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March 4, 2005

Mr. Victor Stetsenko  
Cognizant Technical Officer  
U.S. Agency for International Development  
Kiev, Ukraine

**SUBJECT: Quarterly Report – September 30, 2004 to December 31, 2004**  
Contract No.: PCE-I-00-99-00006-00: Task Order No. 827  
Banking Supervision Development Project, National Bank of Ukraine

Dear Mr. Stetsenko:

Please find attached our quarterly report for the USAID Banking Supervision Development Project at the National Bank of Ukraine, captioned above. Our report follows the elements of the Task Order referenced above. We first summarize our assistance through June 30 2004, at which time we drafted our most recent, and final, annual work plan. We then discuss the elements of our annual plan for the June 30 2004 to June 30 2005 period. Finally, we have addressed our progress with respect to this annual plan.

If you need further information or require additional copies of this report, please do not hesitate to contact our local project office (Mr. Alex Kutsenko) or me via email at [bryan.stirewalt@bearingpoint.com](mailto:bryan.stirewalt@bearingpoint.com).

Very truly yours,

BearingPoint, LLC

Bryan Stirewalt  
Chief of Party

cc: Ms. Gloria White, USAID/PPC/CDIE, Washington, DC  
Ms. Iris Young, Contracting Officer, USAID/Kiev  
Mr. Richard Abrams, Advisor, International Monetary Fund  
Mr. Gerardo Corrochano, World Bank  
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Project File



## **Future Bank Supervision Technical Assistance Goals**

**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: BSD 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.*

### **Progress and Completions through June 30, 2004:**

In early 2003, we assisted the GDBS with formation of a risk-based supervision implementation committee (the RBS Task Force). Through the RBS Task Force, we assisted with design, development and delivery of a Risk Assessment System ("RAS"). The NBU's Supervisory Board formally approved this document as part of the On-Site Inspection Manual on March 15, 2004. Our project has collected input from commercial bankers, NBU senior management, on-site inspectors and off-site analysts on the format, content and usage of the RAS, and we will use this feedback to develop needed amendments to the RAS document and overall supervision process.

We conducted "train-the-trainer" sessions for twenty (20) persons from the nationwide banking supervision function on risk-based supervision and usage of the RAS. The technical training for the potential instructors of RBS seminars was held November 10 through November 21, 2003. Course materials included brief presentations on Risk Based Supervision, Key Banking Risks, Risk Management Systems, Corporate Governance and an extensive case study illustrating all banking risks and risk-based supervision concepts. The persons attending this seminar are now participating in delivery of the three-day risk-based supervision courses. The World Bank's Dutch Grant project is scheduled to deliver training to the GDBS on individual risk components. This is coordinated with the NBU's Personnel Department and the GDBS Training Unit Manager, Ms. Tatyana Khimich. Our project has also delivered train-the-trainer sessions focused on training skills, in addition to technical expertise mentioned above.

Following the train-the-trainer seminar, we assisted GDBS inspectors with a pilot inspection of a commercial bank using a draft version of the RAS, incorporating the concepts of risk-based supervision. This was a highly intensive inspection process focusing on each of the bank's major risk areas, including considerable effort with on-the-job training of inspectors. This on-the-job training, coupled with formal training on risk-based supervision and individual components of banking risk with form the basis of risk-based supervision implementation.



We presented recommendations regarding the GDBS's On-site Manual, including the following: 1) to publish and practically implement the chapters developed earlier, used informally, but not officially adopted; 2) to expand the 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 RAS 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.

Our project has delivered comprehensive legal recommendations regarding necessary amendments to the Law on Banks and Banking Activity and various critical regulations including, but not limited to, the following topics: licensing (registration) activity, essential and controlling participation, collection of information from holders of such participation, transparency issues and enforcement, corporate governance and risk management principles, enhancements to external and internal audit activities, consolidated supervision principles, capital of banks, purchasing by banks of their own shares. We have assisted the NBU Legal Department in their discussions with the Ukrainian banking associations and with Parliamentary working groups. Due to the unique connections between the banking industry and members of Parliament in Ukraine, the legal and judicial areas are among the most difficult areas of reform.

Our project is in constant contact with the RBS Task Force. In our discussions during each of the risk-based supervision seminars, we are assisting the members of the RBS Task Force with areas of possible improvements, including our delivery of a detailed "action plan" for implementation of risk-based supervision. We have carefully emphasized that the risk-based assessment system and risk-based supervision plan is a working document, to be viewed as a living document. Many people have expressed a desire for more detail with the RAS and we are exploring ways to assist the NBU to give more detail, without making the document too lengthy and too formulaic in its approach.

#### Project Work Plan through June 30, 2005:

We will deliver additional risk-based supervision seminars throughout the duration of our project, increasingly involved more personnel from the NBU as instructors. We expect to deliver at least five more seminars, in Kyiv and in regions, to a minimum of 100 participants through the end of the first quarter of 2005. At the end of the fourth quarter of 2004, we will initiate an update of our traditional risk-based supervision course to include feedback from seminar participants and different bank supervision functions to make sure that all RBS training in 2005 focuses on the most problematic issues, i.e. risk measurements tools, communication, individual risk categories. We will also explore distance-learning possibilities for the NBU regional staff.

We will develop recommendations for enhancements to the standard Report of Inspection and CAMELS rating policy based to match the findings and conclusions contained in the RAS. Our recommendations will be delivered in the fourth quarter of 2004.

We will continue to collect feedback from risk-based supervision seminar participants and on-site inspectors in order to provide recommendations for amendments to the RAS. Our recommendations will be delivered in the first quarter of 2005.



We will provide recommendations for improvements to the On-Site Supervision Manual, in order for the On-Site Manual to match the RAS, for at least two major risk areas. One of the risk areas will be credit risk, the largest risk in the banking sector.

#### Quarterly Update – December 31, 2004

Our project team collected feedback and data from our risk-based supervision seminar audiences. We used this feedback to adjust the training course material and we have initiated amendments to Risk Assessment System. We have highlighted the areas of most significant confusion with the assessment system and are adjust the matrix components, adding more detail where needed and eliminating certain items where possible.

We delivered three additional risk-based supervision seminars to 89 NBU participants during the fourth quarter of 2004, bringing the total to 385 persons trained. Please see the detail in section #4 below.

We discussed the overall approach to CAMELS ratings and risk assessments with Ms. Iryna Pozharska, and suggested amendments to the report of inspection to align risk assessments with existing CAMELS ratings.

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

#### Progress and Completions through June 30, 2004:

As stated above, the NBU Board of Directors approved the RAS on March 15, 2004. We have discussed several recommendations to NBU senior management regarding management information systems, connected with the RAS, including the supervisory strategy document and the Bank Dossier. The supervisory strategy document already incorporates external audit results.

#### Project Work Plan through June 30, 2005:

We will provide further, more comprehensive recommendations, for improving management information systems based on the RAS during the fourth quarter of 2004. This will include information that senior management of the NBU and senior management of the GDBS should have on a monthly basis to be informed of the financial condition and current trends in the banking industry.

#### Quarterly Update – December 31, 2004

We have provided additional feedback on the existing management information systems and the necessary management information systems for risk-based supervision objectives. We will continue to work closely with the working group assigned to management information systems, as part of the NBU action plan for risk-based supervision implementation. As noted earlier, the GDBS is quite good at collecting



information, but the GDBS and the NBU are not good at using the collected information in an efficient manner. The new supervisory strategy, bank “dossier” and risk assessment system allow for easier collection and usage of data by senior management in designing supervision strategies on an aggregate level.

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

#### Progress and Completions through June 30, 2004:

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

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

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

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

#### Project Work Plan through June 30, 2005:

The submission to Parliament of a set of draft amendments to the Banking Law is planed for the end fourth quarter. Taking into consideration the complexity of above-mentioned issues and large cultural hurdles in this area this dead line could be postponed.

#### Quarterly Update – December 31, 2004



Our legal advisors have provided assistance to the NBU Legal Department in the areas of corporate governance and risk management requirements. We are also assisting the NBU with research of international standards and guidelines in these areas, as support for Parliamentary approval. We should note, the confusion associated with the “Orange Revolution” caused Parliamentary issues relative to the banking industry to reach a standstill.

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

Progress and Completions through June 30, 2004:

Following advisory recommendations from BearingPoint, the organizational structure of the GDBS has been changed to reflect the evolution of risk-based supervision. A new, senior-level, position within the GDBS was formed for the purpose of risk-based supervision implementation. Mrs. Svitlana Farber heads this new unit, entitled “Department of Risk-Based Supervision Methodology and Planning.” Mrs. Farber is highly competent in this role. She and the Methodology Unit under her direction are our project’s closest and most valued counterparts. Without Mrs. Farber and Mrs. Iryna Pozharska, our project would not have the momentum for change that we now enjoy.

Our advisors developed a comprehensive, two-week risk-based supervision program for the GDBS. As stated earlier, we coordinated the organization and delivery of this comprehensive program for twenty (20) select persons from the GDBS in November 2003 as a train-the-trainer seminar addressing technical topics (as opposed to delivery techniques and teaching methods). The NBU Personnel Department and GDBS assisted with selection of the appropriate persons to attend this program covering the nine basic banking risk areas<sup>1</sup>. These same persons were also selected to attend another train-the-trainer course focused on presentation skills, sponsored by the World Bank’s Dutch Grant program. This select group is assisting our advisors to delivering a more concentrated three-day, case study program on risk-based supervision to a wide cross-section of GDBS personnel nationwide.

During the first half of 2004, we assisted the GDBS and the RBS Task Force with delivery of eleven (11) risk-based supervision seminars. The seminars were held in Kyiv (3), Zaporozhzhya, Cherkassy, Dnipropetrovsk, Donetsk, Kharkiv, Lvov, Crimea and Odessa. A total of 227 participants attended the 11 courses. The participants have been active in discussions and have voiced their concerns, positive and negative about the RAS. 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. 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. The three-day seminar is not a complete discussion of each individual risk area of banking operations. It is only designed to be an overview of the risk assessment

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<sup>1</sup> The basic banking risks are: credit risk, liquidity risk, interest rate risk, foreign exchange risk, price risk, operational risk, legal risk, strategic risk, and reputation risk.



system. A related project, through World Bank's Dutch Grant program, is implementing a training program on individual risk areas. All participants say more training and experience is necessary to fully implement this program.

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

With BearingPoint advisory assistance, Mrs. 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 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.

With BearingPoint advisory assistance, three persons from the GDBS participated in the course ("Credit Risk Management: Bankers and Regulators Perspective") organized by the Training Initiatives for Banking Supervision ("TIBS") of the National Bank of Poland during the week of May 29, 2003. One person from the GDBS (Mr. Oleg Kostiusko) made presentations on the Ukrainian bank supervision experiences and challenges, and two other persons from the GDBS also attended this forum. Our advisors have secured a more active "partnership" role with TIBS, which allows Ukraine to send more than the normal two participants per seminar.

#### Project Work Plan through June 30, 2005:

BearingPoint advisors will coordinate a one-week discussion between the National Bank of Poland and the National Bank of Ukraine covering the topics of risk-based supervision, planning processes and advancement risk management techniques with derivative products during the week of September 6, in Kiev. We have assisted the GDBS with the agenda items and the persons to be involved. 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. As can be seen above, our advisors have forged a stronger partnership between the National Banks of Poland and Ukraine.

Through the remainder of this project, we will assist with delivery of additional six to eight risk-based supervision seminars throughout Ukraine. Four to six of these seminars will be held in the third and fourth quarter of 2004, while the remaining seminars will be held in the first quarter of 2005. This will bring the grand total of seminars to 17-19 and the total number of participants will likely exceed 400.

In June 2004, the Basle Committee on Banking Supervision issued the "International Convergence of Capital Measurement and Capital Standards." The Basle Committee's capital requirements sets an international standard, which all banks and banking supervisors need to understand. We will assist the GDBS with a basic understanding of this document. We will develop recommendations for its implementation in Ukraine by the third quarter of 2004.

#### **Quarterly Update – December 31, 2004**

**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.**

**We coordinated and participated in a four-day seminar delivered by representatives of the General Inspectorate of Banking Supervision from the National Bank of Poland. The seminar covered the topics of risk-based supervision in Poland, a detailed assessment of credit risk monitoring and assessment tools, and the examiner accreditation process used by the National Bank of Poland. A total of 41 participants attended this seminar, representing different areas of GDBS. The National Bank of Poland is a closer peer country to Ukraine, and has overcome many of the difficulties that the NBU is currently experiencing. Establishing long-term relationships between a European Union country and Ukraine will have benefits lasting well beyond our technical assistance project. We believe that increased connectivity between Poland and Ukraine is a success story of our project.**

**We delivered three additional risk-based supervision seminars to 89 NBU participants during the fourth quarter. These seminars were held in Lviv, Sumy and Kharkiv. Overall, during 2004, 385 bank supervision employees have attended 16 RBS seminars in different regions of Ukraine. Importantly, the GDBS is teaching the majority of the seminar, indicating a higher degree of sustainability.**

**We prepared and delivered a summary of Basle II, including recommendations for its implementation in Ukraine. Our recommendations were attached to the September 2004 quarterly report. The final version of Basle II is well over 200 pages in length, not including materials that are merely included by reference in the text. This is an**



extremely complex issue that will take several years to finalize in Ukraine, as well as in Western countries. As our recommendations were well received by the NBU Acting Governor, we were asked to prepare speaking notes for his attendance at an international banking conference in Madrid, Spain.

5. *Legal Issues<sup>2</sup>: 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.)*

#### Progress and Completions through June 30, 2004:

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

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

#### Project Work Plan through June 30, 2005:

We will assist the NBU and its Legal Department in drafting future amendments to the Banking Law in the area of risk management and overall corporate governance of Ukrainian banks. Our resident legal advisor will work with the NBU's Legal Department on a continuous basis, while our temporary advisor will travel to Ukraine on two occasions for this purpose.

The NBU has requested legal advice in achieving better consistency with Basle Core Principles and with international practices in the areas of consolidated supervision, connected lending and related party exposures, and corporate governance. Our ex-pat legal advisor will return to Ukraine to assist our resident legal advisor in the second half of 2004, if necessary, and in early 2005 to address these issues further.

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<sup>2</sup> 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.)



## Quarterly Update – December 31, 2004

Our legal advisor has drafted amendments to the banking law to regarding risk management and corporate governance, and this has been presented to the NBU. Due to the political uncertainty through the fourth quarter of 2004, legal issues were sidelined by the NBU. Our short-term legal advisor will return to Ukraine in the second quarter of 2005 to again push this initiative.

**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 BSD develops a plan for compliance with the new regulations on risk-based supervision.*

### Progress and Completions through June 30, 2004:

In 2003, we assisted NBU senior management with development of a “Comprehensive Program for the Development of the Banking System of Ukraine for the years 2003-2005.” We have also drafted a comprehensive action plan for implementation of risk-based supervision throughout the NBU organization. These documents are used as the base of risk-based supervision implementation and development of the banking industry according to modern risk management concepts. We have assisted the NBU through research and participation in discussions with commercial bankers and with banking associations.

Our assistance with banking law amendments is targeted at ensuring the NBU has the authority to enforce changes in a bank’s operations if risks are excessive or if risk management systems are inadequate for the size and complexity of the bank’s operations. We are working closely with the NBU senior management and legal personnel on issues related to strengthening enforcement measures, ensuring that penalties for non-compliance are severe enough to warrant bank management’s attention in an appropriate manner. We are assisting the GDBS to develop an effective quality assurance program, to ensure banking supervision personnel are properly using the risk-based supervision concepts. Finally, our training program for risk-based supervision is designed to enforce these concepts and ensure at least basic understanding of banking risks.

### Project Work Plan through June 30, 2005:

We consider this area of our task order as technically complete, but our work is ongoing. We will continue to work with the NBU in the area of enforcement.

## Quarterly Update – December 31, 2004

**The requirements of this aspect of our task order have been met.**



2. *Diagnostic: NBU Bank Supervision Department (BSD) 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.*

Progress and Completions through June 30, 2004:

We have developed a questionnaire for commercial banks addressing various corporate governance and risk management issues. In order to achieve the best results, without fear of reprisal, the survey has been conducted on an anonymous basis. However, we do know that the majority of the top two tiers of banks have completed the survey, easily surpassing three-fourths of the banking industry's total assets. In each of the "banker roundtable" sessions we have conducted in 2004, we have discussed the aggregate results of the survey with senior management of commercial banks.

Project Work Plan through June 30, 2005:

The final "banker roundtable" sessions, for a total of nine, will be completed in July 2004. Following these sessions, we will prepare a summary of the results of the survey and deliver to NBU senior management. This summary will be included in the fourth quarter of 2004. We originally planned for finalization during the third quarter; however, we have delayed this to the fourth quarter of 2004 to add further detail. The total assets of all banks attending a banker's roundtable discussion was over US\$19 billion, or 83% of the total banking assets in Ukraine (using data of June 30, 2004).

Quarterly Update – September 30, 2004

We assisted the NBU with organization of the final banker roundtable session held on July 7-8, including a roundtable session for small banks on July 7 and for large banks on July 8. A total of 106 participants from 55 banks attended these final two roundtable sessions, bringing the total banking assets represented at roundtable meetings to nearly 85%. Overall, 258 participants from 123 banks attended these 9 roundtable discussions. We believe our project has assisted the NBU to spark more intense debate and discussion relative to risk management practices, and strengths and weaknesses, in Ukraine. From a previously developed and widely disseminated questionnaire, our project team has produced a summary of the various banking products and services being offered in Ukraine, and well as an overview of corporate governance and risk management practices.

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

Progress and Completions through June 30, 2004:

We have developed a matrix of the categories of banking risk, common methods of measuring those risks and our estimation of the level and direction of those risks in the Ukrainian banking system. We have also developed a similar matrix showing the major banking products and the major risks associated with each of those products. These items



have been used as handouts in our risk-based supervision seminars and will be delivered to senior management after refinement from banker roundtable discussions.

#### Project Work Plan through June 30, 2005:

Bankers have identified corporate governance weaknesses, particularly at the most senior levels of bank management and the supervisory board, as one of the most serious deficiencies in the Ukrainian banking system. This is in addition to general lack of information, “know-how” or access to training in the area of risk management. In order to improve this aspect of the banking system, our advisors will illustrate the matrices described above in more detail, focusing on the common methods of measurement of banking risks. We will also develop a handbook for supervisory board members, describing the items they should be reviewing and questions they should be asking of senior management during regular meetings. We will obtain feedback from all interested parties, including the NBU, the various bankers’ associations, and the commercial banks and we will make active use of quality products already developed in this area by USAID contractor Financial Markets International.

We will gather information and hold various discussion groups for the handbook layout and content through the remainder of 2004, and develop a first draft before year-end. We will finalize the product during the first quarter of 2005, and prepare for distribution. We will deliver presentations to interested parties in the second quarter of 2005.

#### Quarterly Update – December 31, 2004

We are developing guidance for use by inspectors, discussing key management information systems and reports to be prepared for senior management. We are also searching for actual examples of senior management reports to use as examples. Due to the propriety nature of management reports, obtaining examples for more wide spread distribution has proven difficult.

We continue to draft a supervisory tool that describes all significant banking products and services and their respective risks. To date, we have completed sections of this manual describing the following topics: inter-bank accounts, commercial lending, accounts receivable financing, commercial real estate lending, residential real estate lending, agriculture financing and international trade finance. We will develop sections dealing with bank investments in the first quarter of 2005.

*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.*

#### Progress and Completions through June 30, 2004:

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. As mentioned above, our



project will also develop of a second document specifically covering minimum requirements for management information systems, both at a senior management and a board of directors' level.

Project Work Plan through June 30, 2005:

Please see the work plan under item #3 (template of banking risks).

Quarterly Update – December 31, 2004

**Please see the work plan and accomplishments under item #3 in this section.**

5. *Risk-based Supervision Director and Committee<sup>3</sup>: The NBU designates 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.*

Progress and Completions through June 30, 2004:

A risk-based supervision task force was formed in 2002, consisting of the following NBU positions: "Head of Strategy, Planning and Coordination Division", "Deputy Head of Inspection and Monitoring Department", "Head of Banking Legislation Improvement Unit", "Director of Registration and Licensing Department", "Head of Methodology Division", "Head of Economic Analysis", "Head of Enforcement Action", "Head of Inspections Division", "Head of Monitoring Division", and "Head of Large Bank Monitoring Division." This task force has been instrumental in the development and review of training materials and for implementation of risk-based supervision, in general. The GDBS has created a methodology unit for risk-based supervision. This group is responsible for risk-based policy implementation issues. Our advisors have assisted this group in its formation and in establishing the unit's basic responsibilities and duties. We have proposed that the unit be divided by banking risks, with the head of the unit taking charge of supervision processes. The members of this methodology unit are actively involved in training initiatives and will be involved more activity in assisting the on-site inspectors to develop cross-cutting knowledge and skill sets.

Project Work Plan through June 30, 2005:

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<sup>3</sup> . As noted in previous work plans, 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 BSD through the implementation of "Risk-based Supervision".



We consider this area of our task order as complete; however, we will continue to focus our project's attention to the strengthening of this methodology unit. We will have ongoing contact and communication with this unit, as will be demonstrated in our quarterly reports.

#### **Quarterly Update – December 31, 2004**

**The requirements of this aspect of our task order have been met.**

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.*

#### **Progress and Completions through June 30, 2004:**

With assistance from our advisors, the NBU's Risk-Based Supervision Task Force has developed a comprehensive document titled "Methodological Recommendations on the Organization and Functioning of Risk Management Systems in the Banks of Ukraine." This policy manual has been developed with considerable input from the commercial banks and the bankers' associations of Ukraine. Although the document has not yet been finalized, all banks are keenly aware of its concept and have begun implementation of these recommendations. Discussion of this document is an integral part of our banker roundtable meetings. This drafting process has opened a new era of transparency for the NBU in its relations with commercial banks. The openness and transparency of this project has benefit both sides.

#### **Project Work Plan through June 30, 2005:**

We consider this area of our task order as complete, pending finalization and approval of this policy manual. More importantly, the policy manual is already functioning in the banking industry, even though not formally approved.

#### **Quarterly Update – December 31, 2004**

**The requirements of this aspect of our task order have been met.**

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.*

#### **Progress and Completions through June 30, 2004:**

The NBU is committed to improve the quality of external and internal audits in commercial banks, as can be evidence by amendments to the Banking Law. As briefly mentioned earlier, external audit issues were the part of the set of submitted draft amendments to the Banking Law. The law will require external auditors to bring to the attention of the NBU any matter



that they discover in the course of their audit, which could have a significant adverse impact on the bank. The auditors will be relieved of any obligation of professional secrecy when they furnish information to the NBU in connection with this requirement. Also, the auditors will be required to share their work papers and other materials with NBU representatives, if requested. We are confident that management boards of commercial banks are incorporating analysis and recommendations of internal and external auditors.

An Audit Certification Committee Policy has been adopted and the Committee established (based upon recommendations from Mr. Chuck Canfield, WB/Dutch Grant Advisor). The Committee includes nine member: five representing NBU, four from the Audit Chamber, and one from the non-bank financial regulator agency. The Director of the GDBS, Mr. Pushkariov was named Chairman and a Director of Banking Supervision Policy Department, Mrs. Faber, was named its Deputy Chairman. The Certification Committee of the NBU 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 completion of an accounting certificate program (i.e. 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. Our project continues to support the certification process for improvements in the audit industry.

#### Project Work Plan through June 30, 2005:

We consider this area of our task order as complete. We will continue to assist the NBU and GDBS in this area through amendments to the Banking Law.

#### Quarterly Update – December 31, 2004

**The requirements of this aspect of our task order have been met.**

**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.**

*1. Curriculum: The NBU GDBS develops a comprehensive, classroom-training curriculum for a set of core courses that all bank supervision personnel would be expected to take during their initial years in the Department.*

#### Progress and Completions through June 30, 2004:



The GDBS has developed a comprehensive, class-room training curriculum<sup>4</sup> for banking supervisors, which includes a set of core courses and a set of more advanced courses. The risk-based supervision seminar is listed as a core course in this curriculum.

Project Work Plan through June 30, 2005:

We consider this area of our task order as complete.

Quarterly Update – December 31, 2004

**The requirements of this aspect of our task order have been met.**

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

Progress and Completions through June 30, 2004:

Our advisors, in cooperation with the World Bank's Dutch Grant Program, have trained a group of seasoned supervisors to become classroom trainers. This training included twenty (20) supervisory staff, and took place in November 2003. This training included a two-week seminar, developed by our advisors, discussing all areas of banking risk and focusing on the technical aspects of risk management and risk-based supervision. The World Bank Program continued with the same group of people, delivering a one-week, "train-the-trainer" seminar on methods of classroom instruction. The persons who attended these seminars are already delivering portions of formal classroom training, although it remains questionable whether this is part of the "regular duties."

Project Work Plan through June 30, 2005:

We consider this area of our task order as technically complete. We will continue efforts to ensure that in-house training, in terms of development, delivery and participation, are made part of a person's core functions as a supervisor, not as an "extra item" when time permits. Enhancements to the training and development process are an integral part of our action plan for implementation of risk-based supervision, referenced earlier in this report. Senior management (Deputy Governor Shlapak) has indicated his concurrence with this concept; however, we await the change in practice.

Quarterly Update – December 31, 2004

**The requirements of this aspect of our task order have been met.**

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 BSD bank supervision staff (from Kiev and regions) during their first three years in the Department; successful ratings by supervisors*

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<sup>4</sup> The training program is embodied in "Resolution #153 On the Approval of the Concept of a Comprehensive Training Program for Bank Supervision Employees", dated April 25, 2002.



*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 BSD will administer from time to time.*

#### Progress and Completions through June 30, 2004:

This area of our scope of work has been the most problematic for a variety of reasons. The foremost area of difficulty is that training is mostly viewed as an item to be outsourced, not developed or delivered internally and training is viewed as an "extra item", only if a person has time to spare. Unfortunately, this attitude towards training leads to the unintended consequence of a general lack of training for on-site inspectors, who are the group needing the most training. The on-site inspectors rarely have "free time", thus they are not permitted to attend training and are certainly not given time to develop training materials for others. This is common for most central banks from the former Soviet Union, which stems from the historical role of banking supervision. Training is not a high priority in a compliance-based supervisory structure as decisions made by supervisors are objective in nature. Training and communication are the lifeblood of a risk-based supervisory structure, as decisions are more subjective in nature.

The training coordinator for banking supervision is in general agreement with the concept of accreditation; however, the NBU Personnel Department would like to form an overall career development plan for the entire NBU, rather than for each department. This is a relatively positive development for NBU staff members; however, this has also caused long delays, and in some instances roadblocks, in our implementation schedule as we do not have the resources budgeted for comprehensive assistance to the NBU as a whole.

Regardless of the hurdles mentioned above, we have made progress in this area. Accreditation is specifically mentioned in the comprehensive program for the development of the banking system of Ukraine for 2003-2005 and was included in our action plan for implementation of risk-based supervision, which was accepted by NBU senior management. As part of our risk-based supervision implementation, we have constantly stressed the need for a more comprehensive and formal training plan for all banking supervision personnel. We believe we now have an active counterpart in the area of accreditation, Ms. Farber, Director of Methodology and Planning. She is willing to push the accreditation program and to coordinate it with the NBU Personnel Department and she has elicited our support in terms of development of a specific action plan for the accreditation implementation. Mrs. Faber has also indicated that the NBU may have some flexibility in terms of compensation schemes in this area. As we now have a willing counterpart in this area, and have eliminated the majority of confusion with the NBU Personnel Department, we can move forward at a more rapid pace.

#### Project Work Plan through June 30, 2005:

We will review the existing NBU policies and procedures to gain a better perspective on the opportunities and threats that current legislation presents for our accreditation program. This will be completed in the third quarter of 2004.



We will develop sample test questions for validation of bank supervisor's knowledge and develop recommendations for administration of these tests as part of the accreditation program. We will test these questions with some pilot group to make sure that they are understandable and feasible. This will be complete by the end of 2004.

We will continue to assist the banking supervision training coordinator with drafting a policy on training and accreditation. Currently the NBU Personnel Department is working on the general human resource management and training policy that will cover all functions of the NBU. We believe this policy will be completed by the end of the first quarter of 2005.

#### **Quarterly Update – December 31, 2004**

As mentioned above, in September 2004 BearingPoint consultants facilitated discussion between the Training Unit of GDBS and the respective training and accreditation function of the National bank of Poland (NBP). During the four-day seminar conducted by the National Bank of Poland at the NBU, a separate training session was dedicated to the issues of training and accreditation process at the NBP.

BearingPoint provided further assistance to the GDBS in the fourth quarter, on the issues of policy development and practical implementation of the accreditation program. We discussed the human resource development process with the banking supervision coordinator, Ms. Khimich, and the roadblocks she encounters with the NBU Personnel Department. We are also planning a study tour for Ms. Khimich to visit the National Bank of Poland in 2005. We will attempt to include NBU Personnel Department management on this tour as well.

#### **IV. Surveys, Assessments and Ad-hoc Assistance**

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

#### **Progress and Completions through June 30, 2004:**

We completed the first of two surveys of the gender composition of staff in August 2002, as required.

#### **Project Work Plan through June 30, 2005:**

We will complete the second of two surveys of the gender composition of staff during the second quarter of 2005. We will follow the format and layout of the first survey for comparative purposes. This survey will be included in the final report mentioned below.

#### **Quarterly Update – December 31, 2004**

We did not perform any activity related to this benchmark in this quarter.



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

Progress and Completions through June 30, 2004:

Our project has performed Basle Core Principles reviews in the past, and our advisors are keenly aware of the weaknesses in this area for the NBU. We are focused on improving the NBU's adherence in many areas with a particular focus on risk management, connected lending, and consolidated supervision.

Project Work Plan through June 30, 2005:

Ms. Karen Wilson will perform a Basle Core Principles review in the second quarter of 2004. As she has completed such reviews in Ukraine on previous occasions, this will improve the efficiency of this review process. Results of the review will be presented to NBU senior management and to USAID officials.

Quarterly Update – December 31, 2004

**We did not perform any activity related to this benchmark in this quarter.**

3. *Obtain an average examination rating of the "M" component of CAMELS for Tier 1 and Tier 2 banks.*

Progress and Completions through June 30, 2004:

We completed the first of two surveys of the "M" components in CAMELS during June 2003, as required.

Project Work Plan through June 30, 2005:

We will complete the second of two surveys of the "M" component in CAMELS during the second quarter of 2005. We will follow the format and layout of the first survey for comparative purposes. This survey will be included in the final report mentioned below.

Quarterly Update – December 31, 2004

**We did not perform any activity related to this benchmark in this quarter.**

4. *Ad-hoc Assistance Items*

Quarterly Update – December 31, 2004

We assisted the NBU with researching prudential controls over foreign currency lending for residential mortgages. Fixed rate, long term lending does not exist in Ukraine, which brings some level of interest rate risk to mortgage clients as their payment could change dramatically on a year-to-year basis. This is compounded by the fact that many persons also borrow in foreign currencies. A loan in foreign currency



typically carries a much lower interest rate than domestic currency loans. The NBU has concerns with the potential volatility in residential lending, as a result of these risks.

Mr. Kutsenko participated in the Seminar on Credit Risk Transfer held by Financial Stability Institute together with TIBS in Warsaw, Poland, in September-October. Mr. Kutsenko will be using gained knowledge to widespread best international practice in respect to credit risk mitigation.

We have delivered two presentations and participated in the 3rd Eastern European Risk Management Forum held in Kiev, in October. Mr. Stirewalt and Mr. Kutsenko spoke about Risk-Based Supervision and Ukrainian Risk Management Practice Survey, respectively. Mrs. Faber represented the National Bank at the Forum.

Mr. Stirewalt prepared a series of overviews for USAID and US Treasury concerning the period of financial turbulence in Ukraine after the second round of presidential election.

## **V. Other Administrative Items**

### Exit Strategy

USAID's technical assistance program to the GDBS of the NBU will end on June 30, 2005. Per request from the NBU Governor, we will keep our resident advisor for a longer period. For the final six months of this project, Mr. Alex Kutsenko will be the project director with short-term assistance from the following ex-pat advisors: Mr. Bryan Stirewalt, Ms. Karen Wilson, and Mr. Gary Gegenheimer.

By the end of April 2005, we will develop a full inventory of equipment purchased with USAID funding. We will divide the inventory by its final disposition: worthless items for disposal; items to be transferred to USAID or other USAID projects; and, items to be transferred to the NBU. All equipment will be transferred by June 30, 2005.

By the end of May 2005, we will complete an update to the most recent Basle Core Principles Assessment discussing progress made to date, paying particular attention to risk-based supervision and risk management practices in commercial banks. This assessment will be discussed with senior management of the NBU and will be included as an attachment to the final report mentioned below.

By the end of May 2005, we will transfer all intellectual capital items (i.e. training courses; supervisory tools; recommendations; and key translations of international standards or practices) to the NBU.

On or before July 15, 2005, we will deliver a final report to USAID with a summary of progress in each of tangible results and illustrative tasks mentioned above. The report will include lessons learned, continuing problems and bottlenecks with technical assistance at the NBU, strengths and weaknesses of the banking supervision function, the health and



continuing problems in the Ukrainian banking system and a discussion of potential follow-on work needed in Ukraine, and more generally in the region's transition economies.