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**Deloitte Touche  
Tohmatsu**



*Pre-Privatization Assistance to  
the Ceskoslovenska obchodni  
banka, a.s.*

*Final Report*

*Delivery Order No. 31  
Contract No. EUR-0014-I-00-1056-00  
Eastern Europe Enterprise Restructuring and  
Privatization Project*



*U.S. Agency for International Development  
ENI/EUR*

*March 1996*

**Deloitte Touche  
Tohmatsu  
International**

# Deloitte Touche Tohmatsu



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March 25, 1996

Mr. Lawrence Camp  
USAID  
ENI/PER/EP  
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Washington DC 20523

**Re: Contract No. EUR-0014-I-00-1056-00, Delivery Order No. 31, Ceskoslovenska  
obchodni banka, a.s.**

Dear Lawrence:

In accordance with Article IV of the above-referenced delivery order, enclosed please find the Final Report for Pre-Privatization Assistance to the Ceskoslovenska obchodni banka, a.s.

If we can provide you with further information, please do not hesitate to contact me at (202) 879-5626. Copies of these reports will be distributed as detailed in the delivery order.

Sincerely,

Deborah Billig  
Senior Consultant  
Central & Eastern Europe

Enclosure

**Deloitte Touche  
Tohmatsu  
International**

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## **Pre-Privatisation Assistance to the Československá obchodní banka a.s.**

### **Final Report**

#### **I Introduction**

Under a project funded by the United States Agency for International Development (USAID), Deloitte & Touche has provided pre-privatisation assistance to Československá obchodní banka a.s. ("ČSOB"). This technical assistance program was designed to support the bank's efforts to move toward privatization. To this end, the assistance focused on strengthening organizational structures, policies, procedures and skills. This report summarises the work undertaken during the period May 1994 to January 1996.

The technical assistance was provided in the following five areas:

1. Treasury and Risk Management
2. Problem Loan Workout
3. Retail Banking Strategy
4. Internal Audit and Control
5. Management Information Systems

The sections that follow describe the work that was performed in each of these areas during the course of the technical assistance program. It should be noted that the assistance provided through and by Deloitte & Touche comprised Phases I and II of the technical assistance program. Technical assistance under a Phase III is being provided to CSOB without the assistance of Deloitte & Touche in accordance with USAID contracting procedures.

## **II. Treasury and Risk Management**

The approach of Deloitte & Touche to the risk management related assistance provided has been to provide advice to enable ČSOB senior management to formulate and implement its overall strategy in this area: such advice has always been presented from a senior management perspective.

A number of documents have been prepared for the Bank which have included recommendations to enable ČSOB to address the multiple risks to its long-term financial well-being. In general, the Bank has not responded to these documents.

Deloitte & Touche has been committed to working closely with the Bank to ensure that ČSOB achieves its objectives. Support for the role of Deloitte & Touche in this project has been forthcoming from the Bank's senior management, particularly since the Bank's Chairman intervened personally, but unexpected reluctance to either heed advice, or to play an active part in the implementation of recommendations made, has often been experienced from elements of the Bank's middle management - particularly in the areas of risk measurement and reporting.

It has been stressed throughout the entire Project that a key requirement of the Bank's overall strategy is to ensure that senior management is provided with reports that are essential for appropriate financial management of the Bank. The current MIS Project is intended to address the Bank's overall reporting requirements. However, evidence to date suggests that, at below Board level, there is a general failure to recognise the fundamental need of management to receive risk reports generated by IBIS which are: relevant; accurate; and timely.

The overall effect of this is that:

- a) insufficient attention is being given by the Bank to the reporting of risk; and
- b) attempts that are being made to provide risk reports have so far been ineffective.

The consequences of this is that the MIS project is:

- a) reporting risk is difficult since data necessary for the process has generally been incorrectly specified; and
- b) it is inefficient in that, in many cases, it has involved the development of reports that are already standard features of IBIS.

### **1. Recommendation for Future Phases of the Project**

It is strongly recommended that the Bank carries out an immediate extensive review of its back office systems strategy. This will entail:

- a) a detailed investigation of current and proposed activity by the Bank;
- b) consideration of the various modules available within IBIS and alternative systems measured against the needs of ČSOB;
- c) the preparation of a report for the Board detailing the findings of the review and making recommendations for the best course of action for the Bank; and
- d) positive immediate action by the Board.

The rationale behind this recommendation is that, as stated below, the Bank's reporting systems are the key to the success or failure of the strategic objectives of ČSOB. IBIS is currently fundamental to the Bank's reporting systems.

It appears that the version of IBIS implemented in ČSOB has been subjected to considerable modification. This poses three potentially serious risks to the Bank:

- it is almost certain that the modifications have not been properly documented;
- the modifications may have produced a "domino effect" within the base system, some of which may not yet have materialised; and
- the modifications may negate any maintenance agreement(s) in place with IBIS.

The situation is further complicated, and risk to the Bank increased, by attempts by the Bank to develop and integrate in-house software solutions.

In some cases it is believed that the Bank has acted upon poor external technical advice. For example, the Bank has already spent the best part of a year developing an "enhancement" to allow domestic Treasury Bills to be processed by the base IBIS product implemented in ČSOB. However, investigations confirm that another Czech Bank is able to process Treasury Bills without any problems following a small adjustment within base IBIS. This enhancement took approximately two days to implement; is an integral part of the proven standard system; and will be supported by IBIS.

The overall effect of the above is that the Bank's core accounting system poses a serious long-term risk to its financial well-being.

### **1.1 Initial USAID Guidelines**

The original guidelines provided by USAID indicated that the role of Deloitte & Touche was to fall under the following headings:

- To review existing foreign exchange and treasury policies and procedures and assist in the establishment of improved risk management techniques, policies and procedures.
- To assist with the selection of a Front End Dealing System (FEDS).

- To monitor the installation of the selected FEDS.
- To provide training to ČSOB Staff.

A paper was submitted in June 1994, based on these guidelines, which set out the initial terms of reference for the provision of technical assistance in the area of treasury and foreign exchange management to the ČSOB.

## 1.2 Initial Terms of Reference

The initial terms of reference proposed was based on the tasks set out in the USAID guidelines. However, a number of caveats to the implementation of the project were also set out.

- a) It had not been possible for Deloitte & Touche to effectively gauge ČSOB management's attitude towards:
  - i) the foreign exchange and treasury activity within the Bank;
  - ii) risk taking; and
  - iii) the concomitant risk management techniques currently (or likely to be) adopted to ensure the Bank's objectives were met.
- b) The selection process for the FEDS was somewhat unstructured: the pressure for the installation of the FEDS was coming from the treasury/dealing areas rather than from the Bank's senior management.
- c) ČSOB's needs with respect to the FEDS would extend beyond the current project life, particularly since neither system under consideration addressed either: a) effective risk assessment; or b) risk management reporting techniques with any conviction. This was particularly important given the ongoing problems being experienced with the Bank's back office system (IBIS).

## 1.3 Revised Terms of Reference

Subsequent to discussions with ČSOB the terms of reference were amended to focus the efforts of Deloitte & Touche on the Bank's immediate priorities within the time-frame and budget of Phase 1. In the meantime, the Bank had decided to acquire the Valuta FEDS developed by Data Sciences, Aachen.

The Phase was initially split into four tasks:

- Task 1: Develop a Risk Management Technique Paper
  - review and report on existing foreign exchange and treasury policies and procedures; and

- prepare and present a paper on the establishment of improved risk management techniques.
- **Task 2: Implement Proposed Risk Management Techniques**
  - advise on the incorporation of the proposed risk management techniques into the MIS; and
  - provide training to staff relating to the proposed risk management techniques.
- **Task 3: Review Valuta for Ability to Meets Risk Management Requirements.**
- **Task 4: Assist with FEDS Contract Negotiations**
  - assist with the preparation of a detailed specification of the exact needs for ČSOB in liaison with the preferred supplier; and
  - assist with the preparation of a detailed implementation plan.

Subsequently, a further task was added to the Phase:

- **Task 5: To Review the Current Funding Base of ČSOB.**
  - conduct a detailed analysis of the funding base of the Bank;
  - to focus on the nature and extent of any dependency on inter-bank market funding by ČSOB; and
  - consider the viability of "tapping" retail funding sources as an alternative means of meeting the Bank's needs.

## **2. Task 1: Develop a Risk Management Techniques Paper**

This task was split into two sections:

- a) to review and report on existing foreign exchange and treasury policies and procedures; and
- b) to prepare and present a paper on the establishment of improved risk management techniques.

### **2.1 Review of Existing Foreign Exchange and Treasury Policies and Procedures**

A review was conducted over the period 1 July to 28 July 1994 and was considered under five categories:

- Credit Risk
- Operations Risk
- Liquidity Risk
- Market Risk
- Human Risk

### **2.1.1 Conclusions of the Review**

The review concluded that:

- a) If ČSOB conducted its foreign exchange and treasury business in a market where the Central Bank imposed the full regulatory requirements of member banks of the Basle Committee it would almost certainly face significantly increased reporting requirements than it is currently required to make. This might mean that it would have to seriously curtail its activities.
- b) There was no limit structure in place which addressed either interest rate risk or liquidity risk and, more importantly, there were serious deficiencies in IBIS and the Bank's operating procedures which rendered the effective management control of the business difficult to achieve.
- c) There seemed to be a belief that the introduction of the proposed Front End Dealing System (FEDS) would cure the shortcomings of the IBIS system to address a number of key risk management issues.
- d) The truly successful implementation of FEDS depended as much on the integrity of the data in IBIS as on any other factor. A risk business could not, realistically, be managed or controlled by relying on a front end system - especially if that system could not be reconciled to its main back office system.
- e) Unless the Bank took positive steps to address the reporting and processing deficiencies of IBIS in the foreign exchange and treasury area, then there was little chance of avoiding problems in the implementation of FEDS and its subsequent use.
- f) In general, IBIS had the potential to produce what was required but to achieve this necessitated immediate and positive action by management and the relevant individuals in the IT, foreign exchange, and treasury areas.

### **2.1.2 Recommendations of the Review**

The following recommendations were made under the headings of the review:

### 2.1.2.1 Credit Risk

The report recommended that:

- All approved credit limits for banks and non-banks having a direct dealing relationship with the Treasury area should be entered into **IBIS** immediately.

In this respect there would need to be close liaison between the key personnel involved concerned with the credit enhancements to **IBIS** and the splitting of the Prague database.

- The format of all credit utilisation reports currently produced, or available but not produced, should be reviewed. Where there were deficiencies in the reports, a detailed specification of the dealing room requirements should be drawn up and implemented.

This would ensure that **IBIS** actually produced reports which met the needs of **ALCO**, the Treasurer, and the Chief Dealer to measure, monitor, and control counterparty risk.

- A detailed specification of the dealing room requirements should be drawn up and implemented to ensure **FEDS** produced appropriate reports that met the needs of **ALCO**, the Treasurer and the Chief Dealer to measure, monitor, and control counterparty risk.
- Procedures should be introduced to ensure effective reporting of all breaches of credit limits by the dealers. This should also set out appropriate disciplinary measures to be taken against offenders.

### 2.1.2.2 Operations Risk

The report recommended that procedures should be introduced to report losses which result from administrative errors by the dealers or the back office (e.g. incorrect completion of deal tickets, incorrect settlement of deals; etc). This should also set out appropriate disciplinary measures to be taken against persistent offenders.

### 2.1.2.3 Liquidity Risk

The report recommended that:

- There should be a review of the format of all **IBIS** liquidity analysis reports currently produced, or available but not produced (reports **20R**; **20T** etc). Where there were deficiencies over and above the requirements currently being addressed in the bank, a detailed specification of the dealing room requirements should be drawn up and implemented.

- This would ensure that IBIS and the Central Database actually produced reports which met the needs of ALCO, the Treasurer, and the Chief Dealer to measure, monitor, and control liquidity risk.
- A detailed specification of the dealing room requirements should be drawn up and implemented to ensure FEDS produces appropriate reports that met the needs of ALCO, the Treasurer and the Chief Dealer to measure, monitor, and control liquidity risk.
- Procedures should be introduced to cover all breaches of liquidity limits by the dealers. This should also set out appropriate disciplinary measures to be taken against offenders.
- A contingency plan should be established which addressed all perceived criteria in the event of a full scale liquidity crisis. For example it should detail the frequency of reporting; the availability of Senior Management etc.
- An exercise should be carried out to establish the cost of maintaining liquidity in accordance with the Bank's liquidity policy.

#### **2.1.2.4 Market Risk**

The report recommended that:

- Limits for the control of all market risk should be introduced immediately. This included:
  - Setting more appropriate foreign exchange open position limits both inter-day and intra-day.
  - Setting limits to control interest rate risk
  - Setting limits to control liquidity risk.
- ALCO should not approve the introduction of any new trading activity unless there was documentary evidence that the requested activity could be fully supported by the back office and accounting departments. This must confirm that detailed systems and reporting procedures were in place.
- There should be a review by the relevant personnel of the format of all reports currently produced, or available but not produced which address market risk.

Where there were deficiencies in the reports, a detailed specification of the dealing room requirements should be drawn up and implemented.

This would ensure that IBIS actually produced reports which met the needs of ALCO, the Treasurer, and the Chief Dealer to measure, monitor, and control market risk.

- A detailed specification of the dealing room requirements should be drawn up and implemented to ensure FEDS produced appropriate reports that met the needs of ALCO, the Treasurer and the Chief Dealer to measure, monitor, and control market risk.
- Procedures should be introduced to cover all breaches of trading limits by the dealers. This should also set out appropriate disciplinary measures to be taken against offenders.

#### **2.1.2.5 Human Risk**

The report recommended that:

- An intensive on-going training programme should be introduced to provide detailed training in all aspects of trading and risk management.

Senior management could draw considerable comfort from the fact that the members of Treasury and the Dealing Room were extremely professional, dedicated, and capable individuals. However, they lacked in-depth experience. Under normal circumstances this might not have presented too serious a problem to the bank. However, when this was combined with the existence of ineffective management systems in place to record and report all risks carried, and a weak limit structure, then potentially the problem became very serious.

- A Trainee Dealer programme should be introduced.

The dealing team headcount was considered to be at, or below, the minimum critical level for a Bank with ČSOB's market profile. The Bank had already lost a number of its experienced traders and, as the market in Prague developed, there would be a continuing major risk of further defections. A trainee dealer scheme would at least provide some cover in this eventuality.

#### **2.1.3 Recommended Time-Scale**

The paper stressed that the nature of the issues raised were very serious, warranting the most urgent remedial action. In particular it was stressed that the Bank was carrying significant risks which could have a material impact on its profitability. It was considered essential that the Bank provided the necessary resources (notably from within the IT area) to address the issues raised immediately.

It was recommended that issues raised should be resolved by 1 October 1994 at the latest. However, it was recognised that to achieve this required considerable effort and commitment on the part of all concerned.

## **2.2 Paper on the Establishment of Improved Risk Management Techniques**

Following on from the review detailed above, a paper was presented to the Board which set out recommended solutions to management's requirements of all concerned.

### **3. Review of IBIS Reports**

Whilst carrying out Task 1 a review was also made of a selection of IBIS reports which were available to the Bank and could be used to carry out its responsibilities. However, this review showed that:

- few reports were actually taken;
- fewer still reports were taken by Treasury or the dealers;
- of those reports not taken:
  - many were incorrectly configured in the system as installed;
  - significant amounts of system testing would be necessary for their eventual production; and
  - data necessary for their production was corrupted.

A list of reports reviewed is shown below. (NB -Not every report capable of being produced was reviewed.)

Report Ref	Function of Report	Dept Using	Frequency
<b>06B</b>	Analysis of Sales and Purchases: provides a summary of forward and spot currency movements.	Not Produced	
<b>06C</b>	Consolidated MM and FX CZK/Month Report: provides, by currency, a method of measuring the interest rate risk of the Bank's MM and forward FX dealing.	Not Produced	
<b>06D</b>	Daily Average Rates: details the daily average rates on outstanding L & D - including investment swaps.	27	Weekly
<b>13A</b>	Currency Positions: shows the positions for all currencies as at close of business on the previous day - including limit breaches.	27	Daily
<b>20R; 20RA</b>	Analysis of Exposure on Deposits: provides an analysis of exposure on commercial deposits by immediate geographic category.	11	Monthly
<b>20T</b>	Maturity Analysis Assets & Liabilities: provides a summary maturity analysis of assets and liabilities in base currency.	11	Daily
<b>051</b>	Ladder Details Report: provides a detailed backup report for report 061.	Not Produced	
<b>061</b>	Dealing Ladder: provides the dealers with a daily report of the positions of loans, deposits, interest, purchases and sales in each currency over a complete time profile. Investment swaps are included in this report.	27	Weekly

IBIS reports continued

Report Ref	Report Function	Department	Frequency
<b>061F</b>	Consolidated Ladder with Futures: shows the effect of open futures on the net position of the forward and deposit books at each future delivery date.	27	Weekly
<b>062</b>	Currency Flow: shows positions of all loans, deposits, interest and FX in each currency from now and forward for any day for which a movement occurs in that currency. Positions shown closely reflect those portrayed in the dealing ladder, and differ only in that the masking effect of investment swap matching deals is omitted from this ladder. The report is intended for use by management to control and review positions taken by the dealers.	Not Produced	
<b>073</b>	Forward Exchange Position Analysis: provides a forward exchange position analysis showing all FX deals with a forward value date.	Not Produced	
<b>075</b>	Settlement Limit Exceeded: shows those forward FX settlements for which the total settlement that day exceeds the settlement limit for that counterparty.	Not Produced	
<b>L79</b>	Client Limits Report: shows all client limits currently in force. An "out of order" column indicates a limit exceeded or a review date passed.	28	Monthly
<b>113; 113A; 113B</b>	Out-of-Order Reports: provides detail of any out-of-order accounts for the day / the day with reason for out-of-order status / the week.	None are Produced	
<b>GMHA / B</b>	Country Limit Reports: show limit, utilisation, and the next limit review date for each limit category and country.	Not Produced	
<b>GMIA / B</b>	Industry Limit Reports: show limit, utilisation, and the next limit review date for each limit category and industry. Any limit excesses are flagged.	Not Produced	

#### **4. Task 2: Implement Proposed Risk Management Techniques**

This element of the project was taken under two headings:

- advise on the incorporation of the proposed risk management techniques into the MIS; and
- provide training to staff relating to the proposed risk management techniques

##### **4.1 Advise on the Incorporation of the Proposed Risk Management Techniques into the MIS**

###### **4.1.1 Control of Interest Rate Risk**

The Bank was advised that interest rate risk for both Prague and Bratislava could be individually measured and reported **daily** in terms of "Milli-months". The functional specification of IBIS included the reporting of risk in this format. (*Report 6C - Consolidated MM & FX CZK/M* described on page 8/1-1 *IBIS/AS Foreign Exchange and Money Market Reports Manual*). However, the Bank was also advised that this report needed considerable testing and validation before it could be used in a live environment.

It was recommended that management should give priority to the production of this report to ensure that there might at least be some means available for quantifying the majority of the interest rate risk being run in ČSOB. In the event the Bank failed to respond to or act upon this advice.

###### **4.1.2 Control of Liquidity Risk**

A method was recommended to enable management to measure, monitor and control liquidity risk effectively. This method is based on the Česká narodní banka Quarterly Residual Maturity Report. The process controls the ratio of cumulative maturing assets to liabilities - against which a limit is set. The principal feature of the suggested process is that its main purpose is to ensure that management is able to maintain control over the bank's liquidity position **even in a worst case scenario**.

##### **4.2 Provide Training to Staff Relating to the Proposed Risk Management Techniques**

Computer Based Tutorials were produced to explain the various methods for controlling market risk.

## **5. Task 3: Review Valuta for Ability to Meet Risk Management Requirements**

### **5.1 Background**

During May and June 1994, Deloitte & Touche attended demonstrations given by the two suppliers short-listed by the Bank. Following these demonstrations, a note dated 29 June was circulated at a meeting to decide which system to select. This note stated that "... (o)verall the demonstrations were extremely disappointing, and scarcely justified the manpower costs involved by having 4 key members of the bank plus (D&T) away for 4 working days .... ". The note concluded that " .... (n)either system (could) immediately support the existing requirements of ČSOB, nor any reasonably foreseeable development of the dealing activities of the bank ..... (D&T) ... do not believe that either supplier will be able to meet ČSOB 's current objectives. .... If ČSOB can extend the time scale for selection and implementation they should do so. Suppliers of dealing systems exist in abundance! Certainly there will be others worth consideration."

Subsequently, the Bank did look at one other system which was at a similar stage of development and equally unsuitable to those shortlisted but decided to select Valuta despite the reservations voiced.

### **5.2 The Review of Valuta**

An extensive review was made of the Valuta test system installed in ČSOB during the pre-contract specification phase of the FEDS project. The review focused specifically on the capability of the system to meet the needs of senior management over and above the day to day needs of the dealers.

### **5.3 Conclusion of the Review**

The review concluded that:

- Valuta IDS would only have the most basic reporting and risk management functionality;
- The risk management functionality would not meet the needs of ČSOB senior management;
- Few, if any, of the developers of Valuta knew and understood the products or the markets for which the system was intended;
- ČSOB management should be under no illusion that what they were buying initially was anything other than a sophisticated - expensive- electronic deal "blotter" that (for the cost) provided a basic (minimal) ability to monitor positions, P/L reporting, and counterparty risk;

- Virtually all the features that attracted ČSOB to choose Valuta were still being "manufactured". These features were likely to be bought "sight unseen" if the Bank committed to purchase within the proposed negotiation time-table.
- The Bank would be required to detail virtually all its needs to Valuta - right down to the format of basic deal capture, let alone the detailed specification necessary to enable the system to meet the needs of senior management for the capture, reporting and control of risk.

In addition to the above, the very real fact that there were serious deficiencies in IBIS was stressed at length to the Bank. These deficiencies rendered the effective management control of the Bank's business virtually impossible to achieve. Furthermore, it was stressed that:

- as it was installed in the Bank, IBIS could not process or could only partially process the following products:
  - Treasury Bills;
  - Certificates of Deposit;
  - Fixed Income Securities;
  - Floating Rate Notes;
  - Repos; or
  - Reverse Repos;
- the truly successful implementation of Valuta depended as much on the integrity of the data in IBIS as on any other factor; and that
- unless the Bank took positive steps to address the reporting and processing deficiencies of IBIS in the foreign exchange and treasury area, there was little chance of avoiding problems in the implementation of Valuta and its subsequent use.

#### 5.4 Recommendation

It was strongly recommended to Senior Management that the Bank should only consider the implementation of a FEDS after the problems with IBIS had been resolved - although that should not necessarily preclude them from looking at alternative FEDS in the meantime.

## **5.5 Ensuing Action by the Bank**

The Bank postponed any final decision on Valuta until after the Bank had both reviewed the implementation of Valuta in S.G. Warburg, London, and had considered alternative FEDS. This exercise was scheduled to take place in early 1995.

## **6. Task 4: Assist with FEDS Contract Negotiations**

This element of the project was divided into three sections:

- to assist with preparation of a detailed specification of the exact needs of ČSOB in liaison with Valuta;
- to assist with the FEDS implementation final testing process.

### **6.1 To Assist with the Preparation of a Detailed Specification of the Exact Needs of ČSOB in Liaison with Valuta.**

User requirement specifications were set out for the following:

- Improvements to the Interest Rate Gap Analysis reporting of the system
- Outright Foreign Exchange Deals
  - Spot Buy.
  - Spot Sell.
  - Forward Outright Buy.
  - Forward Outright Sell.
- Forward Swaps.
  - Swap Buy.
  - Swap Sell.
  - Swap Buy - different start and maturity amounts of Currency 1.
  - Swap Sell - different start and maturity amounts of Currency 1.
  - Investment Swap Buy.
  - Investment Swap Sell.

- Deposits.
  - Fixed Rate Deposit Taken.
  - Variable (Floating) Rate Deposit Taken.
  - Fixed Rate Deposit Given.
  - Variable (Floating) Rate Deposit Given.
- Certificates of Deposit
  - CDs Bought
  - CDs Sold
  - CDs Issued.
- Commercial Paper
  - CP Bought.
  - CP Sold.
  - CP Issued.
- Treasury Bills.
  - Domestic TBs Bought.
  - Domestic TBs Sold.
  - Foreign TBs Bought.
  - Foreign TBs Sold.
- Bills of Exchange.
  - Commercial Bills Bought.
  - Commercial Bills Sold.
- FRAs
  - Trading FRA Bought.
  - Trading FRA Sold.
  - Hedge FRA Bought.
  - Hedge FRA Sold.

- Interest Rate Swaps
  - Pay Fixed.
  - Interest Rate Swap Receive Fixed.
  - Basis Interest Rate Swap.
- Financial Futures.
- Bonds.
  - Fixed Coupon.
  - Variable Coupon.

## **6.2 To Assist with the FEDS Implementation Final Testing Process.**

Deloitte & Touche drafted a revised version of the Bank's original Request to Tender. This was sent to Data Sciences to obtain an updated response which was subsequently reviewed by Deloitte & Touche.

The review concluded that generally the Data Sciences responses were unsatisfactory, and in some cases appeared to avoid the issues raised. This further confirmed the view that Valuta was not stable enough for the Bank to purchase. Additionally, the responses to the Appendices given by Data Sciences appeared to indicate significant commercial risk to the Bank, since all documentation submitted by them to that point in time suggested that it would be virtually impossible for ČSOB to bind Data Sciences contractually to such responses.

Other elements of the task were not pursued once the Bank took the decision to postpone selection of a FEDS until early 1995 (i.e. within Phase 2).

## **7. Task 5: To Review the Current Funding Base of ČSOB**

### **7.1 Background**

ČSOB was aware that a large percentage of its liabilities were drawn from the inter-bank market and the Bank was investigating alternative, more diversified, sources of funding. The domestic retail deposit market had been suggested as a target source of funding and ČSOB was considering a strategy to aggressively market for such deposits with a view to reducing the level of funds it took from the inter-bank markets.

In theory this strategy had considerable merits. It offered the potential to fund by straightforward deposit taking and/or the issuance of a range of banking instruments to a clientele that might not be quite so price sensitive as the wholesale markets.

However, there might have been fundamental factors that existed within the business profile of the Bank that would have direct implications for the immediate viability of such a strategy. In particular it was essential that the strategy did not create liquidity risk. For this reason, before it decided on a course of action, it was necessary for ČSOB senior management to know:

- the nature and extent of any liquidity risk currently being carried by the Bank;
- the nature and extent of an apparent concentration of funding from the inter-bank markets;
- the likely impact of a significant switch from inter-bank funding to retail funding; and
- any other related issues;

Deloitte & Touche, therefore, carried out a detailed analysis of the funding base of the Bank which focused on:

- a) the nature and extent of any dependency on inter-bank market funding by ČSOB; and
- b) the viability of "tapping" retail funding sources as an alternative means of meeting the Bank's needs.

## **7.2 Findings**

### **7.2.1 The Nature and Extent of the Liquidity Risk Currently Being Carried by the Bank.**

The analysis showed:

- That despite the recent domestic bond issue and international syndicated loan, ČSOB was still carrying a liquidity risk which might extend to CZK 3.5 billion in the period "Sight to 1 Month". (NB - This period is considered to be critical in any liquidity crisis.)
- That of the alternatives considered to eliminate this liquidity risk, the cheapest and (possibly) easiest to implement was for ČSOB to negotiate committed stand-by facilities in both CZK and convertible foreign currencies. It was also highly relevant to the way in which the liquidity risk was actually created within the Bank.
- The current inadequacies of the Bank's reporting systems ensured that it was virtually impossible for management to identify, measure and control liquidity risk - or to direct its strategic efforts in this area.

### **7.2.2 The Nature and Extent of any Dependency on the Inter-bank Markets as a Funding Source**

The analysis showed that ČSOB drew over 40% of its funding from the inter-bank markets: this might have been regarded as being extensive. However, inter-bank funding accounted for nearly 70% of the Bank's funding with a maturity exceeding three months but only 11% of funding with a maturity of less than one month.

### **7.2.3 The Likely Impact of a Significant Switch from Inter-bank Funding to Retail Funding.**

The analysis showed that the existing deposit base suggested that it would be extremely difficult to merely substitute retail deposits for inter-bank funding for comparable maturities.

For this reason if the bank pursued a strategy for no other reason than to switch from inter-bank to retail sources of funding it was probable that it would significantly increase the liquidity risk being carried.

To avoid creating liquidity risk, any reduction in the level of inter-bank funding as a percentage of total funding would need to be matched by other funding with a maturity at least equal to that which it was replacing. Alternatively there would need to be either:

- an appropriate reduction in the Bank's balance sheet and corresponding reduction in inter-bank funding. (NB - This alternative still required an appropriate maturity structure of the residual liabilities.); or
- a significant increase in the balance sheet funded entirely from non-bank sources. (NB - This alternative required an appropriate matching of maturities of new assets and liabilities.)

## 7.2.4 Other Related Issues.

The analysis showed that:

- Retail deposits might in practice be a more expensive source of funding compared with wholesale deposits.
- There were serious deficiencies in IBIS that rendered the effective management control of the **current** business virtually impossible to achieve. Any extension of a branch network to tap further retail business would serve only to exacerbate the situation, particularly since this would almost certainly result in a substantial increase in deal volumes by virtue of the nature of retail business.

## 7.3 Recommendations.

It was recommended that:

- the Bank took immediate action to eliminate the current liquidity risk;
- the Bank postponed any thoughts it has regarding aggressively marketing for retail deposits until:
  - it had completed a full cost/benefit exercise; and
  - it had totally eliminated the current systems deficiencies;
- in addition to further long term bond issues similar to the recent three year deal, the Bank should consider issuing longer-term subordinated floating rate debt to non-bank domestic institutions in preference to a full scale effort to attract retail deposits.

## 8. Phase 2 Terms of Reference

Following a request by Československá obchodní banka a.s. ("ČSOB") to continue the advisory assistance provided by USAID it was agreed that Deloitte & Touche would assist the Bank in three areas:

- Task A: Implementation of the Front End Dealing System.
- Task B: Definition of Back-Office Information Reports.
- Task C: Implementation of Risk Management Policies and Procedures.

A paper was presented which set out updated terms of reference for the continuing provision of technical assistance to ČSOB in the area of Treasury and foreign exchange management.

The project was subsequently extended to include:

- Task D: Production of a Strategic Risk Management Plan; and
- Task E: Production of an Organisation Structure and Key Personnel Profiles for a proposed Global Treasury (Markets Division).

## **9. Task A - Implementation of the New Front End Dealing System ("FEDS").**

### **9.1 Background**

At the end of Phase 1 the Bank decided that it would investigate the possibility of acquiring an alternative FEDS that was more suitable to its needs. This decision coincided with the commencement of the new phase of the assistance being provided.

### **9.2 Structure of Task A.**

Task A was separated into three functions:

- Function 1: to short-list and select an alternative FEDS;
- Function 2: to evaluate any test system installed in ČSOB; and
- Function 3: to implement the FEDS in ČSOB.

#### **9.2.1 Function 1: To Short-list and Select an Alternative FEDS.**

The work undertaken entailed:

- a) confirming the Bank's selection criteria;
- b) investigating systems available in the market against the Bank's selection criteria;
- c) drawing up a short-list of systems for consideration by the Bank;
- d) arranging and attending demonstrations in London to see four FEDS:
  - i) Valuta (as implemented in S.G. Warburg);
  - ii) IDSS2;
  - iii) Tantus; and
  - iv) Global Trader

- e) attending further demonstrations in Praha to see:
  - i) Tantus; and
  - ii) Global Trader
- f) making a recommendation to the Bank based on these demonstrations / visits;
- g) re-writing the Bank's *Request to Tender* document; and
- h) evaluating the responses to the *Request to Tender*.

### **9.2.2 Function 1: Outcome**

Function 1 was successfully completed. Following demonstrations in London and Praha of Global Trader ["GT"] and the submission of a full response to ČSOB's *Request to Tender* document by ADS Associates [the vendors of GT], this system was selected by the Project Team. Senior Management were informed on 28 April 1995 and the contractual process was started with ADS Associates on 6 June 1995.

### **9.2.3 Function 2: Evaluation of Test System to be Installed in ČSOB.**

### **9.3 Structure of Function 2.**

Function 2 was originally separated into three elements:

- a) to evaluate:
  - i) the system against the specific needs and requirements of senior management; and
  - ii) its performance against the Bank's original selection criteria.
- b) to provide a detailed specification of the Bank's configuration requirements in liaison with the vendor; and
- c) to specify any enhancements to the base system and assist with the preparation of a detailed implementation plan.

### **9.3.1 Function 2: Outcome**

It was subsequently established that a test system would not be installed in the Bank. However, the demonstrations of the system in London and Praha confirmed that it was necessary to make a number of major specifications for the system prior to its implementation in the Bank. Detailed user requirement specifications were, therefore, submitted to ensure that the system provided appropriate reports for:

- the control of liquidity risk;
- the control of interest rate risk by the use of "milli-months"; and
- the control of interest rate risk by the use of "value at risk".

These specifications are expected to be submitted by the Bank to ADS at the appropriate stage of the contractual negotiations (which is now assumed to be in the next phase of the project).

### **9.3.2 Function 3: Implementation of FEDS.**

Function 3 was originally separated into five elements:

- a) to provide ongoing monitoring throughout the installation of system to ensure that the vendor met its contractual obligations to the Bank;
- b) to advise on all stages of testing of the system as it was being installed;
- c) to undergo training on system;
- d) to monitor and advise on the integration of system reoprtng into the MIS; and
- e) to provide training to staff on the system.

### **9.3.3 Function 3: Outcome**

It was originally planned to relocate the ČSOB dealers to a new dealing room in the former Banka Bohemia building in Jungmannova in January 1996. It had also been decided by senior management that the FEDS would not be installed in the Bank prior to this event.

Subsequent difficulties relating to the proposed relocation has resulted in the postponement of the implementation of GT probably until January 1996 at the earliest. It has not, therefore, been possible to progress Function 3.

## **9.4 Task B - Definition of Back Office Information Reports.**

#### **9.4.1 Background**

During Phase 1, a review was made of a selection of standard IBIS reports which were available to the Bank and which could be used to carry out its responsibilities.

This review showed that:

- few reports were actually taken;
- fewer still reports were taken by Treasury or the dealers;
- of those reports not taken:
  - many were incorrectly configured in the system as installed;
  - significant amounts of system testing would be necessary for their eventual production; and
  - data necessary for their production was corrupted.

Subsequently, Deloitte & Touche were informed that the MIS project included the preparation and production of a number of risk reports.

#### **9.4.2 Review of Reports being Developed within MIS**

A review was made of a number of reports at varying stages of development within the MIS project at ČSOB. The following reports (which include a further assessment of some of the standard IBIS reports) were reviewed:

- Úvěrové Angažovanost - přesah 10% kapitálu - banky
- Úvěrové Angažovanost - Banky - CBDJ
- Out of Order Report: Úvěrové Angažovanost - Banky
- FX Settlement Limit - Banks
- Úvěrova Angažovanost - CRDI / Standard IBIS Reports GMHA/B
- Úvěrova Angažovanost Podle Odvěti / Standard IBIS Reports GMIA/B
- Denní Devizová Pozice - TRCJ / IBIS Standard Report 13A
- Denní Devizová Pozice - rozdíl re FWB - TRCJ
- IBIS Standard Report 06B
- IBIS Standard Report 06C

- IBIS Standard Report 061F/MIS Report TSY4
- CRDB klienti s nevyřílí úvěr etc
- Interest rate and liquidity statement - TRBM
- Korunová pozice - Backup - FICL
- Korunová pozice - Detail - FICM
- Korunová pozice - Sumář - FICN
- Zásoba hotovosti - TRCA
- Zásoba hotovosti - chyby syntetik - TRCD
- Překročení limitu - CBBT
- Úvěrová angažovanost podle odvětví - CRDC
- Other Credit Utilisation Reports - CRBP; CRBQ; CRAS; CRDA.

This review concluded that whilst some of the MIS reports seen added some value for ČSOB, a number appear to be unnecessary rewrites of standard IBIS reports. These appear to stem from past difficulties with IBIS produced reports. However, the Bank has engaged in its own extensive report development programme. The MIS project has, therefore, tended to get itself bogged down.

#### **9.4.2.1 Report TSY 3: Interest Rate and Liquidity Statement**

The specification for this report does not:

- appear to address cashflows resulting from foreign exchange or derivatives transactions (if this is the case the report is totally meaningless as a statement of liquidity);
- present the information in a format that can be readily used to assess liquidity risk;
- allow liquidity risk to be assessed against limits; or
- appear to form any part of a process to consolidate the Bank's liquidity exposure.

#### **9.4.2.2 Report TSY 4: Interest Rate Sensitivity Report (GAP)**

The proposed report has been in development over a protracted period of time - the specification contained comments dated 7th October 1994. Unfortunately, this report appeared to represent merely an attempt to "re-invent the wheel". IBIS produces standard dealing ladders (061; 061F; 062; 051; etc) which, if "debugged" and/or properly specified, should meet the requirements of the Bank. Certainly, experience suggests that other users have experienced very few difficulties in obtaining Gap Ladders - even from earlier versions of IBIS. In its proposed format this report appears to have little or no value. The proposed report does not:

- appear to address committed forward start, fixed rate transactions;
- appear to address positions resulting from foreign exchange;
- present the information in a format that can be readily used to assess interest rate risk; or
- allow interest rate risk to be assessed against limits.

The principal criticism of the proposed report is that it:

- potentially masks major interest rate risks;
- precludes a risk manager from taking discrete incremental steps to control exposure; and
- encourages the introduction of a domino effect in the exposure management process.

#### **9.4.3 Reports Specified by Deloitte & Touche**

Detailed user specification requirements for implementation within IBIS/MIS were completed for the following risk areas:

- liquidity risk;
- interest rate risk - gap analysis;
- interest rate risk - milli-month analysis;
- interest rate risk - modified milli-month analysis; and
- market risk - value at risk analysis.

Where appropriate, additional user requirements were also suggested in the case of some of the MIS reports detailed in paragraph 9.4.2 above.

Subsequent to the submission of the specifications, elementary demonstration computer programmes were prepared and submitted in an attempt to:

- a) expedite implementation of the reports; and
- b) enhance the material already submitted,

These focused on the reporting of cash liquidity and the "modified milli-months" method for control of interest rate risk. The programmes were written in Microsoft Visual Basic and linked either to a Microsoft Access database or to random access files. These programmes also indicated ways of extending the reporting of risk graphically.

Investigations were made to see whether IBIS held information could be downloaded into Microsoft Access with a view to developing simple but effective risk management reporting as an interim to the recommended resolution to the Bank's back-office system problems and the implementation of FEDS.

These enquiries confirmed that there appeared to be no reason why such a download should not be possible, either by the use of text files or through the use of Excel spreadsheets. The only potential problem for IBIS is if data is required to be written to the IBIS database.

#### **9.5 Task C - Implementation of Risk Management Policies and Procedures.**

Throughout Phases 1 and 2 of this Project Deloitte & Touche have stressed to senior management the fact that the risks faced by the Bank can be complex and will threaten its safety and soundness if they are not fully understood and managed. In particular, Deloitte & Touche has stressed that management must ensure that the **basic principles** of risk are applied within the Bank.

These basic principles are:

- a) that the Board exercises appropriate oversight;
- b) that an adequate risk management process is established within ČSOB; and
- c) that comprehensive internal controls and audit procedures are set in place.

##### **9.5.1.1 The Risk Management Process.**

The risk management process requires that ČSOB defines:

- a) how risk will be measured;
- b) how risk will be reported; and
- c) its systems requirements.

### **9.5.1.2 Risk Measurement.**

Risk should be automatically aggregated across trading and non-trading activities on a bank-wide basis to the fullest extent possible. Risk assumed by the Bank should also be measured against a limit structure that may reasonably be expected to restrict losses that might accrue to the Bank in a pre-defined market (disaster) scenario to an acceptable and pre-determinable amount.

#### **9.5.1.2.1 Limit Structure.**

A sound structure of integrated bank-wide limits is an essential component of the risk measurement process. Any limit structure to be incorporated within ČSOB should:

- a) allow the control of exposures;
- b) allow the initiation of discussion about opportunities and risks; and
- c) allow the monitoring of actual risk taking against pre-determined tolerances.

Limits should be expressed:

- a) in a form that is the same for both individual products and portfolios, no matter how complex or diverse the product or portfolio;
- b) in a way that can conform to a range of different market levels and conditions; and
- c) in a way that can reflect changes in the circumstances of ČSOB itself.

Additionally, the limit structure:

- a) must be consistent with the effectiveness of the Bank's overall risk management process and within the constraints of the Bank's capital adequacy requirements;
- b) must allow global limits to be set for each major type of risk involved in the Bank's trading activities;
- c) must provide the capability to allocate limits down to individual business units; and, most importantly,
- d) must set out the procedure to be followed in the event of any breaches of the Bank's limits.

#### **9.5.1.2.2 Reporting Risk.**

An effective risk reporting process requires:

- a) sound measurement procedures and information systems;

- b) continuous risk monitoring; and
- c) frequent management reporting.

An accurate, informative and timely management information system is essential to the prudent operation of trading activities. It also follows that the quality of the management information system is an important factor in the overall effectiveness of the risk management process. Management information systems should translate the measured risk for market activities from a technical and quantitative format to one that can be easily read and understood.

Reports should provide adequate relevant, accurate and timely information about:

- credit exposures and approved credit lines;
- funding exposure and approved liquidity mis-match limits; and
- market exposure and approved trading limits.

#### **9.5.1.2.3 Systems Requirements.**

The Bank's reporting systems should serve two functions:

- a) to capture all information relating to the business performed; and
- b) to enable effective use of that information.

In the case of the latter requirement, the Bank's reporting systems should:

- a) identify ALL the risks being carried; and
- b) identify Profit and Loss issues and allocate costs and benefits.

#### **9.5.1.2.4 Comprehensive Internal Controls and Audit Procedures.**

A sound system of internal controls should be established within ČSOB that will ensure:

- a) that business is conducted in an environment with clearly defined and properly segregated areas of responsibility;
- b) that there is reliable financial and regulatory reporting; and
- c) that there is compliance with Bank policies at all times.

In determining whether internal controls can achieve these aims the Board should consider:

- a) the overall control environment;
- b) the process for identifying, analysing, and managing risk;
- c) the adequacy of management information systems; and
- d) adherence to control activities.

In the case of control activities, particular attention must be paid to reconciliation control (i.e. that management is not receiving conflicting information about the Bank's business). This is particularly important where there are:

- a) differences in valuation methodologies; and
- b) separate systems used by the front and back offices.

The Board should take into account any perceived weaknesses in this area when called upon to approve limits and / or business activities.

### **9.5.2 The Basic Principles**

Deloitte & Touche has:

- produced a draft Rules & Procedures Manual for the Bank which sets out a format detailing how the Board will meet its primary responsibilities (see below);
- recommended a Strategic Risk Management Project which includes an organisation structure that establishes responsibility for risk management;
- recommended a method to aggregate risk associated with all activities as fully as possible and readily determine maximum probable losses in a given disaster scenario;
- recommended an approach to implement the method to aggregate risk which is consistent with the Bank's system capabilities;
- pointed out the weaknesses of the Bank's current limit structures and indicated alternative structures;
- pointed out the very substantial weaknesses in the Bank's current reporting capabilities and recommended a course of action to the Bank;
- produced user requirement specifications for implementation into the Bank's reporting systems for the control of risk; and
- recommended procedures in respect of products traded, limit breaches and losses arising from human error.

The Policies and Procedures Manual was presented in six sections:

- The Basic Principles (of risk);
- Dealing Code of Conduct;
- Control of Liquidity Risk;
- Control of Credit Risk;
- Control of Market Risk; and
- Approved Products.

#### **10. Task E: Strategic Risk Management**

An outline for a Strategic Risk Management Project was provided at the request of the Bank. This set out:

- an overall structure for a proposed Global Treasury (Markets Division);
- a structure for the Trading Group of Markets Division;
- a structure for the Asset & Liability Management Group of Markets Division;
- the potential use of risk based capital allocation within ČSOB;
- the need to be able to reconcile the P & L and risk management reporting of the FEDS with IBIS;
- the potential need for a Simulation package; and
- the need for appropriately trained internal auditors.

#### **11. Task E: Production of an Organisation Structure and Key Personnel Profiles for a proposed Global Treasury (Markets Division)**

Following further discussions with the Bank a paper was submitted which provided:

- an organisation structure for a proposed Global Treasury (Markets Division);
- a rationale for risk based capital allocation;
- the terms of reference for:

- the Board of Directors;
- the Treasurer;
- the Asset & Liability Management Group;
- the Trading Group; and
- the Economists;
  
- personnel profiles for:
  - the Treasurer;
  - the Head of Dealing; and
  - the Head of Asset & Liability Management.

### III. Problem Loan Workout Assistance

The USAID technical assistance program in the area of problem loans was designed to assist CSOB in developing its policies and procedures, capacities and skills, so that by the end of the assistance the Bank will possess a fully functional Problem Loan Department. This final report reflects the work performed during Phases I and II of the program.

#### Technical Assistance Program

Work began on this component of the project in September, 1994 and phase I was completed on schedule in January, 1995. Phase II followed on from Phase I without interruption.

The first task was to understand the Bank and the environment within which it operated, this took approximately the first month of professional time. Cooperation from the bank, although poor initially, improved dramatically and full assistance was subsequently provided by the Bank.

The requirements of the original terms of reference were adhered to closely although the sequential arrangement was restructured so that assistance was provided first with the establishment of the work-out function and the defining of roles and functional responsibilities, together with the development of appropriate policies, procedures and the necessary early warning systems. This was essentially the planning stage, following which, deliverables were provided in the format of the Problem Loans Policies and Procedures Manual.

The emphasis then changed to an analysis of the structure of the problem and non-performing loan portfolio.

Following discussions it was agreed with the Bank that in view of the limited resources available, the Problem Loans Department would in the initial stages of its operation, concentrate on the Bank's largest and most problematic exposures. As a consequence, the department now concentrates on and prioritises problem loans of Kc 25 million or greater which are classified as "Doubtful" or "Loss".

This role led directly into the final stage of Phase I where the advisor was involved in the day-to-day operation of the department, assisting, training and explaining as required.

Phase II continued and built on the achievements of Phase I, providing support for the implementation of recommendations for the Problem Loans Department and also direct assistance in the workout of problem loans.

These two modules were run contemporaneously in order to make the best use of time available and provide maximum flexibility and support to the Bank.

## **Benchmarks**

The following Benchmarks were established to measure as at December 31, 1995, the progress of the assistance:

- a.) Successful resolution of ten problem loans;
- b.) Completion of training for loan workout staff on policies and procedures;
- c.) Implementation of a problem loan portfolio management, monitoring and record keeping system; and
- d.) Resolution with the Czech Government on policies and procedures regarding old debts of foreign trade companies.

Benchmarks (a), (b) and (c) have all been successfully achieved. However, Benchmark (d) has not been achieved although this should be considered within the context of the terms of the technical assistance.

## **Successful Resolution of Ten Problem Loans**

More than ten problem loans have been resolved or are in course of resolution. For the purposes of this benchmark, the ten cases for consideration are:

Platex s.r.o.  
CHS Czechia International s.r.o.  
Multisys Group a.s.  
Bet Nir s.r.o.  
Strojimport a.s.  
Claudio Osorio  
Multisys Leasing a.s.  
Intersigma a.s.  
KPM a.s.  
Jaminex a.s.

These cases have an aggregate value of Kc5,280 million (approximately US\$193 million). Within this figure Kc 4,032 million has been restructured successfully, restructuring the basis of the exposure, updating documentation, improving collateral, completing debt/equity swaps and using zero coupon unsecured convertible debentures to take control of companies in order to improve the Bank's position. Kc1,022 million has been or is in course of recovery and Kc 226 million has been written off or is now placed into the bankruptcy process.

## **Completion of Training for Loan Workout Staff on Policies and Procedures**

There has been close cooperation with the Head of Problem Loans Department and his staff. The advisor has worked with many of the Bank's Problem Loans Officers both in the department and through the branch network.

Policies, procedures and techniques developed both by the advisor, the Bank and outside legal counsel have been consolidated and enhanced and it is believed that as a direct result of this technical assistance, the Bank is now at the leading edge in the Czech Republic in the context of handling problem loans.

Loan workout staff are now broadly conversant with the requirements of the Bank and progress will now be slower, developing mainly from further time and practice on the job.

### **Implementation of a Problem Loan Portfolio Management, Monitoring and Record Keeping System**

The Bank has a fully operational record keeping system and reports in compliance with requirements of the Czech National Bank are produced on a monthly basis.

Given the size of the Bank's classified loan portfolio, management and monitoring are not so advanced and are still at a comparatively early stage of development.

However, all classified exposures are reviewed on a quarterly basis and a detailed provisioning exercise undertaken. Despite this, detailed management and monitoring of problem loans still leave room for further improvement.

### **Resolution with the Czech Government on Policies and Procedures Regarding Old Debts of Foreign Trade Companies**

It is appropriate to quote from the work plan dated February 1995 (page 5):

"Item (iv) is different in that it requires a degree of political influence which is beyond the ability of the advisor and the role of this contract. However, the consultant and the Bank are at the leading edge of developments in this field and as such, many matters which are now unclear, will be clarified as a result of the work financed under this contract. It is anticipated that the consultant and the Bank will make a major contribution to the understanding and resolution of this problem."

The position remains as stated in February, 1995. However, significant progress continues to be made in the resolution of this sector of the Bank's problem exposures. Much of this progress is attributable directly to the USAID technical assistance.

### **PHASE III**

Work required under Phase III of the technical assistance program has been commenced and the Problem Loans Policies and Procedures Manual has now been converted from that provided as the deliverable under Phase I of the assistance, into a format which the Bank believes is a practical, action directing manual for use by credit officers in the Branch Network. The final version which it is anticipated will be approved by the Board of Directors, is now available although to date this in Czech only. This portion of the work will now no longer be necessary under Phase III.

Cases taken over by the department have now increased from twenty-five to fifty and the department maintains files and a watching brief on a further forty-five exposures.

## **CONCLUSION**

The Bank recognizes the benefits which have flowed from the first two phases of the technical assistance program and more particularly the significant assistance, guidance and practical work and training provided by Deloitte & Touche. Of the five components included in the USAID technical assistance program, the work in the area of problem loans is among the most successful and with commercially measureable results.

#### **IV. Retail Banking Strategy**

At the beginning of work on this component of technical assistance the management of CSOB felt that the Bank should be moving in the direction of becoming a universal bank. This move toward universal banking was popular among all of the major Czech banks at the time. CSOB also felt that because of its own historical development, it was heavily dependent on interbank funds and that the cost of these funds was going to increase substantially as the banking sector develops. As a result, the bank decided that it should develop its own retail deposit base. At the same time, a second-tier bank was being taken under administration and the possibility existed for CSOB to acquire the assets and liabilities of this bank.

The USAID technical assistance program for CSOB included a component focused on a review of the Bank's retail strategy. This assistance included two main elements:

- a) An analysis of the Bank's exposure to interbank lending;
- b) An assessment of the Bank's retail banking strategy and recommendations on the bank's plan to expand its retail banking activities;

#### **Exposure to Interbank Lending**

An analysis was undertaken to assess the exposure of CSOB to interbank funds. At the time, the bank management felt that it should be moving in the direction of retail banking. A detailed report was produced by the advisor on the results of this analysis.

#### **Retail Banking Strategy Study**

At the outset of the project, CSOB management was convinced of the desirability of getting into retail banking. An assessment of retail banking was undertaken to examine the market shares of other banks, their strengths and weaknesses and to assess CSOB's competitive position relative to the competition. The object being to identify those market segments (customers/locations/products and services) where CSOB could attempt to compete. This strategy assessment included the following elements:

1. Evaluating bank penetration/branch density among all Czech and foreign banks operating in the market and looking for opportunities for CSOB to compete.
2. Evaluating the main competitor's retail banking products, services, strategies and target customers
3. Examining objectively the current quality of CSOB's retail products/services
4. Assessing CSOB's ability to deliver retail products taking into account its current systems configuration and organization.

5. Looking at the factors influenced by the State - fiscal/monetary policy, taxation, impact on saving/borrowing.

The Deloitte & Touche advisor prepared a detailed report on the results of this strategy study. This report was the most comprehensive assessment of the retail banking sector in the Czech Republic available at the time.

### **Branch and Product Profitability Analysis**

Another key component of the assessment of the bank's strategic position was an effort to determine both product and branch profitability. The advisor attempted to estimate projected product profitability based on realistic assumptions regarding cost and volumes. After extensive work with CSOB staff, it was determined that the bank's existing accounting systems and procedures would not support product profitability analysis.

Similarly, the advisor attempted to analyze branch profitability. After extensive work with bank staff, it was determined that the accounting systems and procedures would not support branch profitability analysis.

As a result of the conclusions drawn from the attempts to perform product and branch profitability analysis, it was decided that the technical assistance could best contribute by advising the bank on the accounting methods needed to assess profitability. A seminar was developed and presented to the heads of all major branches, senior accounting staff, representatives from the information technology department and the bank's Board of Directors.

### **CONCLUSION**

The findings and conclusions drawn from the retail banking strategy study were that:

1. CSOB had no current or historical core skill or advantage that would argue in favor of it investing to expand its retail banking activities.
2. Other banks had considerable branch networks and the supporting infrastructure which would make it difficult for CSOB to effectively compete. The retail banking market, while lacking in a strong service culture and offering new product opportunities, was overbanked in terms of branch density.
3. CSOB's position in wholesale and commercial banking represented an advantage which should be the focus of its future strategy.
4. Major deficiencies in the Bank's accounting and management information system are at the heart of the Bank's problems for making a successful transition.

At the conclusion of the strategy component of the study, the Bank Board decided to abandon its consideration to acquire the assets of the failed second-tier bank and to concentrate its growth activities away from retail banking.

## V. Internal Audit and Control

Another major component of the USAID technical assistance program was in the area of internal audit and control. The purpose of this assistance was to assist the bank in reorganizing its internal audit and control function. This effort included:

1. A diagnostic review of the existing IA function, including its organization structure, policies and procedures;
2. Assisting the bank in developing and implementing new policies and procedures for internal audit;
3. Assisting the bank in developing and implementing a reorganization plan for the internal audit function.

The advisor worked closely with senior representatives of the IA department throughout the project. The successful results of this component of the project are reflecting the the fact that during the course of the assistance program:

- a new organizational structure for the IA department was developed and implemented (the organization plan was submitted as a deliverable product);
- policies and procedures manuals were developed for all aspects of the internal audit function (each of these procedures manuals was submitted as a separate deliverable product for the project); and
- training of all central office staff and many branch office staff was completed in all areas of internal audit.

## **VI. Management Information Systems**

The results of Phase I of the USAID technical assistance program indicated that the banks accounting and management information systems were a central problem in all areas. The treasury management and dealing functions lacked adequate information systems and controls. Efforts to improve this situation were lacking coordination and creating considerable exposure for the bank. Similarly, no effective reports were going to the Bank's Board of Directors to guide management decisionmaking. In the area of product and branch profitability analysis, accounting and reporting systems were inadequate to capture any of the necessary information. Despite these shortcomings, it was learned that the bank's MIS department had a list of more than 200 development projects underway, most of which were far beyond an appropriate time schedule for such efforts. Most importantly, the projects were not being coordinated and prioritized effectively.

Therefore, it was requested by CSOB and agreed by USAID that Phase II of the technical assistance effort should include the support of a Czech-speaking advisor to help the bank gain control over its MIS development and implementation efforts. The advisor spent approximately six months undertaking the following activities:

1. Assessing the current status of all MIS development and implementation efforts within the bank;
2. Developing and implementing case tools to gain control over the many diverse IT efforts underway within the bank; and
3. Assisting in managing these efforts according to the priorities of CSOB senior management.

At the conclusion of Phase II, case tools for project management had been put in place, and all of the key MIS development and implementation efforts had been established. Considerable work remains with respect to managing the ongoing MIS development and implementation effort.