority of seats on the Administrative Board and exercise control over the DGF's budget and key operational decisions. Traditionally, one of the NBU representatives chairs the board, which also contravenes this Core Principle.

Since the onset of the crisis, DGF's major source of funding shifted from regular contributions from banks to emergency liquidity support from the NBU and the Ministry of Finance. The cost of the emergency funding provided by other financial safety net participants is unreasonably high (the interest rate is equal to the central bank's discount rate, currently 12%) and draws into question DGF's ability to service the debt from its regular contributions. Special contributions, although allowed by the Law, will not be called by DGF until the preconditions improve, while the high interest rates have the counterproductive effect of eroding DGF's funding base. Risk-based premiums have been designed as a macro-prudential tool to fight dollarization and high interest rates.

Shortcomings in the early intervention framework prevent DGF from undertaking effective resolutions and lead to very high costs / low recoveries from the assets of failed banks and unnecessary hardship for depositors. The current framework does not ensure that problem banks are identified / designated and that early intervention takes place in a timely manner. In many cases, DGF is called by NBU to resolve banks that are already heavily illiquid with few unencumbered assets. This aspect of the deposit insurance and resolutions framework makes it impractical to resolve banks as the failed bank has no remaining franchise value and causes hardship for depositors who are blocked access to their funds for extended periods of time. Because there is usually no other practical alternative than the liquidation of the failed bank, there is no opportunity to realize the potential cost savings arising from resolution.

The effectiveness of the framework for resolutions should be evaluated in relation to the Key Attributes for Effective Resolution Regimes, which is a separate set of international standards that complements the Core Principles for Effective Deposit Insurance Systems. Based on the limited assessment of the resolution framework performed during this review, the current framework does not fulfill the key requirement that depositors are not denied access to their funds for more than a very short period. This stems from weaknesses in the framework for early intervention, which precludes proper resolution planning and implementation.

Although DGF effectively reimburses insured depositors or failed banks, the reimbursement process takes longer than the prescribed benchmark of seven days. The legal framework should require that in cases where insured deposits are not transferred to a healthy bank in a resolution procedure the reimbursement of most insured deposits should be completed within seven working days. Insured deposits should not be blocked for more than a few days under any circumstances, including in banks that are still operating "normally," those under Problem Bank status, those under Provisional Administration, or those that have had their license revoked.

DGF's ability to deal with parties at fault is weak. As DGF is not charged with prosecution and investigation powers it depends on law enforcement agencies. Courts and criminal investigators are not effective in declaring parties at fault hence jeopardizing DGF's ability to hold them financially responsible for misconduct and wrongdoing.

DGF's public communications program for informing depositors about the deposit insurance system is in compliance with the timing benchmarks set forth by the Core Principles, but there is a room for improvement in terms of scope. DGF should employ a wider range of communication channels to inform the public about when, how, and at what conditions the depositors can restore access to their funds. DGF must have a formal strategy for reaching targeted levels of awareness, and allocate adequate financial and human resources to implement it.

APPENDIX A - RATINGS OF COMPLIANCE WITH IADI-BCBS CORE PRINCIPLES

TABLE 1: SUMMARY OF COMPLIANCE WITH IADI CORE PRINCIPLES

Core Principle	Rating	Findings
CP 1 – Public Policy Objectives (PPO)	**C**	The public policy objectives of the DIS are consistent with the Core Principles: to protect the rights and legitimate interests of depositors, strengthen the public trust in the Ukrainian banking system, stimulate investments in the Ukrainian banking system, and ensure an efficient procedure of insolvent bank resolution and liquidation of banks.
CP 2 – Mandate and Powers	**LC**	Based on the functions assigned to the DGF, it has the power to assess and collect premiums, transfer deposits to another bank, reimburse depositors, obtain information directly from banks, share information within the safety net, compel banks to comply with obligations to the deposit insurance, set budgets and policies, and enter into contracts.
CP 3 - Governance	**MNC**	The DGF is not fully independent because the NBU, as chair, and the government have control over the DGF's budget and key operational decisions. In contravention to the Core Principles, the majority of the five-member Administrative Board is comprised of executive branch officials – two from the NBU and one from the Cabinet of Ministers. Traditionally, one of the NBU representatives chairs the board, which also contravenes this Core Principle (Essential Criteria 8). There is no requirement for a periodic review of the effectiveness of the DIS scheme design.
CP 4 – Relationship with other safety net participants	**LC**	To ensure that the financial stability coordination committee members exchange information and coordinate activities with the DGF on an ongoing basis in a substantive manner, the framework for coordination amongst the safety net participants needs to be strengthened. In order to prepare for resolution and minimize costs relating to failed banks, DGF must be informed of potentially failing banks before they become illiquid or fail.
CP 5 – Cross-border issues	**MNC**	Given that foreign bank subsidiaries constitute 35% of the banking market in Ukraine, DGF should have the authority to enter into formal information sharing and coordination arrangements with deposit insurers in the home jurisdictions of these banks as well as in countries where Ukrainian banks operate (Cyprus, China). Such agreements are important for ensuring that in the case of a crisis impacting the foreign parent banking group, there are no uncertainties about which deposit insurance system (jurisdiction) would be responsible to protecting and reimbursing depositors of the foreign banks' operations in Ukraine.
CP 6 – DI's role in contingency planning and crisis management	**LC**	Although there is a Financial Stability Board in place under the current legal framework, it has not established an operational framework for safety net wide contingency planning and crisis management. In practice and in light of the challenges it faces (mainly in terms of funding (CP 9), early intervention (CP 13), and resolutions (CP 14)) DGF is responding to bank failures and other events in a reasonably effective manner (EC 1).
CP 7 - Membership	**LC**	To ensure a level playing competitive field and to simplify the message to depositors for purposes of promoting confidence, the State Savings Bank and the credit unions (which meet the definition of "banks" because they take deposits) should be members of either the DGF or another explicit deposit insurance scheme. Further effort is needed to ensure that all banks are subject to sound prudential regulation

		and supervision.
CP 8 - Coverage	**LC**	The level of coverage is limited and credible. However, the State Savings Bank needs to be brought into the system of limited deposit insurance to eliminate differences in coverage that could contribute to financial instability (currently it enjoys implicit unlimited coverage).
CP 9 – Sources and Uses of Funds	**MNC**	The way funding is structured and has been used creates moral hazard. DGF has access to eventually unlimited emergency funding from NBU and MoF via two instruments: debt and 'perpetual contribution'. The first carries an interest rate which in abnormally high for deposit insurers. The second breaches the concept that the insured banks shall be ultimately responsible for deposit insurance, not the taxpayers. Currently DGF has no plans to introduce special contributions from banks to resolve the funding problems due to adverse preconditions. Risk-based premiums solve macro-prudential problems such as high interest rates and dollarization instead of dealing with risk of a bank failure as they are not based on individual bank's risk assessment.
CP 10 – Public Awareness	**LC**	DGF must improve the scope of its communications to focus on answering the core questions depositors have – when, how, and at what conditions they can restore access to their funds. DGF currently does not have sufficient budget to plan and implement an effective long term communication strategy that ensures its objectives.
CP 11 – Legal Protection	**LC**	DGF representatives should have legal protection beyond their tenure. Additionally, former employees and contractors should be legally protected and there should be operational arrangements in place to ensure legal costs are covered should there be litigation.
CP 12 – Dealing with Parties at Fault in a Bank Failure	**MNC**	Although the current version of the DGF Law makes it clear that DGF has the authority and indeed the duty to pursue parties at fault, in practice the overall framework is deficient. Due to shortcomings in the legal system, DGF is not able to effectively recover from owners or manager, it cannot seize assets of parties at fault to ensure recoveries, and it is weak in the courts. Further resources are needed to ensure that DGF has the necessary capacity and that the law enforcement bodies and the courts have the capacity to follow through when cases are filed.
CP 13 – Early detection and timely intervention	**NC**	Improvements are required in the legal framework and/or in practice to ensure that problem banks are identified and intervened by the prudential regulator at early stages. In particular, "illiquidity" and/or "failing to meet obligations of depositors or other creditors" must be an unequivocal criterion for declaring a bank "failing" i.e. "insolvent" and thus triggering resolution. This Core Principle is linked with the Basel Committee Core Principles for Effective Banking Supervision. An independent party should conduct an assessment of conformance to the Basel Core Principles to identify the root causes behind this finding. In particular, BCP #11, Corrective and Sanctioning Powers of Supervisors, states, "The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system."
CP 14 – Failure resolution	**MNC**	Although the framework incorporates most of the key elements needed for effective resolutions, the overall framework for early detection, timely intervention and resolution of non-viable banks needs to be strengthened to ensure that depositors do not lose access to their funds for more than a very short period before the implementation of a least-cost resolution option. The framework for resolutions should be evaluated in relation to the Key Attributes for Effective Resolution Regimes, which is a separate set of international standards.

CP 15 – Reimbursing depositors	**MNC**	Insured deposits should not be blocked for more than a few days under any circumstances, no matter the status of the bank: 'operating', 'problem', or 'insolvent'. In some cases, DGF effectively undertakes a reimbursement of depositors immediately when a 'problem' bank is put under Provisional Administration. Typically, it happens when depositors had no access to their deposits despite the bank is still 'operating,' and legally it is not a reimbursement but a return of matured deposits. In most cases DGF waits until a bank is decided to be resolved through liquidation and in such cases the revocation of the bank's license triggers a true reimbursement. This can potentially confuse depositors as access to blocked deposits is restored unequally.
CP 16 - Recoveries	**MNC**	DGF's recoveries are extremely limited due to weaknesses in the legal system and delayed intervention in problem banks which typically leads to liquidation rather than resolution of failed banks.

APPENDIX B - RECOMMENDATIONS FOR IMPROVING COMPLIANCE WITH BCBS-IADI PRINCIPLES

TABLE 2: MAIN RECOMMENDATIONS FOR IMPROVING COMPLIANCE WITH IADI CORE PRINCIPLES

Core Principle	Rating	Recommendation
CP 3 - Governance	**MNC**	To ensure that DGF can use its powers without interferences from external parties, the legal framework should be amended to ensure that government and National Bank do not have the majority of seats on the DGF's Administrative Board.
CP 4 – Relationship with other safety net participants	**LC**	To ensure that the financial stability coordination committee members exchange information and coordinate activities with the DGF on an ongoing basis in a substantive manner, the framework for coordination amongst the safety net participants needs to be strengthened.
CP 5 – Cross-border issues	**MNC**	Given that foreign bank subsidiaries constitute 35% of the banking market in Ukraine, DGF should have the authority to enter into formal information sharing and coordination arrangements with deposit insurers in the home jurisdictions of these banks as well as in countries where Ukrainian banks operate (Cyprus, China).
CP 6 – DI's role in contingency planning and crisis management	**LC**	To help ensure early detection of weak banks and system-wide crisis management, the Financial Stability Board should hold regular meetings; The Financial Stability Board should develop and implemented a coordinated communication stance to the crisis situation to ensure comprehensive and consistent public awareness and communications.
CP 7 - Membership	**LC**	To ensure a level playing field and to simplify the message to depositors for purposes of promoting confidence, the State Savings Bank and the credit unions (which meet the definition of "banks" because they take deposits) should be members of either the DGF or another explicit deposit insurance scheme. Further effort is needed to ensure that all banks are subject to sound prudential regulation and supervision. Special eligibility criteria would have to be developed and controlled for credit unions at their first entrance to the system – similar to those developed for other banks at the time of DI first adoption.
CP 9 – Sources and Uses of Funds	**MNC**	The Law should be amended to clearly reflect the concept that the banks have to build the insurance fund. The law should require the DGF to repay any contributions made by NBU before premiums can be lowered. Further, the law should require that DGF produce a time-specific plan about how it is going to repay any emergency support and from what sources. The Law should explicitly prohibit providers of emergency liquidity to charge interest from DGF.
CP 10 – Public Awareness	**LC**	DGF has to set a target awareness level, design a strategy to reach it, and support it with adequate financial and time budget. It should also improve the scope of its communications to explain to depositors who are getting reimbursements during the provisional administration status what are the consequences of advance reimbursement. It is also advisable to use more user-friendly savvy and modern communication channels to reach the focus audience.

CP 12 – Dealing with Parties at Fault in a Bank Failure	**MNC**	Further resources are needed to ensure that DGF has the necessary capacity to investigate. The legal framework needs to be improved to ensure that law enforcement bodies and the courts have the capacity to follow through when cases are filed, including due independence and qualifications. DGF mandate has to be expanded to allow it to collect evidence which can be eligible for court prosecutions. DGF has to be exempt from paying a state duty when soliciting against parties at fault. DGF should be able to outsource special forensic investigators in case needed.
CP 13 – Early detection and timely intervention	**NC**	This Core Principle is linked with the Basel Committee Core Principles for Effective Banking Supervision. An independent party should conduct an assessment of conformance to the Basel Core Principles, in particular, BCP 11, Corrective and Sanctioning Powers of Supervisors, which states, "The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system." To minimize costs and moral hazard, the supervisory framework and its implementation needs to ensure that banks are declared 'problematic' and effective measures are taken to restore them to health well before they become non-viable. A bank that is illiquid or does not meet its obligations of depositors should be immediately de-licensed. In addition to the current criteria for declaring a bank 'problematic,' the criteria should include: a quantitative minimum indicator of the proportion of pledged assets to total assets or total liabilities; an asset quality indicator, for example, non-performing exposures to total exposures; a profitability indicator, for example, return on assets; sensitivity to market risk; and management soundness.
CP 14 – Failure resolution	**MNC**	The framework for resolutions should be evaluated in relation to the Key Attributes for Effective Resolution Regimes, which is a separate set of international standards.
CP 15 – Reimbursing depositors	**MNC**	DGF should not start reimbursement process for 'operating' banks in order not to confuse the public. Access to deposits should be guaranteed by prompt resolution, not by surrogate reimbursement. New amendments to the Law regarding set-off and trigger day for reimbursement have to be tested against the reality.
CP 16 - Recoveries	**MNC**	Amending the legal framework to follow best practices for early detection and timely intervention as well as establishing a legally insulated special resolution regime would contribute to avoiding unnecessary loss of values.

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