"AN EVALUATION OF USAID/UKRAINE BANKING SECTOR ACTIVITIES 1995-2000"

Submitted to:

USAID/Ukraine

Contract: AEP-I-00-00-00023-00
Task Order NO. 801

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April 13, 2001

Mr. Boris H. von Hoffmann
Senior Banking Advisor
USAID/Ukraine, Belarus and Moldova
19 Nizhny Val Street
04071 Kyiv, Ukraine

Re: OUT-AEP-I-00-00-00023-00, Task Order No. 801

Dear Mr. von Hoffmann:

Enclosed please find two copies of the Development Associates Team Report entitled "An Evaluation of the USAID/Ukraine Banking Sector Activities 1995 - 2000." In addition, we enclose one unbound copy and a diskette. You should have previously received a complete copy via e-mail.

Development Associates and the team, Kornelis Walraven and James Wright, wish to express our thanks to you and to USAID/Ukraine. We are very pleased to have had this opportunity to assist you in your efforts to reform the Ukraine banking sector.

Sincerely,

Peter B. Davis
President

PBD:jsa

Enclosures: As stated

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EXECUTIVE SUMMARY

1. Objective

This report is the result of efforts undertaken to evaluate progress made with USAID assistance towards achieving USAID's Strategic Objective 1.4, A More Competitive and Market-Responsive Private Financial Sector. Specifically, the evaluation focuses on those activities aimed at achieving Intermediate Result 1.4.1, the development of a market-oriented private banking sector.

USAID has directed its technical assistance to Ukraine's banking sector on three principal components: (i) developing banking supervision and regulations; (ii) promoting transparency in banking by introducing IAS; and (iii) strengthening human resources through training bank examiners and banking staff. Within this context, USAID contracted with several U.S. consulting firms to undertake in-depth the following six technical assistance and training programs with their respective Ukrainian counterparts:

Program I: *Banking Supervision and Regulations* (the Barents Group/NBU)

Program II: *Introduction of IAS, Internal Auditing and Management Information Systems* [International Business & Technical Consultants, Inc. (IBTCI)/Aval Bank and other Kiev Banks, NCTBP]

Program III: *Training of Bank Staff* (the Barents Group, IBTCI/NTCBP)

Program IV: *Training of Bank Examiners* (the Barents Group/NBU)

Program V: *Training of Bank Management* [the Barents Group/International Management Institute (IMI)]

Program VI: *Commercial Bank Restructuring* [Booz-Allen & Hamilton (BAH), Inc./ NBU, Aval Bank, Ukraibbank, Kharkiv]

All Programs were initiated around the mid- or late-1990's and have been either completed or are scheduled for completion before end-2001. This report, covering the evaluation of the six Programs, was undertaken under a contract between USAID and Development Associates, Inc. The evaluations and subsequent recommendations are based on a review of the contractors' written reports and on interviews with contractors' representatives in both the U.S. and Kiev; with representatives, managements and staff of the counterparts, and with representatives of various Western donor institutions in both the U.S. and Ukraine acquainted with but not directly involved in the project.

II. General Observations

The main observation of this report is that the contractors of the six programs have done a by-and-large thorough and professional job despite frequently (depending on the program) encountering frustrations resulting from misunderstandings or lack of cooperation on the part of the Ukrainian counterparts. It should be understood that the objectives and philosophical foundations of the Programs usually required fundamental changes in the mindsets of the Ukrainians. Given the almost daily contacts and close working arrangements between the two sides, plus a considerable sense of urgency to reach a rather quick and successful completion of the programs (deadlines!), it is not surprising that the cooperation and coordination between the two cultures did not always result in optimum productivity. Yet, it has become obvious that considerable progress has been achieved, both in terms of acquisition of modern technical skills by Ukrainian bank staff and managements (including those of NBU) and in moving toward acceptance – and use – of Western approaches in managerial decision-making (e.g., greater use of planning, marketing, and quantitative analysis). There is no doubt that especially the mid-level staffs have accepted a market-oriented philosophy, which bodes well for the future of Ukraine's commercial banking sector. However, significant changes in this direction will require time. Top-level managements at many of the commercial banks as well as at NBU, have generally not benefited from exposure to Western business philosophies and management approaches through participation in seminars, workshops, etc. are less eager to embrace fundamental changes in their current ways of conducting their business.

Training. A major observation has been the pervasive use of formal training throughout all six programs. The two most successful ones in terms of acceptance by participants and the latter's application of their newly acquired skills in their jobs are probably the ongoing NCTBP and IMI programs. It is therefore extremely important that they continue as crucial ingredients in the ultimate establishment of a viable and efficient private-market economy.

III. Program Evaluations and Recommendations

This section summarizes the results of the evaluations of the six Programs as discussed in greater detail in the main body of the report.

Program 1: Bank Supervision and Regulations.

1. During the 1990's the NBU has received substantial technical assistance from a number of Western donor agencies, including the World Bank, IMF, Western central banks, and USAID. Areas of concentration have included international accounting standards (IAS), bank supervision (including on- and off-site inspections), managerial reform, and investment in informational technologies. Progress in these areas was noted, but has remained insufficient to meet advisors' targets.

2. In 1999, the IMF conducted an assessment of Ukraine's compliance with the Basel Core Principles. NBU was compliant or largely compliant in 14 of the 25 principles. ("Materially noncompliant," "noncompliant", or "not applicable" in the remaining 11 principles). Since the IMF findings, additional progress has been made, including the passage of a new banking law in late 2000. Areas that still need major attention include the full adoption and implementation of IAS accounting standards in consolidated bank reporting and in the treatment of contingent liabilities; the resolution of problem bank issues (e.g., liquidations); and NBU's application of internal auditing standards.

3. For the period 2002-2004, it is recommended that USAID fund both short-term and long-term advisors to assist in the implementation of the new banking law, in development of a problem bank strategy, and in the development of expertise to manage problem banks.

Program 2: Introduction of IAS, Internal Audit and Management Information Systems.

1. Considerable progress has been achieved in introducing an "IAS-based" accounting system throughout the Ukrainian banking system. Deficient areas: (a) see under 2. above; (b) application of IAS-based standards by commercial banks (banks have avoided it so far).

2. Quality of internal auditing by banks remains unsatisfactory, the main reasons being (a) banks' failure to consider the issue a high priority; and (b) a lack of oversight and adequate monitoring by the NBU.

3. The reaction to the introduction of MIS by the commercial banks has been disappointing so far. Reasons: (a) a general lack of interest among the banks; (b) an insufficient MIS training capacity:

it is a big country-wide project, there is a lack of training-of-trainers potential, and the Program expired at the end of 2000.

4. Recommendations include: (a) phase out existing IAS training programs using expatriate advisors and relying exclusively on training provided by the NCTBP and other Ukrainian educational institutions; (b) introduce short-term training by advisors on remaining IAS issues (consolidation, contingent liabilities); (c) introduce short-term training on all internal audit standards (see internal audit manual) throughout Ukraine and assist in establishing internal audit departments at banks without them. **Stress use of Training- the-Trainer approach in providing assistance.**

Program 3: Training Bank Staff.

1. This is one of the most successful programs. With establishment of NCTBP in 1993, the Barents Group has done an excellent job in guiding the Center until its independence from USAID in 1999. IBTCI's contribution in the areas of IAS, Internal Audit, and MIS has been equally impressive, given its efforts outside of Kiev, including the introduction of training programs in local educational institutions. In the case of IBTCI's programs, however, there was on several occasions a lack of interest on the part of bank staff participants.

2. With NCTBP doing well on its own, there is no need to consider at this time further assistance. However, IBTCI's areas of activity do need continuing support. Short-term focused training programs, specifically in internal audit and in the applications of MIS are desirable and needed.

Program 4: Training of Bank Examiners.

1. The bank examiners training program, despite strong efforts by the Barents Group advisors, has failed in its objective to establish a sufficiently large and well trained corps of bank examiners. Basic reason: NBU's unwillingness to allocate adequate financial and human resources to this objective. Consequence: failure to establish a formal training program as proposed by the Barents advisors.

2. It is recommended that efforts to have NBU agree to a formal training program be continued. Future efforts may have a greater chance of success with the IMF's demands to have NBU comply with the Basel Principles. Also, without a formal training program, an accreditation process cannot be meaningfully developed and implemented.

Program 5: Training *Bank Management.*

1. Consisting of IMI's MBA in Finance program and established at USAID's initiative by the Barents Group in 1996, this Program must be considered the most successful of the six being evaluated. Interviews with graduates show high-quality individuals comfortable with and committed to the philosophies of a private-market economy and well-trained in western financial and business concepts and techniques.

2. IMI's – and the MBA Program's – longer-term viability and success depend on a continuous upgrading of curriculum and faculty. USAID's current plans to terminate its association with, and part-funding of, IMI by mid-2002 will come at a particularly inconvenient time. IMI needs an increase in funding assistance as well as an increase in its donor base. USAID should seriously reconsider withdrawing from a most successful project.

Program 6: Aval Bank Restructuring Project.

1. The Project's progress has been in line with the requirements set forth in its Commitment Letter, thanks to a highly cooperative approach between bank and advisors. The bank's staff has gained considerable skills in such areas as programming, in-house monitoring, credit policy, and cost profitability. Important progress was also made in the areas of capital adequacy, asset quality and management. Further progress is expected at least until the end of the current contract.

2. There is no doubt that the lessons learned in the Program can be profitably extended to the general banking community. Also, it is also clear that NBU supervisors have gained valuable experience from the Aval project on how to design remedies for corrective actions in the case of other banks.

3. Given the recognized benefits of using commitment letters as enforcement tools, it is recommended that greater use be made of them in the enforcement process. In connection therewith, it is also recommended that a forum be held by donor agencies and the NBU on the use of commitment letters. In addition, it is recommended that, on the basis of the Aval experience, training models be designed in such areas as risk assessment and management, asset and liability management, and credit policies and procedures.

This evaluation was conducted by a Development Associates team of two banking experts: Kornelus Walraven, Team Leader and James Wright. The team worked on site in the Ukraine during the period February 26 to March 30, 2001. In carrying out the work, the team used a variety of methods including document review, individual and group interviews, informal focus groups and rapid appraisal. The team provided a debriefing to USAID officials prior to departure from Ukraine.

Because of the nature of this very large USAID effort, the report deals with most USAID questions in the context of the of the six funded programs. These sections each include a discussion of the program, the team evaluation, recommendations, and a recommended future scope of work. Two other cross cutting sections are also included: at the beginning is an overall report on the state of the Ukraine banking sector, including an assessment of USAID impact, and at the end recommendations are included for increasing business lending.

Five appendices are included for readers wishing more details.

The team wishes to thank USAID for this opportunity to contribute to their efforts to reform the Ukraine Banking Sector.

THE UKRAINE BANKING SECTOR

The Ukraine banking industry consisted of 199 registered banks, but only 160 are active (i.e. had licenses to conduct banking activities). The other 39 had their licenses revoked since they did not meet the National Bank of the Ukraine (NBU) capital requirements or other standards. As a whole, 69 banks were considered by the NBU as problem banks (not included are Government owned banks). There were 30 banks with foreign shareholders (8 banks with 100% foreign ownership). Two banks (Oshchadny Bank and Ukreximbank are entirely government- owned.

Based on total assets, all banks can be divided into three main groups

- Eight large banks with assets exceeding UAH 1 billion
- Thirty-two second tier banks with assets of UAH 100 million or more
- One hundred twenty Small Banks with assets of less than UAH 100 million

The 160 banks and 1,506 stand-alone branches are distributed throughout the Ukraine's regions unevenly. About 15% of banks and branches were located in Kiev and in Kiev Oblast. Another 6% are located in the Autonomous Republic of Crimea, 7% in Dnipropetrovsk, 8% in Donetsk and 7% in the Kharkiv Oblast. Dispersed throughout the other regions of the Ukraine is the remaining 57%. The most economically active and prosperous regions requiring more banking services are in Kiev and the Southeastern part of Ukraine.[1]

Banking Sector Performance

During the past year the Ukrainian banking system has felt the impact of three changes in the domestic economy: firstly a reorientation on the retail sector of the economy; secondly, a reduction in barter operations; and thirdly a serious battle with the flight of capital overseas and with covert cash conversion operations along with simultaneous strengthening in bank supervision.

During the year 2000 the total profit of active banks plunged by HR 497 mmn or 97% from 513mm in 1999 to Hr 16.mm in 2000. This sharp reduction in profits was explained by the NBU as a reflection of the rise in bank administration overhead, expenditures for the formation of reserves against loans and the staggering burden of losses of certain problem banks, the biggest ones being Slovianskiy, Ukraina and Oschadny. Under pressure from the NBU, commercial banks began putting together solid reserve funds against risky transactions, which tied up a considerable amount of their operating capital. This all had a positive impact on the stability of the Ukraine financial system as a whole. In addition to contributions to banks' reserve funds, banks' also had to contribute to a fund to insure private depositors. While banks may not have posted serious profits, banks were receiving significant revenues with overall assets grew.

Commercial bank credit to private enterprises increased in 2000. Banks assets grew by14 percent in real terms. Credit to private enterprises rose from 45 to 50 percent of total bank credit. Privately owned banks made significant progress in increasing their market share. The ratio of combined total assets of private-owned banks compared to government owned increased to 100 percent, up from 35 percent in 1995 and 482 percent in 1999. [2]

[1] Verchenko, Olesia, Overview of the Banking System in Ukraine, Kiev, Ukraine, Summer 2000.
[2] "Down and Up the Staircase", Eastern Economist, February 26 – March 4, 2001, p. 19.

Banking Sector Service to the Economy

The volumes of finance which the sector has been able to intermediate and make available to the private non-bank sectors in years 1996 to 1999 has averaged only 0.9 %. This is equivalent to only about UAH 1 billion or $200 million annually. The banking sector is inadequately serving the needs of the economy. In quantitative terms the contribution of credit to the whole economy averages only about 1.1 % of GDP. This figure compares to 9.6 in Estonia and 7.2% in Hungary. The involvement of banks in the payment system is also far lower than normal in a well-functioning economy. This is because payments are in cash or via non-payment barter arrears; mutual-offsets are far more prevalent in Ukraine. Ukrainian banking is generally high cost. Large banks, especially state owned and former state owned banks have very high operational costs due to large staffs. Additionally, all banks cannot achieve effective diversification of assets and liabilities and fully serve the Ukraine economy. [3]

Banking Environment

A major contributing factor to inadequate performance is the hostile environment where financial institutions are forced to operate. The table on the following page depicts the Ukraine environment. [4]

Failed Banks

Thirty-eight banks are in liquidation, and with the introduction of new capital standards for banks, it is foreseen that many smaller banks, which will not meet these standards will be closed by NBU.

USAID STRATEGY

USAID's Objective 121-014, a more competitive and market-responsive private financial sector has, been pursued over the last six years through a series of programs to strengthen both the NBU and commercial banks. These strategies have been mildly successful in bringing both NBU and the banking sector to meeting USAID's objectives. USAID will have met its objectives of a more competitive and market responsive private financial system when the three conditions below are in place in the Ukraine financial sector:

1) A market-oriented legal and regulatory framework is in place, requiring sound practice by financial intermediaries and securities issuers dealing with customers/shareholders.

2) Institutions and practices which effectively enforce the protection of investors' rights.

3) The financial market infrastructure is developed and effectively allocates investment.[5]

USAID objective 3 has not yet been met and therefore additional USAID resources are needed to realize this objective. Recommendations for meeting the objectives are contained in each of the following 6 program presentations.

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[3] Roe, Alan., Ukraine: The Financial Sector and the Economy: The New Policy Agenda, World Bank, September 2000, p. 13.
[4] Ibid. p 17 -18
[5] USAID SO Text for 121-04: A More Competitive and Market Responsive Private Sector (Draft, February 28, 2000)

Table: Diagnostics of the Ukrainian Banking Sector's Disfunctionalities According to the Major Causes[6]

Causes	**Symptom No 1** No Price for money. No risk-free ('safe') instrument	**Symptom No 2** Non-level playing field for banks	**Symptom No. 3** Inadequate protection of Creditor's Rights	**Symptom No. 4** High cost of banking due to regulations	**Symptom No. 5** The overwhelming weight of barter and arrears	**Symptom No.6** Not enough creditworthy customers	**Symptom No. 7** No client trust in the banking sector	**Symptom No. 8** Poor and narrow product range and quality	**Symptom No. 9** Slow restructuring of banks
The government generally plays its role badly	Unreliable behavior of government in relation to Tbill and veksel obligations. As a result Tbills have lost their function as low risk instruments. The absence of transparent debt management strategy to inform markets.	Allocation of cheap government budget funds to banks with 'proper ties'. Unresolved directed credits in some banks. Unpaid government capital contributions in others.	Retroactive government regulations create great uncertainty.	High taxation of banks. Taxation at the branch level of banks is in particular need of reform.	Government itself is active in accepting barter and manual settlement of tax obligations. It fails to act sufficiently against energy arrears.	Complex and arbitrary system of State subsidies to non viable sectors and enterprises. (see Ch. 3) Slow pace of privatization.	The existence of Kartoteka. Many enterprise clients of banks lose control of their own accounts.	Banks offer very limited range of products	The state still saves banks that should have been liquidated long ago due to inadequate capital, poor management and other factors.

[6] Roe, Alan, Ukraine: The Financial Sector and the Economy; The New Policy Agenda, World Bank, September 2000.

The NBU has major gaps/weaknesses in the environment that it helps to create.	NBU should make stronger efforts to foster inter-bank markets.	No transparent rules of refinancing and withdrawal of licensing, no automation in liquidation processes.		17% reserve requirement in local currency is high. It also punishes banks with FX deposits.	There is no back list of non-paying companies. So it is harder for banks to know who are the poor credit risks.		Minimum capital requirements are still too low, consolidation of banks not enforced.		
The legal environment has numerous short - comings	No law for promissory notes and bills of Exchange. Contract enforcement is unlikely to be taken seriously until the Government honours its own obligations.	No law for public procurement of banking services. Central Treasury for government funds not yet functioning.	There is no law for the assignment of liquid collateral. Great confusion in registration of company ownership. Total lack of transparency of shareholders.	No requirement for the publication of prices of banking services. (Truth in Lending Act).	Improper/ weak enforcement of bankruptcy law.	Slow pace of accounting reform in the enterprise sector. It is hard to evaluate potential borrowers.	No effective law for Deposit Insurance.	Missing legislation reduces the instruments that banks can use. Examples: Land cannot easily be used as collateral.	
Other parts of the infrastructure are missing or weak			Multiple registries increase costs and enhance confusion. There is no central depositary.		Weak judicial system.	Insufficient supply of professional accounting skills and local companies.		No system for licensing and independent inspection of warehouses. No cadastre registration system.	Functioning asset markets do not exist – assets cannot be properly valued. No asset resolution agency exists or can easily function.

PROGRAM 1: BANKING SUPERVISION AND REGULATION

Consultants: KPMG Barents
Contract Number 121 – C 00-98-00628-00

I. PURPOSE AND BACKGROUND

Beginning in 1995, KPMG Barents under contract with USAID, initiated technical assistance to the National Bank of Ukraine in the areas of: on-site and off-site supervision; improved reporting, problem bank resolution, policy and management advice to senior managers and drafting of regulations and new banking law. The goal of this assistance was to establish the legal, regulatory and policy framework for a sound and competitive banking system. Beneficiaries of these activities include all those involved in the private sector, including enterprises and households that need access to finance.[7]

Bank supervision established under an independent Ukraine took place under a new law in 1992. Little had changed from the old system of bank inspections which consisted of a physical recount of bank information and recalculation, no more than a bookkeeping function. Staff of NBU conducted little or no analysis of risk. An off-site examination received information from both banks and external auditors.[8] Examination staff also found themselves resolving disputes between banks, clients and shareholders.[9]

Phase One (1995-98)

Barents technical assistance during the period 1995 – 98 consisted of six major activities development of an onsite supervision manual, on-the job training, off site supervision, assistance during examinations advice to management, assistance in drafting procedures for dealing with problem banks. Barents consultants were assisted by short-term advisors from the Financial Services Volunteer Corps. As in most bank technical assistance projects, development of the on site supervision manual was key. The development of the skills of the on-site supervision staff was critical as NBU attempted to assess the true financial condition of the banking sector. The manual was based on western bank examination standards and procedures and development of it took place over an extended period of time.[10] On-the-job training was both formal and informal with some during actual bank examinations, with Barents consultants participating in examinations. (See bank examiner training). At the same time information technology consultants provided formal and on the job training to NBU information technology departments in software development for off-site supervision.[11]

Policy development and NBU management was a second important area where consultants advised. For example, consultants recommended that NBU place greater reliance and resources on on-site examinations rather than off site reporting. These management recommendations included reorganization and staffing of departments as well as development of improved reporting and communication.[12] They assisted with designing organization charts, writing functional responsibilities and advised on selection of personnel to fill important managerial roles.[13] For example, in 1996 NBU formed the problem bank division and Barents advisors worked with management on preparation of directives on enforcement actions and commitment letters, which were guidelines to be used in dealing with problem banks. Later

[7] Barents Group, National Bank of Ukraine Financial Infrastructure Development Bank Supervision, Quarterly Report for Quarter Ending December 31, 2001, December 2001.
[8] Interview with Glenn Casky, Advisor, Barents, Kiev, Ukraine, March 2001.
[9] Interview with Igor Y. Goryachek, Deputy Director, General Department of Bank Supervision, NBU, Kiev, Ukraine, March 21, 2001.
[10] National Bank of Ukraine, Policy Guidelines for Onsite Bank and Banking Institution Examinations in Ukraine, National Bank of Ukraine, Department of Onsite Inspection, December 30, 1996.
[11] Ibid. Barents Group p.
[12] Glenn Casky, Op.cit.
[13] Barents Group Op. Cit.

an enforcement manual was developed by Barents for use at NBU.[14] Consultants advised NBU on greater use of written warnings and commitment letters and less use of fines. Fines had been considered by banks as a cost of doing business. In year 2000, NBU issued 282 written warnings, 62 commitment letters and 223 fines.[15] NBU has steadily improved risk and solvency problems, and is using more appropriate measures against problem banks. However for those banks in the liquidation stage, NBU has lagged with several large institutions requiring action. This is in part because of lack of political will and also because of a lack of funding and more innovative methods of dealing with failed institutions. With sufficient political pressure and the introduction of both funding and technical assistance Ukraine can successfully solve the failed bank problem.

Phase Two 1998-2000

During 1998 Barents continued to develop examination manuals and prudent regulations. The Enforcement Manual was developed to identify appropriate use of enforcement actions to force banks to take steps to correct problems. As part of ongoing advice to NBU, Barents advisors have assisted in shaping enforcement policy so as to encourage use of those enforcement mechanisms which bring about desired results, and discourage burdensome bureaucratic measures or measures which have little effect upon improvement in bank performance or corrective actions.[16] A problem bank manual was developed by advisors to prescribe appropriate action to be taken for all degrees of problem banks. Alternative approaches discussed include mergers and acquisitions, divestitures, debt for equity swaps, conversions restructuring and reorganizations, rehabilitation and sales and write-offs. Prudent regulations were developed in such areas as interest rate risk and loan provisions.[17]

In 1998 Barents examiners developed a diagnostic and together with examiners from European countries conducted examination of the 7 largest Ukrainian banks. The results of these diagnostics and exams was the signing of commitment letters in 1999 between NBU and individual banks on steps to be taken to improve the banks operations. Today these banks have met most of the requirements of the commitment letter and are performing better. In July 2000 the NBU Board introduced a new policy on a procedure for formation and usage of loan loss reserves by banks. The loan loss reserve is a special reserve necessitated by credit risks inherent in banking activity. This policy developed by Barents advisors increased the safety and soundness of the Ukraine banking system[18]

In December 2000 NBU Barents submitted for approval a revised CAMELS rating system, which places emphasis on six key components: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market risk. Such a uniform rating system is used by examiners during exams helps identify those banks whose financial, operational and managerial weakness constitute a significant risk of failure and require special supervision attention or, if necessary, NBU intervention to deal with serious weakness. Barents continued to provide management advice in the reorganization of NBU. They assisted with designing the organization chart, advising and writing functional responsibilities and advise on personnel to fill important managerial role.

In January 2001 a new banking law (Law of Ukraine on Banks and Banking) was adopted to build confidence in the banking sector and promote its financial intermediary role. Many of the recommendations were made by Barents advisors. The law defines the types of banks to be admitted in Ukraine and sets out requirements and standards concerning their management structure as well as operational and financial policies. Bank supervision is strengthened by new requirements for capital

[14] National Bank of Ukraine, Enforcement Manual of the National Bank of the Ukaine (Draft), Barents, 2000.
[15] Interview with Glen Casky, Kiev, Ukraine, March 26, 2000.
[16] Barents Group Op. Cit
[17] National Bank of Ukraine, Problem Bank Unit Manual. National Bank of the Republic of the Ukraine, December 2001.
[18] National Bank of Ukraine, Policy on the Procedure of Formation and Usage of the Loan Loss Reserve by Banks, August 3, 2000.

reserves and risk management. Most important, the law strengthens the role of NBU in dealing with problem banks enforcement actions, establishing provisional administrators and liquidating banks.[19]

II. PROGRAM EVALUATION

In addition to interviews with consultants, donors and Ukraine officials, two evaluation reports on the Ukraine banking sector were helpful in evaluating results of Barent's technical assistance. The first was Assessment and Rating of the Ukraine Banking System conducted by Michael Borish and Company, Inc. and Triumph Technologies in April –May 1998 which included regulatory and supervisory capacity in addition to 27 other factors. While the score of "2" indicated the sector was inadequate and weak with significant improvement needed as well as major potential for destabilization via systemic risk, a detailed explanation provided more favorable judgment:

> Ukraine is at the beginning of a long process dedicated to building effective regulatory and supervisory capacity for the banking system. There are several strong points to efforts achieved to date, largely with donor assistance. These include development of an ambitious strategic plan for the NBU's banking supervision department, an increasing clear mandate for supervision to enforce regulations, introduction of new regulations which get prudent norms closer to international standards, movement toward adoption of IAS for the generation of more meaningful information, investment in information technologies to assist with timely flow of information, improvements in the organizational structure of banking supervision to encourage better coordination of information and policy , and an integrated supervision approach which leverages off of a combination of onsite inspections and off –site surveillance. These are all positive steps forward which, in due time, should strengthen the institutional capacity of the NBU to monitor for risks in the banking system as banks themselves engage in riskier activities. It is particularly important that donor support be sustained in these areas to help NBU address existing risks, to plan for contingencies, to contain future risks, and to generally build capacity. It is likely that the emergence of a banking crisis would be exacerbated by the curtailment of such needed support. There are still many weaknesses with regard to regulations and supervisions. New regulations have recently been introduced, and it will take some time for banks to effectively adapt. In some cases, such as minimum capital, regulations support the existence of very small banks, which may add to the cost of supervision. Additionally, it will take time before sufficient human capital is developed to ensure supervision is able to identify, evaluate, monitor and contain risks in a timely fashion. However, significant progress is being made with the provision of technical assistance for on-site inspections, off site surveillance and general policy coordination. These are all necessary building blocks for effective supervision. If the supervisory function is indeed weak, the trend is favorable as long as support is sustained. [20]

This statement summed up both the challenge and extent of progress made in the supervision area by mid 1998.

In 1999 the progress of bank supervision and regulation was evaluated by yet another assessment, the International Monetary Fund's Core Principles Assessment of Ukraine. The Core Principles for Effective Banking supervision were developed by the Basel Committee on Banking Supervision in 1998. The Core Principles were issued by the Basel (Bank for International Settlements) Committee in September 1997, and endorsed by the international financial community during the annual meeting of the IMF and World Bank in Hong Kong in October 1997. [21]

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[19] Law of Ukraine on Banks and Banking, January 2001.

[20] Michael Borish and Company, Inc. with Triumph Technologies, Inc., An Assessment and Rating of the Ukrainian Banking System, USAID Bureau for Europe & Newly Independent States, Office of Privatization & Economic Restructuring, Summer 1998, p. 5.

[21] Basel committee, Core Principles Methodology, Committee on Banking Supervision, August 1999.

The assessment of Ukraine's compliance with the Core Principles was conducted in 1999 by a team appointed by the IMF. A five- part assessment system is used: compliant; largely compliant; materially noncompliant; noncompliance; and not applicable. Ukraine was found compliant with 3 of the 25 core

principles, and largely compliant with 11. (18) It was pointed out in a memo from Barents Senior Advisor to NBU that many of the principles rated noncompliant were in error because of ongoing efforts underway by NBU to achieve compliance. Three additional principles were viewed as largely compliant. These efforts included new prudent regulation and introduction of a new banking law.[22] Given the number of improvements instituted since 1999 it is fair to state that compliance with many of the Core Principles has increased significantly.

Barents technical advice has been rated high quality by NBU and other donor Organizations. As an advisor, Barents consultants have been vigilant in following up on there recommendations. Reminding NBU of consequences of failing to adopt certain recommendations. For the most part Barents has been able to maintained good coordination with World Bank IMF and TACIS. They meet and exchange information and coordinate some activities. But TACIS donors have failed to exchange information on the bank restructuring pilot projects or agree on approaches to solving problem banks. Future efforts will require more agreement and coordination among donors.

Despite the progress attested to by numerous organizations, in four areas NBU lags behind:

- Effective dealing with problem banks especially liquidations,
- complete adoption of IAS accounting,
- complete adoption of internal auditing, and
- consolidated bank reporting.

The failure of NBU to expeditiously address problem banks and current insolvent banks and to be prepared for future liquidations is a major problem in the Ukraine. Currently 38 banks are in liquidation. With the introduction of the new capital requirements and the new banking law many smaller banks are predicted to fail. Currently the process for transferring banks rated poorly into problem bank status doe not always work. As a result many banks which should be brought bank to health through enforcement actions are not dealt with according to NBU standards.

NBU now has the capacity to carry out most of the core functions of a bank supervisory agency and no longer require the current level of day to day advisory services provided by consultants. Further the passage of the new banking law and the continued unresolved issues of bank liquidation require a different strategy going forward.

III. RECOMMENDATIONS

As has been stated, Ukraine has entered a new stage in the development of its financial sector. The Team sees different challenges ahead in the Ukraine financial sector, which require different approaches. For the period 2002-2004 the team recommends that USAID funding be provided for both short term and long term advisors to assist in implementation of the new banking law, development of a problem bank strategy and development of professions to manage problem banks as detailed below.

RECOMMENDED FUTURE SCOPE OF WORK

The work to be undertaken for the period 2002-2004 should include:

[22] Criteria for Assessing Compliance with Core Principles, Ukraine The Core Principles of Effective Bank Supervision, Basel Committee, January 16, 2001.

1. New Banking Law Implementation: Several provisions in the banking law call upon both NBU and commercial banks to undertake specific action in areas where they have little or no actual experience. The purpose of this technical assistance is to provide advisory services to assist both NBU and banks make the transition into these areas.

Objectives: Design a new framework for the licensing and regulation of new financial entities.
Provide resources for banks in developing and conducting risk management.
Provide enforcement manual consistent with new banking law.

Tasks: Provide guidelines/ regulations for licensing and regulating NBFs.
Design models for risk management programs, which can be adopted by banks of all sizes.
Organize regional banker's conference in risk management
Redraft enforcement manual to incorporate new provisions of new banking law.

Level of effort: 1 short-term advisor-Licensing (115)
1 short term advisor-Enforcement manual (115 days)
1 short term advisor-Risk management (115 days)

2. Problem Bank: The current strategy for dealing with problem banks is not working.

Objective: Develop a new strategy offering a more efficient and expedient alternative.

Task: Commission a group of experts from several countries to work with NBU and the Parliament to develop alternatives for dealing with problem banks.

Level of effort: Three short-term advisors

3. Problem Bank Management Professions: There currently is no formal professional training for provisional administrators, liquidators and asset mangers. Moreover these professions are not held in high esteem in Ukraine.

Objective: Elevate the level of professionalism in fields of provisional administrators, liquidation experts and asset management.

Task: Establish programs of advisors from countries were the problem bank profession has matured. Work with universities and trade associations to establish a program of standards, accreditation and other characteristics of professionalism.

Level of effort: Three short-term advisors from each of the three professional fields

PROGRAM 2: INTRODUCTION OF IAS, INTERNAL AUDITING AND MANAGEMENT INFORMATION SYSTEMS

Contractor: International Business & Technical Consultants, Inc. (IBTCI); Counterparts: NCTBP, Aval Bank. Program time: October 1997- December 2000 (Contract # OUT-EPE-I-804-95-00056-00), Part I.

This program includes: (a) introduction of international accounting standards (IAS) and internal auditing techniques throughout the Ukrainian banking sector, and (b) introduction to and development of modern bank management reports through the use of management information systems (MIS).

I. PURPOSE AND BACKGROUND

- The introduction and application of international accounting standards by the NBU and the Ukrainian commercial banks was one of the prerequisites for the World Bank's Financial Sector Adjustment Loan to Ukraine. Specific benefits and purposes of the conversion to the new system included (i) to enhance the global uniformity of the accounting process and reporting format among banking systems, thus facilitating interbank comparisons and analysis; (ii) to enhance communications between central banks and their commercial bank members in terms of financial reporting by and supervision of the banks; and (iii) to increase transparency in banks' reporting procedures, thus benefiting central banks as well as banks' shareholders, creditors, and the general public.

- The introduction of modern internal audit systems as conceived and employed by banks in the West raises the importance and place of the internal audit function within the formal organizational structure, thereby strengthening management's control over the bank's internal operations and aiding management in its planning capabilities.

- Thanks to the introduction of computer systems in banking, MIS has become an indispensable tool in modern bank management, specifically in terms of reporting requirements of the central bank's supervisory authorities and, perhaps even more important, in terms of commercial bank management's internal control, analysis, and planning objectives.

- *IAS reform.* During 1994-1995 NBU was faced with the necessity to introduce IAS in the Ukrainian banking system, thus making accounting the first area, after privatization, selected for banking reform. NBU approached several donor agencies for financial and technical support, and in 1995 EU-TACIS and the British Know How Fund placed their first long-term consultants with NBU. Results: (i) preparation of new Chart of Accounts and of accounting standards and instructions to be issued subsequently to the commercial banks, and (ii) initiation of commercial bank reporting designs and requirements for NBU. (The fact that West European donors initiated accounting reform is frequently being mentioned as the reason why Ukraine's new accounting system is *IAS-based* rather than strictly IAS. The differences between the two are not substantive, however, and appear to have more to do with the fact that at the time of its introduction the Ukrainian commercial banks were in such a financially weak shape that they could not have survived the introduction of the stricter IAS requirements dealing with loan loss reserve and minimum capitalization requirements).

Roughly at the same time the Barents Group, funded by USAID, initiated a two-year assistance program for NBU's Economics Department to develop and implement training programs in macro-economics, statistics, and financial analysis. Also, in 1995 Barents started a USAID-funded technical-assistance project in the NBU Supervision Department, an activity that is going until the present day. The initial focus was on on-site inspections conducted by Barents advisors in combination with NBU staff and consultants from FSVC, an agency with which Barents would work closely for the next five years (see also Program 5, Training of Bank Examiners).

In 1997 NBU issued a chart of accounts for commercial banks based on IAS, together with instructions issued by NBU's Supervision and Statistics divisions. These documents were used by the commercial bank as guidelines for the new IAS-based reporting requirements that became mandatory for all banks on January 1, 1998.

IBTCI entered the IAS reform program in September 1998 when it was awarded a contract with USAID. The Task Order stated as the project's fundamental objective the same as that of USAID's other projects in this area, the development of

> "a more competitive and market-responsive private financial sector, and most specifically, to develop the financial infrastructure. The specific objectives are to assist the National Bank of Ukraine (NBU) in converting the commercial banks to international accounting standards (IAS) and to assist the commercial banks in upgrading their "back office" functions ....such as internal audit, financial management, and fundamental systems". [23]

IBTCI's work in IAS conversion has been intensive and extensive. During its first contract year (October 1, 1998 to September 30, 1999) it established a Pilot Bank Program (PIB) and a Partner Bank Program (PAR), plus a Participating Bank Group (PAB) consisting of about 30 banks selected from a list of banks meeting NBU requirements that had participated in workshops dealing with bank financial reporting and operational reforms. The thought behind this approach was to increase the efficient use of available resources, including manpower, by focusing the training/technical assistance efforts in the IAS/IA/MIS areas on a small, select group of banks including one large bank, Aval, and four medium-sized banks. [24] The IAS program was effectively completed by the end of IBTCI's second contract year (October 1, 1999 - December 31, 2000).

The issue of IAS has become closely interwoven with those of other projects such as NBU reporting, supervision, internal auditing, and MIS. In several of these, IAS has become a standard prerequisite while in others, such as commercial bank in-house reporting and analysis, IAS as an in-house feature remains for many banks an unavoidable objective to be dealt with at some future time. Because of its crucial importance, IAS training throughout Ukraine is still being conducted, but nowadays primarily by Ukrainian instructors. Undoubtedly it will ultimately be the sole accounting system used in Ukraine.

- *Internal auditing.* On March 20, 1998 the NBU issued directive # 114 requiring that all commercial banks implement an internal audit function and describing where the department should be organized within the bank and its objectives, functions and responsibilities.[25] Directive # 358, issued in July, 1999 provided instructions for the implementation of six internal audit standards (i.e., audit management, independence, scope of work, etc.) based on the standards stated in the Statement on Internal Audit Standards (SIAS).

The implementation of IA standards by the commercial banks has not been easy for various reasons and despite IBTCI's diligent efforts to succeed in this area through workshops and direct assistance to the five selected bank's, and specifically to Aval.[26] Reasons for the less-than-successful effort may be enumerated as follows: (i) most Ukrainian banks do not have a functioning internal audit department and its

[23] International Business & Technical Consultants, Inc., Ukrainian Bank Accounting and Operations Infrastructure Development Project for the National Bank of Ukraine, Final Report, submitted to: United States Agency for International Development, December 2000, p. 2.
[24] Idbid., p.3
[25] Ibid., p. 7
[26] Ibid., p. 21

establishment would be costly; (ii) the establishment of an effectively and formally independent audit function would require a fundamental change in management philosophy and a restructuring of the bank's organization; (iii) a truly independent internal audit function might draw unwanted attention to the issues of corporate governance and transparency; (iv) commercial banks don't consider internal audit an important issue and therefore give it a low priority (the preponderance of Ukrainian banks are small by Western standards and managements feel that they can effectively control their operations themselves); and (v) NBU does not appear to effectively monitor compliance by the banks.

Of the five banks mentioned in footnote [24], only Aval has a functioning internal audit department – and apparently a reasonably effective one. Its manager, Ms. Natalia Kozhuchivska who has led the department since its inception in 1998,[27] mentioned that last year (2000) Arthur Andersen had named Aval the leading Ukrainian bank in converting Internal Audit to Western standards. As reasons for this success she offered (i) the TA provided by the IBTCI consultants (recommendations, classroom and on-the-job training, assistance in adopting the EU-Tacis Internal Audit manual, in conducting a pilot plastic card audit and an internal audit of Aval's 5th Kiev branch); (ii) a change in senior management's attitude toward internal audit (now perceived not only as the main control function but also as diagnostic and corrective tool); and (iii) a changed philosophy in the departmental staff toward use of sampling, providing their own conclusions and recommendations, etc.[28]

The internal audit function is highly demanding in Aval, with Ms. Kozhuchivska being responsible for supervising 37 regional and 18 central office internal auditors. Since 1998 regular in-house training is provided to central office staff and since 1999 also to regional staff: several times a year they bring the latter to Kiev for seminars and once a year for a week's course in external and internal directives and to acquire skills in new audit techniques. At the moment Aval has completed the construction of an IA manual and prepared audit procedures for lending operations, fixed assets, and operations with clients. In the next two to three years Aval intends to complete audit procedures for all other bank operations.[29]

It must be recognized that Aval has greatly benefited – and still is benefiting - from expert technical assistance. Yet, its tasks in the area of internal audit have not yet been completed and appear to require future help and possibly supervision. An area of specific criticism by IBTCI has been Aval's failure to comply with one of the benchmarks for the first quarter of 2000, "Aval will have prepared an Internal Audit schedule for 2000 based on a risk assessment of key operational areas".[30] For the first six months of 2000 Aval's internal audit group failed to complete the risk assessment and, consequently, the audit schedule has not addressed the risk areas.

- *Management information systems (MIS).* IBTCI's work, including training, in MIS did not get fully started until the beginning of the second contract year (October 1, 1999 to December 31, 2000) and focused primarily on the in-house use by Aval Bank of the Bank Management Reporting System (BMRS) developed in 1998. One of the benchmarks for the final quarter of 1999 required that Aval Bank prepare a strategic MIS development plan which includes time line and budget and addresses the priorities at Aval Bank [31]

The plan, after some revisions, was agreed to by Aval and IBIS, its software vendor, and completed. A second benchmark called for Aval to "have developed an IAS-compliant consolidated balance sheet and income statement, which is appropriate for internal reporting purposes and will have agreed to prepare

[27]Notes on the meeting with the Head of Aval Bank's Audit Department, Ms. Natalia Kozhuchivska, March 20, 2001.
[28] Ibid.
[29] Ibid.
[30] Ukrainian Bank Accounting and Operations Infrastructure Development Projects for the NATIONAL BANK OF UKRIANE, pp. 20 –21.
[31] Ibid.

these reports monthly starting in year 2000" [32]. Aval agreed and promised to prepare the reports on their own system.

Subsequent benchmarks, including some for the year 2000, were agreed upon by Aval and generally acted upon. An enhanced system, the BMRS 2000, was introduced to accommodate changes to the NBU instructions and to include selected management reports. Training courses and seminars in the use and application of BMRS and BMRS 2000 were conducted throughout this period, and the use of training facilities outside Kiev [a.o., in Kharkiv (ICC) and Odessa] were considered. Response to these courses was not always enthusiastic, however, and on more than one occasion a training course had to be cancelled because of a lack of interest by potential participants.[9] As for the benchmark to be completed by on or about September 20, 2000 ("Aval Bank will have begun implementation of its MIS data base redesign"), the new data base system was not implemented and the first set of applications was not converted to run against the new data base system.[10]

IBTCI has performed yeoman's work in introducing the use of MIS in the IAS and IA reporting and analytical areas. It has put considerable focus on the training area as well as reporting and analysis and has solicited the cooperation of NCTBP, the National Economic University in Kharkiv, the National Economic University in Kiev, the Banking College of Kharkiv, and the Banking College of Lviv in introducing BMRS training courses and workshops.

II. PROGRAM EVALUATION

- IAS was satisfactorily introduced into the Ukrainian banking system through incorporating it in NBU reporting requirements. The system became "IAS-based" primarily because of financial weakness of the Ukrainian banks which could not have withstood actual IAS requirements in terms of loan loss requirements and capital adequacy tests. However, the differences between the two systems are not substantive. Progress toward the full implementation of IAS, specifically of in-house use, has been disappointing and additional TA may be required in (i) consolidation of financial statements, (ii) treatment of contingent liabilities, and (iii) "front office/back office differential"[33].

- The current quality of internal auditing remains unsatisfactory. Problems: little attention from commercial banks' top managements who view IA as merely a "checking numbers" activity rather than as a monitoring of policies-and-procedures exercise. Also, there appears to be a lack of adequate NBU oversight.

- The use of modern MIS in the Ukrainian banks' reporting and audit functions is as yet very limited because of (i) an apparent lack of interest among the banks, and (ii) an insufficient MIS training capability of bank staff. So far, TA has focused primarily on Aval and a few other pilot banks.

- The Program's contribution to the achievement of USAID's Strategic Objective 1.4, A More Competitive and Market-Responsive Private Financial Sector, is, on the one hand, less clear than in the purely training-focused programs, but, on the other hand, helps lay the foundation for a private-sector banking system that ultimately will be highly market sensitive and increasingly competitive. IAS, IA, and MIS must be seen as the necessary tools to reach this objective.

[32] Ibid. p 22.

[33] Notes on the meeting with Ms. Virs I. Rychakivska, Chief Accountant, NBU, March 16, 2001.

III. RECOMMENDATIONS

- Phase out existing IAS contracts and consider objectives largely accomplished. Consider the introduction of specific, narrowly focused short-term programs in as yet uncovered subjects (consolidation, contingent liabilities, etc.) or when new NBU regulations or directives demand.

- Phase out current IA program using pilot bank approach (too expensive). Introduce instead (i) short – e.g., two-day – "symposiums" for banks' senior management and members of internal audit committees on modern bank management techniques and philosophies, including the importance of in-house planning and policy making, internal auditing, and corporate governance and transparency in reporting to supervisory authorities, shareholders, creditors, and the general public; and (ii) short-term (e.g., three months) comprehensive IA training programs focusing on NBU reporting requirements, but primarily on internal needs. Have seminars conducted in all major financial centers and make maximum use of Ukrainian instructors having successfully graduated from intensive train-the-trainer programs. Integrate the use of MIS in these seminars. Crucial need: convince bank management of need to allocate adequate financial resources to develop skilled internal auditors.

- Expand training in use of BMRS beyond the reported banks (16 plus Aval) and include training in MIS applications to all IAS and IA courses. Use train-the-trainer program to the maximum extent possible in order to build up a local instructor corps, thereby reducing the need for expensive expatriate instructors.

VI. RECOMMENDED FUTURE SCOPE OF WORK

- Current contractors whose contracts expire during calendar 2001 should plan on winding up their existing programs. Delay requests for extensions until reviews of new USAID guidelines and programs have been completed and bids for new programs have been sent out by USAID.

- Contractors whose current programs extend beyond 2001 must review their programs' progress and initiate a thorough review for the purpose of ensuring the programs' completion on or before the contract expiry dates. If programs are not expected to be completed by their contract expiry dates, contractors must discuss their alternatives with USAID within the context of any new approaches and priorities decided upon by USAID on the basis of the latest recommendations.

PROGRAM 3: TRAINING OF BANK STAFF

Contractors: the Barents Group, IBTCI;
Counterpart: The National Center for the Training of Bank Personnel (NCTBP)

Contract # OUT-EPE-I-805-95-00070

I. PURPOSE AND BACKGROUND

This Program covers the training of mid-level bank personnel in modern banking skills and techniques, specifically in the areas of accounting (IAS), internal auditing, credit risk evaluation, and basic banking principles.

Training activities under the Program were initiated as early as 1994 after the founding of the NCTBP by the National Bank of Ukraine (NBU) and Ukraine's Association of Commercial Banks by a Resolution of Parliament in late 1993. The Center was created at the initiative of, and with funding by, USAID, which continued to be instrumental in the Center's subsequent growth and ultimate financial self-sustainability in November 1999. Throughout this period the Barents Group was retained as technical advisor to the NCTBP and helped design its curriculum and provide and train its instructors. As for the Center's stated purpose, it listed as its primary objectives:

> To provide **high-quality classroom training** to **middle- and upper-management** levels in Ukrainian Banks to enable them to provide the effective bank leadership necessary to develop a modern banking system that will support the emergence of a private commercial sector in Ukraine.[34]

and

> To contribute to the building of a long-term, self-sustaining Institute of Banking dedicated to the ongoing professional development of bankers in Ukraine especially by training a cadre of Ukrainian instructors able to conduct high-quality week-long seminars in a variety of banking disciplines through a focused Train-the-Trainer program. [34]

In addition to the two primary objectives, the Center lists five secondary objectives of which the last has special significance within the context of the Program:

> To assist the Ukrainian banking system in the implementation of specific goals supported by USAID and the international donor community such as the transition to internationally accepted accounting principles. [34]

Since USAID's and the Barents Group's exit from the Program in 1999, NCTBP has successfully continued and expanded its bank training activities.

Productivity. The Center was an immediate success. Within two months of its opening (January 1994) it had conducted its first regional training seminar for NBU (in Ivano Frankivsk) and its first regional training seminar for commercial banks (in Kharkiv). In its first year of operations the Center trained approximately 1000 bankers, presented 40 courses of which 31 in Kiev and 9 in the regions, moved into modern NBU-provided premises, and became known as the country's leading bank training institution.

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[34] Barents Group, NIS BANKERS TRAINING PROGRAM IN UKRAINE SPONSERED BY USAID, NATIONAL CENTER FOR THE TRAINING OF BANK PERSONNEL OF UKRAINE, November 1994 – August 1998. Pages not numbered. Bold print segments as used by author.

Productivity in terms of course offerings and number of bank staff participating in the Center's training activities continued to grow steadily. It's third year of operations, 1996, was in several respects a milestone, with the following notable developments:

- Focused attempts toward building the Center's financial and technical self-sustainability through the introduction of local instructors (many graduates of the Barents-designed "Train-the-Trainer" program);
- The introduction of an evening certificate program;
- Teaching of courses sponsored by other foreign donors;
- The initiation of a large Train-the-Trainer program (mentioned above) involving Ukraine's International Management Institute (IMI) as a subcontractor (see also Program 6: Training of Bank Management).

By the end of its 5-year contract with USAID in August 1998, the Center had trained a total of 4,071 bankers, broken down into the following categories:

Barents courses	2,916
Other courses	602
Train the Trainers	77
Accounting	422
Study tours/internships abroad	54 [35]

During the next two years (August 1998-August 2000), NCTBP trained an additional 2,454 bankers over a total of 130 seminars. The vast majority (86%) represented commercial banks, with the remainder spread over government banks (7%), foreign banks (4%), and non-bank organizations (4%). [34]

Geographic distribution. Kiev has remained the dominant geographic origin of the Program's attendees, most likely because the preponderance of the seminars were offered in Kiev:

Kiev	-	60%
Eastern Ukraine	-	20
Southern Ukraine	-	9
Central Ukraine	-	5
Western Ukraine	-	6 [36]

Gender. Throughout the team's observations of the training segment no evidence of gender discrimination was encountered. On the contrary, in all bank training activities women were very well represented. During the latest reported period (1998-2000), for example, female seminar attendees outnumbered male attendees by a ratio of 6:4. [36]

Non-USAID donors and programs. As mentioned earlier, following USAID's financial withdrawal from the Center, the latter successfully continued its activities. Among others, it was able to attract other donor and teaching agencies and to add new courses on highly demanded and focused subjects. Examples of this recent development include the Center's following accomplishments between1998 and 2000:

[35] Ibid.

[36] Barents Group, NIS BANKERS TRAINING PROGRAM IN UKRAINE SPONSEREDBY THE UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT, September 1998 – August 2000, p. 2

- Introduced two FX Certification Programs, with 31 dealers being certified (1999 and 2000)
- Introduced a licensed Certification Program in Internal Audit (1999)
- Conducted - in cooperation with EU-TACIS, KPMG Switzerland, and others – 13 courses attended by 232 students
- Conducted – in cooperation with Ukrainian government organizations, agencies and Ukrainian legal firms – 42 courses attended by 728 people on various legal issues
- Completed three Diploma in Banking programs of which one evening program and two "distance-learning" programs
- Organized three internships for Ukrainian commercial bankers in Austria, France, and Germany (39 attended)
- Raised the number of Ukrainian instructors, with the latter teaching 35 courses attended by 565 students.[36],[37]

IBTCI relations with the Center. IBTCI, a USAID contractor on Commercial Bank Accounting Reform, met in April 1999 with the Center's Director and with Barents representatives. Purpose: to discuss IBTCI's possible future role as accounting instructor at the Center. This cooperation between IBTCI and the Center was recommended by USAID. Outcome: in September 1999 IBTCI conducted at the Center a course on "Financial Reporting Preparation". The course was taught in conjunction with a Ukrainian instructor who subsequently would teach it at the Center independently.

In November 1999 IBCTI conducted its second seminar on Internal Audit at the Center. This course, too, was team-taught by a Ukrainian instructor.

Note: Between October 1997 and December 2000 IBTCI undertook a separate USAID-funded project dealing with the Ukrainian commercial banking sector, called "Ukraine Bank Accounting and Operations Infrastructure Development Project" (Contract # EPE-I-00-95-00056-00; T.O. # OUT-EPE-I-804-95-00056-00). A review of the report on this project, also containing descriptions on commercial bank training activities, is covered in Program 3. Given the subject of the present Program, Training of Bank Staff, the Evaluation and Recommendations outlined below include those applicable to the training segments of the IBTCI project.

NBU training activities. NBU, through its "NBU Academy", organizes short-term ad hoc in-house training seminars for its own personnel, which, on occasion, may also be attended by commercial bankers. The term "Academy" is a misnomer: it has no faculty or curriculum and serves exclusively as the administrative arm for any training activities that may be initiated by any NBU division or department and presented at any given time. The subject, structure, and timing of the seminars and the selection of instructors are the responsibility of the initiating unit, with the administrative aspects being the domain of the Academy's permanent staff. The latter – as well as the lecture rooms – are located in a modern NBU-owned building separate from the main NBU building itself. Some of the lecture space is rented out to the NCTBP for use of its own programs.

[37] Ibid., pp. 3-4

II. PROGRAM EVALUATION

- USAID's initiative in 1993 to establish, with the NBU, the National Training Center for Bank Personnel must now be viewed as one of its most successful undertakings in commercial bank training.

- The selection of the Barents Group, in particular, and IBTCI as advisors, curriculum designers, and providers of instructors, was fortuitous and contributed significantly to the Program's success.

- Regular and detailed evaluations of course content, course structure, and quality of instructors by the Barents Group (and course participants) have supported the positive impressions of the training programs.

- The diversity and breadth of the Center's Program have contributed substantially to the building of local capacity to carry on future reform efforts for banking in Ukraine.

- It is as yet too soon to assess the impact of the training programs on the extent of women in decision-making positions in banking. However, throughout the CIS countries women's role in banking has been substantial and often more significant than in many western countries. *Participation* of women in the training activities has been at least on par with that of men.

- The coordination and cooperation among the US contractors funded by USAID and engaged in the various training modules have been good. Specifically, they have clearly contributed to the productivity and efficiency of the over-all training program.

- The results of the Training-the-Trainer Program have generally been good. However, stress on maintenance and/or improvement of the local instructors' quality in terms of teaching skills is needed. Also, in the regions outside of Kiev, availability of local instructors appears occasionally to be insufficient.

- The application of newly acquired skills and understanding of modern banking techniques by local "graduates" of the training programs in their jobs is reportedly checkered. Primary reason: lack of enthusiasm on the part of many top managements of banks to apply the newly acquired skills and systems in their own operations.

- IBTCI's contribution to the training effort – focusing on the IAS, Internal Audit, and MIS and offering seminars in the various financial centers of Ukraine, often in conjunction with local educational institutions – appears to have been valuable. In particular, it appears to have helped lay the groundwork for a permanent presence outside of Kiev.

III. RECOMMENDATIONS

- NCTBP's successful continuation of its training programs since 1999 and growing international support in terms of curriculum diversification and faculty development justify USAID's separation from the general area of bank staff training.

- Follow up on review of IBTCI's training segment concentrating on IAS, Internal Audit, and MIS. Especially in the areas of Internal Audit and MIS, short-term focused training programs to commercial as well as central bankers in the regions – and to regional educational institutions functioning as potential Training of Trainers centers – may well continue to deserve USAID support for the next few years.

IV. RECOMMENDED FUTURE SCOPE OF WORK

- Since NCTBP is no longer connected to USAID and the Barents Group, there is no longer a Scope of Work segment here.
- IBTCI's contract with USAID expired in late 2000 and as such the subject of "Scope of Work" is no longer applicable either. However, as noted in the Recommendations, there is considerable justification for considering a "second edition" of the recently completed IBTCI training programs.

PROGRAM 4: TRAINING OF BANK EXAMINERS

Contractors: the Barents Group; FSVC;
Counterpart: NBU

Contract # 121-C-00-98-00628-00

I. PURPOSE AND BACKGROUND

This program is done mostly in-house at the NBU's Kiev premises and throughout NBU regional offices by Barents Group experts under the Bank Supervision program. The contract expires November 2001.

In addition, the program includes a cooperative agreement (# EPE-0009-A-00-6013-00) with the Financial Services Volunteer Corps (FSVC), New York, NY. They supply senior bank managers and examiners who assist in providing on-the-job training for examiners. FSVC also sponsors internships for examiners in the USA.

The rigorous training of bank examiners – both on-site and off-site – is one of the primary responsibilities of a central bank's Supervision Department. In the case of the National Bank of Ukraine (NBU) this responsibility has become particularly important with the restructuring/privatization of the country's "establishment" banks and the rapid expansion of the commercial banking sector through the creation of a large number of new, mostly small and closely held, banks.

This virtual revolution in the banking industry has taken place over a period of less than 10 years. It created banks whose owners and managers were wholly unfamiliar with modern banking skills and techniques, lacked clearly defined objectives, were unaware of their responsibilities towards their shareholders and clients (specifically their depositors), and – most important – were fully unacquainted with the concepts of financial risk, risk assessment, and risk management. Finally, and consequently, they were incapable of protecting their operations by designing even simple planning and control procedures.

In this environment the newly established central bank (NBU) found itself in virtually the same predicament as the institutions it was charged to regulate and supervise. Technical assistance from its experienced western counterparts was therefore a crucial element in the educational process of developing itself into an effective regulatory and supervisory instrument. Such assistance was forthcoming, as was the case, in varying degrees, in all NIS countries of the former Soviet Union.

Progress in central bank evolution has been slow in Ukraine. Reasons vary, but certainly appear to include the central bank's leadership (actually various leaderships during the past decade) maintaining a culture not conducive to quick acceptance of outside technical and other advice or ideas. Moreover, NBU has been plagued throughout its brief existence with considerable management instability, resulting in frequent organizational restructurings and consequent lack of direction.

History of recent bank training activities. USAID-funded technical assistance in the training of bank examiners goes back to the mid-1990's when Barents placed two-person teams of experts for long-term (over one year) in NBU's Supervision Department to assist it in designing and implementing a variety of supervisory functions, including the training of off-site and on-site examiners. One of these experts has been located within NBU for over four years and the other for over 20 months. In addition, the program has been supported by the FSVC which has been active in Ukraine since 1994 (see subsequent section on FSVC activities).
Given the modest progress made in the training program since its inception, the contract's current expiry date (November 2001) must be considered unrealistic if the program's objective of establishing a well-

trained and motivated examiner corps of adequate size is to be met. This is not the fault of the Barents' in-house experts: they are hard-working, skilled, and motivated individuals who work under often frustrating conditions. Specific problems are (i) a lack of feedback from NBU's senior management, and (ii) the diversified work load which leaves the advisor team too thinly spread to perform at an optimum level on any single subject.

A recurrent complaint of the advisors is that so far the NBU has been unwilling to raise the training effort from its *ad hoc* approach to a formal and structured program, despite their repeated initiatives to convince NBU of the benefits to do so. One of the most comprehensive and cogent proposals to introduce such a program was made in a March 29, 1999 nine-page memo from three Barents advisors (James Satterfield, Senior Advisor for Training; Karen Wilson, Senior Policy Advisor; and Frank E. Blimling, Senior Advisor Onsite Supervision) to O. I. Kireyev, Deputy Governor of NBU; V. O. Zinchenko, Head of Prudential Supervision Department; and S. P. Shcherbak, Head of Methodology Unit. The memo, titled "Proposed Formal Training Program for the Bank Supervision area of the NBU" starts off as follows:

"The bank supervision area is in need of a formal training program to provide its head office and regional staff fundamental skills, knowledge, and experience in bank supervision. Appropriate education via formalized training program would enable the existing bank supervision staff to more effectively supervise the many concerns facing the Ukrainian banking industry. Additionally, as staff numbers grow, new employees would receive the necessary training to properly fulfill their responsibilities and become productive employees." [38]

And later continues:

"The staff has largely trained itself in their current operations, with the majority of formal training opportunities in the past consisting either of participation in overseas programs or training offered locally by outside parties. Reliance on outside training programs tend to limit the number of participants and may prevent employees from receiving a truly comprehensive course of training........This is why a comprehensive training program, which has been institutionalized within NBU, is considered vital to the future success of bank supervision." [39]

The memo continues with outlining what it considers to be the most effective format of a training program and concludes with a five-page appendix providing a detailed outline of a proposed training schedule.

Despite this impressive proposal, the training continues to be conducted on an *ad hoc* basis, as exemplified in the list of in-house training seminars and needs assessments provided by the Barents team during 1999.[40] The current format remains substantially unchanged.

Reasons for lack of success. The underlying reasons why so little progress has been made in bank examiner training can be outlined as follows:

- Frequent changes in NBU management, which makes longer-term planning and effective communications between management and the advisors very difficult. For example, the latest

[38] Satterfield, Wilson and Blimling (the Barents Group), Proposed Formal Training Program for the Bank Supervision area of the NBU, memo to NBU management, March 29, 1999, p.1
[39] Ibid.
[40] KPMG Consulting – Barents Group, Financial Sector Restructuring and Privatization Services in the ENU Region, Contract No. 121-C-00.98-00628-00. National Bank of Ukraine, Kiev, Ukraine. Report prepared for USAID/Kiev, February 1, 2001.

major restructuring at NBU occurred in late 2000, with – reportedly – the new management team still not having taken effective control of its responsibilities.

- Budget and resource constraints, i.e., the cost of a full-fledged training program. NBU points out that the limited number of examiners currently employed does not allow the latter to be taken off their regular examination duties and become better trained. Such a move would require hiring additional candidate examiners that are not provided for in the budget. In addition, the cost of a formal training program is considerably higher than that of presenting occasional seminars by a variety of trainers.

- The high turnover of bank examiners. Bank examination is a costly undertaking. Apart from the fact that the successful training of a bank examiner is a time consuming effort (for example, it involves for on-site examiners the periodic need for one-on-one, on-the-job training), the professional life span of an experienced examiner is short – as it is in the West. Good bank examiners are highly sought after by high-paying commercial banks.

- Over-reliance on TA-provided training from foreign donors other than USAID.

- Over-reliance on academic credentials. "NBU management felt that if a person had a degree in finance, accounting, or economics, they didn't need additional training" (quote from an NBU advisor).

In conclusion, it must be recognized that (i) a sound and well-managed private-banking sector, vital for the development of a competitive and growing private market environment, requires an effective regulatory and supervisory environment; (ii) the creation of such an environment requires the full commitment of the supervisory authorities to establish the proper supervisory framework; and (iii) the creation of such an effective framework, i.e., the establishment of an effective corps of bank examiners, requires an adequate supply of both financial and technical resources.

Coordination with other donors. An item of some concern is the apparent lack of effective coordination between USAID/Barents and other western donor agencies and advisors. Probable reasons are (i) the *ad hoc* approach to bank examiner training which also appears to be employed by other donors (also for cost reasons); (ii) different areas of professional interest; and (iii) differences in philosophical approach (the latter became apparent during a recent discussion with EU-Tacis representatives in Kiev). [41] Efforts to offer training courses on a joint basis by Barents and Tacis have led on at least two occasions to misunderstandings on the division of tasks between the two parties. However, Barents assured us that these were minor and that efforts in this direction ought to continue.

Financial Services Volunteer Corps (FSVC). Barents' partner in this program – FSVC – is a well-known organization in the field of providing financial expertise to, among others, the NIS countries on a voluntary basis. Active in Ukraine since 1994, it's role is to channel the practical professional experience of the American financial community to Ukraine to address complex technical issues in the banking and capital markets arena. This primary focus of FSVC, is to support USAID's Strategic Objective SO1.4, the development of a more competitive and market-responsive private financial sector……The National Bank of Ukraine (NBU) will remain a pivotal client, receiving technical assistance in on-site bank supervision. [42]

[41] Meeting with EU-Tacis Kiev representatives Hans Goetz and Eleonora Nikolaichuk, March 8, 2001.
[42] Financial Services Volunteer Corps., Funding Proposal for Banking and Capital Markets Program Activity in Ukraine, During the period August 1, 1999 – July 31, 2000, Submitted to USAID May 19, 1999.

However, its latest contract expired in November 2000, and was not renewed, leaving Barents as the only contractor under the program.

II. PROGRAM EVALUATION

- The bank examiners training program, despite strong and continuous efforts by the Barents Group advisors, has failed in its objective to establish an effective corps of national bank examiners in terms of both the number of examiners and in their skills levels.

- One of the major reasons of this failure was NBU's unwillingness or inability to follow up on the frequent advice from its advisors to establish a structured and formal training program along the lines proposed in the Barents Group's memo of March 29, 1999. This unwillingness or inability was probably the result of twin factors: (i) the organizational and managerial instability at the NBU throughout the 1990's and continuing until the present, and (ii) a lack of sufficiently sizeable financial resources available for the program.

- USAID appears not to have recognized that the program's objective simply could not be reached by an indefinite continuation of the present approach an *ad hoc* training schedule, and an inadequate budget for a structured formal training program as proposed by the Barents Group advisors.

III. RECOMMENDATIONS

- USAID must consider its options whether to continue funding, after the expiry of the contract in November of this year, the Barents Group's current program of conducting an *ad hoc* training program of indefinite duration; the team recommends that USAID demand NBU's commitment to a training program as outlined in the Barents Group's proposal in the1999 memo and commit itself to provide the necessary funding; or to withdraw from the program at the contract's expiry later this year.

- USAID should consider actively soliciting other potential donors with whom to share the required cost and operations of an effective training program.

IV. RECOMMENDED FUTURE SCOPE OF WORK

- USAID should consider and then instruct the Barents Group's NBU advisors under what conditions it is willing to continue the training program.

- The Barents Group should conduct, as soon as possible, a review of the 1999 memo and prepare a scenario analysis of the options available to USAID.

- Once USAID and Barents decide on how to proceed, the two parties should sit down with NBU management and inform the latter of its options. Their response should be carefully weighed in developing any future efforts.

PROGRAM 5: TRAINING OF BANK MANAGEMENT

Contractor: The Barents Group;
Counterpart: International Management Institute (IMI).

Contract # OUT-EPE-I-805-00070-00 (old); Contract # OUT-PCE-I-815-99-00006-00, TO # 815

I. PURPOSE AND BACKGROUND

This Program centers around the development of a recently established and formally structured one-year full-time MBA in Banking, more recently expanded into an MBA in Finance. The program can be viewed as a natural extension of the program of the National Center for the Training of Bank Personnel (NCTBP), a USAID-initiated and originally funded "undergraduate" type of institution (see: Program 4, "Training of Bank Staff").

IMI itself is a local (Kiev) business school established in 1989 as a joint venture with IMI Geneva. Its organizational structure was completed in 1991-1992 and its first stage of formal instruction took place in the years 1992-1996. Its current and perhaps final phase of USAID-initiated and funded involvement started in 1996 with the establishment of the MBA program. It was undoubtedly the most important year in IMI's history and probably the most decisive one in terms of its long-term viability and ultimate future as an internationally accepted graduate school of business.

The Barents Group, USAID's contractor for the project, has played an instrumental role in the success of the MBA program since its inception. It has been its primary designer and manager, structuring its curriculum, building its faculty, and helping to develop its marketing in terms of attracting a high-quality student body. Perhaps most important, it has built a close working relationship with IMI's management, in particular with its current Director General, Dr. Bohdan Budzan. The latter's efforts appears to lie where they may well be needed most in the foreseeable future: the marketing of IMI among potential Western donors (other than USAID) and the building of a financial base sufficient to upgrade and ensure the long-term quality of its future faculty, to build a strong and comprehensive curriculum, and to attract an optimum flow of high-quality student applicants.

Statistical evidence of the MBA program's success since its inception in 1996 is shown in the following statistics:

- Completion of four one-year MBA programs
- Training of 137 bankers, professor of banking, and financial industry specialists of which:
    - 53% represented private Ukranian commercial banks
    - 7% represented Ukrainian state banks
    - 25% represented Ukrainian educational institutions
    - 15% represented non-bank, non-educational institutions (consulting firms, computer companies, brokerage and investment firms, etc.)
- *Regional distribution of participants:*
    - 57% from Kiev
    - 20% from Eastern Ukraine
    - 13% from Western Ukraine
    - 7% from Central Ukraine
    - 3% from Southern Ukraine
- *Other information:*

- 83 participants represented 40 Ukrainian banks, representing about 20% of the total number of banks in the Ukraine
- 34 participants represented 13 Ukranian educational institutions
- *Gender distribution:* of the 137 graduates, 74 were male and 63 female
- *Average age of participants:* 30.6 years
- Organization of Money and Banking Department (1998)
- Four three-week study tours to the United States by MBA students [43]

The program has placed considerable stress on the training of trainers, i.e., on the generation of future full- and part-time educators in business, specifically banking. For example, by 1998 (latest year available) already 75% of the National Center's administrative staff were IMI-MBA graduates, as were an estimated ten instructors at the Center.

Barents representatives continuously evaluate the quality of the MBA program through the extensive use of questionnaires in which students are asked to comment on the quality of both faculty (knowledge of subject and quality of delivery), course content, and breadth of curriculum (for an example of the latter, see Appendix A). Available data indicate that respondents appear generally objective (i.e., critical in both a positive and negative sense) and consider the program's over-all quality very good. [44]

An extensive interview with Dr. Budzan showed his concern for the viability of IMI and its MBA program.[45] He specifically mentioned the problem of funding as the single most important threat to IMI's future. The near-term (July 2002) expiry of USAID's current donor program makes IMI's financial future is precarious. Reasons: (i) USAID is at present the school's single major donor; (ii) IMI's size in terms of number of students is too small to allow for a financially efficient operation: its average class size (ratio of students per instructor) is well below that found in Western graduate business schools; and (iii) student tuition, though high by Ukranian standards, is far too low to allow for the attraction of a faculty trained and experienced in modern banking and financial management skills. In short, IMI is, under present conditions, not a viable institution.

Weighing against the negatives are some positive factors. First, there is a great demand for an IMI – MBA in Finance education among young Ukrainians. Second, the school is currently finishing the construction of a large (non-USAID donor- funded) building with sizeable classrooms enabling an increase in the average class size. And third, IMI management has successfully established ties with a number of Western educational institutions which, it is hoped, will facilitate future faculty exchanges. [Examples of such institutions include IMD (Switzerland), London Business School (UK), Carnegie Mellon University (USA), Harvard Business School (USA), University of Louvain (Belgium), and others].[46]
In order to become viable as a first-rate graduate business school, IMI must – as with any other such institution – be able to continuously upgrade the quality of its programs, its faculty, and its administration in order to

[43] Barents Group, NIS BANKERS TRAINING PROGRAM IN UKRIANE SPONSERED BY THE UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT, FINAL REPORT, International Management Institute, MBA in Banking Program, IMI Accomplishments since 1996, pages unnumbered.
[44] Ibid.
[45] Interview of March 14, 2001 on IMI premises.
[46] IMI – Kyiv, INTERNATIONAL MANAGEMENT INSTITUTE, International Perspective, Publication undated, pages unnumbered.

meet the ever-changing needs of a rapidly evolving economy. This is a highly expensive undertaking for an institution without a track record and situated in a country whose economic future remains uncertain. It requires a long-term commitment, financial and non-financial, that can help create the required credibility within the business and educational communities.

Western experience has shown that even for the most successful private business management institutions it takes literally decades and often longer to establish a degree of financial sustainability. In the meantime, sizeable long-term financial support from institutional, and other, donors is required. The growing number of business schools throughout the world has led to a sharply competitive environment for the attraction of external funds and of top-quality students. The latter, by the way, in turn become selling points for fund-raising successes.

The non-USAID part of IMI: substantial and synergistic. Perhaps the clearest and best-balanced view of IMI's role in Ukraine's business education environment is the following quote from a March 15, 2001, memo by Margaret Small, IMI-MBA in Finance Project Director:

> "Important to note is that the expansion of programs at IMI including modular programs, short programs, strengthening international contacts etc. were not directly funded by USAID and the Bank Training Program. These improvements were IMI self-directed and financed.
>
> There has been synergy between developments outside the banking program at IMI and developments from within the Banking Program at IMI.
>
> - IMI now enjoys about a 3-1 ratio of applicants to openings for MBA degrees. Before 1996, IMI graduated approximately 50 MBA graduates per year, now approximately 250 per year. Before 1996, they would receive 75 applicants, now approximately 650. So the number of graduates has increased approximately 500% and that of applicants approaching 900%. At the same time tuition has increased very substantially as well. This progress has clearly allowed for tighter entrance requirements.
> - IMI students today are more and more demanding. They have greater exposure to travel and more interaction with western business practices prior to entering IMI. Their demand for high-level faculty and courses, especially in finance, accounting and banking increases every year. This has definitely pushed the IMI faculty to develop deeper courses each year.
> - Career development and satisfaction are being measured now through an extensive survey of banking IMI-MBA alumni." [47]

[47] From a memo of March 15, 2001, by Margaret Small to Kees Walraven.

II. PROGRAM EVALUATION

- IMI's MBA in Banking (now MBA in Finance) program, less than five years old has been an unequivocal success. An informal meeting with recent (2-5 years) graduates, both men and women, elicited an enthusiastic response to questions about the program's curriculum, the usefulness of the over-all program, and the very strong demand for MBA graduates in the Ukrainian business (not only banking) community. Noteworthy was the participants' presentation: they were self-confident, spoke excellent English, were well-groomed, and good conversationalists – in short, attractive representatives of their employers.

- There appears to be, in many instances, a wide gap between the professional sophistication and openness to new ideas of the graduates and the latter's senior managements. In short, the MBA's appear to represent the new generation of future business leaders. It is as yet, uncertain, however, how long it will take for most of them to reach the actual decision-making management level.

- The MBA program, through its continuous supply of young graduates well-trained in modern Western financial techniques and exposed to Western business philosophies and counterparts, must rank among the most effective avenues to stimulate and enhance private market development in Ukraine.

- While the quality of the MBA program has been considered a success by both graduates and MBA administration, it has reached the stage where more attention must be given to – and more resources directed at – a thorough review of the program's curriculum, the composition of its faculty, and its direction. The present provider, the Barents Group, has done an excellent job in getting both the NCTBP and IMI's MBA program established. However, it must be recognized that the Group is not a professional educational body with the necessary track record, skills, and capacity to successfully manage the future growth of a fledgling graduate business school. In short, the program needs to prepare for the start of a new stage in its evolution (see: Recommendations)

- The financial base of the MBA program is both too narrow and too small. While USAID can rightfully claim its parentage and support during its early years, its inability to commit to financial support beyond mid-2002 makes longer-term financial planning for IMI realistically impossible.

- *Gender.* There is no discrimination on the basis of gender in IMI's student acceptance policy, and the numbers of male and female attendees are about equal. Also, female graduates expressed no evidence of discrimination in hiring practices by their employers. They admitted there might be a glass ceiling at the higher levels of management, but, since they had not reached them yet in their careers, they did not express concern.[48]

III. RECOMMENDATIONS

- *The role of USAID.* It is important that at this stage of IMI's development that USAID continue to support the institution financially in its efforts to simply stay solvent and continue its current activities. It is precisely at this point of IMI's development that USAID should consider playing a more active role in its management, e.g., by participating in a proposed international Board of Trustees (see below), raising faculty standards, and aiding in the expansion of the donor base. A broadening of IMI's financial, oversight, and management expertise would not only raise the institute's viability level, but also reduce its dependence on individual donor institutions.

[48] Meeting of March 22, 2001, in apartment of Margaret H. Small, IMI MBA in Finance, Project Director, The Barents Group.

- *IMI should establish a Board of Trustees* consisting of high-level managers, directors (CEOs, CFOs, etc.) of major western corporations, educational institutions of higher learning, and foundations active in supporting financial projects in CIS countries. Such a Board would have an oversight function (in addition to the IMI Board of Directors), but, more importantly, it would help put IMI more firmly on the international map and develop contacts with potential western donors. This project will require intensive marketing efforts, but recent history proves it can be done.

- *Strengthen and expand funding support and TA from western governmental and NGO donors.* Many West European countries have well-established programs to support institutions such as IMI. Such aid is normally tied to the use of consultants of the donor country by the recipient (for example, IMI may have access to Western faculty, equipment, etc. funded by a Western donor country). In the case of Ukraine, the Institute for Economic Research and Policy Consulting in Ukraine of the German Advisory Group on Economic Reforms - a German governmental organization associated with KfW – has reportedly funded a Western professor of economics at the National University "Kyiv – Mohyla Academy's" economics education and research consortium (EERC).

- *Strengthen ties between IMI's graduates and IMI.* It is recommended that a formal IMI MBA alumni – IMI Management "Board of Advisers" be established. Its purpose would be to (i) help organize fundraising for the Institute's MBA in Finance program on a formal and permanent basis; (ii) assist IMI management in evaluating its curriculum; in upgrading and expanding its faculty; in helping to place new graduates in Ukraine's private business sector as well as in business-related Ministries of the National and regional governments; and in providing advice and support to IMI management wherever appropriate. With the MBA program becoming increasingly "established", its graduates will grow in numbers and status in Ukraine's business and political community, thus increasing its potential to materially support IMI's future development.

IV. RECOMMENDED FUTURE SCOPE OF WORK

For the remaining time of the Barents Group contract (until July 2002), Barents is expected to continue its present plans for the MBA in Finance program. Budget restraints allow very limited freedom for the introduction of new and expanded activities.

Assuming USAID decides to remain a donor beyond 2002, the new contractor (including the Barents Group, if it wins the new bid) should initiate a new direction in its priorities for the MBA program. In line with the recommendations, the contractor should assist in

- Expanding the faculty selection process and upgrading faculty quality;

- Developing, in close coordination with IMI management, a structured program for aggressively soliciting additional Western donors;

- Strengthening IMI's relationships with Western business schools, including the introduction of regular and/or more frequent faculty exchanges, joint programs such as, for example, an annual summer school program organized by IMI and its foreign partner somewhere in Ukraine.

PROGRAM 6: AVAL BANK RESTRUCTING PROJECT

Contractor: Booz Allen & Hamilton, Inc. (BAH)

Contract No. OUT-NIS-I-800-98-00035-00

I. PURPOSE AND BACKGROUND

Aval Bank was created in 1992 as the postal-pensionary bank to ensure continued pension payments to former employees of the Postal Service and other entities. Aval Bank started out by taking over part of the offices of the Post-Office network. The bank's shareholders include the Postal Pension Fund, Ukrposhta (the Ukrainian postal services), Ukrtelekom (the government-owned nationwide telephone company), and companies in various other industries. Individuals, including the bank's employees and management, hold 65% shares. Aval bank has one of the largest regional branch networks in Ukraine with 726 offices and branches.[49] Total assets of the bank as of January 1, 2000 amounted to UAH 1.483 million, with total capital at UAH 166.7 million. Net profit for the year 1999 came to UAH 23 million. The credit portfolio of the bank amounts to 67% of the total assets. Most of the bank's clients are from the food and light manufacturing industries, whole/sale/retail trade, and shipping.[50]

Under Task Order No. NIS –1- 800-98 00035-00 consultants were to focus on implementation of the "Letter of Commitment" agreed to in May 1999 by the National Bank of Ukraine and Aval Bank's Head of Council of Shareholders and Chairman of the Board. Lessons learned at Aval bank are also expected to be made available to the general banking community. In addition, bank supervisory capacity could be improved. The NBU bank supervision department will be monitoring the progress of the commitment letter. In so doing, the NBU supervisors will be gaining valuable experience on how to develop remedial plans with banks in order to prevent them from becoming candidates for liquidations.[51]

In 1998 Aval Bank underwent an examination (diagnostic) along with 6 other Ukraine banks, conducted by NBU. The results of those exams were shared with the respective banks. Commitment letters, which identified deficiencies, were shared with the banks. All seven banks were offered technical assistance going in meeting requirements of the commitment letter. Four banks accepted this offer with USAID funded assistance provided to Aval Bank and European Union TACIS providing technical assistance to three other banks. Beginning in October 1999, BAH under contract with USAID initiated technical assistance to Aval bank in restructuring improvements to meet the requirements of a NBU Commitment Letter. The project was envisioned to begin October 1, 1999 and to continue for two years.[52] Tasks envisioned for the Aval Bank restructuring were designed to improve capital, assets, management, earnings and liquidity.

Consultant Activities

In October 1999 BAH advisors began work at Aval bank. The project team consisted of a Chief of Party, Credit Specialist, two research consultants and a Project Coordinator, the latter being Ukraine citizens. In addition two short-term consultants supplemented the teams activities. Banking Consultant Peter Hanney joined the team for a period of 5 weeks to advise the bank on Treasury operations, Asset & Liability Management, and Asset Liability Committee's activities. Ms. Colleen Booth joined the team in mid September for a 5-week assignment to review the Bank's branch management strategies. She developed

[49] Verchenko, Olesia, Overview of the Banking System in the Ukraine, Kyiv, Ukraine, Summer 2000, p.13
[50] Booz Allen & Hamilton, Inc. (BAH), Commercial Bank Restructuring Project, Aval Bank 1st Year Project Report, September 2000, p. 5
[51] National Bank of Ukraine, Aval Bank, "Commitment Letter", April 26, 1999, p. 1
[52] BAH Report, op.cit., p.2

work plans, analyzed bank operations, advice management on recommended action, trained bank staff in Kiev and regions.[53]

Compliance with the Commitment Letter

The goals of the project were to:

1. Meet the CAMEL benchmarks established in the letter
2. Provide useful models for NBU
3. Provide useful models for and other Ukraine Banks[54]

As a results of the 1998 bank examination overall findings were that Aval bank must:

- increase its capital,
- address problems associated with adversely classified assets including:
  - loan loss reserves
  -improvement in the lending policy and function
- Institute specific management changes in: risk management, asset liability
  -management, internal audit. International auditing standards and information technology[55]
- develop a uniform price formation policy in terms of the active and passive operations and ensure the procedures to evaluate accurately the general cost, price and profitability of certain product, groups of products, clients, departments, affiliates and Regional management as well as entire bank

- undertake six separate actions to strengthen liquidity.[56]

<u>Capital</u>

<u>Objective</u>: To restore the capital to an adequate level, the Bank was to develop the plan for capital increases with special attention paid to current financial state of the bank.

<u>Team Finding</u>: Advisors in coordination with Aval Bank management developed a capitalization plan to meet NBU requirements. Full compliance with the Capital aspects of the commitment letter was met as of March, 2000. The NBU examination of March, 2000 assessed the Bank's capital level and noted that the bank's correct capital was equal to UAH 126. 7mm (US$ 23.0MM @ 5.50). During calendar years 1999- 2000 the bank had achieved a substantial excess over the targeted requirement, UAH 196,059 vs. UAH 145,965. This capital growth was achieved through income and an issuance of a modest level of new bank shares.[57] Due to Aval Bank's asset growth rate, new capital requirements were set by NBU in 2000. Bank management estimates that by the issuance of new bank shares in the first quarter of 2001, an additional UAH 16.0 million will be raised. Advisors will continue to track the Bank's capital position to assure the approved levels are maintained. [58]

<u>Asset Quality</u>

<u>Objectives</u>: (i) The Bank was to develop and implement a plan for asset quality improvement

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[53] ibid p.5
[54] USAID, Scope of Work, Commercial Bank Restructuring, Task Order No. 1 – 800, Attachment A, 1999, p.2
[55] Interview with Frank Bimbling, Advisor, Barents Group, Kiev, Ukraine, March 27, 2001.
[56] Commitment Letter, op.cit. p. 4
[57] BAH Report, op.cit., p. 9
[58] Interview with Chief of Party, William Emery, BAH, Kiev, Ukraine, March 23, 2001.

(ii) The Bank was to revise its policy on lending to business to include minimum amount of borrower's contribution to finance the project, loan amount in relation to collateral value, criteria for monitoring loan condition, value and liquidity of collateral during the life of the loan.

(iii) The Bank was to develop policy and procedures regarding insiders, related parties and affiliates, interest rates, loan documentation, relation ships between head office and regional offices, bills of exchange, investment policy and reserve policy.[59]

The credit department was restructured and a central credit authority established including a management information unit. The advisors' action plan for improvement of asset quality has been successful. The quality of the loan portfolio has improved steadily from fiscal year- end 1998 (1/1/99) when performing loans comprised 76.5% of the loan portfolio. Performing loans comprised 84.5% of the total portfolio. Loan loss reserves remain at %100 and are in compliance with NBU directives.

Team Findings: A plan for reorganizing the bank's credit function was designed by advisors and adopted by Aval bank management in 4th quarter. This reorganization addresses many of the credit administration problems such as:

1. Absence of a bank-wide credit or loan department
2. Unnecessary complicated organizational sharing of loan approval and management responsibilities
3. A rudimentary loan classification system not administered by the Credit Department
4. Shared but uncoordinated administration of existing loans between different departments of the bank
5. Weak follow-up of non-performing loans
6. Absence of a formal loan review
7. Low quality loan administration reports

The reorganization replaces the Credit Department with three divisions; Loan Administration, Credit Analysis and Corporate Banking. The new organization has credit authority over the bank -wide system including regions. The loan classification function is now within Loan Administration. The new organization strengthens the entire credit process from initiation loan approval and administration. New credit policies and procedures have been developed during the recent quarter [60]

Management

Objectives: (i) Aval Bank was required to develop, implement and sustain the service of the internal Audit that meets the principles of the NBU's Handbook for onsite inspections.

(iii) The Bank's internal audit functions must cover all activity of the Central Office, Regional Offices, and branches. The internal auditors must be well trained, report exclusively to the counsel of the bank and keep the Board of Directors informed. Counsel and Board of the bank should insure that management reacts immediately to problems and drawbacks reflected in the internal audit reports.

(iii) Aval Bank was required to develop a formal risk management program, which would be implemented throughout the institution

[59] Commitment Letter, op.cit., p. 4
[60] BAH op.cit., p. 14.

(iv) Bank was required to develop a comprehensive strategic plan for improvement in information technology.

(v) Bank was required to ensure all operational areas work in compliance with IAS. [61]

Aval bank has not instituted IAS in all operations of the bank (see program 2 for an explanation).

Team Findings: As a first step in establishing a bank-wide risk management program advisors' developed and implemented a product appraisal/approval process. A risk management implementation plan was produced in fall 2000 and reviewed by Aval bank and is now being implemented. The plan identifies goals and basis principles with detailed steps identified for successfully carrying out a bank risk management program. The Treasurer, with banking departments reporting monthly, supervises implementation of the Risk Management program. [62] To enhance the risk management program, BAH is assigning a short-term advisor during 2001 to review the program and make recommendations for improvement.[63] An improved risk management program will produce good model programs for other banks to adopt.

Considerable progress has been made in developing auditing procedures to serve management. Procedures have been developed for four banking areas, including lending. However, to date auditing of the loan portfolio has not taken place. Formal audit training programs have been instituted and audit practices are installed at the regional level. Senior management is taking corrective action as a follow up to audits.[64]

Earnings

Objectives: (i) The Bank was required to develop a unified price formulation policy in terms of active and passive operations.
(ii) The Bank was required to have procedures to evaluate accurately the general cost and price and profitability of certain product, groups of products, clients, departments, affiliates and regional management. .[65]

Team Findings: Advisors are assisting the bank in developing an asset and liability pricing policy. A Banking Business Profitability Estimate Program has been established throughout the bank.[66]

Liquidity

Objectives: To address liquidity, the bank was required to:

1. Develop contingency plans for liquidity management
2. Develop policies and procedures that specify the problems of liquidity and departments functions in liquidity support and monitoring
3. Develop the procedures and practices to analyze efficiently the interest rate risk.
4. Develop policy that strengthen control over foreign currency position and detail a strategy for the use of foreign currency

[61] Commitment Letter, op.cit., p. 7
[62] Interview with E. Rosenblatt, Treasurer, Aval Bank, Kiev, Ukraine, March 20, 2001.
[63] Emery, op.cit.
[64] Interview with Natalia Kozhuchivska, Head, Aval Bank Internal Audit, Kiev, Ukraine, March 20, 2001
[65] Commitment Letter, op.cit., p. 8.
[66] BAH, op.cit.

5. Ensure that no single individual has unilateral authority to set or change limits on foreign currency operations and that all limits established have to be approved by the Bank's Assets and Liability Committee.
6. Segregate more fronts and back office functions by ensuring that back office simultaneously receives an electronic print out of trade tickets. [67]

Team Finding: A Contingency plan for liquidity is being developed. Liquidity forecasting and liquidity risk evaluation have been instituted. An interest rate risk management strategy has been developed and GAPS analysis and analysis of interest rate margins is ongoing. Aval Bank has developed new regulations to define currency risk for assets and liabilities operations and an action plan for reducing open currency positions. [68]

Use of Aval Model Programs in Training

In order to give the Aval initiatives the best chance of succeeding over the long term and to facilitate adoption of similar banking practices in other institutions, advisors expect to conduct at least one work-shop session in each of the five geographic regions which the bank operates. At each session representatives from the regional offices will attend. In addition to the advisors, instructors will include selected members of the Aval Credit Department and qualified local institutions such as the National Center for Bank Training. As the training commences, the advisors will develop modules which when proven at Aval Bank may be rolled out to other Ukrainian banks at USAID's discretion. The first regional training session was held in Mykolayiv during the period March 13- 14 2001 and was attended by both Aval Bank officers and representatives of other Commercial bank officers in the region. Topics covered during the training included strategic planning, risk management and the CAMEL approach to managing a commercial bank. See appendix ii for training program.

II. PROGRAM EVALUATION

Objective 1. Aval Bank is meeting the requirements of the commitment letter. More than 70% of the items identified in the commitment letter have been meet and many major changes instituted as a direct result of the advisor work. This is directly attributed to the high quality work of BAH. Their relationship with the client Aval Bank has been very good and as a result many recommendations have been taken which move the bank beyond some of the original requirements. This is particularly true for work in the areas of credit policy, and cost profitability. BAH project management, programming, monitoring and evaluation skills are good. Technical skills are good especially in the credit area, asset liability areas. BAH has excellent use of local staff.

During the project's first year these have been major accomplishments in capital adequacy, asset quality and management. To a lesser extent progress was made in the areas of earning and liquidity and it is expected that the bank will meet requirements by the end of the two year period.

Objective 2. NBU supervisors gain valuable experience on how to develop remedial work with the Bank in order to prevent them from becoming more of a serious problem.

It was difficult to draw conclusions about the value of the project to NBU supervisors. Attempts were made to contact NBU in order to gain a perspective on how Aval bank was meeting the commitment letter requirements. However NBU would not approve such a meeting.[69] Nonetheless, the team has deduced from a number of facts that some NBU benefits were derived from the project. During the March 2000

[67] Commitment Letter, op.cit., p. 9
[68] BAH, op.cit.
[69] Interview with Edward Nolan, BAH, Kiev, Ukraine, March 2000.

exam, the commitment letter approach was used extensively to ensure requirements were met and new requirements instituted. NBU examiners also gained knowledge from the consultant's work. Often bank examiners learn during examination from the work performed by outside consultants. In addition, NBU statistics for enforcement action during 2000 show enforcement letters use in 67 instances. Given the fact that there are 153 operating banks, this is a significant number.

Objective 3. Lessons learned at Aval Bank can be made available to the general banking community.

Aval bank has already begun providing training on the lessons learned at Aval Bank to banks in the Region. Two areas are credit administration and risk management. A third area of importance is asset liability management.

III. RECOMMENDATIONS

- *Forum on the Commitment Letter Process*

The use of commitment letters is becoming a successful enforcement tool in the Ukraine.
To improve the performance commitment letters contain different requirements to different banks. Certain strategies are more successful than others. Donor agencies which have participated in the diagnostic and NBU should convene a conference together with Ukraine banks to discuss shared experiences and "best practices".

- *Develop training models based on Aval Bank Experience*

The law of Ukraine on Banks and Banking requires banks to set up a standing unit of analysis and management of risk and create standing committees; credit committee, asset and liabilities management committee and a tariff committee. Knowledge acquire through the Aval bank restructuring project could be used in the development of models programs. These model programs could than be distributed to Ukraine banks and used in bank training.

- *Pilot Bank Program*

The use of on- site technical advisors has proven to be a success in numerous counties. The Aval bank project in a good example. Once a pilot project has been successfully implemented and documented, other banks more readily accept such. This has been well-documented in experience in providing aid to former Soviet Countries. Therefore it is recommended that a second pilot program be establish at a smaller bank with specific objects connected to a banks requirements to conform though the new banking law.

IV. RECOMMENDED FUTURE SCOPE OF WORK

- Forum on Commitment Letters. This project should be managed jointly by the Donor agencies. Consultants working in each bank should participate in planning and implementation.

- Training Models. BAH should be provided sufficient funds to produce training models.

- Pilot Bank. A similar scope of services as that contained in the current Aval Bank contract should be used to develop the pilot bank contract. It should be developed at a reduced level and time period (one year duration). Staff should consist of one resident advisor, two in country staff members and two short tem advisors.

RECOMMENDATIONS FOR INCREASING BUSINESS LENDING

In pursuance of USAID Strategic Objective 1.3 "Accelerate development and growth of private enterprise," the following recommendations are made:

1. Prudent Lending

Banks must develop better processes for making good business loans. This can be accomplished through adherence to NBU prudent lending regulations and in setting up better processes for making loans and managing loan portfolios. With healthier loan portfolios, banks will have more capital to devote to lending. This will also allow banks to develop more lending products tailored to the needs of business.

2. Better Working Relationships with Business Clients

Banks can increase the number of creditworthy customers by helping them develop more transparent financial statements and business planning. Better attention to the financial needs of the customer enable banks to structure loans that customers are able to repay.

3. Creating Different Loan Guarantee Programs

Long-term financing for Ukraine business is a critical need. Some long-term funding is already being offered by Ukraine banks with the use of EBRD guarantee programs. Working with other donor organizations, USAID should fund an increase in loan guarantee programs. The donors could experiment with different structured guarantee programs to meet different business customer needs.

4. Development of Credit Rating Agencies

Currently Ukraine banks use a variety of sources to obtain information on the payment history and financial status of prospective clients. Some information from from utility companies, transportation companies, etc provide useful information. However this information is incomplete and for some perspective clients unavailable thus limiting some companies' access to credit. Ukraine needs to establish credit agencies which can provide information and rating of perspective clients.

5. Development of New Markets in Ukraine Regions

Often regional areas are cut off from adequate business financing, even though good bankable clients exist. Ukraine needs to make a greater effort to reach these regional areas. Several of the banks interviewed were increasing banking activities in the regions. One way to increase lending is to strengthen lending skills in bank's branch offices. A second way is to establish more small business centers that provide technical assistance in preparing clients to apply for loans

6. Serving the Ukraine Agricultural Market

With Ukraine's successful land privatization, a whole new wave of farmers who own their land need financing for crops and equipment. Agricultural lending with its special risk requires a special kind of lending skill. USAID should set up more programs to bring agricultural lenders to the Ukraine to teach western agricultural lending technique. A good source for this talent is the US Farm Credit Administration which caters to small farmers. Also technical assistance could be provided on how to establish agricultural cooperative banks.

APPENDIX A: MBA PROGRAM IN BANKING

MBA Program in Banking

Tentative schedule for 1999\2000 academic year

UNDERSTANDING PEOPLE, MARKETS AND MANAGERIAL FUNCTIONS

Term 1 7 weeks

Subjects	Credit Hours*	Contact Hours
Money & Banking	4.5	63
Financial Accounting	3	42
Management Information Systems	1.5	21
General Management	1.5	21
Managerial and Teaching Skills	2.5	35
Total	**13**	**182**

Term 2 7 weeks

Subjects	Credit Hours	Contact Hours
International Accounting	2	28
Organizational Development	2	28
Corporate Finance/FAST	4	56
Financial Markets	1.5	21
Managerial and Teaching Skills	4	56
Total	**13.5**	**189**

APPLYING MANAGERIAL FUNCTIONS

Term 3 7 weeks

Subjects	Credit Hours	Contact Hours
Investment Analysis and Portfolio Management/FAST	2.5	35
Bank Accounting	2	28
Managerial Accounting	3	42
Tax Planning	1.5	21
Managerial and Teaching Skills	4	56
Total	**13**	**182**

Term 4 7 weeks

Subjects	Credit Hours	Contact Hours
Financial Analysis for Banks	1.5	21
Managing People in Organizations	1.5	21
Foreign Exchange	1.5	21
Trade Finance	1.5	21
Bank Regulation	1.5	21
International Finance	2	28
Bank Marketing	2	28
Managerial and Teaching Skills	2	28
Tota	**13.5**	**189**

INTEGRATING AND SPECIALIZING MANAGERIAL FUNCTIONS

Term 5 6 weeks

Subjects	Credit Hours	Contact Hours
Strategic Management	2	28
BankExec (Computer simulation)	2.5	35
Bank Management	3	42
Managerial and Teaching Skills	4.5	63
Total	**12**	**168**

The Managerial Skills Course is taught all of the year. The following describes the content of the course:

Subjects	Credit Hours	Contact Hours
Time Management	1	14
Conflict Resolution	1	14
Presentation Skills	1	14
Negotiation Skills	1.5	21
Business Etiquette	1.5	21
Business English	11	154
Total	**17**	**238**

INTERNSHIP IN USA 3 weeks

PREPARATION OF MASTER'S DISSERTATION 2 weeks

GRADUATION EXAMS 2 weeks

TOTAL PROGRAM **65 Credit Hours = 910 Contact Hours**

APPENDIX B: AVAL TRAINING

MYKOLAYIV SEMINAR SCHEDULE Tuesday 13th and Wednesday 14th March

Tuesday- 13th March— AVAL Bank Officers Only

1400-1700- SWOT Methodology and Analysis—Practical exercise—

Wednesday- 14th March

I. Morning Session—Aval Bank and Other Commercial Bank Officers

0900-0915—Introduction

0915-0930—Strategic Planning—Importance of a Mission Statement and Annual Business Plans with Goals, Action Plans and Monitoring

0930-1000—CAMEL approach to managing a commercial bank

1000-1010—Break

1010-1045—Risk Management Concepts

1045-1200—Credit Risk Management Concepts

1200—1230—Questions and Discussion

II. Afternoon Session—Aval Bank Officers only

1400-1410- Introduction

1410-1445-Discussion on Aval Bank's approach to Strategic Planning, Mission Statement, Annual Business Plans (Goals, Action Plans, and Monitoring) and the CAMEL concept

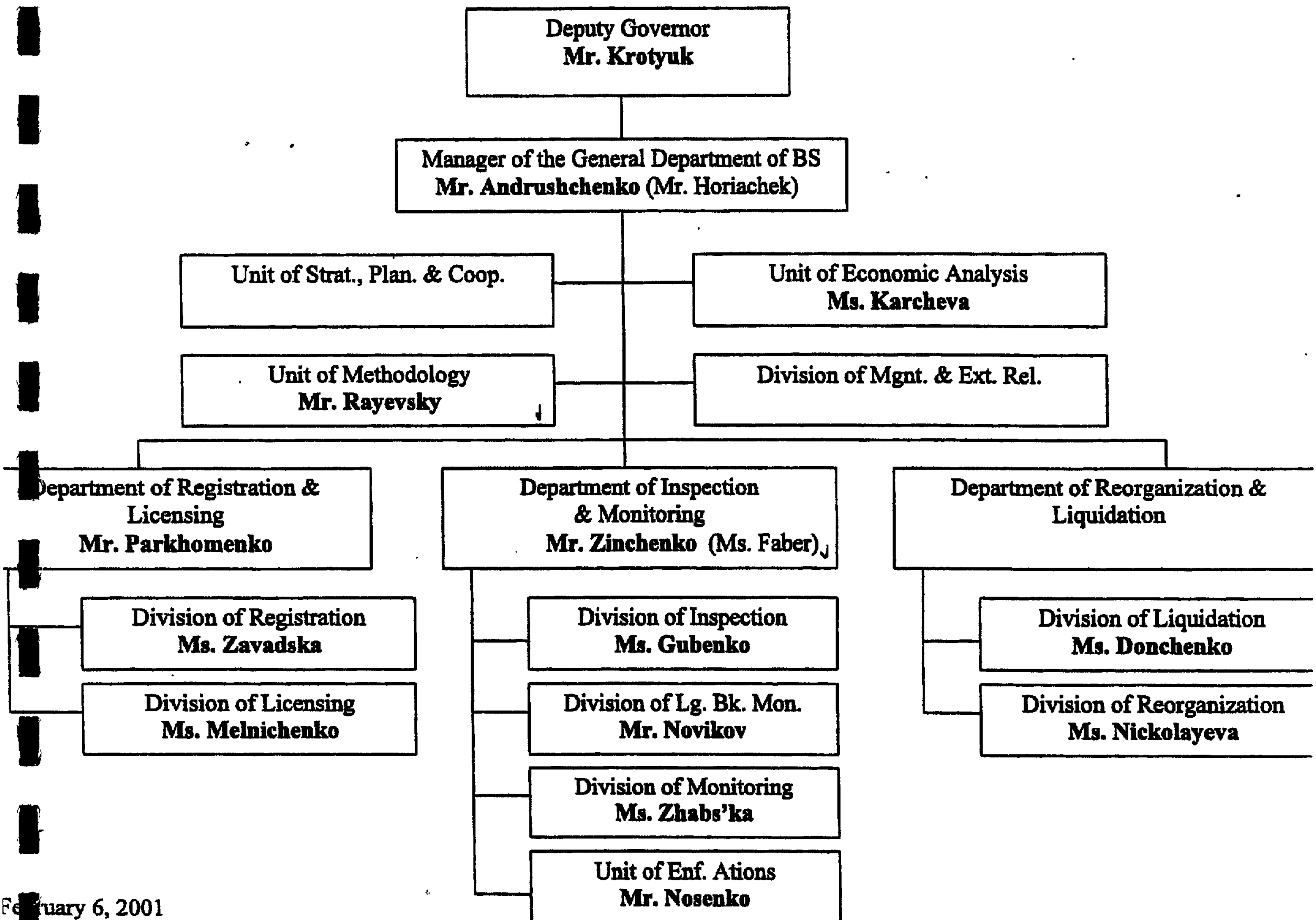
1445-1510- Discussion on Aval Bank's approach to **Risk Management** concepts

1510-1630—Discussion on Aval Bank's approach to **Credit Risk Management** concepts

1700—Depart for Night Train to Kyiv (1731 departure)

Appendix C: NBU Organization Chart

NBU Bank Supervision Management



February 6, 2001

Appendix D: UKRAINE BANKING EVAUATION PROJECT CONTACTS/MEETINGS

IBTCI (Washington, DC)

February 23, 2001

Craig McAllister
Banking Manager

Al Hrabak
Accounting Manager

Patricio Crespo
Principal

Booz Allen & Hamilton, Inc. (Washington DC)

February 23, 2001

Marc Hersh
Principal

Tom Parr
Senior Associate

World Bank (Washington, DC)

February 26, 2001

Katalin Forgacs
Financial Sector Specialist

International Monetary Fund (Washington, DC)

March 27, 2001

Arne Petersen
Director
Financial Institutions and Markets Division

USAID (Kiev)

March 1, 2001

David Dod
Deputy Director
Office of Economic Restructuring

Boris von Hoffmann
Senior Banking Advisor

Victor Verhun
Banking Specialist

Paul F. Mulligan
Director
Office of Economic Restructuring

USAID Washington DC

March 2, 2001

John Seong
Private Sector Development Officer

Booz Allen & Hamilton, Inc. (Kiev)

March 2,2001
March 8,2001
March 20,2001

Edward Nolan
Credit Special

Bill Emery III
Chief of Party

KPMG Barents (Kiev)

March 5, 2001
March 7,2001
March 13,2001
March 7, 2001
March 9,2001
March 23, 2001
March 26, 2001
March 28, 2001

Glenn Tasky
Senior Advisor in Bank Supervision

Frank Blimling
Senior Advisor in Bank Supervision

Larry Boren
Banking Advisor, (Belgrade, Yugoslavia)

Margarett Small
IMI MBA in Finance Project

Marina Antonova

IMI MBA in Finance Project

International Management Institute

March 7,2001

Svitlana Kucherova
Manager of Career Development and Alumni Relations

Alla Voronova
Director of Marketing and International Relations

Olena Sagaydachna
Director of MBA Program in Banking

Dr. Bohndan Budzan
Director General
International Management Institue

National Center for the Training of Bank Personnel

Olexander Geyets,
Managing Director,
National Center for Training of Bank Personnel

US Treasury (Kiev)

March 8, 2001

George Mullinax
Resident Banking Advisor

German Advisory Group on Economic Reform In Ukraine

March 13, 2001

Lars Handrich

Ihor Ermenko

TACIS European Union

March 20,2001

Franz Goetz
Eleonora Nikolaichuk

Aval Bank

March 20, 2001
March 21, 2001
March 23, 2001
March 26, 2001
March 27, 2001

Oksander V. Derkach
Chairman of the Board

Vadym Berezovyk
Chief Loan Administration

Natalia Kozhuchirvska
Head of Internal Audit

Edward M. Rosenblat
Treasurer,
Director of Finance Department

Jakov V. Smoliy
Deputy Chairman of the Board

Ivan Voloschuk
Chief Accountant

Forum Bank

March 28, 2001

Ludmila Parchamenka

Tonya Kvoska

World Bank (Kiev)

March 21, 2001
March 29, 2001
Angela Prigozhina
Financial Sector Specialist

National Bank of Ukraine

March 19, 2001
March 21, 2001
March 22, 2001
March 23, 2001

Vira I Rychakivska
Chief Accountant

Igor Y. Goryachek
Deputy Director
General Department of Banking Supervision

Victor Zinchenko
Director
Department of Inspections and Monitoring

Constintine Rayevsky
Unit of Methodology

Ms. Donchenko
Division of Liquidation

Olena Poletaeva
Internal Audit of NBU

APPENDIX E: LIST OF REPORTS AND PUBLICATIONS

Reports

1. Agency for International Development (A.I.D.), A.I.D. Evaluation Handbook, A.I.D. Program Design and Evaluation Methodology Report No 7, April 1987

2. Bank Aval, Commitment Letter, April 26, 1999

3. Basel Committee on Banking Supervision, Core Principles Methodology, Revised 30.08.99

4. Barents Group, Financial Sector TA/Monetary: Ukranian Financial Infrastructure Development: Bank Supervision, Project Number: 110-0009 Economic Restructuring

5. Barents Group, IMF Core Principles Assessment, a review by Karen Wilson, Senior Advisor, to O. I. Kireyev, Deputy Governor, NBU, November 12, 1999 (Note: See IMF, Core Principles Assessment, 1999)

6. Barents Group, Final Report, NIS Bankers Training Program in Ukraine, Sponsored by USAID, National Center for the Training of Bank Personnel of Ukraine, August 1993 – August 1998

7. Barents Group, Final Report, NIS Bankers Training Program in Ukraine, Sponsored by the United States Agency for International Development, September 1998 – August 2000

8. Barents Group, Financial Sector Restructuring and Privatization Services in the ENI Region, *National Bank of Ukraine, Kiev, Ukraine*, December 31, 2000

9. Barents Group, Contract No. # OUT-PCE-815-99-00006-00, T.O. # 815

10 Barents Group, Contract No. # OUT-PCE-I-815-00006-00, T.O. # 815, with attachments

11. Booz Allen & Hamilton Inc., First Project Year Report – Aval Bank, 1 October 1999-30 September 2000

12. Michael Borish and Company, Inc., with Triumph Technologies, Inc., An Assessment and Rating of The Ukrainian Banking System (for the United States Agency for International Development, Bureau for Europe & New Independent States, Office of Privatization & Economic Restructuring), Summer 1998

13. James R. Brady, Preparing Your Own Project Evaluation Checklists: A Conceptual Framework and Sample Questions, Revised August 1994
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14 International Bank for Reconstruction and Development, Ukraine: The Financial Sector and the Economy, The New Policy Agenda, *Summary Report*, September 2000

15. International Bank for Reconstruction and Development, Ukraine: Financial Sector

Adjustment Loan, February, 2000

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17. International Monetary Fund, II. Core Principles Assessment, 1999 (Note: part of a larger Report)

18. Ukraine, Government of, Law of Ukraine On the National Bank of Ukraine, with amendments through July 13, 2000

19. Ukraine, Government of, Law of Ukraine On Banks and Banking, December 2000 United States Agency for International Development, UKRAINE, Congressional Presentation 2000, 2000

20. United States Agency for International Development, USAID Mission to Ukraine, Belarus and Moldova, Overview of the Banking System in Ukraine, by Olesia Verchenko, edited by Boris H. von Hoffmann, Summer 2000

21. USAID Ukraine, SO Text for SO: 121-014 A more competitive and market-responsive private financial sector, Kiev, February 2001

22. National Bank of Ukraine, Department of Onsite Inspection, Policy Guidelines for Onsite Bank and Banking Institution Examinations in Ukraine, Kiev 1998

23. National Bank of Ukraine, 8.1. Banking, through 8.3. Accounting and Auduting, 4 pages, undated

24. Financial Services Volunteer Corps, Funding Proposal for Banking and Capital Markets Program Activity in Ukraine, August 1, 1999 – July 31, 2000. Submitted to USAID, May 19, 1999

25. Bank Aval, Commitment Letter, April 26, 1999

26. IBTCI, Scope of Work, Financial SectorTA/Monetary, Ukraine Bank Accounting and Operations InfrastructureDeveleopment Project, Addendum II: Omnibus 2 Task Order OUT-EPE-804-95-00056-00, Contract EPE-I-00-95-00056-00

27. The Barents Group, Financial SectorTA/Monetary: Ukranian Financial Infrastructure Development: Bank Supervision, Strategic Objective: 1.4; Project Number: 110-0009 Economic Restructuring, Period October 1,1998 – September 30, 2,000

28. NBU Board Resolution # 279 dated 07-06-2000, POLICY On the procedure of formation and usage of the loan loss reserve by banks, Registered with the Ministry of Justice of Ukraine on Augus3, 2000 under # 474/4695

29. National Bank of the Republic of Ukraine, Enforcement Manual of the National Bank of Ukraine, Draft 6/2000

30. National Bank of the Republic of Ukraine, Problem Bank Unit Manual, undated

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31. International Management Institute (IMI-Kyiv), Building IMI-Kyiv: The Next 10 Years, published by IMI-Kyiv, Kiev, 1999

32. International Management Institute (IMI-Kyiv), International Management Institute, history and program directory, published by IMI-Kyiv, Kiev, 2000

33. United States Agency for International Development, USAID Activities in Ukraine "Partnership 2001", USAID Regional Mission to Ukraine, Belarus and Moldova, Kiev, 2001

34. National Bank of Ukraine, Herald Digest of the National Bank of Ukraine, Issues 1-6, 2000

35. Bank Forum, Financial Statements In Accordance with International Accounting Standards As at December 1999 and 1998 Together with Independent Auditors' Report (prepared by Arthur Andersen)

36. National Center for the Training of Bank Personnel; Illustrated Pamphlet describing Objectives, Partners, Major Activities, etc. Kiev, undated

37. Kyiv Investment Management Institute, International MBA, published by the Consortium for Enhancement of Ukrainian Management Education (CEUME), Kiev, 2000

38. European Bank Training Network, Newsletter, Nr. 12, Fall 2000

APPENDIX F

I. SCOPE OF WORK

I. Background

A. Development of Banking since Independence

Following independence in 1991, Ukraine embarked on a restructuring of its planned economy towards one guided more by market principles. However, instead of making a sudden change the government adopted a gradual approach with state-owned enterprises still an important element in nearly all sectors of the economy today. A similar development took place in the banking industry. Initially the government banks for savings, heavy industry, export-import, public housing and the agricultural industry were restructured from branches of the Soviet banking system to stand-alone Ukrainian entities.

Following the passage of a banking law in 1992, government-owned or newly privatized economic entities, either alone or together with partners, started to establish banks to service their businesses and provide financing for their activities. In many cases enterprises established their own "pocket" banks, encouraged by minimal capital requirements. This led to a proliferation of banks. While at the end of 1997 there were 227 banks, today there are still over 160 banks operating in Ukraine, many of which are very small and unable to meet the capital requirements of the National Bank of Ukraine (NBU).

The financial condition of banks was severely affected by the highly inflationary environment during the period from 1991 to 1995. In 1994 the NBU began to institute stricter banking supervision criteria and principles, supported by technical assistance made available by international donors. To better evaluate the financial condition of banks, the NBU required banks to adopt International Accounting Standards (IAS) for their general ledger as of January 1, 1998.

This helped the banking system in Ukraine to survive the financial crises of August 1998 that led to the breakdown of, for example, the banking system in Russia. However the crisis also demonstrated that there were serious weaknesses in the banking system which together with the highly unstable economic situation could lead to a meltdown of the system. The potential consequences of not addressing these problems would have been the loss of the savings of millions of people as happened in Russia.

Led by experts from the International Monetary Fund (IMF) and the World Bank (WB), USAID, EU-TACIS and other international donors assisted in the implementation of IAS at the banks and then participated in comprehensive audits of the seven largest and most "second tier" banks. As a result of these audits in mid-1999 the banks agreed to restructure their operations in order to improve their financial condition, as mandated by the NBU in "Commitment Letters" with the banks. USAID and EU-TACIS agreed to assist the seven largest banks in this restructuring, with insights gained in accounting, auditing and credit operations made available to the rest of the banking community.

B. USAID Banking Sector Strategy

In 1995 USAID embarked on a comprehensive strategy for assistance in building the foundations of a viable banking sector in Ukraine. The basic assumption was that in order for an efficient market economy to develop, the function of banks had to be transformed. Instead of being providers of funds according to the government's plan, they had to become intermediaries for individuals as well as institutions accumulating savings so that these funds could be made available to production and service industries requiring loan and shareholder capital for investments. Only then could Ukraine expect sustained growth of the economy.

Also, in view of several negative experiences by savers in the past such as hyper-inflation, institution of new currencies and bank failures leading to the loss of most savings, trust in the banking system needed to be reestablished. USAID decided to address the lack of trust in the banking system through technical assistance, the three principal components of which were: developing banking supervision and regulations; promoting transparency in banking by introducing IAS; and strengthening human resources through training bank examiners and banking staff.

Our assistance efforts in the restructuring of the larger banks during 1999 to 2001 are focused on Aval Bank, one of the largest banks. Lessons learned at Aval Bank are also expected to be made available to the general banking community, especially to "second tier" banks. Besides several "second tier" and small banks in Kiev we assisted Ukrsib Bank of Kharkiv in implementing IAS accounting and internal audit procedures.

In addition, principles of modern banking, accounting and auditing have been disseminated to the banking community through USAID training programs at the National Center for Training Bank Personnel (NCTBP), the International Management Institute (IMI), the NBU Academy and other bank training centers in Kharkiv and Lviv. To assist with the introduction of IAS and internal auditing procedures, our advisors also organized workshops in various banks. Accounting and auditing techniques and programs have also been available electronically through the Internet. This includes the software for converting Ukrainian balance sheets to IAS-compliant financial statements.

II. USAID Technical Assistance for the Banking Sector

<u>Activities, Implementers and Counterparts</u>

<u>Banking Supervision and Regulations:</u>
<u>Contract # 121-C-00-98-00628-00</u>
Starting in 1995, technical assistance in on-site and off-site supervision, problem bank resolution and policy advice to senior supervision managers, the Deputy Governor for supervision and the Governor of the NBU has been provided mostly by KPMG Consulting-Barents Group (Barents Group), McLean, VA.

Barents Group has also provided short-term advisors for drafting the new Law on Banks and Banking and related legislation as well as various regulations such as for enforcement actions by the NBU. This activity is continuing at a reduced level until November 2001.
Counterpart: National Bank of Ukraine (NBU

Introduction of IAS, Internal Auditing and Management Information Systems:
Contract # OUT-EPE-I-804-95-00056-00
The contractor for these activities was International Business & Technical Consultants (IBTCI), Inc., Vienna, VA. While the emphasis during the initial phase was on introducing IAS and internal auditing throughout the banking industry, during the last year the contractor concentrated on introducing modern bank management reports and systems at Aval Bank and assisting in the development of IT application systems for monitoring risks. Activities have been completed and the contract is terminating in December 2000.
Counterparts: Aval Bank, other banks in Kiev, NCTBP

Training of Banking Staff:
Contract # OUT-EPE-I-805-95-00070
Contractors at the NCTBP were IBTCI and Barents Group. Courses covered IAS, internal auditing procedures, credit risk evaluation and basic banking principles. This activity has ended with the contract terminated in July 2000 and the NCTBP continuing on a stand-alone basis.
Counterpart: NTCBP

Training of Bank Examiners:
Contract # 121-C-00-98-00628-00
This was done mostly in-house at the NBU in Kiev and throughout NBU regional offices by Barents Group and will continue until November 2001 under the Banking Supervision program.
Cooperative Agreement # EPE-0009-A-00-6013-00
The Financial Services Volunteer Corps (FSVC), New York, NY supplied senior bank managers and examiners who assisted in providing on-the-job training for examiners. FSVC also sponsored internships for examiners in the USA.
Counterpart: NBU

Training of Bank Management:
Old: Contract # OUT-EPE-I-805-95-00070-00
New: Contract # OUT-PCE-I-815-99-00006-00, TO # 815
Contractor at the IMI for the MBA in Banking, now MBA in Finance, is Barents Group. This is a one-year full-time program covering standard management principles and procedures with a concentration on the financial sector. It includes a three-week study tour of financial institutions and organizations in the USA. This activity is expected to continue until July 2002.
Counterpart: IMI

Commercial Bank Restructuring:
Contract # OUT-NIS-I-800-98-00035-00

Contractor for this continuing activity is Booz-Allen & Hamilton (BAH), Inc., McLean, VA. During the first year restructuring included development of Management Information systems and reports (by IBTCI, see above). BAH has been concentrating on developing a strategy to meet the requirements of Aval's Commitment Letter with the NBU. This consists essentially in improving the bank's CAMEL ratios (i.e. capital, asset quality, earnings, liquidity). In addition, BAH is assisting in developing a credit department and sound risk and credit management. This contract is scheduled to end in September 2001.
Counterparts: NBU, Aval Bank; Ukrsibbank, Kharkiv

B. Banking Industry Outlook

Based on USAID experience gained in Poland, where it took seven years to develop a functioning banking supervision department at the National Bank of Poland, we estimate that development of an autonomous banking supervision entity in Ukraine would take at least another two years since Ukraine, unlike Poland or other Eastern European countries, started out without the benefit of any institutional memory of a market economy.

Our training efforts to date have resulted in developing the NCTBP to operate on its own, and our MBA in Finance program at IMI is expected to be self-sufficient in a few years. However, it will probably take several more years to develop an adequate number of bank examiners, accounting, auditing and banking staff and managers and to introduce modern bank and risk management principles and procedures throughout the banking industry in Ukraine.

Also, in the near future the banking industry in Ukraine will have to start consolidating through merging the many small, medium-sized and "second tier" banks and by eliminating insolvent and/or capital-deficient institutions. This will require outside technical assistance. Consolidation will include restructuring or winding up of several large banks that are either owned by the government and/or where their poor financial condition is due to government-directed lending. The government will therefore have to assume responsibilities for resolving these problem banks.

III. Purpose of the Evaluation

A. The evaluation is being conducted to measure progress made with USAID assistance towards the achievement of USAID's Strategic Objective 1.4, A More Competitive and Market-Responsive Private Financial Sector. Specifically, the evaluation will focus on those activities that are aimed at achieving Intermediate Result 1.4.1, Market-oriented private banking sector developed.

B. The principal aim is to arrive at an appreciation of the progress made in the three areas outlined previously, i.e.

- improving banking supervision and banking regulations;
- promoting transparency in banking through use of IAS and International Standards of Auditing (IStA);
- and strengthening human resources in banking and supervision through training.

C. Finally, it will indicate specific activities in the banking sector that may be proposed to realize the Strategic Objective as well as the Intermediate Result.

The evaluation should address, but not be limited to, the following key questions:

- Are the activities achieving or helping to achieve the desired results of SO 1.4?
- Are USAID activities well-coordinated with those of other international donors, such as EU-TACIS, the WB, IMF etc.?
- <u>What is the extent of progress of enforcement of corrective actions by the NBU banking supervision unit?</u>
- <u>To what extent are the conditions for securing loans (such as the new Pledge Registry) adequate/inadequate to permit the growth of lending by banks?</u>
- Are activities building local capacity to carry on reform efforts for banking after USAID–funded technical assistance ends?
- What institutional reforms have been or are being instituted to support an effective banking system in a market economy?
- What future technical assistance or training activities would be recommended to improve and increase lending by banks?
- <u>What in-bank technical assistance activities would be recommended to improve risk management?</u>
- Other key questions that may point to follow-on activities and/or should be asked in the U.S. of previous consultants not now in Kiev.

IV. Statement of Work

The Bank Evaluation Team shall:

- at the beginning of the contract period spend three working days interviewing AID/W personnel and gathering background information and assessments on banking and financial sector reform from both the ENI and Global bureaus (a list of potential interviewees and information sources will be provided by the Mission following signing of the contract);

- review recent reports and assessments on the banking and financial sector issued by the IMF, the WB, the EBRD and other international donor organizations;

- interview relevant USAID/Kiev and contractor personnel and review Mission and consultants' reports, evaluation and analyses of the banking sector reform activities (such as Performance Monitoring Reports) as well as become thoroughly familiar with the Mission Strategy on Banking Sector Development;

- review the underlying assumptions of USAID's banking sector strategy;

- review the legal framework governing banking operations and lending in Ukraine, including an assessment of the statutes dealing with secured lending and the outlook for needed reforms;

- review documents and reports issued by the National Bank of Ukraine (NBU) addressing issues of banking supervision and banking regulations;

- interview Ukrainian counterparts from the banking industry such as management of large, "second tier" and small banks and from the Ukrainian Association of Banks (UAB);
- assess what progress has been made by the NBU bank supervision unit in assessment of risk and solvency problems at commercial banks;
- determine to what degree and in which way the NBU has been able to enforce appropriate corrective measures against problem banks;
- assess the outlook for further strengthening of the NBU's measures for enforcement;
- determine to what degree political will exists to implement enforcement measures;
- assess the role of women in decision-making positions in banking;
- assess the participation of women in USAID's training activities;
- assess the contribution made by contractors mentioned above in their respective activities;
- propose future activities that would address specific issues identified above and would advance the Strategic Objective for the financial sector;
- no less frequent than weekly, brief Mission management and technical personnel on overall progress and findings of the evaluation team and development of concepts/ideas for future activities;
- prior to departure from Kiev present a final briefing to Mission management and technical personnel on recommended changes/improvements to USAID's activities in the banking and sector.

To accomplish the task, the Contractor will provide a Bank Evaluation Team consisting of two persons, one specialist in banking supervision (Team Leader) and one in bank and credit management. The Bank Evaluation Team will begin work within fifteen days of the signing of the contract. After the initial discussions in Washington, DC the Bank Evaluation Team will travel to Kiev, Ukraine to complete the activities in above Statement of Work.

The Bank Evaluation Team will work three days in Washington, DC meeting with USAID personnel, the WB and with contractors Barents Group and BAH in McLean, VA and IBTCI in Vienna, VA. Subsequently the Bank Evaluation Team will work three weeks in Ukraine (six-day workweek).

Not less than three workdays prior to departure from Kiev, the Team Leader will present a draft of the Team's report on program status and recommendations for review and comments by USAID (draft of deliverable # 2). On or before the final workday in Kiev the Team will present an oral

C. Finally, it will indicate specific activities in the banking sector that may be proposed to realize the Strategic Objective as well as the Intermediate Result.

The evaluation should address, but not be limited to, the following key questions:

- Are the activities achieving or helping to achieve the desired results of SO 1.4?
- Are USAID activities well-coordinated with those of other international donors, such as EU-TACIS, the WB, IMF etc.?
- What is the extent of progress of enforcement of corrective actions by the NBU banking supervision unit?
- To what extent are the conditions for securing loans (such as the new Pledge Registry) adequate/inadequate to permit the growth of lending by banks?
- Are activities building local capacity to carry on reform efforts for banking after USAID–funded technical assistance ends?
- What institutional reforms have been or are being instituted to support an effective banking system in a market economy?
- What future technical assistance or training activities would be recommended to improve and increase lending by banks?
- What in-bank technical assistance activities would be recommended to improve risk management?
- Other key questions that may point to follow-on activities and/or should be asked in the U.S. of previous consultants not now in Kiev.

IV. Statement of Work

The Bank Evaluation Team shall:

- at the beginning of the contract period spend three working days interviewing AID/W personnel and gathering background information and assessments on banking and financial sector reform from both the ENI and Global bureaus (a list of potential interviewees and information sources will be provided by the Mission following signing of the contract);

- review recent reports and assessments on the banking and financial sector issued by the IMF, the WB, the EBRD and other international donor organizations;

- interview relevant USAID/Kiev and contractor personnel and review Mission and consultants' reports, evaluation and analyses of the banking sector reform activities (such as Performance Monitoring Reports) as well as become thoroughly familiar with the Mission Strategy on Banking Sector Development;

- review the underlying assumptions of USAID's banking sector strategy;

- review the legal framework governing banking operations and lending in Ukraine, including an assessment of the statutes dealing with secured lending and the outlook for needed reforms;

- review documents and reports issued by the National Bank of Ukraine (NBU) addressing issues of banking supervision and banking regulations;

briefing to the Mission on the results and draft recommendations. A period of five workdays will be provided to the Team Leader to prepare deliverables # 1 and # 3 in the USA.

The Final Report is due within twenty days of the Team Leader's departure from Kiev, but in any event no later than March 20, 2001.

V. Deliverables

The Contractor's Bank Evaluation Team will deliver a Final Report that will include the scope and methodology used, important findings and facts collected, and conclusions and recommendations. Specifically, the Final Report, not to exceed 40 pages, will contain an Executive Summary highlighting the major conclusions and recommendations, as well as the following:

1. Report on banking sector activities by Barents Group, IBTCI and BAH for the years 1995 to 2000.
2. Report on the state of the banking sector of Ukraine, evaluation of the impact of USAID activities and recommendations for future technical assistance during the coming years 2002 to 2003 consistent with USAID Mission strategy.
3. Draft scope of Work for contractor's activities for the years 2002 and 2003.

VI. Logistics

The Bank Evaluation Team will perform the functions required in Kiev, including visiting the NBU, the UAB and selected banks, the NCTBP and IMI.

VII. Qualifications

The Bank Evaluation Team will consist of a Team Leader and a Banking and Credit Specialist. The Team Leader and the Banking and Credit Specialist should be experienced professionals having a thorough knowledge of the banking industry in at least one former Comecon country, such as Poland, the Czech Republic, Hungary or the Baltic States. Both should be thoroughly familiar with the problems facing the banking industries in the NIS.

The Team Leader will have at least ten years experience in banking supervision policy and operations in the United States and should be familiar with evaluations for USAID.

The Banking and Credit Specialist will have at least eight years wholesale/retail banking experience and preferably also have a background in accounting, auditing and bank training.