

KPMG Consulting
Barents Group

Quarterly report for quarter ending December 31, 2001
Ukraine Infrastructure Development – Bank Supervision
Contract #121-C-00-98-00628-00

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The advisors identified with each benchmark are the "lead" advisors in that area. However, all team members contribute to fulfillment of objectives in all areas.

Benchmarks for the extension period (end results of joint efforts by NBU and advisors):

1. The General Department of Bank Supervision (GDBS) will have the capacity to deal with problem banks and will have a strategy in place to deal with large problem banks.

Relevant core principles: P1.1, EC4; P1.4, EC4; P16; P18; P22

Advisor: Glenn Tasky and Oleksiy Kutsenko
NBU counterpart: Faber, Zinchenko
Authority: Krotyuk, Kiryeyev

By December 31, 2001:

- Provide examples of supervisory strategies for large and largest banks to initiate the process of supervisory strategies development.

A supervisory strategy prototype has been developed, and actual sample supervisory strategies were prepared by the advisors for several problem banks. Department of Inspections and Monitoring (I&M) has grasped the importance of supervisory strategies. "Problem bank" designation changed to "bank requiring special supervision" to avoid stigma. Such banks were identified and I&M began preparing supervisory strategies themselves on these banks.

By March 31, 2002:

- Assist in development of special supervision regime in NBU head office to ensure consistency in supervisory approach towards problem banks.

- Review the applicable policies and procedures in the area of capital restoration plans to suggest improvements and amendments.

By June 30, 2002:

- Follow progress by NBU in monitoring approved capital restoration plans and issue guidelines in approval of new plans.
- Review current practice of applying stricter benchmarks for capital and liquidity to banks with excessively high risk profiles in order to ensure its proper application.

2. The Enforcement Manual of the GDBS will be modified to correspond to relevant portions of the Law on Banks and Banking as well as to Amendments to the NBU law and accounting and tax laws.

Relevant core principles: P1.1, EC4; P1.4, EC4; P16, P18; P22

Advisor: Glenn Tasky and Oleksiy Kutsenko

NBU counterpart: Faber, Zinchenko

Authority: Krotjuk, Kiryeyev

By December 31, 2001:

- Propose a streamlined method of applying enforcement actions that increases the role of the Commission on Bank Supervision.

Proposal was made and well-received by Mr. Kiryeyev (Attachment 1). The NBU is now in the process of changing the composition of the Commission in line with advisors' recommendations and to increase its role in enforcement actions.

- Review Resolution 369 (Enforcement Actions) and make proposals for improvement.

At the request of Mr. Kiryeyev, advisor prepared memorandum with initial recommendations (Attachment 2). This first step revealed that several aspects of the regulation would require clarification through the issuance of "reglements" or internal documents specifying the procedures for selecting and applying various enforcement actions. Methodology Unit has already prepared one such "reglament" which the advisors reviewed (Attachment 3).

By March 31, 2002:

- Continue to review Resolution 369 and make additional proposals for improvement based upon its practical application.
- Issue additional guidelines in the use of written agreements and orders to suspend various banking operations.

By June 30, 2002:

- Issue additional guidelines in the use of written warnings to banks, including timing of such actions to correspond to problems identified by early warning system.

3. The GDBS will have an Outreach Program to banks in place.

Relevant core principles: All

Advisors: Karen Wilson (when in country), Glenn Tasky

NBU Counterpart: Kiryeyev

Authority: Krotyuk

By December 31, 2001:

- The NBU will have had one meeting with commercial banks to discuss regulatory developments in 2001.

Bankers meeting held Nov-22-01. Agenda discussed with BS management and revised to allow for more participation/dialogue. Due to time commitments of NBU senior management and Banking Association management, a decision was made to have one meeting for all banks.

By March 31, 2002:

- The advisors will assist the NBU in planning for another meeting with commercial banks, to be held in the second quarter. Possible topics of discussion will include enforcement actions, banks' responsibilities in the fight against money laundering, and supervision of banks' affiliates.

By June 30, 2002:

- The NBU will hold the meeting with commercial banks that was planned with the assistance of the advisors.

4. Reporting by banks presently requiring much redundant data will be rationalized:

Relevant core principles: P1.1: EC2, AC2; R4: AC1; P6: EC6; P18: EC1; P20: EC5, EC6.

Advisor: Alex Kutsenko

NBU counterpart: Karcheva

Authority: Richakivs'ka (Director, Accounting Department), Kiryeyev

(The major focus of this initiative will be on reporting requirements imposed on commercial banks by bank supervision function. If circumstances permit and if cooperation with other NBU departments is reached the scope of the initiative will be broadened to cover reporting requirements imposed by other NBU departments.)

By December 31, 2001:

- Follow-up on the activities from preceding quarters.

Basically there was no activity this quarter. NBU management is mostly satisfied in the quality and frequency of information arriving from banks as they tend to pay much more attention to data in areas other than bank supervision. In bank supervision, one reporting form was added to collect information on 20 largest shareholders as a step towards consolidated supervision. Another step in this direction are consolidation procedures drafted in Accounting Department and pending for official approval. It was decided that in the beginning of 2002 there will be another attempt by bank supervision to reduce the number of forms by taking raw data available to other departments and arriving to necessary data through mathematical calculations. Mr. Tasky and Mr. Kutsenko wrote memo (Attachment 4) suggesting to remove the possibility to abuse accrual method and to implement more appropriate accounting treatment for impaired accrued items.

By March 31, 2002:

- Study the possibility to use data files received by other NBU departments to generate bank reports currently used by Bank Supervision in order to rationalize the data flow from commercial banks.
- Participate in development of new accounting policies concerning assets valuation and the reporting forms thereto.

By June 30, 2002:

- Follow up on the activities from the preceding quarters.

5. Capacity to screen banks for their ability to deal with sudden changes in interest rates and exchange rates will have been developed.

Relevant core principles: P12. P13: AC3. P18

Advisor: Glenn Tasky

NBU counterpart: Romanenko, Karcheva, Zinchenko

Authority: Kiryeyev

By December 31, 2001:

- No activity planned for this quarter.

By March 30, 2002:

- Reactivate work on enhancing maturity-gap reporting form for the measurement of interest-rate risk.
- Review use of early-warning system variables for the measurement of foreign exchange risk and make recommendations for their further development.

By June 30, 2002:

- Assist the NBU in conducting experiments with newly-received data to estimate interest-rate risk exposure.

6. GDBS supervision principles will be largely compliant with the Basle Core Principles of Banking Supervision.

Relevant core principles: All

Advisors: Karen Wilson (when in country), Raisa Ladokhina, all advisors in their functional areas

NBU counterparts: Kiryeyev, Rayevs'kii, Romanenko,

Authority: Krotiuk, Kiryeyev

By December 31, 2001

- Assist the NBU in clarifying actions needed to reach compliance with Principle XX (Consolidated Supervision).

As an initial step, advisors prepared a table summarizing actual and necessary additional authorities and policies to implement consolidated supervision according to Basle Committee and EU standards (Attachment 5).

- Introduce the topic of consolidated supervision at a seminar of regional managers.

Advisor presented a conceptual framework for consolidated supervision at a seminar for 9 regional managers and 3 deputy regional managers. Also present were two representatives from the methodology department, which will be responsible for writing and implementing much of the additional necessary regulations.

- Assist the NBU in clarifying actions needed to reach compliance with Principle 15 (Anti-Money Laundering).

Advisor prepared a memorandum summarizing necessary actions to ensure that banks fulfill their responsibilities for customer acceptance, customer identification, reporting of suspicious transactions, recordkeeping, and training, and that the NBU fulfills its responsibility to share information with other supervisors both inside and outside Ukraine (Attachment 6).

- Assist the NBU in preparing proposals to be submitted to the Verkhovna Rada for amendments to the Law on Banks and Banking Activity to provide the legislative base for further compliance.

NBU Board submitted proposals to VR in late December. Most of the advisors' recommendations for amendments to the Law that specifically focused on Basle Committee compliance were accepted by the NBU and forwarded to the VR. The NBU legal department considers it unlikely, however, that the VR will act on the proposal until after the March parliamentary elections. (A summary of the most important changes necessary to achieve Basle Committee compliance is contained in Attachment 7.)

- Assist the NBU in completing a self-assessment of compliance with the Principles, in anticipation of a review by the IMF or World Bank in early 2002.

Performed an assessment of the Basel Core Principles in coordination with Bank Supervision staff at the request of Kiryeyev and Krotiyuk. The assessment was done using the Apr-01 Self-Assessment Guidelines issued by the Basel Committee. Each criteria was rated and recommendations made on actions to bring Bank Supervision into compliance with each principle. In compliance with the Basle Committee recommendations, the assessment consisted of two parts: a) assessment of the legal and regulatory framework; b) assessment of practices. Another new aspect of the current assessment was that it was stated at what level actions are to be taken to improve the level of compliance for each criteria. (See Attachment 8, which contains a sample of the Assessment Table that shows the assessment of Principles 9 (Credit Policy) and 19 (Accounting)).

- Assist in the identification of essential issues to be addressed in order to achieve full or large compliance with all Core principles in terms of the legal framework

The major four areas identified as priorities to be addressed by the NBU are: Consolidated Supervision, Risk Management Systems, Money Laundering, and Corporate Governance.

- Provide advice on specific Principles and criteria to achieve the full or large compliance with them

Advice was provided primarily to the following Principles: 6(Capital Adequacy), 10 (Connected Lending), 12(Market Risk), 13 (Other Risks), 14 (Internal Control), 18 (Offsite Supervision), 20 (Consolidated Supervision), 21 (Accounting), 22 (Remedial Measures), 23(Global Consolidation), 24 (Host Country Supervision).

By March 31, 2002:

- Assist in the updating of the action plan aimed at achieving full or large compliance with all Core principles in terms of legal framework
- Assist in the preparation of the NBU bank supervision to the assessment of their compliance with Core Principles by the joint IMF and World Bank mission
- Provide advice on specific Principles and criteria to achieve the full or large compliance with them. Specifically, prepare proposal for the introduction of a policy to regulate country risk.

By June 30, 2002:

- Assist the NBU bank supervision area to go through the IMF and World Bank assessment
- Assist the NBU to the updating their action plan in compliance with the IMF and World Bank conditions
- Provide advice on specific Principles and criteria to achieve the full or large compliance with them

7.1: Institution building of the GDBS as a stand-alone entity under the "umbrella" of the NBU will be well on its way.

Relevant core principles: P1.2. P1.5

Advisors: Karen Wilson (when in country), Glenn Tasky

NBU counterpart: Krotjuk, Kiryeyev

Authority: Krotjuk, Kiryeyev

(In conformance with the NBU's own proposals for implementing the Presidential Decree of July 2000, the concept of "be a stand-alone entity under the umbrella of the NBU" will be interpreted as "function more autonomously within the NBU." Of course, the measures taken to function autonomously within the NBU are necessary prerequisites to becoming a stand-alone entity; however, full autonomy is not contemplated for 2002.)

By December 31, 2001:

- Propose a reorganization of the Bank Supervision Commission to reduce influence of individuals outside bank supervision.

Proposal was made and accepted. (See Attachment 1, already referenced.) Bank Supervision Commission will now consist of representatives only from the bank supervision, accounting, legal, and foreign exchange areas, and Bank Supervision will have a majority of the representatives. More work needs to be done to change the composition of the Commissions in the regions, which still rule on relatively minor issues like branch manager approval and still consist primarily of non-supervision people.

By March 31, 2002:

- Propose further measures to reduce influence of regional NBU governors on the supervision process.

By June 30, 2002:

- Propose concrete measures for autonomous budgetary allocation to bank supervision from general NBU revenues.
- Follow up on earlier proposals.

7.2. Coordination and cooperation among units of the GDBS as well as with the banking supervision units at the NBU regional branches will have been established.

Relevant core principle: P16, EC4

Advisor: Glenn Tasky, Oleksiy Kutsenko, Raisa Ladokhina

NBU Counterpart: Zinchenko, Faber

Authority: Zinchenko

By December 31, 2001:

- Continue training regional staff in the use of the Uniform Bank Performance Report to facilitate a standardized method of financial analysis for use both on-site and off-site.

First, the Kiev regional office held a seminar for its own staff using its own trainers, with the help of the advisor. Next, the advisor conducted an additional seminar in Odesa for the southern regions. The report was also presented to the regional managers of bank supervision at the Chernigov conference. Plans are being made to carry the series to the western and eastern regions in the first quarter of 2002.

- Propose a method of standardizing the application of enforcement actions to eliminate the problem of inequality among regions.

Proposal was made as part of a complex document (see Attachment 1, already referenced).

By March 31, 2002:

- Assist the NBU in further development and refinement of the Uniform Bank Performance Report.
- Conduct two additional regional training sessions in the use of the Uniform Bank Performance Report.
- Lobby for the implementation of new enforcement action procedures.
- Advise on further centralization of regional activities.

By June 30, 2002:

- Assist the NBU in the issuance of general instructions for use of the Uniform Bank Performance Report in financial analysis.
- Assist the NBU in preparation of a pre-inspection scoping package to be prepared by off-site supervision for on-site inspection.

7.3. A management information system for the GDBS will be in place:

Relevant core principles: P1.1: AC1, AC2; P10: EC7; P18: EC4, EC6.

Advisor: **Oleksiy Kutsenko**

NBU counterpart: **Karcheva**

Authority: **Kiryeyev**

(For the purpose of this benchmark the “Bank Dossier” system is deemed to be the management information system. “Bank Dossier” includes, but is not limited by, licensing information, onsite reports, offsite analysis, Uniform Bank Performance Reports, supervisory strategy and other pertaining information.)

By December 31, 2001:

- Review the rules of access to Dossier to make sure that respective personnel in NBU Head Office as well as Regional Offices has the ability to retrieve data from Dossier.

The rules of access to Dossier have been reviewed and proposed to be streamlined. The management of GDBS has committed to ensure access to Dossier by all regional offsite analysts as part of UBPR implementation. However in some regions this still will be a problem for the most part of next year because of the security issues (protocols, passwords, and connection hardware). It was agreed that regional analysts shall have at least the review access (where edit access is not possible). After UBPR seminars presented by Mr. Tasky and Chernigiv Conference regional offices became fully aware of Dossier advantages and have great desire to use this MIS.

By March 31, 2002:

- Participate in the development of Bank Passport as a concise management report.
- Participate in development of additional modules to Bank Dossier.

By June 30, 2002:

- Continue efforts to ensure management information system of bank supervision is in place and operational.

7.4. GDBS will have started to develop its own personnel policies and the capacity to train and certify examiners.

Relevant core principles: P1.2: EC5; P16

Advisor: Raisa Ladokhina

NBU counterpart: Rayevsky, Faber, Ivanenko

Authority: Krotiyuk, Kiryeyev

(A major focus of this benchmark is assisting in the development a formal training program of basic courses to be taken by all supervision personnel and a process for its step-by-step implementation, as well as ensuring that a group of dedicated individuals are trained as instructors. This objective will require NBU management commitment.)

By December 31, 2001:

- Assist in the preparation of a training schedule for the next year

A proposal was made to the NBU to add to the existing schedule seminars on the Instructor Training, Risk Management, Risk Sensitivity, and UBPR for the regional staff.

- Assist in organizing a train the trainers seminar for managers of regional bank supervision units

The seminar was held from December, 10 through December, 12 in the NBU Training Center. Participant were managers or deputy managers of banks supervision units of the NBU key regional offices. This time the seminar had a new focus: 1) our intention was to have people practice not just their general presentation skills, but discuss matters relevant to their professional activities (Attachment 9 is the list of discussion topics developed and proposed by us); 2) a presentation of the formal training concept that we are working on was made to them as representatives of the NBU regional offices; 3) a brief research of their training needs was made with the help of a questionnaire developed for this seminar in order to take this

information into consideration during the updating of the existing program proposal (Attachment 10).

- Assist in the preparation of a new training concept (in cooperation with the NBU and the Dutch grant)

At the request of the NBU and the Dutch grant, and consistent with our own task order, we have come up with a proposal on the new training concept that will be developed to replace the one passed on July, 2001. Our proposal is based on a thorough needs analysis of the NBU bank supervision. Under the proposal of the Dutch grant, a working group was organized to work on the new concept, of which Glenn Tasky and Raisa Ladokhina are members. The draft version of the concept is to be discussed by the middle of January. (Attachment 11 is a short synopsis of the current version of the concept, followed by full Ukrainian text.)

By March 31, 2002:

- Assist in the development of a general training program for the NBU Central Office and regions
- Assist in the development of a detailed basic course of the training program passed by the NBU
- Assist in the updating of the training schedule for the next quarter

By June 30, 2002:

- Assist in the development of a detailed advanced course of the training program for bank supervisors
- Assist in the development of a CD – rom with training materials to be distributed to the NBU bank supervision staff
- Assist in the updating of the training schedule for the next quarter

7.5. Quality control measures covering inspection of banks will have been instituted

Relevant core principles: P1.1: AC1; P16, AC1

Advisor: Raisa Ladokhina, Glenn Tasky

NBU counterpart: Gubenko

Authority: Kiryeyev, Zinchenko

(The main focus of this benchmark is to evaluate and assist in the improvement of the existing quality control process in the area of onsite inspections. The objective is to help bank supervision management develop quality control tools and standards. The ultimate goal is to provide to the

inspection area a process that would encompass both “after the fact” and proactive quality control together with appropriate measures and approaches, that would allow to satisfy changing requirements.)

By December 31, 2001:

- No activity planned for this quarter.

By March 31, 2002:

- Develop proposal for statistical cross-check of CAMEL ratings assigned by inspectors using objective indicators.
- Reactivate proposal initiated in 2001 (but not supported by previous management) of quality control questionnaire for workpapers, documentation, and support of conclusions in report of examination.

By June 30, 2002:

- Assist NBU in testing new system of cross-checking CAMEL ratings.
- Follow up on earlier proposal of quality control questionnaire.

Outside Contacts (for quarter ending December 31, 2001)

Karen Wilson/Glenn Tasky

Organization	Contact Name	Time
IMF	Edward Lopes Peter Lomus	4 Hours
World Bank	Angela Prigozhina	2 Hours
U.S. Treasury	Paul Leonovich	2 Hours
US AID	David Dod Boris von Hoffmann	8 Hours

Other Work Requested By NBU

Karen Wilson

At the request of Mr. Kiryeyev, provided input into changes needed in the Structure of Bank Supervision (Attachment 12).

Provided input to the new regulations on Subordinated Debt/Deposits.

At the request of Mr. Krotiyuk, discussed with staff the process for dealing with Systemic Risk.

Raissa Ladokhina

The article on the formal training written for the NBU Herald in the previous quarter was published in the November issue (Attachment 13).

At the invitation of the NBU, I participated in a Train the Trainers seminar provided by Luxembourg Financial Technology Transfer Agency held from November 28 through November 30, 2001 in the NBU Training Center). The seminar was devoted to the techniques of needs analysis, program development and organization, as well as the evaluation of results, and was beneficial to my work in developing the program of comprehensive training for bank supervision (Attachment 14).

I translated for the NBU Recommendations of the Basle Committee on the self assessment of the Core Principles compliance (issued in April, 2001), OCC materials on the recruitment, and the KPMG consulting employee evaluation form.

Glenn Tasky

At the request of Mr. Kiryeyev, the advisor prepared a critique of the regulatory development at the NBU during the tenure of Mr. Andrushchenko. The advisor was especially critical of NBU resolutions on asset valuation and licensing separate banking activities of non-bank financial institutions (Attachment 15).

The advisor prepared a memorandum (Attachment 16) detailing why bank corporations as envisaged in the Law on Banks and Banking Activity will not work.

At the request of Mr. Kiryeyev, the advisor prepared a memorandum (Attachment 17) arguing against placing a representative of the Association of Ukrainian Banks (AUB) on the NBU's Bank Supervision Commission. The recommendations were accepted.

At the request of Mr. Kiryeyev or the Methodology Unit, the advisor prepared various memoranda on regulatory issues (Attachments 18, 19, and 20).