PD-ACA-274

BearingPoint

Ukraine Bank Supervision Development
Contract #PCE-I-00-99-00006-00 TO#827
Quarterly Report
July 1, 2003 to March 31, 2003

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

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

By September 30, 2003

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

According to the RBS training plan developed earlier, technical training for trainers (who will deliver regional RBS training throughout 2004) started on November 10 and continued for two weeks. At this time, the pilot seminar for GDBS Central Office personnel was scheduled for February 2004. BearingPoint RBS training was coordinated with Dutch Grant training events, and as a result potential RBS trainers from the NBU will be scheduled to attend Train-the-Trainers courses organized and delivered by Dutch Grant at three different locations.

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

Working with the Task Force, implement the recommended schedule (developed in September 2002) to review chapters of the Onsite Manual to focus and emphasize the evaluation of banks' risk management system and results of the Risk Assessment System (RAS). Begin the review of chapters based on an approved (by Task Force) schedule. This process will continue through 2004 and into 2005. Advisors: Ladokhina, Baranovich, Blimling; NBU Counterpart: Task Force

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

By December 31, 2003

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

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

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

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

The technical training for the potential instructors of RBS seminars was held November 10 through November 21, 2003. Twenty participants finished the seminar. Course materials included brief presentations on Risk Based Supervision, Risk Management Systems, Corporate Governance and included completion of an extensive case study.

The RBS pilot seminar for GDBS personnel scheduled for December 2003 was postponed because of delays in developing the Minimum Guidelines for Risk Management Systems in Commercial Banks. The delay gave BearingPoint and the NBU sufficient time to develop the most appropriate format of training and finalize all training materials. The seminar was then slated for next quarter.

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

We presented recommendations to the NBU on the Onsite Manual review, focusing on the following: 1) to publish and practically implement the chapters developed earlier, used informally, but not officially adopted; 2) to expand the Onsite Manual into a Banking Supervision Manual, specifically, by including a chapter on Offsite Analysis; 3) to review the Manual in order to make the terminology consistent with the Risk Assessment System and Policy Guidelines for Comprehensive Risk Management Systems in Banks; and, 4) to make sure that corporate governance principles are adequately reflected in the Manual.

By March 31, 2004

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

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

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

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

By June 30, 2004

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

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

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

By September 30, 2003

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

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

By March 31, 2004

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

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

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

By September 30, 2003

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

Draft amendments to the Law on Banks and Banking have been developed. Articles 17-20 address issues related to licensing. The amendments are to be considered during round table discussions with the Legal Department by December 31, 2003.

By December 31, 2003

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

Due to reasons beyond our control, working group on amendments to BBL related to issues of Risk Management systems (including addressing the RMS functions at the time of licensing) has not been formed yet, and it is supposed to start its activities only in early 2004. Please see comments in Section 5 "Legal Issues".

By March 31, 2004

Assist in the development of amendments of appropriate licensing regulations to implement revised laws. Advisors: Gegenheimer, Telychko, Burlaka; NBU Counterpart: NBU Legal Department, Parkhomenko

Our legal advisors continued to advise the NBU working groups on the banking law and implementing regulations, primarily in the area of related parties to banking operations. The principal items of concern are amendments to the Law on Banks and Banking Activity as it pertains to: "essential participants" in banks, the concept of "beneficial ownership," and related parties. Advisors have met with Ms. Ivanenko, Ms. Farber and Mr. Novikoff to present ideas and suggestions for provisions that we believe the NBU should advocate in the amendments. Advisors have also attended working group sessions with NBU representatives and representatives from the Bankers Association to discuss the proposed amendments. We are continuing to work on these items, as well as preparing for discussions later on audit requirements, bank corporate governance, and consolidated supervision.

By June 30, 2004

Continue assisting in the development of amendments of appropriate licensing regulations to implement revised laws. Advisors: Gegenheimer, Burlaka; NBU Counterpart: NBU Legal Department, Parkhomenko

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

By September 30, 2003

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

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

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

A proposal was provided to Mr. Pushkariov on the selection of GDBS personnel members for study tours in the United States.

With BearingPoint advisory assistance, Ms. Ivanenko, Deputy Director of the General Department of Banking Supervision, participated in the course development of a seminar ("Best Practices of On-Site Examinations: Regional Experience and Challenges" for CEE and former Soviet Union countries) organized by the Training Initiatives for Banking Supervision ("TIBS") of the National Bank of Poland. This seminar was held during the week of November 17, 2003. Ms. Ivanenko made presentations on the Ukrainian bank supervision experiences and challenges. Three other persons from the GDBS also attended this forum. BearingPoint advisors continue to work closely with the NBU and TIBS on future topics for seminars and cooperation avenues between the NBU and TIBS. We are also considering a future trip for the GDBS Training Unit Manager to visit TIBS for the purpose of discussing best practices, policies and approaches to organizing a self-sufficient and effective training function for the NBU bank supervision area.

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

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

By December 31, 2003

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

Training materials were developed and "training-of-trainers" ("TOT") for RBS was delivered in November 2003. A group of instructors from Kyiv and regions was selected by the NBU and BearingPoint to assist in the future implementation of RBS training. During the next quarter, BearingPoint will focus on formatting training materials and on the development of the best delivery mechanisms – combination of distance and classroom training. Selected individuals from TOT group will be heavily involved in the development and then in the delivery of the RBS training. The first session of RBS training was conducted in February, regional training will commence in March 2004.

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

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

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

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

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

By March 31, 2004

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

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

Participants in the seminars are concerned about the degree of subjectivity associated with risk-based supervision. The former regime, of compliance-based supervision, was targeted at simply verifying compliance with detailed normative requirements issued by the NBU. Inspectors are more confident in their discussion of findings when the inspection goals are more objective in nature, focusing on the bank's compliance with pre-established formulas. When a commercial bank disagrees with a formula, inspectors know exactly how to proceed. When a bank disagrees with a subjective judgment, the inspectors are less certain. This is an understandable reaction to this change in culture. The risk-based supervision seminars illustrate the weaknesses associated with merely verifying compliance with normatives, as opposed to understanding and acting on a bank's risk profile. In essence, supervision is assuming a more "proactive" stance, rather than "reactive." The inspectors understand and agree with the new concepts; however, they do have valid concerns of a bank's reaction to their subjectivity. The NBU realizes that risk-based supervision cannot be implemented overnight, and that fact is precisely why an implementation phase is planned. The accompanying risk management guidelines should also provide guidance to inspectors and assist them with making their decisions on banking risk.

Inspectors are concerned about the complexity of risk-based supervision and are worried they do not have enough training to properly follow and implement the risk-based supervision principles. The three-day seminar introducing risk-based supervision is not enough to fully grasp each of the risk areas. These concerns are again acknowledged through a transition or implementation phase for risk-based supervision and risk management guidelines for banks. Inspectors must earn the right to make subjective decisions and this is typically accomplished through career development planning and formal and informal training opportunities. The NBU is establishing an accreditation process and career development plan for banking supervisors, which will incorporate a formal training schedule. The three-day seminar is not a complete discussion of each individual risk area of banking operations. It is only an overview of the risk assessment system. The sister project through BankWorld is implementing a training program on individual risk areas.

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

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

By June 30, 2004

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

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

Ongoing

As risk-based supervision is developed within the GDBS, make recommendations to management concerning potential changes in organizational structure. (Continuation from year 1. Advisors: Blimling, Wilson; NBU Counterpart: Shlapak, Pushkayov

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

5. Legal Issues: Elements of the legal framework are further elaborated which deal with different aspects of the banks' required systems of risk management. In particular new implementing regulations are developed requiring risk-

management units and board-approved risk limits within banks. An amendment to the Law on Banks and Banking is developed to require the internal auditors of commercial banks to report to the Supervisory Council of their bank (rather than, as currently required, to their Board of Management.)[1]

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

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

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

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

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

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

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

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

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

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

By March 31, 2004

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

The amendments to the Law on Banks and Banking Activity have not yet been finalized for submission to the Rada. See above for a discussion of the remaining contentious items concerning related parties to banking operations. Nonetheless, our legal advisors have identified several regulations that may need to be amended once the law has been passed, assuming it will contain the suggested amendments.

By June 30, 2004

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

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

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

By September 30, 2003

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

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

By December 31, 2003

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

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

By March 31, 2004

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

On March 15, 2004, the NBU's Board of Governors passed the "Resolution On the Approval of the Methodological Guidelines for Bank Examinations, "Risk Assessment System." The final document is attached to this report as an appendix. Several members of NBU senior management were wavering on their support of the new system; however, the NBU Chairman fully supported the concept. Our most critical counterpart in this effort is Ms. Svitlana Farber, and our project has devoted considerable resources to assisting her with developing proper arguments in favor of risk-based supervision. We continue to participate in banker's meetings regarding the recommendations for risk management for commercial banks. This document is also nearing its completion, and will provide a higher level of transparency of expectations to the commercial banks.

By June 30, 2004

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

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

By March 31, 2004

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

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

By June 30, 2004

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

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

By September 30, 2003

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

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

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

By December 31, 2003

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

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

The Working Group for the development of the Policy Guidelines for Comprehensive Risk Management Systems in Banks gathered two times in October and November. At the first meeting, the Guidelines were presented, its purpose explained, and the input and comments requested.

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

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

By March 31, 2004

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

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

By June 30, 2004

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

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

The Risk Based Supervision Task Force is established and fully functioning. This illustrative task is complete.

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

By September 30, 2003

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

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

By December 31, 2003

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

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

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

By March 31, 2004

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

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

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

By June 30, 2004

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

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

By September 30, 2003

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

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

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

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

By December 31, 2003

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

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

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

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

By September 30, 2003

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

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

By December 31, 2003

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

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

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

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

By September 30, 2003

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

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

By December 31, 2003

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

BearingPoint continued to provide assistance to Dutch Grant/Bankworld in this sphere. BearingPoint participated in all three TOT courses delivered by BankWorld and contributed to course development and delivery.

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

By December 31, 2003 / March 31, 2004

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

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

By June 30, 2004

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

IV. Surveys and Assessments.

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

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

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

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

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

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

Outside Contacts (for quarter ending March 31, 2004)

Advisor	Organization	Contact Name	Time
Bryan Stirewalt	USAID	Victor Verhun	5 hours
	U.S. Treasury	Mel Brown	40 hours
	FMI	Ann Wallace and Demir Yenner	4 hours
	EBRD	Aurora Ferrari	10 hours

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

Advisor	Organization	Contact Name	Time
Maryna Antonova	USAID	Victor Verhun	16 hours

Other Work Requested By the NBU

Mr. Stirewalt participated in a presentation with the advisors from the US Treasury on financial modeling and early warning systems.

Attachment

The Board of Governors of the National Bank of Ukraine

RESOLUTION

Dated 03/15/2004 #104

City of Kiev

On the approval
of the methodological guidelines for bank examination
"Risk Assessment System"

In order for the National Bank of Ukraine to implement risk-based supervision of banks and in order to improve the methodological framework of the National Bank of Ukraine, the Board of Governors of the National Bank of Ukraine herewith resolves:

1. To approve the methodological guidelines for bank examination "Risk Assessment System".

2. The General Department of Bank Supervision (Pushkarev) is to communicate the contents of this Resolution to the independent structural subdivisions and regional offices of the National Bank of Ukraine for guidance in work and to the banks of Ukraine for familiarization with the methods of the National Bank of Ukraine pertaining to the assessment of risks inherent in their activities.

3. To establish that during 2004 there will be a transitional period (until the implementation of risk-based supervision) for the usage of the methodological recommendations for bank examination "Risk Assessment System".

4. To require the General Department of Bank Supervision (Pushkarev) and the heads of the regional offices of the National Bank of Ukraine:

to ensure the consistent application of the methodological guidelines for bank examination "Risk Assessment System" in practical work;

to perform appropriate work with the banks in order to improve their risk management systems.

5. The General Department of Bank Supervision is to ensure, within 2004, the training of bank supervision specialists in practical application of the methodological guidelines for bank examination "Risk Assessment System".

6. The regional offices of the National Bank of Ukraine are, before 10/01/2004, based on the results of application of the aforementioned methodological guidelines for bank examination "Risk Assessment System" during examinations of banks, to provide proposals for their improvement taking into account practical experience.

7. The General Department of Bank Supervision (Pushkarev), before 12/15/2004, is to provide for review to the Board of Governors of the National Bank of Ukraine improved methodological guidelines for bank examination "Risk Assessment System" taking into account the results of their practical application during examinations of banks of Ukraine.

8. The Resolution shall come into effect from the date of its signing.

9. Control over the fulfillment of this Resolution is to be placed on Deputy Governor Shlapak, the General Department of Bank Supervision (Pushkarev) and the heads of the regional offices of the National Bank of Ukraine.

Governor ***Tigipko***

Approved:

First Deputy Governor
Yatsenuk

Deputy Governor
Krotuk

Deputy Governor
Senyshch

Deputy Governor
Shlapak .B.

Director
of the General Department of Bank Supervision
Pushkarev

Director
of the General Economic Department
Shumylo

Director of the Monetary Policy Department
Grebenyk

Director
of the Personnel Department
Ivanuk

Director

of the Financial Department
Kandybka

Director
of the Internal Audit Department
Matviychuk

Director of the Legal Department
Pashichnyk

Chief Accountant – Director of the Accounting Department
Rychakivska

Director
of the Information Department

Savchenko

Head of the Kiev Regional Office
Stepanenko

Director
of the Department of Foreign Exchange Regulation
Yaremenko

Doers:
General Department of Bank Supervision

Deputy Director
of the General Department of Bank Supervision
Ivanenko

Director of the Department of Methodology and
Planning of Bank Supervision
Faber

Head of the Unit of Risk Assessment Methodology
of the Department of Methodology and Planning of Bank Supervision
Pozharska

Department of Offsite Supervision and Examinations:
Director of the Department
Zinchenko

Legal Department

Editor

-APPROVED
NBU Board Resolution # 104
dated 03/15/2004

Methodological guidelines "Risk Assessment System"

General Provisions

These methodological guidelines define the methods the National Bank of Ukraine (hereinafter – the NBU) uses to assess risks in banks. Risk-based supervision is an internal NBU process adopted to ensure greater consistency and efficiency in inspections and other supervisory activities. Banks are not required to adjust their own methodological framework and risk management systems to coincide with this methodology.

The NBU's position for supervising all institutions focuses on risk. Higher risk institutions or areas with higher risk profiles demand greater supervisory attention. While applying this common approach to all institutions, the NBU recognizes the different complexities of risk facing banks. The NBU is committed to providing high-quality supervision directed at identifying existing or emerging material problems in individual institutions or the banking system as a whole, and ensuring that such problems are appropriately corrected.

The policy begins with definitions that will be used throughout the process. The following section describes the NBU's supervision philosophy, *Risk-based Supervision*. The policy then describes the risk assessment system.

Risk-based Supervision

By using this approach representatives of the NBU's bank supervision function (hereinafter – supervisors) have to determine how certain existing or emerging issues facing an institution or the banking industry affect the nature and extent of risks in that institution. Based on that risk evaluation, supervisors then structure regulatory supervisory plans and actions. Risk-based Supervision is an enhanced continuation of the risk-based supervisory function that has been used by the NBU for a certain time period. This enhancement provides consistent definitions of risk, a structure for assessing these risks, and an integrated procedure for risk assessment in the supervisory process.

Banking is a business of taking risk in order to earn profits. Risk levels, therefore, must be appropriately managed and controlled. Banking risks also must be evaluated in terms of their significance. These assessments should be ongoing.

The Risk-based Supervision concept leaves the responsibility for controlling risks with bank management and the Supervisory Council. The NBU assesses how well a bank manages risks over time, rather than only assessing the condition at a single point in time. With *Risk-based Supervision*, the NBU functions in more of an oversight than an audit role. *Risk-based Supervision* allows the NBU to supervise in a proactive manner by concentrating on risks of specific institutions and systemic risks of the banking system.

For the entire industry, *Risk-based Supervision* identifies areas that, in aggregate, pose the potential for presenting an unacceptable level of risk to the banking system. For high risk activities or activities that have become particularly risky because of market conditions, the NBU's goal is to influence the industry appropriately through communication with it with the help of direct supervision and relevant NBU regulations. In situations where an individual bank is not properly managing its risks, the NBU shall use appropriate means to influence bank management to adjust its practices to conform with sound fundamental banking principles.

Some risks are inherent to banking. A wide body of knowledge exists within the industry on how to identify, measure, control, and monitor these inherent risks. *Risk-based Supervision* acknowledges those inherent risks and seeks to guide supervisory resources in the most effective manner. For example, risk profiles will be supported by the performance of limited testing during inspections directed at confirming whether adequate controls are in place. This should reinforce initial risk profiling and assist in tailoring supervisory programs to risk profiles of individual institutions. This profiling is essential in the development of supervisory cycles and the choice of supervisory tools. The risks facing the industry are diverse and complex. More significant and sophisticated risks require enhanced controls and monitoring by both the bank and the NBU. The NBU is committed to directing its most significant resources to these complex and evolving risks where they present material, actual, or potential risks to the banking system.

Risk-based Supervision allocates greater resources to those areas with higher risks. The NBU accomplishes this by:

- Identifying risks using common definitions. This set of risks forms the basis for supervisory assessments and actions.

- Measuring risk based on common evaluation factors. Risk measurement is not always quantified in monetary terms; it is sometimes a relative assessment of exposure. For example, numerous internal control deficiencies may indicate a bank has an excessive amount of operation and technological risk.

- Evaluating risk management to determine if bank systems adequately manage and control the identified risk levels. The sophistication of the systems will vary based on the level of risk present and the size and/or complexity of the institution.

- Assigning greater resources to areas of higher or increasing risk, both within an individual institution and among institutions in general. This is done through the supervisory strategy process.

- Using appropriate supervisory tools based on the risks identified, reaching conclusions on risk profile and condition, and following up on areas of concern.

To accomplish the above tasks, supervisors should discuss preliminary conclusions of this risk-based supervisory strategy with bank management and adjust conclusions and strategies based on those discussions, if appropriate. The NBU can then focus supervisory efforts on significant risks, i.e., the areas of highest risk within a bank and within the banking system.

Definition of Risk

For purposes of Risk-Based Supervision, the NBU assesses banking risk by its impact on capital and earnings. Risk is the potential that events, expected or unanticipated, may have an adverse impact on the institution's capital and/or earnings.

The simple existence of risk is not necessarily reason for concern. To put risks in perspective, supervisors should decide if the risks a bank is undertaking are warranted. Generally, risks are warranted when they are understandable, controllable, measurable, and within the institution's capacity to readily withstand adverse performance. Unwarranted risk can occur whether deliberate or unintentional. When risks are unwarranted, supervisors must communicate with management and the Supervisory Council, and encourage them to mitigate or eliminate the unwarranted risks. Appropriate actions for the bank to take would include reducing exposures, increasing capital, or strengthening risk management processes.

Risk Management

Because market conditions and company structures vary, there is no single risk management system that works for all banks. Each institution should develop its own risk management program and system tailored to its needs and circumstances.

The sophistication of the risk management system will increase, for example, with the size, complexity, and geographic diversity of each bank. All sound risk management systems, however, have several common fundamentals. For example, sound risk management systems are independent of risk-taking activities. Regardless of the risk management system's design, each system should include:

- Risk identification: Proper risk identification focuses on recognizing and understanding existing risks or risks that may arise from new business initiatives. Risk identification should be a continuing process, and should occur at both the transaction and portfolio level.
- Risk measurement: Accurate and timely measurement of risks is a critical component of effective risk management. A bank that does not have a risk measurement system has limited ability to control or monitor risk levels. Further, the sophistication of the risk management tools a bank uses should reflect the complexity and levels of risk it has assumed. The bank should periodically verify the integrity of the measurement tools it uses. Good risk measurement systems assess both individual transactions and portfolios.
- Risk control: The bank should establish and communicate limits through policies. standards, and/or procedures that define responsibility and authority. These control limits should be meaningful management tools that can be adjusted if conditions or risk tolerances change. The institution should have a process to authorize exceptions or changes to risk limits when they are warranted.
- Risk monitoring: Institutions should monitor risk levels to ensure timely review of risk positions and exceptions. Monitoring reports should be regular. timely. accurate, and informative, and should be distributed to appropriate officials to ensure action when needed.

Effective risk management requires the bank's Supervisory Council be informed. The Supervisory Council must guide the bank's strategic direction. A key component of strategic direction is endorsing the organization's risk tolerance by approving policies that set standards, either orally or in writing. Well-designed monitoring systems allow the Supervisory Council to hold bank management accountable for operating within established tolerance levels.

Capable management and appropriate staffing also are critical to effective risk management. Bank management is responsible for the implementation, integrity, and maintenance of risk management systems. Management also must keep the Supervisory Council adequately informed. Management must:

- Implement the bank's strategic direction.
- Develop policies, formal or informal, that define the institution's risk tolerance that are compatible with the institution's strategic goals.
- Oversee the development and maintenance of management information systems to ensure they are timely, accurate, and informative.
- Ensure that strategic direction and risk tolerances are effectively communicated and adhered to throughout the organization.

When supervisors assess risk management systems, they consider policies, processes, personnel, and control systems. Significant deficiencies in one or more of these components constitute a deficiencies in risk management. All of those systems are important, but the sophistication of each will vary depending upon the complexity of

the institution. Smaller, less complex institutions normally have less formalized policies, processes, and control systems in place than do larger institutions. This does not mean, however, that risk management systems are not just as important for less complex institutions. It simply means that the formalization of the process is less distinct. All institutions should be able to clearly articulate and demonstrate the effectiveness of their own risk management systems. Effective risk management envisages consistent policies, processes, qualified personnel, and control systems.

- Policies reflect the institution's intent and commitment to pursuing desired results. They set standards and courses of action to pursue in order to fulfill certain specific tasks. Well-designed policies build on an institution's formulated mission, values, and operating principles. They also clarify the institution's tolerance for risk. Mechanisms should be in place to trigger a review of policies in the event that activities or tolerances change. Policies should be written and take into account the complexity of operations, branching level of the organizational structure, etc. Policies should be clearly articulated and adhered to in practice.

- Processes are the procedures, programs, and practices that govern how an institution will pursue its objectives. Processes define how daily activities are carried out. Properly designed processes are consistent with the underlying policies, are efficient, and their functioning leans on the appropriate authority of doers.

- Personnel are the staff and managers that execute or oversee performance of the processes. Good staff and managers are qualified, competent, and perform as expected. They understand the institution's mission, values, policies, and processes. Compensation programs should be designed to attract, develop, and retain qualified personnel.

- Control systems are tools and information systems that bank managers use to measure performance of employees, units, and the institution in general, make decisions, and assess effectiveness of existing processes. These feedback devices must be timely, accurate, and informative. They measure bank performance and assist in decision-making.

Categories of Risk

The NBU has defined nine categories of risk for bank supervision purposes. These risks are: Credit, Liquidity, Interest Rate, Market, Foreign Exchange, Operations and Technology, Reputation, Legal, and Strategic . These categories are not mutually exclusive; any product or service may expose the institution to multiple risks. For analysis convenience purposes, however, the NBU identifies and assesses the risks separately.

Credit risk is the current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any financial contract with the institution (its subdivision) or otherwise fails to perform as agreed. Credit risk is found in all activities where the result depends on counter party, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested or otherwise exposed through actual or implied contractual agreements, whether reflected on or off balance sheet.

In assessing credit risk it is advisable to segregate individual and portfolio credit risk. The source of individual credit risk is a separate specific counter party of the bank – a borrower, debtor, or issuer of securities. Individual credit risk assessments envision an assessment of the creditworthiness of a specific counter party, i.e. its individual capacity to timely and fully meet its obligations. Portfolio credit risk shows in a decrease in bank assets value (other than as a consequence of change of a market interest rate). The source of portfolio credit risk is the bank's overall outstanding transactions bearing credit risk – loan portfolio, securities portfolio, accounts receivable portfolio, etc. Portfolio credit risk assessment envisions an assessment of bank assets concentrations and diversification.

In addition to credit risk, international lending includes country risk, which is associated with the economic, social and political environments of the borrower's home country. Country risk is most apparent when lending to foreign governments or their agencies, since such lending is typically unsecured. However, this risk should always be considered in lending and investment activities, whether to public or private borrowers. There is also a component of country risk called "transfer risk" which arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition.

Liquidity risk is defined as the current or prospective risk to earnings and capital arising from a bank's inability to meet its liabilities when they come due without incurring unacceptable losses. Liquidity risk arises from the inability to manage unplanned outflows of funds and changes in funding sources and/or to meet off-balance sheet liabilities.

We also single out market liquidity risk, which is defined as the current or prospective risk to earnings and capital arising from a bank's inability to quickly unwind gaps in its positions at current market rates without incurring unacceptable losses. Market liquidity risk arises from the failure to recognize or address changes in market conditions that affect the ability to attract funds in necessary volumes and at acceptable rates and/or to liquidate assets quickly and with minimal loss in value.

Interest rate risk is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. This risk impacts both the earnings of a bank and the economic value of its assets, liabilities and off-balance sheet instruments. The primary types of interest rate risk to which banks are typically exposed are: (1) repricing risk, which arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of bank assets, liabilities and off-balance sheet positions; (2) yield curve risk, which arises from changes in the slope and shape of the yield curve; (3) basis risk, which arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments whose all other repricing characteristics are the same; and (4) optionsality risk, which arises from the express or implied options imbedded in many bank assets, liabilities and off-balance sheet portfolios.

Market risk is the current or prospective risk to earnings and capital arising from adverse movements in security and commodity prices and foreign exchange rates in the trading book. This risk arises from market making, dealing, and position taking in debt and equity securities, currencies, commodities, and derivatives.

Risks arising under similar circumstances with regard to similar instruments in the banking book are addressed in other relevant categories of the risk assessment system.

Foreign exchange risk is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates and banking metal prices. Foreign exchange risk can be separated into:

- Transaction risk
- Translation risk
- Economic foreign exchange risk

Transaction risk refers to the impact of adverse movements in currency exchange rates on the real value of open foreign currency positions. However, since it generally arises from market making, dealing and position taking in foreign currencies it is covered in the market risk guideline. Translation risk refers to the variability in accounting values that result from variations in exchange rates which are used in translating carrying values in foreign currencies to base currency. Economic foreign exchange risk refers to changes in competitive strength of the financial institution or its entities constituting its consolidated group in the foreign market due to fundamental changes in exchange rates.

Operations and technology risk is the potential risk for the existence of a banking institution, which arises from breakdowns in corporate governance, internal controls or inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability, and continuity. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or too risky manner. Operations and technology risk also arises from an inadequate IT strategy and policy, and from inadequate use of the information technology. Other aspects of operations and technology risk include the probability of unforeseeable events such as fires or other disasters.

Reputation risk is the current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution by customers, counter parties, shareholders, or regulators. This affects the bank's ability to establish new relationships or services or service existing relationships. This risk may expose the institution (or its managers) to financial loss or a decline in its customer base including administrative, civil or criminal liability. Reputation risk exposure is present throughout the organization and, therefore, banks are obligated to exercise appropriate treatment in dealing with its customers and with the community.

The public perception can be delineated as follows:

- Market perception: e.g. actual or potential customers or counter parties, or shareholders
- Regulatory perception: e.g. the National Bank of Ukraine, Securities and Exchange Commission, State Tax Administration, and other authorized bodies.

Legal risk is the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, regulations, agreements, prescribed practices, or ethical standards, as well as from the possibility of their dubious interpretation. Banks are exposed to legal risk due to relations with a great number of stakeholders, e.g. customers, counter parties, intermediaries, etc., as well as regulators, tax authorities, and other authorized agencies. Legal risk can lead to fines and administrative penalties, payment of damages, diminished reputation, deteriorating position in the market, reduced expansion potential, and lack of contract enforceability.

Strategic risk is the current or prospective risk to earnings and capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to changes in the business environment. This risk is a function of the compatibility of a bank's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

Measuring and Assessing Risk

To ensure effective risk-based supervision, the NBU requires a common framework to document decisions about risk. The risk assessment system (RAS) provides the convenience for documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern (measured as aggregate risk), and the direction of risk. The common definitions explained above are critical to identifying risks consistently. A list of evaluation factors that supervisors should consider in making the assessments is also provided. These evaluation factors are recommended risk assessment criteria and may be expanded by supervisors, if necessary.

Assessments of risk in the RAS must reflect both a current and prospective view of the institution's risk profile. This assessment drives supervisory strategies and activities. It also facilitates discussions of the bank's condition with bank management and Supervisory Council members and helps to ensure more efficient supervisory activities (examinations, offsite surveillance, etc.).

Supervisors should discuss conclusions from the RAS with appropriate bank management and the Supervisory Council. Bank management's input may help clarify or modify the supervisor's RAS conclusions. While the NBU does not require bankers to adopt a similar process, supervisors must effectively communicate the rationale for their decisions in evaluating risk to interested parties to ensure effective supervision. This communication will help the NBU and bank management reach a common understanding of the risks, focus on the strengths and weaknesses of risk management, and ensure that future supervisory plans are achieved.

The Risk Assessment System

The NBU has defined a system for assessing each risk category. The Risk Assessment System provides a consistent means of measuring the risk and determining which supervisory procedures will be performed. For six of the risk categories – credit, liquidity, interest rate, market, foreign exchange, and operations and technology, the supervisor assesses the quantity of risk, the quality of risk management, the aggregate risk and the direction of risk. For effective use of the risk assessment system, supervisors should consider the current condition of the bank as well as factors that may identify increasing risks. Under the Risk Assessment System, a bank's risk profile has four components:

- **Quantity of Risk**, which is the level or volume of risk that the bank faces and is characterized as low, moderate, or high.

- **Quality of Risk Management**, which is how well risks are identified, measured, controlled, and monitored and is characterized as strong, needs improvement, or weak.

- **Aggregate Risk**, which is a summary judgment that reflects the level of supervisory concern considering both the quantity of risk and the quality of risk management, weighing the relative importance of each. Aggregate risk is assessed as high, moderate, or low for each of the nine categories of risk. Mitigating factors such as insurance may impact the assessment of aggregate risk. Aggregate risk assessments direct the specific activities and resources outlined in supervisory strategies. Assessment components supplement the list of evaluation factors.

- **Direction of Risk**, which is the probable change in the aggregate level of risk over the next 12 months and is characterized as decreasing, stable, or increasing. The direction of risk will influence the supervisory strategy, including the extent that expanded procedures might be used. Decreasing direction indicates the supervisor anticipates, based on current information, the aggregate risk will decline over the next 12 months. Stable direction indicates the supervisor anticipates that aggregate risk will probably remain unchanged. Increasing direction indicates the supervisor anticipates that aggregate risk will be higher 12 months in the future.

The quantity of risk and quality of risk management should be assessed independently. Therefore, when assigning the individual Risk Assessment System ratings, it is necessary to remember that the assessment of the quantity of risk should not be affected by the quality, no matter how strong or weak, of risk management. Also, strong capital support or strong financial performance should

not mitigate an inadequate risk management system. The supervisor should not conclude that "high" risk levels are bad and "low" risk levels are good. The quantity of risk simply reflects the level of risk the bank accepts in the course of doing business and whether this is good or bad depends on whether its risk management systems are capable of identifying, measuring, monitoring and controlling that amount of risk.

The remaining risks – strategic, reputation, and legal - affect the bank's capital and earnings, but are difficult to measure precisely. Consequently, the NBU decided that for these risks the **aggregate risk** and **direction of risk** would be assessed. The characterizations of **aggregate risk** and **direction of risk** are the same as for the other six risks.

Supervisors should complete the Risk Assessment System for institutions at the end of each supervision cycle (usually 12 months). It can be updated any time the supervisor becomes aware of changes to the risk profile on an interim basis.

The Application of the Risk Concept to Supervision

In completing the Risk Assessment System, the supervisor determines the level of supervisory concern (that is, aggregate risk) and direction of risk for each risk category. The supervisor's conclusions will determine the supervisory procedures to be used: for example, a scheduled on-site examination, an unscheduled on-site examination, offsite surveillance activities, etc.

The application of risk management techniques and standards will enable supervisors to tailor supervisory programs for each institution. The goal of supervision is to provide the most effective but least intrusive supervision possible, which is in the interest of both the institution and its depositors and other creditors.

Glossary

For the purposes of the Risk Assessment System of the NBU, the following terms will be used in the meanings given below:

ACTIVE OPERATIONS OF A BANK	A bank's operations aimed at placing the bank's resources. This term derives from the fact that active operations are recorded on the asset (*active in Ukrainian)* side of the balance sheet or in asset-side off-balance-sheet accounts. See: ***RESERVES FOR ACTIVE OPERATIONS, ADVERSELY CLASSIFIED ASSETS, PASSIVE OPERATIONS OF A BANK***
SCENARIO ANALYSIS	A method of forecasting the level of risk based on grouping all possible events and determining a logical sequence of consequences for each group of events. Scenario analysis is used when the probability of different events is almost equal and the bank has to select beforehand a strategy of its conduct for each scenario. See: ***CONTINGENCY PLAN***
OUTSOURCING	Performing certain functions and works, which are conventionally considered as "in-house" and are performed by staff, by engaging external independent parties on a contractual basis. Outsourcing is used to optimize the bank's expenses and processes.
BASIS RISK (INTEREST RATE)	A risk that during ***VARIABLE INTEREST RATE REPRICING*** the range of change in the interest rate will not completely coincide with the range of fluctuation of the ***BASE RATE***. For example, while LIBOR (market rate) changes by 3 percentage points, the rate of return on the bank's assets may change by 1 percentage point only. In this case, correlation between rate adjustments would not be close enough and, thus, ***STRESS TESTING*** would not be fully accurate for risk assessment. See: ***SHOCK VALUES***
BASE RATE	An interest rate used as a "basis" to calculate a ***VARIABLE INTEREST RATE*** during its ***REPRICING***. Normally, it is so-called "risk free" rates like LIBOR (they are also called "prime rates") or "specific" rates like the cost of the bank's attracted funds that are used as a base rate.
BANKING BOOK	A portion of a bank's total ***PORTFOLIO*** consisting of items as to which the bank has explicit intentions to retain them in order to earn economic income in the form of capital gain. The current market value of banking book has no essential impact on the bank's decisions to retain the items. Thus, a change in market conditions does not cause a change in the ***ECONOMIC VALUE*** of items in the banking book in the eyes of bank management. See: ***TRADING BOOK***
DETERMINATION OF ALLOWABLE RISK	Determination of the level of risk that a bank agrees to take to achieve its business goal and to fulfill its strategic tasks. The level of allowable risk is normally determined in the internal policies and plans of a bank, which are approved in line with corporate governance principles. See: ***RISK TOLERANCE***
EXCEPTIONS	(1) A difference, discrepancy between a fact and an established criterion; (2) Contracts having nonstandard parameters; (3) With regard

	to lending process – a credit file lacking documents envisaged in an established list, etc.
INTERNAL LOAN REVIEW	A review of the lending activity of a bank, which is performed by the bank itself or ***OUTSOURCED***. The key idea of internal reviews of lending activity is to ensure an independent assessment of the quality and reliability of the ***CREDIT ADMINISTRATION*** process of a bank. See: ***EXCEPTIONS*** Also see: Bank Examination Handbook, Section "Loan Portfolio Management: Domestic and International", Subsection "Internal Loan Review"
INTERNAL RATINGS	A standardized assessment of individual credit risk, which is normally presented in the form of a summarized indicator that has letter or figure semantics. Internal ratings received their name because a bank identifies a counterparty's rating on its own based on its internal methodology without using ratings of outside organizations. According to the internal rating approach in the credit process, every borrower of a bank is assessed based on a number of parameters and assigned to one of the categories (ratings) pre-determined by the bank. This way, the bank identifies a ***PORTFOLIO*** of its borrowers by risk level of transactions with them.
VOLATILITY	The variability degree of the value of an indicator, a variable, a parameter. See: ***CAPITAL AT RISK, EARNINGS AT RISK***
SECONDARY LIQUIDITY	The ability of assets to be used as security to receive funds, for instance, through lending or ***REPO*** transactions. Secondary liquidity is characterized with a relationship between the value of an asset and the amount of funds that may be received by pledging it. When realizing secondary liquidity, the bank does not lose the asset. See: ***PRIMARY LIQUIDITY***
DERIVATIVES	See: ***DERIVATIVE INSTRUMENTS***
DEALING	Purchase-and-sale transactions performed by a bank on its own behalf, but on the instructions and at the cost of customers. So, while formally dealing transactions are reflected on the balance sheet of the bank, in fact the entire benefit and risk of such transactions belongs to the bank's customers. See: ***CUSTOMER TRANSACTIONS***
DIVERSIFICATION	A method of ***RISK MITIGATION*** by diversifying investments and limiting the impact of a risk factor by avoiding excessive ***CONCENTRATION*** in one ***PORTFOLIO***. Unlike ***HEDGING***, diversification calls for search for and combination of portfolios that under the same conditions lead to different but not necessarily directly opposite results. Diversification is a ***RISK MITIGATION*** method applicable to both ***ACTIVE OPERATIONS*** and ***PASSIVE OPERATIONS***.
FIDUCIARY MANAGEMENT	Bank operations on managing property and providing other services in the interests and on the instructions of customers as an agent.
ECONOMIC VALUE	A concept according to which any item as to which there exists a flow

	of funds is exposed to a change in its value because of opportunity costs. Economic value differs from market value in that market value takes into account the current market situation, that is, the level of balance of demand and supply. See: *FIXED INTEREST RATE*
OPPORTUNITY COSTS	A concept according to which the *ECONOMIC VALUE* of an item as to which there exist flows of funds depends on the relationship of the current rate on the instrument to the market interest rate on similar items. The best illustration of the concept of opportunity costs is a change in the value of securities with a *FIXED INTEREST RATE* in case the market rate of return exceeds the rate on the security. The *ECONOMIC VALUE* of such a security decreases, since it is more lucrative for investors to invest funds in other instruments (whose rate of return is higher). True is also a reverse relationship: if the market rate is lower than the rate on a security, the *ECONOMIC VALUE* of the security increases.
REVERSE QUOTATION	A quotation where the exchange rate of a foreign currency is presented in the form of the number of foreign currency units making up a domestic currency unit. For example: 1 UAH = 0.2 USD See: *DIRECT QUOTATION*
VARIABLE INTEREST RATE	An interest rate whose level is subject to periodic *REPRICING* depending on a change in the *BASE RATE*. See: *BASIS RISK, FIXED INTEREST RATE, SHOCK VALUES.*
HEDGING INSTRUMENT	An item whose behavior under certain conditions or events is directly opposite to the behavior of an *ITEM HEDGED* under the same conditions or events. For example, if the *ITEM HEDGED* loses its value in case of *CURRENCY REVALUATION*, then the hedging instrument should grow in its value in case of *CURRENCY REVALUATION.* In practice, hedging instruments should also meet certain additional conditions: be unconditional, irrevocable, etc.
MANAGEMENT INFORMATION SYSTEMS	Implementation of an internal function that consists in collecting, verifying, processing, analyzing, storing, distributing and transmitting within the bank data needed to make informed management decisions. See also: Bank Examination Handbook, Section "Management and Supervisory Board Processes. Introduction", Subsection "Management Information System"
CAPITAL AT RISK	A risk measurement method whose essence consists in finding a value (economic capital) that is constantly at risk and, thus, may be lost even in the course of normal business. Mathematically, capital at risk is determined as the product of the size of the *POSITION* exposing the bank to risk, the *VOLATILITY* of the item making up the position, confidence level factor, and the time length of the *POSITION.* See: *EARNINGS AT RISK*
CUSTOMER TRANSACTIONS (IN THE CONTEXT OF THE	Transactions performed by a bank on its own behalf but on the instructions and at the cost of customers – purchase of securities,

TRADING BOOK)	foreign currency and banking metals. As a consequence of accounting specifics, customer transactions are included in the ***TRADING BOOK*** of a bank, since they may not be included in the ***BANKING BOOK.*** See: ***DEALING***
CREDIT ADMINISTRATION	A process of performance of lending activity and extension of loans consisting of the following stages: receipt and review of loan documentation, analysis of financial information and collateral, making a credit decision, operating procedures, collecting the debt, and problem loan work-out (including proper accounting of loans). See: ***INTERNAL LOAN REVIEW, EXCEPTIONS***
YIELD CURVE	A graphical representation of a relationship between the level of the interest rate and the maturity of the instrument. The slope of the yield curve within a separate time interval reflects investor perception of the future level of interest rates.
CONCENTRATIONS	Focusing, bunching of risk, that is, its uneven distribution among items. Concentration occurs when a bank's assets or liabilities characterized with a certain common factor exceed a certain benchmark of its capital. Among others, such factors may include: ■ Commitments to one borrower or a small group of related borrowers ■ Use of loans by two or more borrowers to finance the same project, in the same industry or in related industries, or by a group of connected enterprises ■ A bank's investment(s) in the same project, the same industry or in a group of related industries, or in a group of related enterprises ■ The same type of collateral used to secure obligations to a bank ■ A common source of repayment of several loans or investments ■ Deposits and/or other liabilities regardless of their terms to the same person or a group of related persons.
CORPORATE GOVERNANCE	A system of organization of activity and control of a corporation (in this case – a bank). Corporate governance determines the distribution of rights and responsibilities among different participants of a corporation, namely: the Supervisory Council (Board of Directors), management (Board of Managers), shareholders, and other stakeholders (for banks – first of all, depositors and other creditors), as well as rules and procedures for decision-making on the affairs of the corporation. This way, the tasks of the organization are set up and fulfilled, and its activity is monitored. The key purpose of corporate governance is to ensure fair and transparent business and responsibility and accountability of all parties concerned.
FOREIGN CURRENCY EXCHANGE RATE	The price of one currency expressed in units of another currency. Another name is quotation. See: ***DIRECT QUOTATION, REVERSE QUOTATION, CURRENCY DEVALUATION, CURRENCY REVALUATION***
MARKET-MAKING	Activity of a professional participant in the market (foreign exchange

or stock market) that consists in maintaining constant quotations of bid and ask prices for financial instruments on his own behalf or on behalf of his client. A market-maker is obligated to post quotations even in those cases, when other market participants do not do it. In other words, he commits himself to constantly supporting the liquidity of a financial instrument even at his own cost.
See: ***DEALING***

MISSION OF A BANK — A statement explaining for what purposes and why the institution exists and what it wants to achieve. It has the format of a document that formulates the bank's role in the financial market, contains the definitions of existing and prospective banking products and transactions, markets, regions, and those areas of activity where the bank has achieved advantages over its competitors and those where it anticipates to achieve steady competitive advantages. The mission also determines the sequence of implementation of long-term strategic goals.

EARNINGS AT RISK — A method of quantitative risk assessment whose essence consists in finding the size of a bank's income that is constantly at risk of non-receipt or the need for urgent usage to cover losses.
See: ***CAPITAL AT RISK***

ADVERSELY CLASSIFIED ASSETS — A portion of a bank's assets that does not meet the criteria of ***STANDARD DEBT***. Different types of assets may be subject to different classification requirements (factors), for example: the condition of a counterparty and status of debt servicing on lending transactions; the chronological factor for accounts receivable, etc.
Adversely classified assets include substandard, doubtful and loss loans; accounts receivable assigned to classification categories subject to provisioning; accrued income over 31 days past due; and balances of correspondent accounts assigned to classification categories subject to provisioning.
See: ***ACTIVE OPERATIONS, RESERVES FOR ACTIVE OPERATIONS***

MISMATCHED POSITIONS — A situation where a bank's ***POSITIONS*** are not equal to zero. Thus, there is a disproportion between the size of the bank's assets and liabilities having common characteristics.

ITEM HEDGED — Any item bearing a risk for a bank. Most often this is a banking product whose value may decrease if certain conditions or events occur.
See: ***HEDGING INSTRUMENT***

OPTION — A contract similar to a ***FORWARD*** and a ***FUTURES*** under which one party – the buyer of the option – is given the exclusive and unconditional optionality to effect a purchase-and-sale transaction or not. While the other party – the seller of the option – is obligated to follow the decision of the buyer of the option and has no right to refuse from its obligations.
We differentiate a call option that gives you the right to buy the underlying asset and a put option that gives you the right to sell the underlying asset.

We also differentiate an American option – a contract that can be exercised any moment within its entire validity term, and a European option that can be exercised at the end of the validity term only.
See: ***DERIVATIVE INSTRUMENTS***

PASSIVE OPERATIONS OF A BANK — Operations of a bank directed at forming the bank's resources. Such a name passive operations received because they are recorded on the liability (*passive in Ukrainian*) side of the balance sheet. We differentiate passive operations to form capital and passive operations to form attracted funds.
See: ***ACTIVE OPERATIONS OF A BANK***

PRIMARY LIQUIDITY — The ability of assets to convert to cash. Primary liquidity is characterized with two basic parameters: the term within which an asset can do such conversion, that is, the term within which it is possible to sell it; and a relative loss in value, that is, the difference between the book value of an asset and the amount of funds that the bank can receive from its sale. The shorter the term and the lesser the loss in value, the more liquid the asset is considered to be.
When realizing primary liquidity the bank losses the asset.
See: ***SECONDARY LIQUIDITY***

REPRICING (INTEREST RATE) — A periodic change in the previously established value of an interest rate for instruments with a ***VARIABLE INTEREST RATE***.
See: ***FIXED INTEREST RATE, ECONOMIC VALUE, SHOCK VALUES***

CONTINGENCY PLAN — A formalized document listing the sequence of the bank's actions in case of occurrence of crisis circumstances: a collapse of a certain market or a currency, a rapid and unplanned outflow of depositor funds, failures in operational systems, etc. A contingency plan is an element of the system of proactive management of the bank, where possible problems are identified beforehand, and an approach to address them is formulated.
A plan has to be approved by an appropriate body of the bank based on ***CORPORATE GOVERNANCE*** principles.
See: ***SCENARIO ANALYSIS***

POSITIONS — (1) Generally – the difference between the assets and liabilities of a bank.
(2) Foreign exchange positions – the difference between assets and liabilities denominated in the same currency.
(3) Liquidity position – the difference between assets and liabilities with the same maturity.
See: ***MISMATCHED POSITIONS***

RISK MITIGATION — See: ***DIVERSIFICATION, HEDGING***

PORTFOLIO — A group of items that are homogeneous by certain characteristics: type of counterparty, type of instrument, and other. Most often the terms "loan portfolio", "security portfolio", and "investment portfolio" are used.
See: ***THEORY OF PORTFOLIOS, TRADING BOOK, BANKING BOOK***

CURRENT CURRENCY EXCHANGE RATE — ***THE RATE OF A FOREIGN CURRENCY*** that is used in performing ***SPOT*** foreign exchange transactions.

	According to accounting practices, when compiling reports, all unhedged monetary items in the bank's balance sheet denominated in foreign currency should be translated to the currency of the reports at the current currency exchange rate. See: ***FORWARD CURRENCY EXCHANGE RATE***
DERIVATIVE INSTRUMENTS	Financial instruments that derive from (are based on) other financial instruments known as the underlying instruments. Derivative instruments include ***SWAPS, FORWARDS, FUTURES*** and ***OPTIONS.***
OPTIONALITY (INTEREST RATE)	The option of one or both counterparties to refuse from ***REPRICING OF A VARIABLE INTEREST RATE*** in case of a change in the ***BASE RATE***. For instance, in case of growth in the prime rate the bank may refuse to increase the rate on attracted deposits and this way protect its ***NET INTEREST MARGIN*** and ***SPREAD*** from decrease. Thus, for the purposes of ***STRESS TESTING*** such items will behave as items with a ***FIXED INTEREST RATE.***
PRODUCTS (BANKING)	A separate banking service or a set of several related banking services that are offered to customers on typical terms. For instance: a special-purpose deposit, a deposit certificate, plastic cards, etc. In marketing, a product is any goods, service, idea, etc. that is offered in the market for sale or exchange.
DIRECT QUOTATION	A quotation where the rate of a foreign currency is represented in the form of the number of national currency units per foreign currency unit. 1 USD = 5 UAH See: ***REVERSE QUOTATION***
RESERVES FOR ACTIVE OPERATIONS	A portion of the value of ***ADVERSELY CLASSIFIED ASSETS*** of a bank that the bank for certain, based on previous experience, can consider as lost and, thus, counts it in its business losses. From the standpoint of accounting, reserves are a contra-asset regulating account that reduces the book value of assets. Reserves are not included in bank capital. Reserves consist of loan loss reserves, reserves for accrued income, reserves for accounts receivable, and reserves for correspondent accounts.
REPO	An abridgement of the English term "repurchase agreement" – an agreement to sell and to buy back in future. In practice – a type of a banking transaction where an item (normally securities) is transferred to a counterparty in exchange for another item (normally cash), and a mandatory reverse exchange is conducted after a specified period of time. Thus, the party transferring the item obtains ***SECONDARY LIQUIDITY*** and does not lose title to the item. On the other hand, the party receiving the item for temporary usage acquires the right to receive income on the item plus earns on the difference between the initial price and the repurchase price. See: ***SECONDARY LIQUIDITY***
SWAP	1) An interest rate swap is a contract between two parties known as participants of a swap about the exchange of cash flows calculated based on different rates but the same amount known as a notional

amount. Normally, one cash flow is calculated based on a ***FIXED RATE***, while the other is calculated based on a ***VARIABLE RATE***.
2) A currency swap is simultaneous conclusion of a ***SPOT*** contract and a reverse ***FORWARD*** contract. A foreign currency purchased under a ***SPOT*** contract is sold again within a certain time interval and, accordingly, a currency sold under a ***SPOT*** contract is bought again within a certain time interval. Both contracts are concluded with the same partner, and rates, value dates and methods of payment are established at the moment of contract conclusion.
See: ***DERIVATIVE INSTRUMENTS***

SECURITIZATION — Redistribution of risks by transforming a bank's assets – loans and other assets – into securities for sale to investors. A bank issues securities on its own behalf or through subsidiary institutions, but such securities are tied to specific assets of the bank – payment of income and repayment of the securities depend on receipt by the bank of income and loan principals.

SPOT — A purchase-and-sale contract where the gap between the date of contract conclusion (the date of the contract) and the date of exchange of assets (the value date) does not exceed two business days.
See: ***FORWARD***

SPREAD — The difference between the average weighted rate of return on interest-bearing assets of the bank and the average weighted rate of cost of its interest-bearing liabilities. Spread indicates a bank's real ability to manage interest rates on its instruments.
See: ***NET INTEREST MARGIN***

STANDARD DEBT — A portion of a bank's assets as to which there arises no doubt with regard to its quality, that is, the probability of timely and full repayment in accordance with the terms of conducting active operations.
See: ***ADVERSELY CLASSIFIED ASSETS***

STRESS TESTING — A quantitative risk assessment method whose essence consists in determining the size of a ***MISMATCHED POSITION***, which exposes a bank to risk, and in determining the ***SHOCK VALUE*** of a change in an external factor – currency exchange rate, interest rate, etc. Combining these values gives you an idea of what amount of losses or income the bank would receive in case events develop according to the assumptions set.
Stress testing is widely used to assess liquidity risk, foreign exchange risk, and interest rate risk.

FORWARD CURRENCY EXCHANGE RATE — ***THE RATE OF A FOREIGN CURRENCY*** that is used in conducting foreign exchange transactions like a ***FORWARD***, ***FUTURES*** and ***OPTION***.
According to accounting practices, some on-balance-sheet and off-balance-sheet items are translated to the currency of reports when compiling the reports.
See: ***CURRENT CURRENCY EXCHANGE RATE***

DEGREE OF SENSITIVITY TO A CHANGE IN AN — The relative size of a change in the ***ECONOMIC VALUE*** of an item in response to a specified change in an interest rate.

INTEREST RATE See: ***STRESS TESTING***

THEORY OF PORTFOLIOS A theory widely used in risk management, which is based on the assumption that several homogeneous items (***PORTFOLIO***) will possess the same characteristics as does each separate item. Portfolio management is viewed as management of one item rather than several.

RISK TOLERANCE See: ***DETERMINATION OF ALLOWABLE RISK***

TRADING BOOK A portion of a bank's total ***PORTFOLIO***, which consists of items as to which the bank has explicit intentions to sell in near future and to earn speculative income from price (rate) fluctuation. Normally, the trading book includes securities, foreign currency, and banking metals.
The trading book also includes the portion of a bank's position that was created as a result of conducting ***CUSTOMER TRANSACTIONS***.
From the standpoint of managing a bank, management should always have current information on the current value of items making up the trading book. Thus, the trading book is subject to constant marking to market and, therefore, is under the influence of risk of change in market conditions.
See: ***BANKING BOOK***

FIXED INTEREST RATE An interest rate whose level is fixed for the entire maturity of the instrument and is not subject to ***REPRICING***.
See: ***VARIABLE INTEREST RATE***

FORWARD A purchase-and-sale contract where the gap between the date of contract conclusion (the date of the contract) and the date of exchange of assets (the value date) exceeds two days. The price (rate) at which a transaction will be conducted in future is fixed at the moment of conclusion of a forward contract.
A forward contract is binding upon each party.
We differentiate a foreign exchange forward and a commodity forward.
A forward contract is not standardized, that is, it can be concluded for any term and for any amount at the desire of the parties.
See: ***DERIVATIVE INSTRUMENTS, FUTURES, SPOT***

FUTURES A contract that is similar to a ***FORWARD*** but is concluded on standardized terms: they are executed only at exchanges, under their control, and the format and terms and conditions of contracts are clearly unified (the exchange strictly defines the type of currency to be sold, transaction volume, payment date, ***RATE***). Payments on purchase and sale of forward contracts are effected through the clearing house of the exchange that guarantees the timeliness and fullness of payments. Until the final payment of a forward it can be resold at the exchange.
See: ***DERIVATIVE INSTRUMENTS***

HEDGING A ***RISK MITIGATION*** method whose essence consists in determining an ***ITEM TO BE HEDGED*** and selecting an adequate ***HEDGING INSTRUMENT***.
The essence of hedging consists in compensating for losses from the ***ITEM HEDGED*** at the expense of profit from the ***HEDGING INSTRUMENT***, which occur under the same conditions or events.
If there is a hedging scheme, the bank fully eliminates both risk and opportunity of earning extra profit: in case conditions and events are

	favorable from the standpoint of the ***ITEM HEDGED***, any profit is automatically offset by losses from the ***HEDGING INSTRUMENT***. See: ***DIVERSIFICATION***
NET INTEREST MARGIN	The relationship of a bank's net interest income (interest income minus interest expenses) to average net assets or interest-bearing assets. Net interest margin indicates the skills of bank management in performing the major function of a bank – financial intermediation. See: ***SPREAD***
SHOCK VALUES	A hypothetical value of change in a factor of the outside environment – interest rate level, currency exchange rate, etc., which is used in ***STRESS TESTING***. A shock value should meet two criteria: be essential and probable.

NBU Risk Assessment System

Credit Risk

Credit risk is the current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any financial contract with the institution (its subdivision) or otherwise fails to perform as agreed. Credit risk is found in all activities where the result depends on counter party, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested or otherwise exposed through actual or implied contractual agreements, whether reflected on or off balance sheet.

In assessing credit risk it is advisable to segregate individual and portfolio credit risk. The source of individual credit risk is a separate specific counter party of the bank – a borrower, debtor, or issuer of securities. Individual credit risk assessments envision an assessment of the creditworthiness of a specific counter party, i.e. its individual capacity to timely and fully meet its obligations. Portfolio credit risk shows in a decrease in bank assets value (other than as a consequence of change of a market interest rate). The source of portfolio credit risk is the bank's overall outstanding transactions bearing credit risk – loan portfolio, securities portfolio, accounts receivable portfolio, etc. Portfolio credit risk assessment envisions an assessment of bank assets concentrations and diversification.

In addition to credit risk, international lending includes country risk, which is associated with the economic, social and political environments of the borrower's home country. Country risk is most apparent when lending to foreign governments or their agencies, since such lending is typically unsecured. However, this risk should always be considered in lending and investment activities, whether to public or private borrowers. There is also a component of country risk called "transfer risk" which arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition.

Evaluation Factors

Supervisors should consider the following evaluation factors in making credit risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

The assessment factors are as follows:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for credit risk management approved by appropriate bodies of the bank based on the principles of corporate governance_ and appropriate compliance practices.

  - Asset (loan, investment, etc.) portfolio composition and the existence of concentrations. Relevant factors include:

  - Products.
  - Types of economic activity.
  - Risk classification/ratings.
  - Debt Originations.
  - Customers.
  - Size of loans.
  - Geographic regions.
  - Single/related counterparty(s).
  - Sources of repayment.
  - Collateral.

  - The protection provided by collateral. In evaluating collateral, supervisors should analyze collateral type, quality, margins, adequacy and frequency of collateral revaluation, marketability, and the level and nature of documentation exceptions.

  -

- The bank's exposure to unfunded commitments (guarantees, commercial and standby letters of credit, lines of credit mandatory and not mandatory for delivery, etc.).

- Trends in active operations volume and growth, delinquencies, adversely classified loans, and losses from active operations.

- The adequacy of the institution's provision for losses from active operations.

- The existence of timely, accurate, and comprehensive management information.

  - The effectiveness of credit administration, including credit analysis, monitoring, problem asset resolution, collateral valuation, and lien documentation.

  - The adequacy of methods used to identify credit problems.

  - Staffing levels and skills in relation to volume and complexity of the bank's active operations.

  - Whether proper accounting treatment is used for balance sheet and off-balance sheet assets and provisions.

  - The existence of appropriate control mechanisms (audit, internal reviews of lending activity, appropriate procedures, etc.) to grade portfolios, ensure accuracy of data, and monitor compliance with policies or laws.

Quantity of Credit Risk

Review of those factors should allow supervisors to assess the Quantity of credit risk as:

Low	Moderate	High
Effective credit risk diversification is performed.	Diversification is generally satisfactory but there are certain concentrations.	Credit risk diversification is unsatisfactory.
The level of loans outstanding and credit commitments are low relative to total assets.	The level of loans outstanding and credit commitments are moderate relative to total assets.	The level of loans outstanding and credit commitments are high relative to total assets.
The ratio of loans and credit commitments to regulatory capital is low.	The ratio of loans and credit commitments to regulatory capital is moderate.	The level of loans and credit commitments to regulatory capital is high.
Growth in credit risk generating assets has been planned for, and appears consistent with management and staff expertise and/or operational capabilities.	Some growth in assets generating credit risk has not been planned or exceeds planned levels, and may test management and staff expertise or operational capabilities.	Growth in assets generating credit risk was not planned or exceeds planned levels, and stretches management and staff expertise and/or operational capabilities. Growth may be in new products or with borrowers from outside the bank's traditional business.
New loans are conservative in structure, terms, growth, or settlement practices.	New loans are prudent in structure, terms, growth, or settlement practices.	The bank increases new extensions at an excessively high pace, introduces new products are in terms of their structure, terms, or settlement practices.
Few or no exceptions to sound procedures and practices for performing active operations exist.	A limited volume of exceptions to established procedures and practices for performing active operations exists.	A large volume of exceptions to established procedures and practices for performing active operations exists.
Collateral values and quality satisfactorily support credit exposure.	Collateral values and quality protect credit exposure.	Collateral is illiquid or values and quality provide inadequate support.
The level of non-current and loss loans under balance sheet classification is low and the trend is stable.	The level of noncurrent and loss loans under the balance sheet classification is moderate; the trend is stable.	The level of noncurrent and loss loans under the balance sheet classification is high, and the trend is stable, or is moderate and the trend is increasing.
The level of adversely classified assets is low.	The level of adversely classified assets is moderate.	The level of adversely classified assets is high.
Adversely classified assets can be worked through in the normal course of business	Adversely classified assets can be worked through, provided that the bank takes certain actions	Collection of adversely classified assets is questionable or they may require extended time and/or significant expense for resolution.
Reserves for losses on active operations are adequate and cover possible losses. Exposure to loss of earnings or capital from credit risk is minimal.	Possible losses on active operations should not seriously deplete current Reserves or necessitate more than normal provisions. Exposure to loss of earnings or capital from credit risk is manageable.	Losses on active operations may seriously deplete current Reserves or require significant additional provisions. Exposure to loss of earnings or capital from credit risk is substantial.

Quality of Credit Risk Management

Review of those factors should allow supervisors to assess the quality of credit risk Management as:

Strong	Improvement needed	Weak
The current internal regulatory framework on active operations, approved in compliance with corporate governance principles effectively establish and communicate portfolio objectives, risk tolerances, procedures and practices for performing active operations and determining an allowable level of risk .	Policies approved in compliance with corporate governance principles are fundamentally adequate. Enhancements can be achieved in one or more areas, but are generally not critical. Specificity of risk tolerance, procedures and practices for performing active operations or determining an allowable level of risk may need improvement to fully communicate policy requirements.	Polices are deficient in one or more ways and require significant improvement in one or more areas. They may not be sufficiently clear or are too general to adequately communicate portfolio objectives, risk tolerances, and procedures and practices for performing active operations and determining an allowable level of risk.
Management fully understands all aspects of credit risk and anticipates and responds timely and adequately to changes in market conditions of lending.	Management reasonably understands key aspects of credit risk and generally adequately responds to changes in market conditions of lending.	Management does not understand, or has chosen to ignore, key aspects of credit risk. It does not anticipate or take timely and appropriate actions in response to changes in market conditions of lending.
Management information systems (MIS) provide accurate, timely and complete portfolio information. Management and the supervisory council receive appropriate reports to analyze and understand the bank's credit risk profile.	MIS may require modest improvement in one or more areas, but management and the supervisory council generally receive appropriate reports to analyze and understand the bank's credit risk profile. MIS facilitates exception reporting, and MIS infrastructure can support ad hoc queries in a timely manner.	MIS have deficiencies requiring attention. The accuracy and timeliness of information may be affected in a material way. Portfolio risk information may be incomplete. As a result, management and supervisory council may not be receiving appropriate or sufficient information to analyze and understand the banks credit risk profile. Exception reporting requires improvement, and MIS infrastructure may not support ad hoc queries in a timely manner.
Staffing levels and expertise are appropriate for the size and complexity of portfolios of active operations. Staff turnover allows for the orderly transfer of responsibilities. Training programs facilitate on-going staff development.	Staffing levels and expertise are generally adequate for the size and complexity of portfolios of active operations. Staff turnover may create some gaps in portfolio management. Training initiatives and staff development may be inconsistent.	Staffing levels are inadequate in numbers or skill level. Turnover is high. Bank does not provide sufficient staff training/development.
Credit risk analyses are comprehensive and promote early identification of emerging risks.	Credit risk analyses are satisfactory, as are risk measurements and monitoring systems.	Credit risk analyses are not comprehensive or are of deficient quality.

Internal grading appropriately stratifies portfolio quality and provides early detection of potential problems.	Internal grading reasonably stratifies portfolio quality.	Internal grading of loans does not accurately reflect the portfolio's quality.
Internal lending activity review and internal and external audit of active operations are timely, comprehensive, and independent	Lending activity review and internal and external audit of lending operations are acceptable.	Serious weaknesses exist in lending activity review and audit of lending operations, such as lack of independence, timeliness, and/or scope of review.
The methodology of calculation of reserves for losses on active operations is sound and appropriate coverage of risks exists.	The methodology of calculation of reserves for losses on active operations is generally adequate and coverage of risks is acceptable.	The methodology of calculation of reserves for losses on active operations is flawed. It provides insufficient coverage of risks present in the portfolios.

Summary Conclusions:

The quantity of credit risk is:

☐ Low	☐ Moderate	☐ High

The quality of credit risk management is:

☐ Strong	☐ Improvement needed	☐ Weak

Inspectors should consider both the quantity of credit risk and quality of credit risk management to derive the following conclusions:

Aggregate credit risk is:

☐ Low	☐ Moderate	☐ High

The direction is expected to be:

☐ Decreasing	☐ Stable	☐ Increasing

Liquidity Risk

Liquidity risk is defined as the current or prospective risk to earnings and capital arising from a bank's inability to meet its liabilities when they come due without incurring unacceptable losses. Liquidity risk arises from the inability to manage unplanned outflows of funds and changes in funding sources and/or to meet off-balance sheet liabilities.

We also single out market liquidity risk, which is defined as the current or prospective risk to earnings and capital arising from a bank's inability to quickly unwind gaps in its positions at current market rates without incurring unacceptable losses. Market liquidity risk arises from the failure to recognize or address changes in market conditions that affect the ability to attract funds in necessary volumes and at acceptable rates and/or to liquidate assets quickly and with minimal loss in value.

Evaluation Factors

Supervisors should consider the following evaluation factors in making liquidity risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

The assessment factors are as follows:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for liquidity risk management approved by appropriate bodies of the bank based on the principles of corporate governance_ and appropriate compliance practices.

- The volume and composition of asset-based liquidity in relation to the liability structure. Relevant factors include:
  - Highly liquid assets.
  - Securities and other assets, which can be accepted for refinancing transactions (taking into account the liquidity of their market).
  - Asset sales, including repo operations, or securitization opportunities, or an access to secondary liquidity sources etc.

- Volume, structure and diversification level of *passives* (liabilities and capital). Relevant factors include:
  - Proportion of liabilities in the bank's *passives*
  - Proportion of:
    - Term liabilities and demand liabilities
    - Individual funds and corporate funds
    - Interbank funds
  - Existence of volatile sources of funds sensitive to changes in the bank's risk level
  - Concentrations:
    - By provider of funds
    - By instrument (for example, certificate of deposit, deposit account, debit card, etc.)
    - By maturity

- The average weighted cost of attracted funds for a given bank in relation to its peer banks

- Net funding gaps, with an emphasis on short-term exposures, including:
  - Projected funding needs.
  - Ability to cover potential funding gaps at reasonable interest rates by attracting additional resources
  - The liquidity of financial markets, where funds can be attracted

- The composition of on- and off-balance sheet portfolios, including:

- Outflows and inflows of funds
- Liquidity of collateral and early termination arrangements (for example, deposit arrangements, etc.)
- The liquidity of secondary markets available to convert the instruments to cash.

- Deterioration of the institution's reputation in the marketplace as demonstrated by deteriorating credit ratings and increasing interest rates when this bank attracts funds.

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- The views of formal or informal rating services and analysts about the institution, including current ratings and rating trends. Publications in mass media.

- The existence of appropriate contingency planning.

- The existence of timely, accurate, and informative management information.

- The level and skill of management and staff.

- The existence of proper control mechanisms to monitor the accuracy of information, proper accounting treatment, and compliance with policies or laws.

Quantity of Liquidity Risk

Review of those factors should allow supervisors to assess the quantity of liquidity risk as:

Low	Moderate	High
Earnings and capital exposure from the liquidity risk profile (cash flows, current position and liquidity needs, liquidity management strategy) is negligible	Earnings or capital exposure from the liquidity risk profile is manageable.	Potential exposure to loss of earnings or capital due to high liability costs or unplanned asset reduction below their balance-sheet value may be substantial.
Liquidity position is adequate, with negligible exposure to earnings and capital expected.	The liquidity position is not expected to deteriorate in the near term.	Liquidity position is extremely unfavorable, resulting in substantial exposure to loss of earnings or capital.
Funding sources provide the bank with a competitive cost advantage (cost of funding is lower compared to the average in the peer group).	The bank can attract funds at a moderate cost level (at the average cost in the peer group).	Funding sources and portfolio structures suggest current or potential difficulty in sustaining long-term cost-effective liquidity (cost of funds is significantly higher then the average in the peer group).
Borrowing sources are widely diversified, with little reliance on significant funds providers.	Borrowing sources are diversified with few providers sharing common investment objectives, timing, and economic influences.	Borrowing sources are concentrated in a few providers or providers with common investment objectives or economic influences.
Market alternatives exceed demand for liquidity, with no adverse changes expected.	The bank is not excessively vulnerable to funding difficulties should an adverse change in market perception occur. Earnings or capital exposure is manageable.	The institution has virtually no access to market of funds as a consequence of its adverse perception or ignoring by the market.
Support provided by the parent company is strong.	Agreements exist with the parent company on providing support, however, the bank has not yet actually applied to the parent company for such support	Inadequate support provided by the parent company.

Quality of Liquidity Risk Management

Review of these factors should allow supervisors to assess the quality of liquidity risk management as:

Strong	Improvement needed	Weak
Policies approved by the appropriate bodies of the bank, in compliance with the principles of corporate governance, effectively communicate to personnel guidelines for liquidity risk management and designate responsibility.	Policies approved by the appropriate bodies of the bank, in compliance with the principles of corporate governance, adequately communicate to personnel guidance for liquidity risk management and assign responsibility. Minor weaknesses may be present.	The internal regulatory framework is inadequate or incomplete. Policy is deficient in one or more material respects.
Management fully understands all aspects of liquidity risk.	Management reasonably understands the key aspects of liquidity risk.	Management does not understand, or ignores the key aspects of liquidity risk.
Management anticipates and responds well to changes in market conditions.	Management adequately responds to changes in market conditions.	Management does not anticipate or take timely or appropriate actions in response to changes in market conditions.
Liquidity risk management processes are based on appropriate approaches that have proven effective over time.	Liquidity risk management processes are adequate.	Liquidity risk management processes are deficient.
Management information is timely, complete and reliable.	Management information is generally timely, accurate, complete and reliable.	Management information systems do not provide adequate information for managing liquidity risk.
Access to funding markets is properly assessed and diversified	Access to funding markets is generally assessed and diversified, however, not all market alternatives are taken into consideration	Management has not realistically assessed the institution's access to sources of funds and has not paid sufficient attention to diversification.
Contingency plans are effective and take into account all relevant factors.	Contingency planning is effective, and the cost of liquidity alternatives is adequately considered.	Contingency planning is either nonexistent or incomplete. The cost of liquidity alternatives has not been adequately considered. A high probability exists that additional contingency funding sources will be needed. Improvement is not expected in the near future.

Summary Conclusions:

The quantity of liquidity risk is:

❑ Low	❑ Moderate	❑ High

The quality of liquidity risk management is:

❑ Strong	❑ Improvement needed	❑ Weak

Inspectors should consider both the quantity of liquidity risk and quality of liquidity risk management to derive the following conclusions:

Aggregate liquidity risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

Interest Rate Risk

Interest rate risk is the current or prospective risk to earnings and capital arising from adverse movements in interest rates. This risk impacts both the earnings of a bank and the economic value of its assets, liabilities and off-balance sheet instruments. The primary types of interest rate risk to which banks are typically exposed are: (1) repricing risk, which arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of bank assets, liabilities and off-balance sheet positions; (2) yield curve risk, which arises from changes in the slope and shape of the yield curve; (3) basis risk, which arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments whose all other repricing characteristics are the same; and (4) optionsality risk, which arises from the express or implied options imbedded in many bank assets, liabilities and off-balance sheet portfolios.

Evaluation Factors

Supervisors should consider the following evaluation factors in making interest rate risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These are the following factors:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for interest rate risk management approved by appropriate bodies of the bank, in compliance with the principles of corporate governance, and appropriate compliance practices.

- The size and stability of net interest margins and its correspondence to the peer group level.

- The component and aggregate levels of interest rate risk including repricing, basis, yield curve, and option risk relative to earnings and capital.

- How adequately the bank assesses interest rate risk over both the short- and long-term.

- The vulnerability of earnings and capital under meaningful rate changes such as gradual rate shifts and yield curve twists. The appropriateness of the scenarios should be evaluated in the context of the current rate environment. Rate scenarios of sufficiently wide variability will be necessary to provide meaningful analysis.

- The character of risk such as the volume and price sensitivity of various products.

- The relative volume of and prospects for continued support from low cost and stable funding sources.

- The existence of timely, accurate, and informative management information to monitor interest rate risk.

- The existence at the bank of practices of periodical review of the justification and validity of risk assessment assumptions and models.

- Whether a process exists for independently measuring and analyzing risk in all significant activities from interest rate movements using a variety of scenarios.

- Whether the bank has sufficient expertise and whether it adequately responds to changing market conditions.

- Whether the bank has sufficient market access to flexibly adjust risk levels.

- The level and skill of management and staff.

- The existence of proper control mechanisms to monitor the accuracy of information, proper accounting treatment, and compliance with internal policies, regulations or laws.

Quantity of Interest Rate Risk

Review of those factors should allow supervisors to assess the quantity of interest rate risk as:

Low	Moderate	High
Exposure reflects little repricing risk and minimal exposure to basis risk and yield curve risk. Options positions are clearly identified and well managed.	Exposure reflects repricing risk, basis risk, yield curve risk, and options risk that are collectively maintained at manageable levels.	Exposure reflects significant repricing risk, high levels of basis risk, undue yield curve risk, or significant levels of options risk.
Mismatched positions are short-term.	Mismatched positions may be longer term, but are effectively hedged.	Mismatched positions are longer term and costly to hedge.
The mismatches are unlikely to cause earnings or capital volatility due to the movement in interest rates.	Substantial volatility in earnings or capital due to the movement of interest rates is not anticipated.	The probability of substantial volatility in earnings or capital due to the movement of interest rates is high.
The support provided by low-cost, stable nonmaturity deposits is significant and absorbs or offsets exposure arising from longer-term repricing mismatches or options risk.	The support provided by low-cost, stable nonmaturity deposits absorbs some, but not all, of the exposure associated with longer-term repricing mismatches or options risk.	The support provided by low-cost, stable nonmaturity deposits is not significant or sufficient to offset risk from longer-term repricing mismatches or options risk.

Quality of Interest Rate Risk Management

Review of those factors should allow supervisors to assess the quality of interest rate risk management as:

Strong	Improvement needed	Weak
The internal regulatory framework approved by appropriate bodies of the bank, in compliance with corporate governance principles, is sound and effectively communicates guidelines for management of IRR, functional responsibilities, and risk tolerance.	The internal regulatory framework approved by appropriate bodies of the bank, in compliance with corporate governance principles, adequately communicates guidelines for management of IRR, functional responsibilities, and risk tolerance. Minor weaknesses may be evident.	The internal regulatory framework is inadequate in communicating guidelines for management of IRR functional responsibilities, and risk tolerance.
Management, responsible officials and respective structural units fully understand all aspects of interest rate risk.	Management, responsible officials and respective structural units reasonably understand the key aspects of interest rate risk.	Management, responsible officials and respective structural units do not understand or choose to ignore key aspects of interest rate risk.
Management anticipates and responds to changes in market conditions in a timely and appropriate manner.	Management adequately responds to changes in market conditions.	Management does not anticipate or take timely and appropriate actions in response to changes in market conditions.
The function of monitoring risk limits and measuring exposures is independent from those executing risk-taking decisions.	-	The function of monitoring risk limits and measuring exposures is not independent from those executing risk-taking decisions.
Risk measurement tools and methods enhance decision making by providing meaningful and timely information under a variety of defined and reasonable rate scenarios.	Risk measurement tools and methods have minor weaknesses, but are appropriate given the size and complexity of the institution's on- and off-balance sheet exposures.	Risk measurement tools and methods are overly simplistic in light of the relative size and complexity of the institution's on- and off-balance sheet exposures.
Management information is timely, accurate, complete and reliable.	Management information is generally timely, accurate, complete and reliable.	Management information systems contain significant weaknesses.
Limit systems provide clear parameters for risk to earnings and the economic value of equity under a variety of defined and reasonable interest rate scenarios.	Limit systems are adequate to control the risk to earnings and the economic value of equity under a variety of defined and reasonable interest rate scenarios.	Limit systems are not reasonable or do not reflect an understanding of the risks to earnings and the economic value of equity.

Summary Conclusions:

The quantity of interest rate risk is:

❑ Low	❑ Moderate	❑ High

The quality of interest rate risk management is:

❑ Strong	❑ Needs improvement	❑ Weak

Inspectors should consider both the quantity of interest rate risk and quality of interest rate risk management to derive the following conclusions:

Aggregate interest rate risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

Market Risk

Market risk is the current or prospective risk to earnings and capital arising from adverse movements in security and commodity prices and foreign exchange rates in the trading book. This risk arises from market making, dealing, and position taking in debt and equity securities, currencies, commodities, and derivatives. Risks arising under similar circumstances with regard to similar instruments in the banking book are addressed in other relevant categories of the risk assessment system.

Evaluation Factors

Supervisors should consider the following evaluation factors in making market risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These are the following factors:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for market risk management approved by appropriate bodies of the bank, in compliance with corporate governance principles, and appropriate compliance practices.
- The source of market risk including interest rate, foreign exchange, commodity, and equity prices.
- The size, tenor, and complexity of positions.
- The components of market risk and price sensitivity of various products including under off-balance sheet arrangements (for instance, swaps, forwards, and options).
- The stability of trading revenues.
- The trend of earnings and capital at risk.
- The vulnerability of the bank under probable rate scenarios and stress environments (stress-testing).
- The ability to hedge or close risk positions existing at a given moment, including management's professional ability to conduct hedging transactions and the bank's access to appropriate markets.
- The size of open positions versus revenues realistically expected (i.e., risk versus reward).
- The existence of timely, accurate, and informative management information.
- The level and skill of management and staff.
- The existence of proper control mechanisms to monitor the accuracy of information, proper accounting treatment, and compliance with policies, limits, regulations or laws.

Quantity of Market Risk

Low	Moderate	High
Exposure reflects limited open unhedged positions. When prices and rates change, the fluctuations of the size of earnings and capital would be minimal.	Exposure reflects moderate open unhedged positions. When prices and rates change, the fluctuations of the size of earnings and capital would be moderate.	Exposure reflects significant open unhedged positions. When prices and rates change, the fluctuations of the size of earnings and capital would be significant.
Exposures primarily arise from customer transactions, and involve liquid and readily manageable products, markets, and levels of activity.	Exposure originates primarily in conjunction with customer transactions. The bank has access to a variety of risk management instruments and markets at reasonable costs, given the size, tenor, and complexity of open positions.	High exposure may arise from transactions or positions that are taken as management's or trader's views of the market. The volume and terms and conditions of customer transactions are not adequate for the bank.
The tenor and size of open positions are expected to continue at, or decline from, current levels.	The tenor and size of open positions are expected to remain at current levels.	The positions may be difficult or costly to close out or hedge due to complexity of the positions; difficulty in readily accessing certain instruments, markets or tenors; or the general illiquidity of markets or products. The tenor and size of open positions are expected to continue at or increase beyond, current levels.

Review of those factors should allow supervisors to assess the quantity of market risk as:

Quality of Market Risk Management

Strong	Needs improvement	Weak
The internal regulatory framework approved by the bank's appropriate bodies in compliance with the principles of corporate governance clearly defines the level and types of risk that the bank is willing to take and establishes clear authorities, conservative limits, and assigned responsibilities. Policies permit risk-taking only to personnel of an appropriate level who have proper experience and professional knowledge.	The internal regulatory framework approved by the bank's appropriate bodies in compliance with the principles of corporate governance defines the level and types of risk that the bank is willing to take and generally establishes clear authorities, reasonable limits, and assignment of responsibilities. Risk-taking authority is generally consistent with expertise of bank personnel.	The bank's internal regulatory framework reflects the Board of Managers' rather than the shareholders' attitude towards risk. No clear assignment of responsibilities. Risks are taken by personnel having no appropriate expertise.
Management, responsible officials and respective structural units fully understand all aspects of market risk	Management, responsible officials and respective structural units fully understand the key aspects of market risk	Management, responsible officials and respective structural units do not understand, or have chosen to ignore, key aspects of market risk
Management and responsible officials anticipate and respond timely and effectively to changes in market conditions.	Management and responsible officials adequately respond to changes in market conditions.	Management and responsible officials do not anticipate or take timely and appropriate actions in response to changing market conditions.
Risk measurement tools and methods are sophisticated, given the size and complexity of activities.	Risk measurement tools and methods have minor deficiencies, but are sufficient give the size and complexity of activities.	Risk measurement tools and methods are inadequate given the size or complexity of activities.
Management information is sufficient for a clear assessment of the potential volatility of the market and aggregate risk-taking	Management information is generally sufficient for an assessment of the potential volatility of the market and aggregate risk-taking	Management information does not accurately characterize the potential volatility of the market or aggregate risk-taking
Limit systems establish clear parameters of the risk to earnings and capital under a variety of defined and reasonable scenarios.	Limit systems establish clear parameters of the risk to earnings and capital under defined and reasonable scenarios.	Limits systems do not reflect a complete understanding of the risk to earnings and capital.
The function of measuring exposures and monitoring risk is independent from risk-taking activities.	-	The function of measuring exposures and monitoring risk is not independent from risk-taking activities.

Review of those factors should allow supervisors to assess the quality of market risk management as:

Summary Conclusions:

The quantity of market risk is:

☐ Low	☐ Moderate	☐ High

The quality of market risk management is:

☐ Strong	☐ Improvement needed	☐ Weak

Inspectors should consider both the quantity of market risk and quality of market risk management to derive the following conclusions:

Aggregate market risk is:

☐ Low	☐ Moderate	☐ High

The direction is expected to be:

☐ Decreasing	☐ Stable	☐ Increasing

Foreign Exchange Risk

Foreign exchange risk is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates and banking metal prices. Foreign exchange risk can be separated into:
- Transaction risk;
- Translation risk;
- Economic foreign exchange risk.

Transaction risk refers to the impact of adverse movements in currency exchange rates on the real value of open foreign currency positions. However, since it generally arises from market making, dealing and position taking in foreign currencies it is covered in the market risk guideline. Translation risk refers to the variability in accounting values that result from variations in exchange rates which are used in translating carrying values in foreign currencies to base currency. Economic foreign exchange risk refers to changes in competitive strength of the financial institution or its entities constituting its consolidated group in the foreign market due to fundamental changes in exchange rates.

Evaluation Factors

Supervisors should consider the following evaluation factors in making foreign exchange risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These are the following factors:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for FX risk management approved by appropriate bodies of the bank, in compliance with corporate governance principles, and appropriate compliance practices.

- The volume of balance sheet and off-balance sheet items subject to revaluation due to changes in the spot currency exchange rate and in the forward currency exchange rate.

- The structure of balance-sheet and off-balance-sheet items by:
    - Currency.
    - Products.
    - Tenor or anticipated term of maintenance of positions.
    - The size and maturity of cash flow mismatches.
    - The extent of positions in thinly traded currencies.

- The potential size of capital losses from translating accounts denominated in other currencies to their hrivna equivalent in case of change of currency exchange rates, taking into account recent trends and projections.

- The existence of timely, accurate, and informative management information.

- The level and skill of management and staff.

- The existence of proper control mechanisms to monitor the accuracy of information, proper accounting treatment, and compliance with internal policies, regulations or laws.

Quantity of Foreign Exchange Risk

Review of those factors should allow supervisors to assess the quantity of foreign exchange risk as:

Low	Moderate	High
The size of unhedged open FX positions in specific currencies is limited.	The size of unhedged open FX positions in specific currencies is moderate.	The size of unhedged open FX positions in specific currencies is significant.
Cash flows are predictable and are closely matched or hedged.	Cash flow mismatches are predictable and moderate in size.	Some positions may be denominated in soft currencies, complicating the ease, speed, and cost of hedging.
The impact of changes in currency exchange rates on the size of earnings and/or capital is insignificant.	The impact of changes in currency exchange rates on the size of earnings and/or capital is moderate.	The impact of changes in currency exchange rates on the size of earnings and/or capital is significant.

Quality of Foreign Exchange Risk Management

Review of those factors should allow supervisors to assess the quality of foreign exchange risk management as:

Strong	Improvement needed	Weak
The internal regulatory framework approved by the bank's appropriate bodies in compliance with the corporate governance principles clearly and reasonably defines the limits of FX positions by currency, term and instrument.	The internal regulatory framework approved by the bank's appropriate bodies in compliance with the corporate governance principles generally defines the limits of FX positions by currency, term and instrument.	There is no internal regulatory framework for FX risk or it is inadequate to the volume and nature of the bank's operations given management expertise, the bank's capital position, and/or volume of assets and liabilities denominated in foreign currencies. Responsibilities are not clearly assigned.
Management, responsible officials and respective structural units fully understand all aspects of foreign exchange risk.	Management, responsible officials and respective structural units fully understand the key aspects of foreign exchange risk.	Management, responsible officials and respective structural units do not understand, or have chosen to ignore, key aspects of foreign exchange risk.
Management and responsible officials anticipate and respond timely and appropriately to changes in market conditions.	Management and responsible officials adequately respond to changes in market conditions.	Management and responsible officials do not anticipate or take timely or appropriate actions in response to changes in market conditions.
Risk measurement tools and methods are sophisticated, given the size and complexity of activities.	Risk measurement tools and methods may have minor deficiencies, but are sufficient given the size and complexity of activities.	Risk measurement tools and methods are inadequate given the size or complexity of activities.
Management information is sufficient for a clear assessment of the potential market volatility and aggregate risk-taking.	Management information is generally sufficient for an assessment of the potential market volatility and aggregate risk-taking.	Management information does not accurately portray the potential market volatility or aggregate risk-taking.
Limit systems establish clear parameters of the risk to earnings and capital under a variety of defined and reasonable scenarios.	Limit systems establish clear parameters of the risk to earnings and capital under a variety of defined and reasonable scenarios.	Limit systems do not reflect a complete understanding of the risk to earnings and capital.
The function of measuring exposures and monitoring risk is independent from risk-taking activities.	-	The function of measuring exposures and monitoring risks is not independent from risk-taking activities.

Summary Conclusions:

The quantity of foreign exchange risk is:

❑ Low	❑ Moderate	❑ High

The quality of foreign exchange risk management is:

❑ Strong	❑ Improvement needed	❑ Weak

Inspectors should consider both the quantity of foreign exchange risk and quality of foreign exchange risk management to derive the following conclusions:

Aggregate foreign exchange risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

Operations and Technology risk

Operations and technology risk is the potential risk for the existence of a banking institution, which arises from breakdowns in corporate governance, internal controls or inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability, and continuity. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or too risky manner. Operations and technology risk also arises from an inadequate IT strategy and policy, and from inadequate use of the information technology. Other aspects of operations and technology risk include the probability of unforeseeable events such as fires or other disasters.

Evaluation Factors

Supervisors should consider the following evaluation factors in making operations and technology risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These are the following factors:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for operations and technology risk management approved by appropriate bodies of the bank, in compliance with corporate governance principles, and appropriate compliance practices.

- The number and complexity of processing of transactions in relation to the development and capacity of operational and control systems taking into account the historical performance record of these system, their current condition, and prospects for further improvement.

- The potential for technological and operational failures, breaches of authority by staff, inadequacies in the pre-transaction analysis for decision-making , and failure (including temporary) to monitor and register transactions with customers or counter parties.

- The existence and adherence by the bank to *technological cards* (procedures) for conducting transactions.

- The existence, number, reasons and nature of violations of administrative and accounting control procedures.

- The potential for financial loss due to:
  - Human error or fraud.
  - Low operational competitiveness of the bank.
  - Inadequacy of existing IT systems
  - Incomplete information on a counterparty or transaction.
  - Operational and technological disruption.

- The history and nature of litigation on the part of customers related to deficiencies in operational systems and how the bank dealt with it.

- The volume and adequacy of controls of outsourced software and its maintenance and other services, as well as over other outsourcing arrangements.

- Adequacy of IT strategy. IT strategy should address current and foreseen business requirements, and take into consideration hardware, telecommunications, software, data and network structure, and informational database integrity

- A process exists for:
    - Identifying information needs to manage the bank efficiently.
    - Defining the information systems architecture for transaction processing and for delivering products and services.
    - Assuring the reliability and retention of information (e.g., data creation, processing, storage, and delivery). This includes business continuity planning.
    - Providing the timely production and use of management information

- The existence of timely, accurate, and informative management information.

- The level and skill of management and staff.

- The existence of proper control mechanisms to monitor the accuracy of information, proper accounting treatment, and compliance with policies or laws.

Quantity of Operations and Technology Risk

Review of the following factors should allow supervisors to assess the quantity of operations and technology risk as:

Low	**Moderate**	**High**
Client identification, pre-transaction analysis and procedures are standardized.	Client identification, pre-transaction analysis and procedures are difficult to standardize because of complexity of schemes of conducting transactions involving separate products.	Client identification, pre-transaction analysis and procedures cannot be standardized because of complexity of schemes of conducting transactions involving separate products.
The number of transactions and technological complexity of their processing is low and well supported by operational systems development.	The number of transactions and technological complexity of their processing expose the bank to some degree of risk. Operational systems development adequately supports the level of transaction processing.	The level of technological transaction processing and state of operational systems development are inconsistent and reflect weaknesses.
The bank fully meets the requirements to settlement and cash transactions.	There exist certain violations of settlement and cash discipline.	There exist major violations of settlement and cash discipline.
The schemes of conducting transactions are simple, the average size and number of transactions conducted in different time zones are low.	The schemes of conducting transactions are characterized with certain complexity, there may be deviations from the standard schemes of conducting transactions, the average size of transactions is significant, and the number of transactions conducted in different time zones is moderate.	The schemes of conducting transactions are characterized as complex and virtually not standardized, the average size of operations is high, and the number of transactions conducted in different time zones is significant.
The expansion of the number and range of banking services is consistent with management's plans. Implementation plans are clear and followed.	The expansion of the number and range of banking services is generally consistent with management's plans. Implementation plans are generally clear although they are not always comprehensive.	The bank lacks adequate plans of expansion of the number and range of services.

Quality of Operations and Technology Risk Management

Review of the following factors should allow supervisors to assess the quality operations and technology risk as:

Strong	Improvement needed	Weak
Policies of the bank approved by the bank's appropriate bodies in compliance with the corporate governance principles, where operational and technological risk is addressed, are well developed and adequate.	Policies of the bank approved by the bank's appropriate bodies in compliance with the corporate governance principles, where operational and technological risk is addressed, are generally adequate.	Policies of the bank do not cover all aspects of operational and technological risk and are not adequate.
Management fully understands all aspects of operations and technology risk.	Management reasonably understands the key aspects of operations and technology risk.	Management does not understand, or has chosen to ignore, the key aspects of operations and technology risk.
Management anticipates and responds well to changes in the size of operations and technology risk.	Management adequately responds to changes in the size of operations and technology risk.	Management does not anticipate or take timely and appropriate actions in response to changes in the size of operations and technology risk.
The IT strategy and policy are fully complied with and supported by adequate resources.	The IT strategy and policy are generally complied with and supported by generally adequate resources.	The IT strategy and policy are not complied with and/or not supported by appropriate resources.
The bank has a history of no operational failures. The likelihood of that the bank may not be able to restore and to further process the transaction is minimal because of the presence of strong internal controls.	The bank has a history of no significant operational failures. The likelihood of that the bank may not be able to restore or to further process the transaction is minimized by generally effective controls.	There are instances of significant (in number and/or consequences) operational failures. The likelihood of inability to restore and to further process the transaction is high because of the absence of effective internal controls.
The level of operational control at the bank is high. Internal controls, audit, and contingency plans are sound.	The level of operational control at the bank is adequate. Internal controls, audit coverage, and contingency plans are adequate.	The level of operational control at the bank is inadequate. Serious weaknesses exist in internal controls, and audit coverage or contingency plans.
Management information is satisfactory.	Minor deficiencies may exist in management information on transaction processing activities.	Management information related to transaction processing activities exhibits significant weaknesses.
The quantity, skills and experience of personnel are satisfactory. No scarcity of qualified personnel in the market.	Current quantity and quality of staff is troublesome. Scarcity of required knowledge and experience in the market.	Current quantity and quality of staff is insufficient. Required knowledge and experience is hard to obtain in the market.

Summary Conclusions:

The quantity of operations and technology risk is:

❑ Low	❑ Moderate	❑ High

The quality of operations and technology risk management is:

❑ Strong	❑ Improvement needed	❑ Weak

Inspectors should consider both the quantity of operations and technology risk and quality of operations and technology risk management to derive the following conclusions:

Aggregate operations and technology risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

Reputation Risk

Reputation risk is the current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution by customers, counter parties, shareholders, or regulators. This affects the bank's ability to establish new relationships or services or service existing relationships. This risk may expose the institution (or its managers) to financial loss or a decline in its customer base including administrative, civil and criminal liability. Reputation risk exposure is present throughout the organization and, therefore, banks are obligated to exercise an appropriate treatment in dealing with its customers and with the community.

The public perception can be delineated as follows:
- Market perception: e.g. actual or potential customers or counter parties, or shareholders
- Regulatory perception: e.g. the National Bank of Ukraine, Securities and Exchange Commission, State Tax Administration, and other authorized bodies.

Evaluation Factors

Supervisors should consider the following evaluation factors in making reputation risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These factors are the following:
- The market or public perception of management and the financial stability of the institution.
- The market or public perception of the products and services offered by the bank.
- Management's willingness and ability to adjust business strategies based on regulatory changes, market conjuncture, or other factors (for instance, termination or restriction of the validity of separate items in the license, change of the bank's status, etc.).
- The bank's practices of analyzing the prospects for expanding the range of products and services and developing an appropriate internal regulatory framework, including as it pertains to conducting due diligence of and getting information on costomers. The prospects for maintaining such practices in future.
- The volume of fiduciary services and the terms and conditions of rendering them.
- The nature and volume of customer complaints and management's ability and willingness to respond to those complaints appropriately.
- The existence of highly visible or conspicuous litigation, which has affected the bank's image.
- Historical fines, penalties and other financial losses arising from administrative, civil or criminal liability incurred by the bank (or its managers).
- The findings of supervisory reviews and management's willingness and ability to respond to these reviews appropriately.
- The bank's participation in the Household Deposit Insurance Fund.

Summary Assessment

Review of those factors should allow supervisors to assess aggregate reputation risk as:

Low	Moderate	High
Management anticipates and responds well to changes that impact the bank's reputation.	Management adequately responds to changes that impact the bank's reputation.	Management does not anticipate or take timely or appropriate actions in response to changes of a market or other nature.
The existence of a Code of Ethics, developed in compliance with the corporate governance principles, which is fully complied with.	The existence of a Code of Ethics, developed in compliance with the corporate governance principles, which is generally complied with.	No Code of Ethics exists at the bank or it does not function.
The bank's internal discipline is maintained at a very high level.	The bank's internal discipline is maintained at an acceptable level.	The bank's internal discipline is not maintained.
Internal controls and audit systems are fully adequate.	Internal controls and audit systems are generally adequate.	Internal controls or audit systems are not effective in reducing exposure. Management has either not initiated, or has a poor record of, corrective action to address problems.
The public image and good reputation of the bank is only minimally exposed by internal and external factors. Control action is taken (for instance, through an effective public relations function). . No adverse exposure is expected in the foreseeable future.	The exposure of the public image and good reputation of the bank from internal and external factors is controlled (for instance, through an effective public relations function). Exposure is expected to remain low in the foreseeable future.	The public image and good reputation of the bank are substantially exposed by internal and external factors. This is shown in significant litigation against the bank and its managers, large dollar losses, or a high volume of customer complaints. The situation is notexpected to improve in the foreseeable future.
The Household Deposit Insurance Fund insures a significant portion of total household deposits. The average amount of a deposit does not exceed the amount of guaranteed compensation.		The bank is not a participant of the Household Deposit Insurance Fund or is its temporary participant.

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Summary Conclusions:

Aggregate reputation risk is:

☐ Low	☐ Moderate	☐ High

The direction is expected to be:

☐ Decreasing	☐ Stable	☐ Increasing

Legal Risk

Legal risk is the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, regulations, agreements, prescribed practices, or ethical standards, as well as from the possibility of their dubious interpretation. Institutions are exposed to legal risk due to relations with a great number of stakeholders, e.g. customers, counter parties, intermediaries, etc., as well as regulators, tax authorities, and other authorized agencies. Legal risk can lead to fines and administrative penalties, payment of damages, diminished reputation, deteriorating position in the market, reduced expansion potential, and lack of contract enforceability.

Evaluation Factors

Examiners should consider the following evaluation factors in making legal risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the examiner in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.
The factors are the following:

- The existence of an adequate, effective and communicated internal regulatory framework (policies, procedures, etc) for legal risk management approved by appropriate bodies of the bank, in compliance with corporate governance principles, and appropriate compliance practices.

- The number and significance of violations or nonconformance with prescribed standards or legal requirements (significance is determined by analysis of the frequency, dollar amount, and nature of noncompliance). The analysis should incorporate both current and historical perspectives.

- The history of complaints, claims and litigation by customers and others. The complaints, claims or litigation may involve:
    - Consumer rights protection in connection with usage of banking products or receipt of banking services (lending, deposits, funds transfer, etc.).
    - Violation of laws and regulations.
    - Other prudential or ethical standards, whether established internally or mandated by the bank's regulators.

- How policies and powers are communicated to management and staff.

- The existence of timely, accurate, and complete management information.

- The level and skill of management and staff (in particular, legal staff).

- The existence of appropriate controls (internal and external audit, appropriate procedures, etc.) to ensure compliance with the requirements of laws and regulations, the requirements of the internal regulatory framework and concluded agreements.

Summary Assessment

Review of those factors should allow examiners to assess aggregate legal risk as:

Low	Moderate	High
Management fully understands all aspects of legal risk and exhibits clear commitment to compliance with all of the established requirements.	Management reasonably understands the key aspects of legal risk.	Management does not understand, or has chosen to ignore, key aspects of legal risk.
Authority and accountability for compliance are clearly defined and enforced throughout the institution, in compliance with the corporate governance principles.	Authority and accountability for compliance are communicated throughout the institution, in compliance with the corporate governance principles, although some refinements may be needed.	Management has not established, has not communicated throughout the institution or enforced accountability for compliance performance.
Management anticipates and responds well to changes of regulatory nature.	Management adequately responds to changes of a regulatory nature.	Management does not anticipate or take timely or appropriate actions in response to changes of a regulatory nature.
Legal considerations are incorporated into the product and system development process.	While compliance may not be formally considered when developing products and systems, issues are typically addressed before they are fully implemented	Legal considerations are not incorporated in product or systems development.
Violations and/or noncompliance issues are insignificant, as measured by their number or seriousness.	The frequency or severity of violations and/or noncompliance is reasonable.	Violations and/or noncompliance expose the bank to significant impairment of reputation, value (capital), earnings, or the bank's position in the market.
When deficiencies are identified, management promptly implements meaningful corrective action.	Problems can be corrected in the normal course of business without significant investment of money or management resources. Management is responsive when deficiencies are identified.	Errors are often not detected internally, corrective action is often ineffective, or management is unresponsive to identified deficiencies.
The institution has a good record of compliance. Appropriate legal control systems are implemented to identify potential legal issues, compliance problems and assess the performance of respective units and employees , which minimize the likelihood of numerous or serious future violations.	Compliance management systems are adequate to avoid significant or frequent violations or noncompliance.	Compliance management systems are deficient, reflecting an inadequate management commitment to risk management. The bank has no corrective action plan, or it would take a lot of time to implement such a plan.
Training programs ensure ongoing staff development.	There is certain inconsistency in the staff training and development process.	The bank provides no meaningful and consistent staff training/development programs.

Summary Conclusions:

Aggregate legal risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

Strategic Risk

Strategic risk is the current or prospective risk to earnings and capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to changes in the business environment. This risk is a function of the compatibility of a bank's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

Evaluation Factors

Supervisors should consider the following evaluation factors in making strategic risk assessments. These evaluation factors are recommended criteria and may be expanded by supervisors, if necessary. They are an overview of issues that can assist the supervisor in making decisions within the RAS. The actual data of the ongoing risk assessment and control system existing at the bank are to make sure that management makes adequate and effective decisions and are considered by supervisors when assessing the bank's risk.

These factors are the following:

- The bank's mission, goals, corporate culture and values, and tolerance for risk.
- Management's practices of communicating, modifying, and implementing strategic plans.
- The status of implementation of strategic plans, the frequency and magnitude of changes in the bank's risk tolerance.
- Management information systems and controls available to monitor business decisions.
- Strategic choices relating to technological, product, and competitive environments and their impact on the public image and reputation of the bank.
- Plans and opportunities for the bank's structural reorganization (for example, mergers and acquisitions).
- The compatibility of strategic initiatives with available or planned resources.
- The bank's market position, including market penetration at both the product and geographic level.
- The bank's diversity in terms of products, geography, and clientele.
- The bank's past performance in implementing plans to offer new products and services.

Summary Assessment

Review of those factors should allow supervisors to assess aggregate strategic risk as:

Low	Moderate	High
Risk management practices are an integral part of strategic planning.	The quality of risk management is consistent with the strategic tasks confronting the organization.	Risk management practices are inconsistent with strategic tasks, or a lack of strategic direction is evident.
Strategic goals, objectives, corporate culture, and behavior are effectively	Management has demonstrated the ability to implement goals and	Strategic tasks are inadequately supported by the

communicated and consistently applied throughout the institution. The effectiveness of implementation of strategic tasks is enhanced by the depth of management qualifications at all levels.	objectives. There are some unresolved tasks, that, however, do not have a significant impact on overall goals and objectives	bank's internal regulatory framework. The structure and qualifications of the staff of the organization do not support long-term strategies.
The bank has a good record of accomplishing goals and implementing strategic tasks. Strategic plans do not pose a threat of destabilization of the bank's condition.	The bank has a reasonable record of accomplishing goals and implementing strategic tasks. Strategic plans pose a minor and generally manageable threat of destabilization of the bank's condition.	The bank demonstrates its inability to accomplish goals and to implement strategic tasks. The implementation of the bank's strategic plans may cause destabilization of its condition.
Management information systems effectively support strategic tasks.	Management information systems reasonably support short-term strategic tasks.	Management information systems supporting strategic tasks are seriously flawed or do not exist.
The bank's strategic plan implementation tactics are consistent with the defined strategy, are supported by capital and pose only nominal possible effects on earnings. Decisions can be easily changed with reasonable expenses.	The bank's strategic plan implementation tactics are generally consistent with the defined strategy and are basically supported by capital and operating systems development. Decisions are not likely to have a significant adverse impact on earnings or capital. If necessary, the decisions made or actions planned can be reversed without significant cost or difficulty.	The impact of strategic decisions is expected to significantly affect franchise value (the market value of capital). The bank's tactical actions to implement strategic plans are aggressive and/or incompatible with the defined strategy. Decisions are either difficult or costly to reverse in the process of their implementation.

Summary Conclusions:

Aggregate strategic risk is:

❑ Low	❑ Moderate	❑ High

The direction is expected to be:

❑ Decreasing	❑ Stable	❑ Increasing

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Director
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APPROVED
NBU Deputy Governor

_________________Shlapak