Ukraine Bank Supervision Development
Contract #PCE-I-00-99-00006-00 TO#827
Quarterly Report
October 1, 2002 to December 31, 2002

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

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

By September 30, 2002

- Determine the appropriate method of training and devise a plan to deliver training in the evaluation of banks' risk management systems to NBU Senior Management and executive committees, and BSD upper and middle management.
  Advisors: Blimling, Wilson, Ladokhina, Antonova
  NBU Counterpart: Kireev, Ivanenko

The training of NBU and BSD management is to be determined by the Task Force. Training of the Task Force is to begin in October. The Task Force has decided to wait to provide formal training of BSD management and staff until the Risk Assessment System is fully developed and approved. Mr. Krotyuk asked that training for NBU senior management, that is, NBU Board and Supervisory Council, be delayed until the first quarter of 2003.

- Develop schedule to review chapters of the Onsite Manual to focus and emphasize the evaluation of banks' risk management system.
  Advisors: Blimling, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko

A tentative schedule of revising the Onsite Manual has been developed. As part of their responsibilities, the Task Force will review and finalize the schedule. This will occur once the Task Force finalizes the Risk Assessment System.

By December 31, 2002

- Implement training plan in the evaluation of risk management systems to NBU Senior Management and executive committees, and BSD upper and middle management. Determine appropriate method of training and devise a plan to deliver training to the staff of the NBU head and regional offices.
  Advisors: Blimling, Wilson, Ladokhina, Antonova
  NBU Counterpart: Kireev, Ivanenko

Training of Task Force members was held in October, with additional training delivered to Regional supervision managers in December. The training focused on introducing the concept of Risk-based Supervision and the components of a comprehensive risk management system in commercial banks. The Risk Assessment system will be finalized early in the first quarter of 2003. At that time, the Task Force will establish a training schedule for the BSD management and staff. In late December, Mr. Sergey Tyhypko replaced Mr. Stehlmakh as Governor of the NBU. Given these recent changes in NBU senior management, we will discuss with Mr. Krotyuk the training of NBU senior management early in the first quarter.

- Begin to review targeted chapters of the Onsite Manual and ascertain necessary changes to focus and emphasize the evaluation of a bank's risk management system.
  Advisors: Blimling, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko

Although the Task Force has not set a schedule for revising the Onsite Manual, BearingPoint advisors have began reviewing credit related chapters to develop recommendations and revisions.

- Review and recommend revisions to the CAMELS Policy and Report of Examination to place more emphasis on the evaluation and impact of a bank's risk management system:
  Advisors: Blimling, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko

The Resident Advisor has begun a review of the CAMELS Policy and Report of Examination. Recommendations from this review will be provided to the Task Force when they begin the review of Risk-based Supervision tools and techniques.

By March 31, 2003

- Initiate recommendations to change the targeted chapters of the Onsite Manual to focus and emphasize the evaluation of a bank's risk management system.
  Advisors: Blimling, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko

By June 30, 2003

- Assist in the issuance of revised chapters of the Onsite Manual.
  Advisors: Blimling, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko

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

By December 31, 2002

- Review and determine necessary changes that address risk-assessment methodology in current reporting requirements
  Advisors: Kutsenko
  NBU Counterpart: Zinchenko, Romanenko, Karcheva

The review of existing reports submitted by commercial banks to the NBU has been completed. Identification of current risk assessment methodology is in process, and we expect to complete this action by February 2003. Once the Task Force finalizes the Risk Assessment System, we will make recommendations to further enhance commercial bank reporting requirements.

- Review frame work of supervisory strategies and determine if and to what extent audit results are incorporated in their development
  Advisors: Blimling, Kutsenko, Ladokhina
  NBU Counterpart: Zinchenko, Romanenko, Karcheva

The Resident Advisor has reviewed the supervisory strategy process and a sample of individual bank strategies. While audit results are referred to in various comments, there is little evidence that these results are taken into consideration when developing supervisory strategies. We are conducting a complete review (scheduled to be concluded in early February) of the status of the internal and external bank audit processes. Information from this review along with the results of the Risk Assessment System for an individual bank will be fundamental in the further development of supervisory strategies.

By March 31, 2003

- Make recommendations and assist in implementation of changes and additions to reporting requirements and the development of supervisory strategies.
  Advisors: All
  NBU Counterpart: Zinchenko, Romanenko, Karcheva

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

By March 31, 2003

- Review and determine necessary changes to licensing policies and practices to require banks to develop and employ comprehensive risk management systems.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Parkhomenko

By June 30, 2003

- Make recommendations and assist in implementation.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Parkhomenko

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

By December 31, 2002

- Identify training opportunities at the National Bank Poland (NBP) or U.S. based regulators for one or more Bank Supervision employees and begin organizing study tour.
  Advisors: Antonova, Ladokhina, Blimling
  NBU Counterpart: Kireev

NBP based training:
We identified training opportunities at the National Bank of Poland's Training Initiative for Banking Supervision (TIBS) for the year 2003. Having conducted preliminary needs analysis at the NBU's GDBS, we envision training at two levels:

1. *Leadership skills for senior managers in BSD responsible for strategic development. This involves Participation of the General Department of Bank Supervision (GDBS) Director and/or Deputy Directors in the Bank Supervision Leadership Program conducted in Warsaw. The Toronto International Leadership Centre organizes this program in partnership with TIBS. The training is scheduled for March 2003. We also envision additional technical skills training for middle level managers responsible for institutionalizing and implementing a risk-based supervision approach.*

2. *Technical skills development for NBU staff through four seminars offered by TIBS in 2003 on different issues related to Risk-based Supervision, Credit Risk, and Bank Examination Tools and Techniques. This list of courses will be finalized at the beginning of the next quarter. Other initiatives contemplated include Participation of a large group of NBU staff (15 people) in an On-site Supervision Tools and Techniques course delivered by TIBS, and participation of NBU staff, TIBS and BearingPoint advisors in the development of a tailored Risk-based Supervision course specifically designed for bank supervisors in CIS countries.*

Due to our limited training budget, we submitted a request for additional funding to the Academy for Educational Development (AED). USAID and AED are currently reviewing our application and we expect a response by the end of next quarter. If additional funding is not available, we will proceed according to the original plan and allocate available budget taking into consideration our priority list.

U.S. based training:
After consulting with senior managers of GDBS, we believe that we will use the same format for U.S. based training as was used in 1998 when we partnered with the FSVC in arranging study tours. At that time, three examiners from the NBU Inspection staff participated in examinations of U.S. banks located in the states of New York and New Jersey.

Tentatively, this training is scheduled for the fall/winter of 2003. In order to use the same format, NBU staff (4-6 people) must take intensive English language courses. BearingPoint is exploring the opportunity to obtain funding for English courses from AED through its small grant vehicle. Next quarter we will focus on establishing contacts with U.S. based regulators and finalizing the format for U.S. based training programs.

- Identify participants in study tour at NBP or U.S. based regulator and conduct study tour.
  Advisors: Antonova, Ladokhina, Blimling
  NBU Counterpart: Kireev

Meetings were held with Mr. Kireev, Ms. Faber, Mr. Drobiazko, Ms. Zhabska, and Ms. Mironenko to discuss the purpose of the study tours, their focus and required underlying commitments. Together, with BSD management, we began developing a proposal for a group of NBU employees to participate in United States based study tours. A preliminary list of people was developed and a partial commitment was obtained from Mr. Kireev concerning the English lessons.

At this stage of development, we focused on the job descriptions and responsibilities of participants (rather than specific individuals) who we think can benefit from leadership development and technical training. BearingPoint will make a strong recommendation to the NBU management to allow bank examiners from regional offices to benefit from this training. In the next quarter we will finalize the list of people and pursue BSD management agreement.

Ongoing

- As risk-based supervision is developed within the BSD, make recommendations to management concerning potential changes in organizational structure.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

No work in this area during the quarter.

5. **Legal Issues:** *(Note: This section calls for the implementation of new laws and regulations, and amending current legislation. We feel that a thorough review of all pertinent laws and regulations, along with full agreement and cooperation from NBU Bank Supervision and Legal Departments are necessary before implementation can take place. Therefore, the actual implementation phase may only be accomplished after considerable research and consultation with NBU management and staff, and the banking industry.)* **Elements of the legal framework are further elaborated which deal with different aspects of the banks' required systems of risk management. In particular new implementing regulations are developed requiring risk-management units and board-approved risk limits within banks. An amendment to the Law on Banks and Banking is developed to require the internal auditors of commercial banks to report to the Supervisory Council of their bank (rather than, as currently required, to their Board of Management.)**

<u>By December 31, 2002</u>

- Review current body of legislation and regulations to ascertain changes in existing laws and regulations and/or the need for new laws and regulations that would strengthen NBU authority to require and enforce the requirement for risk management systems and appropriate internal/external reporting requirements. Determine the need, degree, and method of educating judges on the proper scope of judicial review, in order to prevent unnecessary legal impediments to achieving bank supervisory goals.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Krotyuk, Kireev, Pasechnyk, Romanenko

We completed our research into relevant international regulatory practices requiring the presence of risk-management systems and systems of internal control in commercial banks. We reviewed banking laws and regulations of approximately 20 prominent countries worldwide, and selected the most trustworthy and comprehensive examples of legal regulations in the areas of risk management and internal controls. The final review contains a description of approaches, references, and actual language from laws and regulations of Canada, Germany, France, The Netherlands, and The United States.

We compared the current body of Ukrainian legislation, in particular, the Law on Banks and Banking and the Law on the National Bank of Ukraine, with the laws and regulations identified from our research. We outlined, in a memorandum, our recommendations to improve the efficiency and enforceability of regulatory requirements for risk-management systems and systems of internal control in commercial banks of Ukraine.

We also reviewed the system of commercial courts in Ukraine and the current legal framework in requiring an adequate competency level for judges. We prepared a memorandum outlining our opinion on the need for additional training of judges in the areas of economic and financial law, and regulatory enforcement actions.

By March 31, 2003

- Develop strategy to ensure recommended changes and the development of new laws and regulations are efficiently accomplished.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Krotyuk, Kireev, Pasechnyk, Romanenko

By June 30, 2003

- Begin to provide recommendations on specific laws and regulations concerning risk management systems and internal/external audit issues per strategy.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Krotyuk, Kireev, Pasechnyk, Romanenko

In November and December 2002, we participated in several meetings of the GDBS working group charged with developing amendments to the Law on Banks and Bank. We took advantage of this opportunity to promote our ideas for improving the efficiency of risk-management systems in banks. As a result, the GDBS included many of our recommendations in their official submission to the NBU Legal Department. These recommendations included subordination of the Internal Audit function to the Supervisory Council (rather than to management as it is in the current law), more emphasize on strategic and controlling functions of the Supervisory Council, requirements of the Supervisory Council members as per Basel principles, requirements as to specific risk management policies rather than merely establishing risk limits, the NBU right to remove members of the management Board or Supervisory Council, ability to apply enforcement measures in case of inadequate risk-management systems or policies, etc.

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

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

<u>By December 31, 2002</u>

- Working with BSD management, determine the minimally acceptable risk management standards that all banks must maintain *(These standards will also guide our recommendations and efforts in the areas of legal, licensing, onsite manual, offsite risk indicators, training, etc.)*. Develop plan for informing and educating bankers on the necessity of effective risk management systems.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

We have begun developing a concept paper that will be used by the Task Force in their development of a strategy to educate the banking community on the need for comprehensive risk management systems. Task Force members have met with three banks, which have also provided presentations on their risk management systems.

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

- Present plan to BSD management.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

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

- Obtain approval and implement plan.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

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

<u>By September 30, 2002</u>

- Develop methodology for surveying a sample of banks to determine the types and volume of products and services they offer, and how the banks management deals with associated risks.
  Advisors: Blimling, Kutsenko
  NBU Counterpart: Kireev, Ivanenko

We have informally conducted an inquiry on the risks that commercial bank management focuses their risk management systems. This information was gathered through discussions with on-site supervisors, off-site analysts, and commercial bankers. The information has allowed us to guide the Task Force in prioritizing the development of the Risk Assessment System. As the Task Force continues to develop the "Pilot Bank" program, they will determine the need, structure, methodology and presentation of a formal survey.

By December 31, 2002

- Assist in conducting survey.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

The Task Force continues its work on the development of a Risk Assessment System and laying the preliminary groundwork for the "Pilot Bank" program.

By March 31, 2003

- Assist in interpreting survey results to assess the risks relevant for each bank and their array of products and services.
  Advisors: Blimling, Wilson
  NBU Counterpart: Krotyuk, Kireev

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

By December 31, 2002

- Determine the best method(s) to communicate elements of an effective risk management system. (*May not involve the development of a "template", but rather incorporated in the revision and development of supervisory manuals, and tools developed for commercial banks.)*
  Advisors: Blimling, Wilson
  NBU Counterpart: Task Force (see #5 below)

The Task Force continues to its work on the development of the "Pilot Bank" program. By working with this group of banks, the Task Force will decide by March the best means of communicating the essential elements of a comprehensive risk management system, that all commercial banks in Ukraine must develop.

By March 31, 2003

- Develop plan to begin the introduction of the methods developed in the above step to BSD management and staff, and banking industry.
  Advisors: Blimling, Wilson
  NBU Counterpart: Task Force (see #5 below)

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

   By December 31, 2002
   - Determine the extent of tools the NBU can provide to commercial banks to assist in implementing and sustaining risk management systems.
     Advisors: **All**
     NBU Counterpart: Task Force (see #5 below)

   The Task Force will begin to address the extent of tools they feel the NBU should provide to commercial banks during the next quarter.

   By March 31, 2003
   - Begin to assist the NBU in developing necessary tools.
     Advisors: Kutsenko, All
     NBU Counterpart: Task Force (see #5 below)

5. *(Note: We have determined that a separate Director and Committee is not necessary since "Risk-based Supervision" is to become an integral part of all supervisory efforts. Instead, we are proposing that a task force be established that will guide the BSD through the implementation of "Risk-based Supervision".)* **Risk-based Supervision Director and Committee: The NBU designate a small group of examiners to be responsible for risk management implementation ("Risk-Based Supervision Committee") and senior Bank Supervision Department Official ("Risk-Based Supervision Director"), who will be the NBU's primary liaison with the banks in the implementation of the new methodology. This group is responsible for training other NBU examiners in risk management, for reviewing implementation plans and policies, and for evaluating and providing on-site assistance regarding the procedures developed by individual banks.**

   By December 31, 2002
   - Develop proposal for creation of the Task Force, establishing specific responsibilities and criteria for membership. Assist in establishment of the Task Force and membership selection.
     Advisors: Blimling, Wilson
     NBU Counterpart: Krotyuk, Kireev, Ivanenko

   With permission from Mr. Krotyuk and Mr. Kireev, the Risk Based Supervision Task Force, with Ms. Ivanenko in charge, was formed in September 2002. The Task Force membership is comprised of key Bank Supervision managers, a representative from the NBU Legal Department, and BearingPoint advisors. We provided training to the Task Force in the essentials of risk-based supervision and the key elements of a commercial bank's risk

management system. Additionally, the Task Force began a series of presentations delivered by commercial bankers covering their risk management systems. The Task Force has identified and defined 10 risk categories that will focus BSD risk based supervision efforts. They have decided on the format of the Risk Assessment System and began to develop risk assessment criteria for each of the risk categories. This process is scheduled for completion by mid-February.

BearingPoint contribution to the Task Force involved the preparation of materials on the definition of risks, risk assessment systems and the concept of risk-based supervision. We provided to the Task Force material from a number of regulatory agencies, including Canada, Hong Kong, India, Japan, South Africa, Singapore, the U.S. Federal Reserve, FSA, FSR, etc., during this development stage. Additionally, we prepared an article on risk management and risk assessment systems requested by Mr.Drobiazko to be published in January 2003 in the Financial Risks magazine. Materials of the Financial Services Roundtable were used for the preparation of the article.

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

By December 31, 2002

- Establish contacts/relationships with trade groups, i.e., bankers association, risk managers' association, training groups/institutes, internal and external auditing groups, etc. Determine the feasibility of industrial advisory groups to work with the NBU, and if feasible, develop method and timing of cooperation. *(This step is critical in the development of bankers training and assessment of products and risk management systems.)*
  Advisors: Antonova, Kutsenko, Ladokhina, Blimling
  NBU Counterpart: Task Force

BearingPoint has established contacts with International Management Institute, the National Center for the Training of Bank Personnel of Ukraine, IBTCI, World Bank and other donor agencies and trade groups. As Task Force finalizes its Risk Assessment System and approaches to Risk-Based Supervision, we will be able to determine the level and need for their involvement as well as specific methods and timeframes. These organizations are aware of our efforts in the development of a Risk-Based Supervision approach and will be informed on our continuous efforts in this area.

- Determine the necessary training materials and plan of delivery to cover all commercial banks in Ukraine.
  Advisors: Ladokhina, Antonova, Blimling

NBU Counterpart: Task Force

This element is delayed until the Task Force finalizes its risk assessment system and "Pilot Bank" program. Meanwhile, BearingPoint is gathering training material for potential seminars to be delivered by the Task Force to commercial banks. BearingPoint is also working with FMI in the development of a Corporate Governance seminar(s) for Supervisory Council members of commercial banks.

By March 31, 2003

- Develop policy manual that will provide guidance to commercial banks in establishing and maintaining risk management systems.
  Advisors: Blimling, Wilson, All
  NBU Counterpart: Task Force

By June 30, 2003

- Deliver policy manual and assist in distribution.
  Advisors: Blimling, Wilson, All
  NBU Counterpart: Task Force

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

By December 31, 2002

- Determine status of regulatory framework requiring bank directorate and management to fully incorporate, in a systematic way, the recommendations of internal and external auditors.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Kireev, Zinchenko, Pasechnyk, Romanenko

We have reviewed the current body of legislation, including the laws "On Banks and Banking Activity", "On the National Bank of Ukraine", "On Audit Activity", in addition to NBU Regulation #114 "On approval of Regulation on organization of internal audit in commercial banks of Ukraine" dated 03/20/98, NBU Regulation #358 "On approval of Methodological guidelines as to application of standards for internal audit in commercial banks of Ukraine" dated 07/20/99, NBU Regulation #53 "On measures as to further development of bank audit" dated 02/09/99, NBU Regulation #271 "On approval of Policy on Qualification Commission of the National Bank of Ukraine on certification of auditors, provisional administrators and liquidators of banking institution, and Policy on certification of auditors of banking institutions", other rules and regulations. Our opinion as to the adequacy of the regulatory framework requiring bank directorate and management to fully

incorporate, in a systematic way, the recommendations of internal and external auditors, will be provided to the Task Force when they begin their review of laws and regulations.

By March 31, 2003

- Make recommendations for necessary changes to statutory requirements.
  Advisors: Gegenheimer, Telychko
  NBU Counterpart: Kireev, Zinchenko, Pasechnyk, Romanenko

- Determine status of bank internal and external audit practices, professional training, certification and licensing requirements.
  Advisors: Kutsenko, Telychko
  NBU Counterpart: Zinchenko

In October – November 2002 BearingPoint advisors established relations with Institute of Internal Auditors (Mrs. Shpakovska) and reinforced relations with National Centre for Training Bank Personnel in Ukraine (Mr. Geyets). Both these institutions are involved in the process of training bank internal auditors. At that time, we explored the possibility of updating their training curricula to address risk management practices and requirements once the Task Force formulates by the Task Force.

- Determine status of NBU efforts to improve internal and external audit functions in commercial banks.
  Advisors: Kutsenko, Telychko
  NBU Counterpart: Zinchenko

In November 2002, the NBU via Dutch Grant/World Bank funding launched a program to review the existing audit regulations pertaining to bank external audits. This program is to be extended into the first quarter of 2003. In December 2002, Mr. Kireev requested that BearingPoint advisors work closely with this WB initiative to ensure application of best international practice with respect to bank external audits.

By June 30, 2003

- Make recommendations for further efforts to improve internal and external audit practices and BSD oversight.
  Advisors: Kutsenko, Telychko
  NBU Counterpart: Zinchenko

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

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

By December 31, 2002

- Analyze and assess existing approaches to the organization of the training process in the NBU and BSD, and develop recommendations on their improvement.
  Advisors: Ladokhina, Antonova
  NBU Counterpart: Ivanenko, Personnel Department

Activity complete. *We conducted meetings with Personnel Department representatives (Mr. Bezugly, Manager of the training unit/Deputy Director of the Personnel Department and Ms. Pshenychna, his deputy), Ms. Ivanenko, Mr. Kireev, Ms. Faber, Mr. Drobiazko, and employees from the Division of Coordination and Planning, which is in charge of the training function for the bank supervision area. The purpose of the meetings were 1) to gain an understanding of BSD management ideas on how to improve the efficiency of bank supervision training; 2) determine how the Personnel Department plans to implement the Comprehensive Program for Training and Retraining of Bank Supervision Employees; and 3) determine the focus of our further cooperation with the Personnel Department, the BSD and the Dutch Grant/World Bank funded training initiatives.*

Bank Supervision managers envision the training of their staff as a combination of different training methods, including internal unit seminars held by managers and experienced employees; formal training events organized by the Personnel Department; and internships and training opportunities conducted abroad.

The Personnel Department plans to more extensively and efficiently use different training facilities throughout the country (the NBU Kiev Training Center, the Sumy Banking Academy and its branches in Kharkiv and Cherkasy, and the L'viv Banking Institute). Due to logistical difficulties the Personnel department is to centralize the training of BS managers (beginning from the lowest level) in the Kiev Training Center, while the base for the BS technical staff training will be the Sumy Banking Academy. In December 2002, we visited the Sumy Banking Academy to meet the Academy representatives, see the facility and evaluate their processes. The meetings and our visit to Sumy provided us with considerable insight about the training issues and activities being addressed by the BSD and the Personnel Department.

In line with our plans regarding the formal training and accreditation programs, and at the request of the BSD Division of Coordination and Planning, we discussed with the Personnel Department the development of a training database for banking supervisor. We learned that the Personnel Department is working with a newly developed personnel database that includes a training module. We will assist them in the implementation of this database as it pertains to the bank supervision training initiatives.

By March 31, 2003

- Prepare a survey of international experience in the training area and approaches to training in bank supervision in different countries to be presented to the BSD management and the Personnel Department together with our recommendations developed within the previous bench mark.
  Advisors: Antonova, Ladokhina
  NBU Counterpart: Ivanenko, Personnel Department

We have started gathering information for the survey of international experience in the Bank Supervision training area. We have gathered information via the Internet on the Australian Central Bank and Prudential Regulation Authority, Bank of England/FSA, Toronto Training Center, Federal Reserve, OCC, Bank of Poland, and South African Central Bank. We are currently analyzing the information and developing a clearer understanding of where we need to focus our efforts to address what the NBU lacks in its training process. This quarter we will concentrate on needs analysis and training database development.

By June 30, 2003

- Revise and further develop curriculum for core courses and, in coordination with the Dutch Grant, present it to the BSD management and personnel for their input and approval.
  Advisors: Ladokhina, Antonova
  NBU Counterpart: Ivanenko, Personnel Department

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

By December 31, 2002

- Update Train-the-Trainers course materials and present to the BSD for approval and further use as a universal teaching tool.
  Advisors: Kutsenko, Ladokhina
  NBU Counterpart: Ivanenko, Zinchenko, Task Force

In October and November of 2002, BearingPoint advisors reviewed existing Train-the-Trainers manuals available to NBU from preceding USAID contracts as well as from other sources. The general findings are that these manuals concentrate mostly on development of oral communication/presentation skills, and are accompanied with planning and control sections. The training is designed to assist instructors on the use of existing training

materials. Therefore, we will focus our updates on sections devoted to teaching how to develop presentations and other training materials. We also decided to postpone until the second quarter of 2003 further development of Train-the-Trainers manual to go in parallel with the Dutch Grant/World Bank training initiative.

By March 31, 2003

- Develop a set of standard teaching tools to be used by BSD management and trainers (e.g. Train-the-Trainers Manual, follow-up forms, evaluations and needs analysis questionnaires, etc.).
  Advisors: Antonova, Kutsenko, Ladokhina
  NBU Counterpart: Ivanenko, Zinchenko, Task Force

We have started analysis of available resources in this area (materials from Bankers Training project) and a survey of other methods and specific tools. In this area we will continue to work closely with BSD managers in charge of training and Personnel Department in order to tailor those materials to specific needs of the NBU.

By June 30, 2003

- Together with BSD trainers, analyze materials available to BSD and develop a pool of resources to be used for training purposes.
  Advisors: Antonova, Ladokhina, Kutsenko, Blimling
  NBU Counterpart: Ivanenko, Zinchenko, Task Force

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

By December 31, 2002

- Study existing laws and regulations in order to support the feasibility of a certification concept for BSD management and the Personnel Department.
  Advisors: Gegenheimer, Telychko, Antonova, Ladokhina
  NBU Counterpart: Krotyuk, Kireev, Zinchenko, Personnel Department, Task Force

We have prepared a memorandum to the Division of Coordination and Planning addressing the general definition of the certification concept and process, and an explanation on how it is related to the formal training process, supported by the provisions of laws and regulations.

We examined the relevant body of legislation, including the Law "On Banks and Banking", Law "On the National bank of Ukraine", Law "On State Service", President Decree "On comprehensive program for preparation of state servants" #1212/2000, CMU Regulation "On conducting attestation of state servants", Labor Code of Ukraine, other rules and regulations. Based on results of the research, we prepared a memorandum in Ukrainian for BSD management and the Personal Department. The memorandum provides brief explanation of a certification concept and supports its legal feasibility by giving specific references and language from current Ukrainian laws and regulations.

By March 31, 2003

- Develop and present a paper on international certification experience for bank supervision personnel to be used as a basis for further development of a certification concept for the NBU.
  Advisors: Antonova, Ladokhina
  NBU Counterpart: Krotyuk, Kireev, Zinchenko, Personnel Department, Task Force

By June 30, 2003

- Develop a certification concept to be presented to the BSD management, Personnel Department and the NBU management for their input and approval (in cooperation with the Dutch Grant).
  Advisors: Ladokhina, Antonova
  NBU Counterpart: Krotyuk, Kireev, Zinchenko, Personnel Department, Task Force

IV. Surveys and Assessments.

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

By September 30, 2002

- Conduct Survey and submit with work plan to USAID.
  Advisors: Ladokhina
  NBU Counterpart: Kireev

Survey complete and officially submitted to USAID in Kiev.

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

By December 31, 2002

- Obtain Permission to conduct assessment or use assessment of third-party.
  Advisors: Blimling
  NBU Counterpart: Kireev

We obtained a copy of the latest Basle Core Principles assessment conducted by IMF/WB. This will be used in monitoring the success of future compliance efforts.

By June 30, 2003

- Conduct assessment, if necessary, and submit to USAID.
  Advisors: Blimling, Wilson
  NBU Counterpart: Kireev

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

By June 30, 2003

- Determine the average rating of "M" component and submit to USAID.
  Advisors: Kutsenko, Blimling
  NBU Counterpart: Kireev, Zinchenko

Outside Contacts (for quarter ending September 30, 2002)

Advisor	Organization	Contact Name	Time
Alex Kutsenko	USAID	Victor Verhun	10 Days – Preparation of material for "Ukrainian Banks: Industrial Snapshot for First Half of 2002"
	World Bank/Dutch Grant	Charles Canfield	4 hours
	U.S. Treasury	Mel Brown	2 hours
Marina Antonova	USAID	Victor Verhun	2 days
	National Center for Training of Bank Personnel of Ukraine	Olexander Geyets	4 hours
	International Management Institute	Alla Voronova	2 days
	Academy for Educational Development	Svetlana Leontyeva	4 hours
	IBTCI	Nataliya Vovchuk	2 hours
	TIBS (National Bank of Poland)	Anna Duda	4 hours
Frank Blimling	Association of Risk Managers of Ukraine	Anatoly Dobryasko	4 hours - Status and Development of Prospects of Risk Management in Financial Institutions (Seminar in Kiev)
	USAID	Victor Verhun	5 hours
	USAID	Rick Gurley & Victor Verhun	2 hours
	USAID	Gary Linden	1 hour
	U.S. Treasury	Mel Brown	12 hours
	Financial Markets International	Ann Wallace	3 hours

	World Bank/Dutch Grant	Charles Canfield	3 hours
	World Bank	Angela Prigozhina	1 hour

Other Work Requested By NBU

Banking Law Working Group meetings included discussion of many changes to the Banking law, not only those pertaining to RBS.

Mr. Kireev requested us to provide input to the Methodology Unit concerning regulatory oversight of Cooperative Banks. We conducted research, developed recommendations, and produced a memorandum.

Mr. Kireev requested us to comment on the regulatory treatment of bank branches for prudential normative purposes. We developed recommendations and produced a memorandum.

Mr. Kireev requested with provide input into a potential reorganization of the Bank Supervision Department. Our recommendations were provided in the form of a confidential memorandum to Mr. Kireev.

Mr. Kireev request that we review the work of the Dutch Grant/World Bank advisor, Charles Canfield, pertaining to the certification of external auditors. We provided preliminary oral input to both Mr. Kireev and Mr. Canfield. This review extended into January.

We submitted our recommendations on the selection of firms – providers of English language courses to the NBU staff.

BearingPoint.
Formerly KPMG Consulting

MEMO

TO: V. L. Krotyck, Deputy Governor

O. I. Kiryeev, Director of the Department
Of Bank Supervision

FROM: Karen Wilson, Senior Advisor
BearingPoint, Inc.

CC: Supervision by Risk Task Force

DATE: October 15, 2002

REF: Risk Management Systems in Banks

Over the last two decades, global financial institutions have been developing better ways to deal with the increasing volatility of the environment in which they work. During that time, the speed of change increased, deregulation occurred in many countries, competition increased as markets became more global, interest rates became more volatile and risks experienced by customers increased based on these same causes. Technology introduced new risks and allowed for the development of new products and methods to control risk. New international capital requirements were introduced and many of the major banks were faced with raising more capital at a time when market forces were squeezing margins.

Bank managers realized that there was a need to better identify and control risk. Some of the risk that banks had traditionally taken became excessive and new methodologies to deal with these risks or move them off the bank's balance sheet were developed. Bankers needed to improve their methods of allocating scarce capital resources. The return on capital needed to be increased to attract new capital. Pricing needed to be improved to ensure that banks were paid for the risk they were taking and received an adequate return for shareholders.

It was against this backdrop that bank managements started to develop new systems and methodologies and products to better manage risk. One point I want to make is that although bank supervisors around the world have recognized the need for better risk management systems, their development was driven by bank managers' need to better respond to the market and the environment. Risk management systems are not just systems designed to limit damage, but have evolved into an important competitive tool, which helps the bank become the most profitable, lowest priced producer.

First, I would like to discuss some broad definitions. What is Risk? Risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. Banks are in the business of taking risk. Both bank managers and bank supervisors are interested in ensuring that the risk taken is warranted. In other words, that the risk is: understood, measurable, controllable and within the bank's capacity to readily withstand adversity. Risk management is the deliberate acceptance of risk for profit. It involves making an informed decision on the trade offs between risk and reward and using various financial and other tools to maximize the risk adjusted returns within established limits. Risk management is designed to: prevent loss, insure against loss, control loss, and price risk appropriately. Risk management includes a comprehensive risk policy, monitoring/reporting procedures and enforcement.

In discussing risk management systems in banks, I would like to cover the following four broad areas, which cover key changes that have taken place in the area of bank risk management systems. Many aspects of these developments have become requirements placed on banks by bank supervisors and have been incorporated in the Basel Core Principles for Bank Supervision. The four areas are: Corporate Governance, Control Systems, Development of New Methodologies and Development of New Products.

CORPORATE GOVERNANCE

In the broadest sense, sound corporate governance is the establishment of strong risk management systems. The elements of sound corporate governance enumerated in the Basel paper on "Enhancing Corporate Governance for Banking Organizations" (November, 1999) are also the key components of a good bank risk management system. The seven elements covered are:

- Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization.
- Setting and enforcing clear lines of responsibility and accountability throughout the organization.
- Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.
- Ensuring that there is appropriate oversight by senior management.
- Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide.

- Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment.

- Conducting corporate governance in a transparent manner.

As you know corporate governance is currently receiving heavy scrutiny in the U. S. due to the corporate scandals that have occurred there. Banks have always been required to maintain a higher level of compliance in this area and have had to meet stricter requirements. Despite this, the Comptroller of the Currency in a recent major speech encouraged bank managements to review and consider even more stringent standards. This is an area that I believe also needs significant strengthening in Ukraine.

In general, I believe the role of the Supervisory Council needs to be strengthened. They should play a key role in the risk management process. There is a need for someone to oversee management and the Supervisory Council should be sufficiently independent of management and have sufficient information to perform this function. This independence from management and significant ownership interests is critical. It is also necessary that those in charge of the control functions have somewhere to report that is independent of management. This is the Supervisory Council or a Committee of the Council made up of outside directors. To ensure that the Supervisory Council fulfills its responsibilities they need to be held accountable. Liability for the decisions of the bank should be attached to Supervisory Council members under certain circumstances and they should be subject to action by the NBU, i.e., fines or removal.

I would briefly like to discuss each of the elements of Corporate Governance and how it ties into Risk Management Systems in Banks.

Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization

A starting point in building a risk management system is to determine how much risk a bank is going to assume and what return must be achieved for the bank and its owners. These issues should be addressed in the strategic objectives set and carried through to the bank's strategic business plan. Risk should be evaluated in terms of the external environment and the internal environment and specific limits should be placed on the level of risk that can be assumed. These limits should then be reflected in the bank's policies. The Supervisory Council should be the management body that performs these functions.

The Supervisory Council should also set the corporate values. They are responsible for ensuring that the bank conducts its business with integrity, care and due diligence. They need to ensure the customer and his interests are treated fairly and ensure that the firm is free of conflicts of interest between the bank and those with significant influence over the bank. The Supervisory Council should develop a Code of Conduct and ensure that it is communicated and enforced.

They are responsible for developing policies that prohibit or strictly limit conflicts of interest, insider self-dealing and preferential treatment to related parties or other favored entities. The Supervisory Council should be responsible for monitoring compliance with these policies and ensure that all such transactions are reported to it. In many cases, it is appropriate for the Supervisory Council or a Committee of the Council to be the approving body for such transactions. It is unrealistic to think that transactions related to senior management or control owners can be effectively dealt with by bank employees without a strong role for an independent Supervisory Council.

Setting and enforcing clear lines of responsibility and accountability through the organization

The Supervisory Council should be responsible for clearly defining the authorities and key responsibilities for themselves and senior management. In delegating responsibilities, the Supervisory Council must ensure that the business and affairs of the bank can be adequately monitored and controlled by the council members, relevant senior managers and governing bodies of the bank. Responsibilities should be reflected in the bank's policies. Internal controls and audit should ensure that business is conducted in conformance with the delegations. A record of delegations should be maintained and kept up to date. Appropriate records for this purpose might include organizational charts, project management documents, job descriptions, committee charters and bank policies.

Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.

The Supervisory Council should ultimately be responsible for the operations and financial soundness of the bank. They must receive timely, relevant and reliable information to judge the performance of management. It is critical that the Supervisory Council be independent of management and any significant owner or outside influence. The Supervisory Council should have an effective number of members who can exercise judgment independent of management and controlling owners or governments. Qualified external council members, in addition to providing independence and objectivity, can also bring new perspectives from other businesses that may improve the strategic direction. Qualified external council members can also become significant sources of management expertise in times of stress for the bank. In some countries, an external board (council) member is designated to represent the Board (Council) on a full time basis in maintaining knowledge and oversight of management's actions. Qualities key to a council member having a strong positive influence on the bank are further enumerated in the Basel paper on Corporate Governance.

In a number of countries, bank boards (councils) have established certain committees of the board (council) in order to build on expertise of members and allocate work among board

(council) members. Typical committees are: Risk Management Committee, Audit Committee, Compensation Committee, and the Nominating Committee. In the case of the last three committees, it is appropriate for them to be staffed with non-management or external directors (council members). The responsibilities of the Board (Supervisory Council) Committees are further discussed in the Basel Corporate Governance paper. In addition, some countries require a Compliance Committee, which is responsible for monitoring compliance with bank policies and with regulatory requirements.

The role and independence of the Supervisory Council is, I believe, a key item that needs to be reviewed in Ukraine. It appears that these responsibilities are often place with the Board of Managers (Directors) rather than with a body substantially composed of external parties. This lack of independent oversight is a critical issue in the effectiveness of risk management systems.

Ensuring that there is appropriate oversight by senior management

Obviously, the key to have a sound bank is the quality of management. Although the board (council) provides checks and balances over senior managers, it is the role of senior managers to implement the objectives and direction of the board (council) and run the day-to-day operations of the bank. Senior managers should play a key role in determining the risk involved in the business they oversee, provide controls for these risks, monitor performance and take action when performance is not as expected.

The Financial Services Authority (FSA) in Great Britain through the Code of Practice for Approved Persons establishes 7 principles. They are that an approved person (senior manager):

- Must act with integrity
- Must act with due skill, care and diligence
- Must observe proper standards of market conduct
- Must deal with the FSA and with other regulators in an open and cooperative way and must disclose appropriately any information of which the FSA would reasonably expect notice
- Must take reasonable steps to ensure that the business of the firm for which he is responsible is organized so that it can be controlled effectively
- Must exercise due skill, care and diligence in managing the business of the firm for which he is responsible

- Must take reasonable steps to ensure that the business of the firm for which he is responsible complies with the regulatory requirements imposed on that business

Further guidance is provided by the FSA on how each principle is interpreted and how it is evaluated. The NBU might want to consider communicating similar requirements and using such requirements in evaluating management. The management rating in CAMELS should not only take into consideration the financial performance of management, but also how well risk is managed and controlled.

Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide.

Audit should play a key role in helping management and the Supervisory Council fulfill their responsibilities. As the Basel Corporate Governance paper points out, "the role of auditors is vital to the corporate governance process." It is also a key component of any effective risk management process. The Basel paper recommends six things to enhance the role of auditors with respect to corporate governance. They are: "(1) recognizing the importance of the audit process and communicating it throughout the bank; (2) taking measures that enhance the independence and stature of auditors; (3) utilizing, in a timely and effective manner, the findings of auditors; (4) ensuring the independence of the head auditor through his reporting to the board (council) or the board's (council's) audit committee; (5) engaging external auditors to judge the effectiveness of internal controls; and (6) requiring timely correction by management of problems identified by auditors."

Two of the key issues that banks and the NBU need to focus on are the independence of auditors and using the findings of auditors in a timely and effective manner that results in the correction of problems. To assure independence the auditors should report to a committee of the Supervisory Council that is made up entirely of external members. At least one of these members should have a strong financial background. The internal auditor should be accountable to this Audit Committee, which should evaluate his/her performance and determine compensation. The Audit Committee should approve both the scope of the work to be performed and the level of staffing. The Audit Committee should monitor the timely correction of all problems identified by the audit staff and hold management accountable. Based on discussions with supervision employees, I understand that although audit departments will frequently identify problems, there is a lack of action by management to correct the identified problems. The NBU should hold both management and the Supervisory Council accountable for failure to take corrective action on audit exceptions.

External auditors similarly need to report to the Audit Committee and Supervisory Council. The Audit Committee should decide which auditor to hire and the scope of the work to be performed. It is critical that bank auditors are trained in international audit standards and that there is a means available to ensure the competency of their staff and work.

For a bank to have an effective internal audit program as part of an overall risk management system, the nature of the internal auditors' work needs to change in many institutions. Internal audit must become risk focused. Historically, internal audit has focused on (1) transaction testing and the reliability of accounting records and financial reports, (2) testing the reliability and timeliness of control reports, and (3) tested adherence to legal and regulatory requirements. Although all of these components are still necessary, internal audit should be making a judgment on the overall control environment. At a minimum, internal audit should review and report on the process by which risks are identified, analyzed and managed, the line of controls over key processes, the reliability and integrity of corporate management functions, the adequacy and compliance with bank policies, safeguarding of assets and compliance with rules and regulations. There should be greater emphasis on the role of the internal auditor in mitigating risks. In order to perform this more comprehensive role, auditors also need to prioritize their work based on the level of risk represented by a product, operation or department.

Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment.

Compensation should be tied to long term performance. The Supervisory Council should approve compensation for senior management and other key employees that is consistent with the bank's culture, objectives, strategy and control environment. Salary schedules should be set in a way that avoids excessive risk taking and in such a way that they do not depend on short term performance, i.e., short term trading gains or loan growth without regard to quality.

Conducting corporate governance in a transparent manner

For shareholders, market participants and the general public to play their role and hold the Supervisory Council and senior management accountable for their performance, the performance of the bank must be transparent. It is the responsibility of the Supervisory Council to determine the frequency and nature of the disclosures to be made. The issue of disclosure for banks will take on increasing importance as the new Basel Accord on Capital is put in place. Under the new Accord disclosure is one of three key components in determining capital adequacy. Each bank is required to have a disclosure policy adopted by the Supervisory Council, which is regularly reviewed and certain disclosures will be required. For those banks, which want to be recognized and competitive in the international community, increased disclosure will be critical. Banks and the NBU will need to determine how they are going to go about implementing the new requirements of the capital accord.

.Summary on corporate governance

Sound principles of corporate governance encompass many of the key components of bank risk management systems. A risk management system includes: risk identification, risk measurement, risk management and risk monitoring and control. In setting strategic objectives

and establishing strategic business plans, management and the Supervisory Council should be involved in the risk identification process. They should determine the nature of the risk they are willing to take and establishing limits on that risk, which is part of the risk measurement process. Risk is managed through the establishment of policies and procedures, the establishment of clear lines of authority and responsibility, through staffing with qualified personnel. Two of the key components of a risk monitoring and control process are an independent, qualified Supervisory Council and a strong, independent audit process. Other control features are to assure that compensation is aligned with goals and controlling risk and to ensure comprehensive disclosure. In addressing the issues of strong corporate governance, a bank or regulator will begin the process of establishing strong bank risk management systems.

CONTROL SYSTEMS

Some of the control systems were discussed under corporate governance. Many of the traditional control systems that banks have used and supervisors have required as part of the overall control environment of the bank are still applicable. However, as banks improved their assessment of risks many of the control systems were modified to better focus on the risk inherent in various products. In discussing control systems, I would like to use the organization used by the Dutch supervisory authorities. They have broken Control Systems into three broad categories: Internal Controls, Organizational Controls and Management Controls.

Internal Controls

Internal controls can be broken into six categories for assessment. These include the Bank's risk management framework, financial and managerial reporting, operational risk controls, audit controls, compliance controls, IT (technology) controls and human resource controls.

As risk management in banks has evolved, banks have developed a risk management framework for identifying, measuring and limiting, monitoring and controlling risk. Risk assessments are performed by each managerial or functional unit and cover all products and services. In many cases, when bank managements used a risk assessment discipline, they have found that all of the risks inherent in a particular area or product were not recognized. This is particular true in areas viewed as operational, but where credit risk also existed. Management assessments have also evolved to take into account the impact of risks, such as interest rate or foreign exchange risk, not just on their own balance sheets, but also the impact on customers and resulting secondary impact on credit risk. This has lead to a better understanding and analysis of the interrelationships of these risks within an individual institution. See the attached matrix from the Dutch Risk Assessment Manual for more specifics on the evaluative factors for a risk management framework.

Once risks are identified there should be a process to measure the level of risk. Earnings at risk and capital at risk methodologies are common ways to measure risk. Typically, strategic plans

and budgets incorporate risk limits. Once a methodology to measure the risk is determined, limits can be established and monitoring through MIS and audit can be developed. Financial and managerial reporting should be adjusted to complement the risk management process.

Operational risk controls such as policies, procedures and operational controls should also be focused on risk. Limits set should be reflected in policies and procedures. Controls should not only ensure management of financial risks but should include compliance controls as well. Controls over technology and human resources should be evaluated. An evaluation matrix for each of these components is also available.

Organizational Controls

Organizational controls include organizational structure, group or insider relationships, reporting lines and a responsibility structure. These have been broadly discussed under Corporate Governance. An evaluation matrix for these components is also available. It is noted that banks committed to risk management have altered their organizational structures to incorporate more extensive risk control units, such as internal loan review, compliance and financial risk management units. This recognizes that often the internal audit department does not have all the requisite skills to do a comprehensive assessment of risk management. As a result, larger institutions have established more specialized units to deal with these risk control functions.

Management Controls

Managerial controls include the quality of management and effectiveness of its structure, decision-making processes, strategic plans and risk control attitudes. Again, all of these areas should be evaluated with an emphasis on their effectiveness with respect to risk management.

DEVELOPMENT OF NEW METHODOLOGIES

As banks have focused on risk and with the assistance of technology, bank managements have developed new methodologies to better understand and measure the risk they are taking. Several models have been developed to better assess the level of risk and determine the impact on bank profitability and capital levels. Conversely, other models have been developed to determine the most effective way of allocating capital. Models to achieve specified risk adjusted returns are used to determine the pricing necessary to offset risk and achieve an appropriate risk adjusted return on capital.

Simulation models have been developed to measure the impact of changes in interest rates and FX rates. Other measures of interest rate risk include duration analysis and the market value of portfolio equity or value at risk models. Through modeling banks can stress test their portfolio and determine the level of risk under various scenarios.

Banks have also greatly improved their internal risk rating processes. Models have also been extensively used in predicting the performance of various portfolios. Banks have been very successful in developing and using models in the consumer credit area. Various models exist for the credit portfolios including default models and various mark-to-market models. Bank managements use scenario analysis to predict vulnerability to various economic or market situations. Managements also stress test portfolios to determine vulnerability of customers to market or liquidity shocks. As banks have developed better ways of measuring risk in their credit portfolios, it has also lead to better reserve for loan loss methodologies.

The development of more sophisticated and reliable risk measurement techniques has caused the Basel Committee to recognize the validity of these techniques in the New Basel Capital Accord. The new Accord recognizes that the existing Capital Accord is but a crude measurement of risk. In banks that have developed better methodologies, supervisors will be evaluate these methodologies and determine whether or the extent to which these risk measurement techniques can be used in place of the standardized approach.

Utilization of these new techniques has driven changes in how risk is managed and the limits placed on risk. The result is less volatility in earnings and capital. Use of these measurement techniques has resulted in the Board of Directors' (Supervisory Council's) improved understanding of risk and its impact on the bank's financial condition.

DEVELOPMENT OF NEW PRODUCTS

As bank managements improved their recognition and analysis of risk, they sometimes found that they were not willing to take on the level of risk inherent in the business they were doing. This has driven efforts to move risk off the balance sheet. As a result, a wide variety of new products were developed in the 80s and 90s to allow bank managements to mitigate their risk. Improvements made in the measurement of risk also facilitated the development of new products. Some of these new products included derivatives, asset securitizations and new forms of credit insurance. Derivatives have been developed to deal with FX, interest rate and credit risk. Through these various risk mitigation techniques, a bank management can pass the various risks on to other banks, insurance companies, securities firms and other market participants. However, it should be noted that these new products have brought new challenges in the analysis of the risks that result from their use.

Although it is recognized that most of these products do not currently exist in Ukraine, a first step in their development is the improvement in risk analysis and measurement by Ukrainian banks. Techniques for sharing credit risk, such as loan participations and syndication of loans, were developed some time ago. They have, however, been facilitated by the use of better credit risk management techniques. Better development of these products in Ukraine may be an appropriate starting point. As new products are developed, it will be critical for the Supervisory Council and management to understand them and their risk or how they mitigate risk.

SUMMARY

This is a quick overview of the development of bank risk management systems. The inspection process has looked at a large number of the elements of sound risk management processes. Although the standards in the inspection handbook need to be updated, examiners have cited weaknesses in bank risk management systems. However, there has been a failure to communicate these standard to the industry and ineffective enforcement. The risk management standards need to be updated, communicated and issued in a form that is enforceable. The area of Corporate Governance is one that I consider to be very weak. Changes to the legislative structure of both the company and banking laws are necessary. Another critical area to be addressed is the audit process. Finally, training for bank managers and bank supervisors is needed in the newer techniques for measuring and evaluating risks.

If the Ukrainian banking system is to be competitive, improvement to risk management processes are critical.

BearingPoint
Formerly KPMG Consulting

MEMO

To: **I.M.Ivaniuk,** Director, Department of Personnel

From: **Frank Blimling,** Senior Advisor, Chief of Party, Bearing Point/USAID Banking Supervision Project
Marina Antonova, Training Specialist
Raisa Ladokhina, Program Specialist

Cc: **I.O.Kireyev,** Director, General Banking Supervision Department
N.V.Ivanenko, Deputy Director, General Banking Supervision Department

Date: **October 17, 2002**

Topic: ***Personnel Training Database***

We, BearingPoint advisors (former Barents Group of KPMG Consulting), have collaborated with the NBU since 1995. We turn to the Department of Personnel for assistance and advise on the issue of the development and implementation of a training **database** for the General Department of Banking Supervision..

We know, that the Department of Personnel has accumulated abundant information concerning the participation of employees of both the NBU in general and its banking supervision area in various training events: seminars, re-training programs, internships both in Ukraine and overseas, etc. organized by the NBU and external organizations.

As you know, during the years of our co-operation with the NBU our advisors together with the NBU experts have always considered personnel training one of priorities. In additional to many seminars on banking supervision issues delivered during this period, we also participated in the development of the Training Concept for Banking Supervision together with NBU experts and the Dutch Grant (NBU Resolution № 153 of 04.25.2002). This Resolution also emphasizes the need to create and maintain "a constantly updating training database" (see Section "Organizational Actions", Sub-section "Organization of Training").

Taking into consideration international experience in the training area, as well as results of our long-term cooperation with the NBU banking supervision area, we believe that a comprehensive and efficient training program requires an appropriate database. A properly structured database will allow to:

1) quickly determine, which seminars and other training events are needed in the first place
2) calculate the number of employees who have attended different courses, including information by separate units of both the Central Office, and regions
3) determine the total number of training events and hours attended by each employee
4) determine the individual workload of trainers and experts, invited to teaching by the NBU
5) in compliance with the tentative list of courses referred in the Resolution № 153, determine the number of basic and advanced courses, attended by each employee of the General Department of Banking Supervision

6) efficiently schedule training for every employee, taking into consideration individual needs in training, workload and prospects for the carrier development
7) coordinate training plans for each unit of the General Department, etc.

In 1998 a software format was developed in the banking supervision area, which with some minor changes and amendments could be used to fulfil the tasks listed above. Additionally, it should be stated that one of the tasks of the Dutch Grant advisors, who are to start their activities in winter 2002-2003, also is to develop and implement such training database. We propose the following:

- the Department of Personnel should view proposals of the General Department of Banking Supervision on the database format (see Attachment) and develop their proposals on its improvement and/or amending, so that it would meet the NBU needs;
- based on the database format proposed and the Personnel Department proposals, a technical assignment for the Dutch Grant advisors should be formulated on the finalization and implementation of a comprehensive and flexible database.

Such database may be used for the further improvement of the training process not only in the General Department of Banking Supervision, but also in all other areas of the NBU. After the database is finalized within the assignment formulated for the Dutch Grant advisors by the Personnel Department and General Department of Banking Supervision, the function of its maintenance and updating may be transferred to the banking supervision area and other structural areas of the NBU, provided the appropriate decision is taken.

We would appreciate your assistance in the development of the final version of the software that would allow to maintain such databases and its updating, as well as ensuring the access for the General Department of Banking Supervision.

BearingPoint
Formerly KPMG Consulting

Мемо

До: **Іванюка І.М.**, директора Департаменту персоналу

Від: **Френка Блімлінга**, Головного радника, керівника проекту "Розвиток банківського нагляду" Bearing Point/USAID
Марини Антонової, спеціаліста з тренингу
Раїси Ладохіної, спеціаліста з розроблення програм

Копія: **Кірєєва О.І.**, директора Генерального департаменту банківського нагляду
Іваненко Н.В., заступника директора Генерального департаменту банківського нагляду

Дата: **17 жовтня 2002 року**

Тема: ***База даних навчання персоналу***

Ми, радники BearingPoint (колишньої Barents Group of KPMG Consulting), що співпрацюють із Національним банком України з 1995 року, звертаємось до Департаменту персоналу за допомогою та порадою в питанні розроблення та запровадження **бази даних** щодо навчання та підвищення кваліфікації працівників Генерального департаменту банківського нагляду.

Нам відомо, що Департамент персоналу накопичив значну інформацію, яка стосується участі працівників НБУ в цілому та служби нагляду зокрема в різноманітних навчальних заходах - семінарах, програмах підвищення кваліфікації, стажуваннях в Україні та за кордоном, організованих НБУ та іншими установами та організаціями.

Як Ви знаєте, протягом років роботи нашого проекту наші радники разом із працівниками НБУ завжди вважали навчання та підвищення кваліфікації персоналу одним із пріоритетних завдань. Крім великої кількості різноманітних семінарів з питань банківського нагляду, прочитаних за цей період, ми разом з експертами Національного банку та Голандського гранту брали участь у розробленні концепції Комплексної програми з підвищення кваліфікації працівників банківського нагляду (Постанова Правління Національного банку України № 153 від 25. 04.2002). Ця Постанова також наголошує на необхідності створення та ведення "постійно поновлюваної бази даних програми підвищення кваліфікації" (див розділ "Організаційні заходи", підрозділ Організація навчання").

Враховуючи міжнародний досвід у галузі підготовки персоналу та результати нашої багаторічної співпраці зі службою банківського нагляду НБУ, вважаємо, що повноцінна, всеосяжна, ефективна програма навчання та підвищення кваліфікації персоналу потребує відповідної бази даних. Належно структурована база даних дасть можливість:

1) швидко визначити, в яких семінарах та інших навчальних заходах існує першочергова потреба

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2) підрахувати кількість працівників, які відвідали той чи інший курс - в тому числі за окремими підрозділами як центрального апарату, так і територіальних управлінь
3) визначити загальну кількість навчальних заходів та годин навчання, відвіданих кожним працівником
4) визначити індивідуальне навантаження викладачів та експертів, яких НБУ залучає до викладання семінарів
5) згідно з орієнтовним переліком курсів, наведеним у Постанові № 153, визначити кількість базових та поглиблених семінарів, відвіданих кожним окремим працівником Генерального департаменту.
6) ефективно спланувати індивідуальні навчальні плани для кожного працівника з огляду на конкретні потреби у підвищенні кваліфікації, робоче навантаження та перспективи кар'єрного росту
7) узгоджувати навчальні плани для кожного структурного підрозділу Генерального департаменту (управління, відділу, сектора) тощо.

У 1998 році у службі банківського нагляду було розроблено та запропоновано для подальшого використання формат програмного забезпечення для створення бази даних щодо навчання персоналу. Крім того, необхідно зазначити, що радники Голандського гранту, які мають приступити до виконання своїх обов"язків в кінці 2002 - на початку 2003 року, також мають одним із своїх завдань розроблення та запровадження такої бази даних. Наша пропозиція полягає в наступному:

- Департаменту персоналу розглянути пропозиції служби нагляду щодо формату бази даних (див. Додаток до службової записки Генерального департаменту банківського нагляду) та надати свої пропозиції щодо її удосконалення та/або доповнення, аби вона відповідала потребам Національного банку України;
- на основі запропонованого формату бази даних та пропозицій Департаменту персоналу сформулювати технічне завдання для радників Голандського гранту щодо доороблення, запровадження та ведення повної, всеосяжної та гнучкої бази даних.

Така база даних може використовуватися для удосконалення процесу планування програм навчання та підвищення кваліфікації не тільки в Генеральному департаменті банківського нагляду, але і в усіх інших структурних підрозділах Національного банку України. Після того, як базу даних буде доопрацьовано в рамках технічного завдання, сформульованого Департаментом персоналу та Генеральним департаментом банківського нагляду для фахівців Голандського гранту, відповідальність за її ведення та поновлення може бути передано до Генерального департаменту банківського нагляду та до інших структурних підрозділів Національного банку, якщо буде прийняте відповідне рішення.

Ми розраховуємо на вашу співпрацю в питанні підготовки пропозицій для Голандського гранту щодо розроблення остаточного варіанту цього програмного забезпечення, яке дозволить вести такі бази даних, переведенні його на більш сучасну програмну платформу, а також в отриманні доступу до такої програми Генерального департаменту банківського нагляду.

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BearingPoint

To: V. L. Krotyck, Deputy Governor
O. I. Kiryeev, Director of the Department
Of Bank Supervision
From: Frank E. Blimling, Senior Advisor
BearingPoint, Inc.
CC: Supervision by Risk Task Force
Date: November 5, 2002
Re: Risk Based Supervision – Risk Assessment System

Introduction

The implementation of risk-based supervision by the Bank Supervision Department (BSD) of the National Bank of Ukraine is a large and far-reaching project, which will impact a variety of constituencies. The initial impact will be on commercial bank managers and supervisory councils, as they will be asked to implement risk management systems in their banks (see Karen Wilson's memorandum dated October, 15, 2002). However, over both the long and short term, all aspects of bank supervision will be impacted as supervisory techniques are adjusted to complement the risk management systems in banks. The end result should be a banking and supervision system in accord with international standards, and commercial banks and a bank supervisor, which are more efficient and effective in their businesses.

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all financial products and services, and to institutions large and small. By clearly delineating the risks that make up each product and service, managers and the BSD are better able to understand risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. It is the responsibility of the management and supervisory council of each bank to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls, and monitors risks.

Under the current supervisory approach employed by the NBU, supervision is usually closely tied to accounting and auditing principles. This traditional supervisory approach often fails to account for the different levels of knowledge and confidence that the BSD has regarding the institutions supervised, and therefore the same procedures and approaches are applied to all institutions equally. The primary focus is on the accuracy of the balance sheet, including loan loss reserves, the income statement, and the adequacy of traditional internal controls that are primarily designed to prevent fraud. The primary objectives are balancing journals, reviewing large numbers of individual transactions such as loans, and quantifying problems based on the aggregate of transactions reviewed. This approach has merit for determining the current condition of a financial institution

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and quantifying current problems but provides little insight into future performance and does not put the onus of accurate record keeping and problem identification and correction where it rightfully belongs, which is on management and the supervisory council. Also, corrective actions are often directed toward the symptoms of problems rather than the causes of problems.

The results of traditional supervision and risk-based supervision can vary greatly. Traditional supervision often results in quantifying problems, correcting symptoms of problems, and instructing banks to *avoid* risks that seem too high. Risk-based supervision assesses the quality of risk-management practices, addresses causes of problems, and makes recommendations that give banks options on how to minimize the adverse consequences of risk-taking. Additionally, traditional supervision tends to apply a cookie-cutter approach to supervision in which all banks are treated alike, often at the lowest common denominator. Risk-based supervision treats banks differently depending on each bank's demonstrated ability to manage risks. It does not penalize well-managed banks by making them operate under standards designed to keep weak, poorly managed banks solvent.

The newly formed Risk Based Supervision Task Force is charged with designing and implementing a risk based supervisory approach suitable for the BSD and the Ukrainian banking system. It is also charged with educating and guiding the BSD staff, as well as NBU management and commercial banks, through the transition from the existing traditional supervisory approach to a risk based supervision approach. These responsibilities are to be carried out in two main phases. Phase one requires the Task Force to design a Risk Assessment System. (The remainder of this memorandum discusses the elements of a Risk Assessment System.) Phase two involves 1) ensuring commercial banks develop comprehensive risk management systems, 2) developing the necessary tools and systems required of a risk based supervision approach, and 3) promoting a legal frame work that will require risk management systems in commercial banks and support an effective risk based supervision approach. (These three areas will be covered in subsequent memorandums.)

Risk Assessment System

A successful Risk Assessment System (RAS) provides a concise method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern, and the direction of risk. There are three major components to a RAS, which are necessary for the BSD to carry out its risk based supervision approach.

First, the BSD, for analysis and discussion purposes, must identify and assess the risks separately. This requires selecting broad risk categories and their definitions for bank supervision purposes. These broad categories include all the risks normally encountered by a commercial bank. The categories are not mutually exclusive, and any product or service may expose the bank to multiple risks. By identifying and defining these risk categories, the BSD establishes common terminology and approaches to evaluating the

management of risk in commercial banks. The common definitions are critical to identifying risk consistently.

The second major component in a RAS is establishing evaluation criteria for each category of risk. This ensures a common framework to document decisions about risk and provides a guide in assessing risk exposure.

The third major component is the actual assessment of risk exposure for each category of risk. The assessment of risk exposure includes:

- Quantity of risk, which is the level or volume of risk that exists and is assessed as high, moderate, or low.
- Quality of risk management, which includes how well risks are identified, measured, controlled, and monitored and is assessed as weak, acceptable, or strong.
- Aggregate risk, which is a summary judgment that reflects the level of supervisory concern considering both the quantity of risk and the quality of risk management, weighing the relative importance of each. Aggregate risk is assessed as high, moderate, or low.
- Direction of risk, which indicates the likely changes to the risk profile over a set period of time, usually 12 months, and is assessed as decreasing, stable or increasing.

The three components that make up the RAS are built on the tradition supervisory approach already in place, and will allow the BSD to better manage its resources and take a proactive approach when considering enforcement actions. The RAS not only allows the BSD to understand and deal with risks in an individual bank, but also provides a more comprehensive understanding of the risks in the entire banking system.

CAMELS Rating vs. Risk Assessment System

Many questions arise as to the need for and validity of the CAMELS rating process when the RAS is more comprehensive and forward thinking. Besides the fact that most supervisors and bankers are familiar with the CAMELS methodology, a rating system is needed to understand the current condition of a bank and is one of the major tools used as part of the RAS to quantify risk, and to some degree determine the quality of risk management. Because of the familiarity of the current CAMELS rating system, BSD can use the rating system to facilitate the implementation of a fully integrated risk based supervision approach. If a rating system did not currently exist, the BSD would have to develop some means of quantifying risks in order to make the RAS function appropriately.

To demonstrate how the CAMELS rating system works successfully with the RAS, three illustrations follow. The first two illustrations concern individual banks and deal with the BSD resource allocation and enforcement actions. The third illustration shows how the BSD, through using the RAS, can identify and address a systemic issue.

Illustration 1

Two banks of similar size receive Asset Quality ratings of "2", under the CAMELS rating system. The RAS for Bank "A" shows moderate Credit Risk and **decreasing**.

Bank "B" is assessed as moderate Credit Risk and **increasing**. While both banks currently have acceptable asset quality, there is concern (as reflected in the RAS) that Bank "B" will most likely experience asset quality problems in the near future.

For Bank "A", the BSD will likely pursue a normal examination and monitoring schedule, without considering enforcement action.

However, for Bank "B", the BSD would increase the frequency of examinations and intensify monitoring, and possibly increase staffing of examinations, particularly in the risk management and asset quality review areas. Additionally, BSD should consider pursuing enforcement action to ensure that the management and supervisory council of Bank "B" take appropriate action to prevent asset quality deterioration.

Illustration 2

Two banks of similar size receive Asset Quality ratings of "3" and Liquidity ratings of "2" under the CAMELS rating system. The RAS for Bank "A" shows high Credit Risk and **decreasing**, and moderate Liquidity Risk and **stable**. While the RAS for Bank "B" shows high Credit Risk and **increasing**, and moderate Liquidity Risk and **increasing**.

Obviously, Bank "A" is dealing with its asset quality problems while maintaining adequate liquidity. In other words, the management of Bank "A" is taking appropriate action to address regulatory issues. The BSD would probably consider a slightly heightened supervisory regime to ensure management continues to make progress in improving asset quality. Even though a "3" rating would normally result in some form of enforcement action, the BSD may decide to delay enforcement action, or not pursue any action if BSD is comfortable that management will continue to successfully address the issues. A normal supervisory regime would be followed when reviewing and assessing Liquidity.

Bank "B" is not only experiencing current Asset Quality problems, but there are strong indications that the problems will worsen and create a liquidity crisis. The BSD would definitely increase the frequency and staffing of inspections and pursue more vigorous monitoring efforts. The BSD would also aggressively pursue enforcement action, not only in the asset quality area, but also concerning liquidity.

Illustration 3

At the current time, systemic liquidity is considered good as demonstrated by the fact that 80% of all banks have Liquidity ratings of "2" or better. However, the RAS for 70% of the banks in the system indicate moderate and **increasing** Liquidity Risk. This is a clear indication that systemic liquidity may become a concern within the next 12 months. The NBU would determine the underlying causes of increasing Liquidity Risk in such a large number of banks, and may consider taking some form of action over the next 3 to 4 months to mitigate any systemic liquidity concerns. Meanwhile, the BSD may begin to alert banks to this trend and encourage bank managers and supervisory councils to focus more on liquidity in their risk management process. By taking a proactive approach, the NBU may be able to prevent or lessen the impact of a system-wide liquidity crisis.

Conclusion

A fully functional and integrated Risk Assessment System provides substantial benefits to the supervision of banks that the current traditional supervisory approach does not entail. Among the more important benefits of a well designed RAS are 1) the ability of the BSD to gain a better and more thorough understand of how risks are managed in individual banks, 2) allow the BSD to more effectively manage its limited resources, and 3) allow the BSD to take a more proactive approach to enforcement actions. The BSD and NBU will also have a clearer picture of the condition of the banking industry and potentially be able to more effectively deal with systemic risk at an earlier stage.

The three major components of a RAS are:

- Identified and defined risk categories that are used throughout the BSD supervisory process;
- Employment of well developed evaluation criteria for each risk category; and
- Assessment of each risk category based on the quantity of risk, quality of risk management, aggregate risk, and direction of risk

The RAS uses and builds on the existing supervisory tools, such as the CAMELS rating system, currently employed by the BSD. However, many additional tools will be needed and existing tools, including the CAMELS rating system, will most likely be modified to enhance and support the RAS and the overall risk based supervision approach.

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Risk Based Supervision – NBU Bank Supervision Initiative
Article for Risk Management magazine

Frank E. Blimling
Senior Advisor
BearingPoint, Inc.

Introduction

The implementation of risk-based supervision by the Bank Supervision Department (BSD) of the National Bank of Ukraine is a large and far-reaching project, which will impact a variety of constituencies. The initial impact will be on commercial bank managers and supervisory councils, as they will be asked to implement risk management systems in their banks. However, over both the long and short term, all aspects of bank supervision will be impacted as supervisory techniques are adjusted to complement the risk management systems in banks. The end result should be a banking and supervision system in accord with international standards, and commercial banks and a bank supervisor, which are more efficient and effective in their businesses.

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all financial products and services, and to institutions large and small. By clearly delineating the risks that make up each product and service, managers and the BSD are better able to understand risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. It is the responsibility of the management and supervisory council of each bank to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls, and monitors risks.

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council. Also, corrective actions are often directed toward the symptoms of problems rather than the causes of problems.

The results of traditional supervision and risk-based supervision can vary greatly. Traditional supervision often results in quantifying problems, correcting symptoms of problems, and instructing banks to *avoid* risks that seem too high. Risk-based supervision assesses the quality of risk-management practices, addresses causes of problems, and makes recommendations that give banks options on how to minimize the adverse consequences of risk-taking. Additionally, traditional supervision tends to apply a cookie-cutter approach to supervision in which all banks are treated alike, often at the lowest common denominator. Risk-based supervision treats banks differently depending on each bank's demonstrated ability to manage risks. It does not penalize well-managed banks by making them operate under standards designed to keep weak, poorly managed banks solvent.

The newly formed Risk Based Supervision Task Force (of the NBU Bank Supervision and Legal Departments) is charged with designing and implementing a risk based supervisory approach suitable for the BSD and the Ukrainian banking system. It is also charged with educating and guiding the BSD staff, as well as NBU management and commercial banks, through the transition from the existing traditional supervisory approach to a risk based supervision approach. The two main focus areas of the Task Force is designing a Risk Assessment System (also requires ensuring the legal frame work and supervisory tools are available to administer the system); and ensuring commercial banks develop comprehensive risk management systems.

Risk Assessment System

A successful Risk Assessment System (RAS) provides a concise method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern, and the direction of risk. There are three major components to a RAS, which are necessary for the BSD to carry out its risk based supervision approach.

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The Risk Based Supervision Task Force is considering the following ten Categories of Risk: Credit Risk, Liquidity Risk, Interest Rate Risk, Market Risk, Foreign Exchange Risk, Operational Risk, IT Risk, Reputation Risk, Legal Risk, and Strategic Risk.

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Risk Management System

Banks are in the business of taking risk and getting compensated for it. Risk management is the process by which a bank identifies, measures, controls and monitors its risk exposures. The U.S. based Financial Services Roundtable (FSR)[i] defines risk as the potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organization's ability to meet its business objectives. Such constraints pose a risk by limiting a bank's ability to conduct its ongoing business or to take advantage of opportunities to enhance its business. The assessment of risk exposures can range from a simple high-low matrix to a complex statistical analysis that quantitatively estimates the probability of a loss occurring and the probable amount of the loss. Regardless of the sophistication of the measure, banks often distinguish between expected and unexpected losses. Expected losses are those that the bank knows with reasonable certainty will occur (*e.g.*, the expected default rate of a credit card portfolio) and are typically reserved for in some manner. Unexpected losses are those associated with unforeseen events (*e.g.*, losses resulting from the Asian financial crisis); banks rely on capital as a cushion to absorb unexpected losses.

A Risk Management System addresses all decisions and actions taken to avoid, mitigate, transfer, insure against, put limits on or explicitly take risk. A Risk Management System is a top down approach involving the Supervisory Council, the highest levels of management, risk review and control functions, and of course, the front line, where the risk is taken.

A bank's Risk Management System and the techniques employed are dictated by the culture of the organization, its size, type of risks being taken and the materiality of potential losses. Thus, the structure of a Risk Management System will differ from bank to bank. Because many of the risks a bank assumes are inherent to the business of banking, the Risk Management System will not eliminate all risks. Inherent risks requires the bank to optimize the risk/return tradeoff by either maximizing return for a given level of risk or minimizing risk required for a desire level of return. Other risks, such as operational and legal/compliance, are risks a bank wants to reduce to an acceptable level by the most economical means. The overall objective of a comprehensive Risk Management System is to enhance shareholder value while meeting the objectives of its other stakeholders, including customers, regulators, employees, management and Supervisory Council members. To meet this overall objective, a Risk Management System must ensure that:

- Risks are understood at all levels of the organization
- Risks are within tolerances established by the Supervisory Council
- Risk-taking decisions are consistent with strategic business objectives
- Risk-taking decisions are explicit and clear
- The expected return compensates for the risk taken
- Capital allocation is consistent with risk exposures
- The bank's performance incentives are aligned with risk tolerances

The FSR recommends seven principles that are essential for any Risk Management System and central to the management of risk across an organization, within its business lines, and within specific risk categories. They include:

- Supervisory Councils and Senior Management responsibility
- Framework for managing risk
- Integration of risk management
- Business line accountability
- Risk evaluation/measurement
- Independent review
- Contingency planning

1. Supervisory Council and Senior Management responsibility. Overall risk management policies and tolerances should be set on a comprehensive, organization-wide basis by Senior Management; and reviewed with, and where appropriate approved by, the Supervisory Council. Policies and tolerances addressing risk identification, measurement, monitoring, and control should be clearly communicated to those areas affected throughout the organization.

Purpose: To ensure that risk taking is consistent with shareholder expectations, the organization's strategic plan, and regulatory requirements, and that the firm's risk culture is understood throughout the organization.

2. Framework for managing risk. The bank should have a framework for managing risk that is effective, comprehensive and consistent. Management should allocate sufficient funds to staff and support its chosen framework.

Purpose: To ensure that all material risks are identified and managed in accordance with Senior Management's expectations, and to facilitate timely communication, coordination, escalation, and corrective action.

3. Integration of risk management. To ensure that interactions among risks are identified, understood and managed as appropriate. Risks should not be evaluated in isolation. The analysis required to aggregate and highlight risks across the entire organization must be done at a level high enough to encompass the whole firm.

Purpose: To ensure that risk is managed consistently across the organization, and that the interactions of various risks and the associated impact are understood and considered when strategic and tactical decisions are made.

4. Business line accountability. Business lines should be accountable for managing the risks associated with their activities within established tolerances, as well as for the results, both positive and negative, of taking those risks. This accountability should exist notwithstanding the presence of one or more support functions dedicated to risk management activities.

Purpose: To ensure that the people who make business decisions understand the risks they are taking; incorporate that understanding into their decision making in order to achieve acceptable risk-adjusted returns; and are held accountable for the associated gains or losses. Those closest to the business in question are best positioned to identify the risks in the business, provided there is adequate independent review and control, and an incentive structure that encourages risk identification and management responses by the line.

5. Risk evaluation/measurement. All risks should be qualitatively evaluated on a recurring basis and, wherever practical, the evaluation should include quantitative analysis. Risk assessments should consider the effects of both likely and unlikely events.

Purpose: To allow management to understand the amount and nature of risk exposures using a common language, and to make informed decisions regarding allocation of resources for taking and managing risk.

6. Independent review. Risk assessments should be validated by independent review functions with resources, authority and expertise sufficient to assess the risks, test the effectiveness of risk management activities, and make recommendations for remedial action.

Purpose: To ensure that those who take or accept risk on the behalf of the institution are not the only ones who measure, monitor and evaluate the risks.

7. Contingency planning. Risk management policies and processes to address potential crises and unusual circumstances should be in place and tested as appropriate.

Purpose: To ensure that the organization is prepared to identify and deal with unusual situations in a timely and effective manner.

A well-designed Risk Management System will address risks, both inherent and unexpected, throughout the organization and by product and activity. The seven principles discussed above should be the framework for a comprehensive Risk Management System, and be evident in identifying, measuring, controlling and monitoring all risk exposures. To be effective, a Risk Management System must start at the top. It must become a part of the way the organization does business and not be viewed as an independent function. Proper risk assessment, analysis and management will not take place unless it is woven into strategic planning, budgeting process, operating plans, and business decisions.

Summary

The primary goal of the Risk Based Supervision Task Force, over the next few years, is to transition NBU Bank Supervision from a traditional, transactional supervisory approach to an approach that is more risk oriented and top down. Bank Supervision will focus on ensuring that a bank's risk management processes are appropriate for the type and level of risk taken and that the bank has an adequate capital and reserve cushion to absorb losses. The approach is intended to ensure that bank activities are consistent with safe and sound practices, are in the public interest, and are beneficial to all interested parties—the NBU, bank management and, most important, bank customers and shareholders.

Bank management and Supervisory Councils will be encouraged, if not compelled, to increase their efforts to ensure they have a comprehensive and dynamic Risk Management System in place. Bank management must recognize that effective risk management will allow for greater control in achieving an appropriate balance between risks they wish to accept and risks they wish to mitigate.

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[i] The Financial Services Roundtable promotes the business of banking and encourages the development of sound banking and financial policies and practices. Membership in The Financial Services Roundtable is reserved for the 125 largest banking and thrift companies in the U.S. The senior executives of those companies serve as representatives to the Roundtable. For a more indepth discussion of the Seven Risk Management Principles, please refer to "Guiding Principles in Risk Management for U.S. Commercial Banks" at the The Financial Sercives Roundtable website: www.fsround.org.

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Мемо

До: **Кірєєва О.І.**, директора Генерального департаменту банківського нагляду
Ричаківської В.І., директора Департаменту бухгалтерського обліку і звітності

Від: **Куценка О.В.**, спеціаліста з економічних питань проекту вдосконалення банківського нагляду

Дата: **22 листопада 2002 року**

Тема: ***Нова редакція проекту Інструкції з бухгалтерського обліку операцій з цінними паперами банків України***

На прохання представників Управління методології Генерального департаменту банківського нагляду працівниками нашого проекту була розглянута нова редакція проекту Інструкції з бухгалтерського обліку операцій з цінними паперами банків України. ***В цілому, ми підтримуємо нову редакцію проекту Інструкції і вважаємо, що він більш повно враховує нові вимоги до обліку фінансових інструментів, які викладені в МСБО 39 "Фінансові інструменти: визнання та оцінка".***

Зокрема, ми повністю підтримуємо нову редакцію класифікації цінних паперів за портфелями та порядку їх переоцінки у зв'язку із зміною ринковою вартістю та на зменшення корисності. Єдиним можливим полемічним пунктом є вимога до переоцінки торгівельних цінних паперів при кожній зміні їх вартості. Однак більш детальний аналіз показує, що бажаючи проводити ділінгові операції з фінансовими інструментами, банк сам зацікавлений в отриманні найбільш актуальної інформації щодо поточної вартості цінних паперів. Таким чином, навіть така, на перший погляд досить жорстка вимога щодо переоцінки торгівельних цінних паперів, є прийнятною, оскільки не спонукає банк до жодних додаткових витрат на отримання інформації.

Так само ми повністю підтримуємо класифікацію факторів, що свідчать про зменшення корисності цінних паперів та сучасну редакції того, яким саме чином, тобто із використанням якої ставки дисконту, слід оцінювати зменшення корисності за цінними паперами в залежності від того, до якого портфелю вони віднесені.

Разом з тим вважаємо за потрібне привернути Вашу увагу до деяких питань, які, на нашу думку, потребують додаткового опрацювання, а саме:

- ***Економічна характеристика рахунків резервів;***
- ***Часткове визнання переоцінки вкладень в асоційовані та дочірні компанії в капіталі банку;***
- ***Використання методу ефективної ставки відсотку.***

Далі наводиться більш детальне викладення наших зауважень та пропозицій.

Економічна характеристика рахунків резервів

Звертаємо Вашу увагу, що в проекті Інструкції деякі рахунки резервів під активні операції мають економічну характеристику "пасивні". Зокрема, це стосується всіх рахунків резервів під нараховані доходи, а саме, рахунків 1492, 1493, 3191 тощо.

Хоча ми неодноразово виступали за скасування практики формування резервів під нараховані доходи та пропонували повернутися до методу їх сторнування, цього разу ми хотіли б звернути Вашу увагу на дещо інший аспект. Сформовані резерви під активні операції повинні обліковуватися на регулюючих контрарних рахунках, а саме – на контрактивних. Встановлення для таких рахунків економічної характеристики "пасивні" може створювати хибне враження про те, що резерви є не регулюючою статтею, а натомість виступають джерелом коштів для банку.

Також зазначаємо, що економічна характеристика рахунків резервів "пасивні" протирічить іншим нормативно-правовим актам НБУ, а саме Інструкції про застосування Плану рахунків бухгалтерського обліку комерційних банків України №388 (наприклад, рахунок 2490 "Резерви під сумнівну заборгованість за нарахованими доходами за операціями з клієнтами" є контрактивним), та Правилам бухгалтерського обліку формування і використання резервів у банках України №268.

Тому ми ***пропонуємо змінити в проекті Інструкції економічну характеристику цих рахунків на "контрактивні"*** з метою більш повного відображення їх суті.

Визнання деякої частини переоцінки вкладень в асоційовані та дочірні компанії в капіталі комерційного банку

Проектом Інструкції передбачено, що вкладення банку в асоційовані та дочірні компанії обліковуються пайовим методом (методом участі в капіталі). Цей метод передбачає, що банк змінює облікову вартість вкладень на пропорційну величину зміни величини капіталу об'єкта інвестування.

Величина капіталу об'єкта інвестування може змінитися: (1) як результат його господарської діяльності – підприємство має фінансовий результат, який визнається як дохід або збиток та збільшує або зменшує його капітал; (2) як результат операцій підприємства з його акціонерами – додаткові емісії акцій не визнаються доходом, але збільшують величину капіталу; або (3) в результаті проведення таких операцій, результат яких в обліку відноситься безпосередньо на капітал, минаючи рахунків фінансового результату – наприклад, переоцінка основних засобів.

В проекті Інструкції передбачено, що переоцінка вкладень банку в асоційовані та дочірні компанії відноситься або на дохід банку, або на поповнення його капіталу, в залежності від ситуації. Зокрема, відображення частки банку у чистому прибутку (збитку) емітента відноситься на рахунок дивідендного доходу, тоді як відображення змін у власному капіталі емітента (крім прибутку) – на рахунки капіталу банку. Це відповідає МСБО, але може викликати деякі проблеми із практичним застосуванням в Україні.

Ми ***пропонуємо доповнити відповідні розділи проекту*** (розділи 7.2 та 7.3) пунктами, в яких передбачити наступне:

- ***Перелік основних операцій, що несуть зміни до власного капіталу емітента (крім прибутку)*** з метою більш чіткого їх усвідомлення бухгалтерами комерційних банків;
- ***Частоту відображення в обліку зміни у чистому прибутку (збитку) емітента*** – раз на рік після затвердження результатів діяльності загальними зборами або частіше (якщо частіше – то коли саме і за яких умов);

- ***Порядок відображення в обліку події включення чистого прибутку (збитку) до власного капіталу емітенту при закритті фінансового року*** – чи потрібно банку переносити частину дивідендного доходу на капітал, оскільки попередньо визнане збільшення чистого прибутку емітента в такому разі вже є збільшенням його капіталу.

Ці моменти викликають в нас деяке занепокоєння, оскільки включення переоцінки вкладень в асоційовані та дочірні установи до додаткового капіталу банку має безпосередній вплив на величину балансового та регулятивного капіталу банку і тому така переоцінка повинна бути виправданою.

Використання методу ефективної ставки відсотку

Зрештою, ми привертаємо Вашу увагу до того, що в проекті Інструкції метод ефективної ставки відсотку наведений в якості безальтернативного методу оцінки амортизації премії та дисконту за операціями з цінними паперами.

В наведеній редакції проекту метод ефективної ставки відсотку абсолютно різниться від методу, який має аналогічну назву – "метод ефективної ставки відсотку" – і описаній в чинній редакції Інструкції з бухгалтерського обліку операцій з цінними паперами установ комерційних банків України №466. Основною перевагою нової редакції методу є те, що його застосування дозволяє сторонньому аналітику чітко знати реальну ставку дохідності цінних паперів в будь-який момент часу на основі аналізу даних балансу та звіту про прибутки і збитки (величина чисельника та знаменника постійно змінюються, але їх співвідношення залишається сталим), що було неможливо при застосуванні методу прямої, та те, що така редакція не прив'язує амортизації премії і дисконту до поточної ринкової ставки, як це робиться за чинної редакції Інструкції.

Проте, на нашу думку, метод ефективної ставки відсотку є досить складним, оскільки вимагає постійного перерахунку величини неамортизованої частини дисконту та премії у разі зміни величини портфелю. Така зміна постійно відбувається (принаймні – теоретично) із торгівельним портфелем та повинна відбуватися із портфелем на продаж. Саме тому ми ***пропонуємо запровадити метод прямої в якості альтернативного методу амортизації дисконту та премії для торгівельного портфелю.*** На нашу думку, це сприятиме зменшенню навантаження на облікові системи та працівників банку, особливо виходячи з того, що проектом Інструкції передбачене щоденне нарахування доходів та витрат за торгівельними паперами, а дохід у вигляді дисконту не є основним доходом від цих паперів.

У разі виникнення у Вас будь-яких запитань з приводу цього меморандуму, Ви можете звертатися до нас у будь-який зручний для Вас час.

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MEMO

TO:	Frank Blimling, Senior Advisor
FROM:	Gary Gegenheimer, Senior Legal Advisor Yevhen Telychko, Legal and Economic Specialist
CC:	Alex Kutsenko, Economic Specialist Marina Antonova, Program Specialist Raya Ladokhina, Program Specialist
DATE:	December 8, 2002
REF:	Legal Framework for Internal and External Audit of Commercial Banks in Ukraine: Requirements for Implementation of Auditor's Recommendations by Bank's Management and Directorate.

LEGAL FRAMEWORK FOR INTERNAL AND EXTERNAL AUDIT OF COMMERCIAL BANKS IN UKRAINE: REQUIREMENTS FOR IMPLEMENTATION OF AUDITORS' RECOMMENDATIONS BY BANK'S MANAGEMENT AND DIRECTORATE.

INTERNAL AUDIT

Internal audit in commercial banks of Ukraine is regulated by laws "On Banks and Banking Activity" (Art. 45), NBU Regulation #114 "On approval of Regulation on organization of internal audit in commercial banks of Ukraine" dated 03/20/98 and NBU Regulation #358 "On approval of Methodological guidelines as to application of standards for internal audit in commercial banks of Ukraine" dated 07/20/99.

LBB Art. 45 requires each bank to have a separate unit of internal control and establishes authorities and responsibilities of internal auditors. The NBU approves the head of the unit. Regulation #114 defines the system of audit in banks and regulates set-up procedure and organization of work for internal audit units in commercial banks of Ukraine. In particular, it is required that each bank has its own internal policy on internal audit that should be followed by the bank.

Current LBB and NBU Regulation #114 still require subordination of internal audit to management of the banks. However, following our efforts, the NBU legal department in its

proposed amendments to the Law made proposals as to subordination of internal audit to the Supervisory Council instead. The NBU management supports this idea for 100%.

Another interesting document regulating internal audit in bank is the NBU Regulation #358. This document is based on international standards of internal audit and provides for, in particular:

"

8.25 After performing an examination, internal auditors should control condition in a bank as to correction of violations revealed and indicated in auditor's conclusion, as well as to determine possible risk of failure to take appropriate measures by the Board of Management or Supervisory Council.

8.26 Further control carried out by internal auditors includes establishment of adequacy, efficiency and timeliness of measures being taken by bank management in connection with internal and external auditors' remarks made in auditor's conclusion.

8.27 Responsibility for further control is to be elaborated in internal banking policy on internal audit.

8.28 Bank's management is responsible for taking measures to eliminate violations indicated in auditor's conclusion. Bank's internal audit head carries out appropriate control.

8.29 Bank's management is entitled to take risk and refuse taking appropriate measures in respect to facts indicated in auditor's conclusion due to large cost of their implementation or due to other reasons. In this case, internal audit head informs bank's Supervisory Council about the decision.

8.30 Some of the drawbacks indicated in auditor's conclusion can be so much substantial that will require urgent actions from bank's management. Internal auditors are obliged to keep those situation under special control.

8.31 If internal audit head is confident that bank's Board of Management and Supervisory Council are taking adequate measures to eliminate violations, further control is carried out during next audit inspection.

8.32 Development of a schedule for the further control must be based on anticipated risks as well as on the complicity and importance of violations revealed.

8.33 To conduct further control, the head of internal audit must: - establish time necessary to obtain a response from managers of bank's subdivisions; - consider responses by managers of units being audited; - carry out a repeated control audit inspection, if necessary; "

The term "management" or "bank's managers" (kerivnytstvo) used in the Regulation, according to BBL Art.42, includes not only bank managers but also members of Supervisory Council of the bank (Directorate).

Pursuant to NBU Regulation #114, one of the objectives of internal audit function in a commercial bank is "establishing and maintaining cooperation with external auditors, state authorities and the NBU bank supervision".

Both Regulations (#114 and #358) clearly stipulate that their provisions are mandatory for observance by commercial banks in Ukraine. The problem with Regulation #358, however, is that it has never been registered by the Ministry of Justice. Though, the NBU does its best to enforce this regulation and, according to the Head of the NBU Internal Audit Department, all banks follow those standards, obviously, there may be a problem in enforcing regulation #358 to the fullest extent.

EXTERNAL AUDIT

External audit in commercial banks is regulated by laws "On the National Bank of Ukraine" (Art.7), "On Banks and Banking Activity" (Art.69), "On Audit Activity", NBU Regulation #53 "On measures as to further development of bank audit" dated 02/09/99, NBU Regulation #271 "On approval of Policy on Qualification Commission of the National Bank of Ukraine on certification of auditors, provisional administrators and liquidators of banking institution, and Policy on certification of auditors of banking institutions".

Pursuant to laws on "On Banks and Banking Activity" (Art.69):

"Financial statements of banks to be submitted to the National Bank of Ukraine must be audited on a annual basis. The audit of a bank is to be performed by an auditor that has a certificate of the National Bank of Ukraine to audit banking institutions *(so far certification is not provided)*

The auditor's report shall contain the following:
1) Bank balance sheet.
2) Profit and loss account.
3) Statement of movement of capital.
4) Schedule on assets and liabilities maturity.
5) Information on the adequacy of bank reserves and capital.
6) Information on the adequacy of accounting, internal audit and bank's control mechanisms.
7) An opinion whether the submitted financial statements reflect the bank's real financial position."

Following our efforts GDBS suggested the NBU Legal Department in their amendments to BBL, either to make p.6 more specific to include risk-management systems in banks or add an additional p.8 dedicated to adequacy of risk-management systems.

None of the laws in Ukraine requires company's managers or directors to follow recommendations of external auditors. However, in respect to commercial banks, given the fact that close cooperation between internal and external auditors is required (NBU Reg #114, p.4.2), and bank's managers and directors are required to follow recommendations of internal auditors (NBU Reg #358, p.8.28), there seems to be a mechanism to force bank's managers and directors to implement recommendations of external auditors (via internal auditors). Again, because Reg #358 has not been registered by the Ministry of Justice, there may be a problem in actual enforcing this point.

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MEMO

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DATE:	December 15, 2002
REF:	System of Commercial Courts and Competence of Judges in Ukraine: Overview of Legal Framework.

SYSTEM OF COMMERCIAL COURTS AND COMPETENCE OF JUDGES IN UKRAINE: OVERVIEW OF LEGAL FRAMEWORK.

The court system dating back to the Soviet period was recently transformed pursuant to requirements of Article 125 of Ukrainian Constitution into a system of courts of general jurisdiction (http://www.ukrpravo.com/Const/chapter8.shtml). Adoption by the Parliament of Ukraine of a number of Laws of Ukraine on June 21, 2001, constituting the so-called "small legal reform" represents a significant achievement in implementing the judiciary reform. In addition, appropriate changes have been made in the Code of Civil Procedure of Ukraine, Code of Economic (Commercial) Procedure of Ukraine, and Code of Criminal Procedure of Ukraine, which bring the rules of procedure in line with the Constitution.

Major laws currently regulating activity of judges in Ukraine are Law on Status of Judges (LSJ), Law on Judicial system in Ukraine (LJS) and Law on Commercial Courts in Ukraine (LCC), Code of Commercial Court Procedure (CCP), Law on Qualification commissions, qualification attestation and disciplinary responsibility of court judges in Ukraine (LQC), Decree of the President of Ukraine No.511/2001 On Creation of Commercial Courts of Appeal and Approval of Network of Commercial Courts of Ukraine.

COMMERCIAL COURTS

Commercial courts are specialized courts in the system of courts of general jurisdiction (Art. 5, LCC). LCC Art.1 specifies that "a commercial court is an independent body to resolve all

commercial disputes among legal entities, legal entities and state authorities, as well as to resolve bankruptcy cases".

Commercial courts represent a unified three-tier system of commercial courts that consists of local (1) commercial courts, (2) appeal commercial courts, and (3) The Supreme Commercial Court of Ukraine. (Art.5, LCC). There are 903 commercial court judges in Ukraine (Decree N No.511/2001).

Local commercial court is the court of first instance considering any disputes (including disputes with the NBU regional office or local tax authorities) in the territory of Ukraine's administrative regions (oblast). Disputes with the National Bank of Ukraine, the State Tax Administration of Ukraine and other national state bodies fall under jurisdiction of the Commercial Court of Kyiv. A decision of a local commercial court shall come into force in ten days from the date of its approval. There are 27 local commercial courts in Ukraine employing 595 judges.

Appeal commercial court is the court of the appeals. There are 8 appeal courts, jurisdiction of which covers the following territories:
- Dnipropetrovsk appeal court – Dnipropetrovsk, Zaporizhya and Kirovograd oblasts (36 judges);
- Donetsk appeal court – Donetsk and Lugansk oblast (35 judges);
- Kyiv appeal court – the city of Kyiv, Vinnytsya, Zhitomyr, Kyiv, Cherkasy and Chernigiv oblasts (57 judges);
- Lviv appeal court – Volyn, Zakarpattya, Ivano-Frankivsk, Lviv, Rivne, Ternopil, Khmelnytskyi and Chernivtsi oblasts (30 judges);
- Odesa appeal court – Mykolayiv, Odesa and Kherson oblasts (31 judges);
- Sevastopol appeal court - the Republic of Crimea and the city of Sevastopol (24 judges);
- Kharkiv appeal court – Poltava, Sumy and Kharkiv oblasts (30 judges).

The appeal commercial courts may review decisions taken by local commercial courts located on the territory, over which the competence of an appeal court is extended, and review its own decisions due to newly discovered circumstances.

In an appeal court, there can be implemented specialization of judges by specific categories of cases (Art 9-2, LCC).

The Supreme Commercial Court employs 65 judges and governs activity of local and appeal commercial courts, and reviews their decisions under cassation proceeding, as well as re-consider cases due to newly discovered circumstances. The Supreme Commercial Court gives explanations regarding practice of enforcement of legislation regulating commercial activities. A cassation claim can be filed with the Supreme Commercial Court within one month from the date a decision taken by the local commercial court or a resolution taken by the appeal commercial court come into force. A cassation claim shall be reviewed within two months since the date a claim is received. Upon consideration of a claim the Supreme Commercial Court takes a resolution, which shall become effective from the date of its issuance.

General Prosecutor of Ukraine or the parties of a lawsuit may dispute a resolution taken by the Supreme Commercial Court with the Supreme Court, which is the highest judicial body of the courts of general jurisdiction. A cassation claim to the resolution of the Supreme Commercial Court may be submitted no later than one month from the date of its issuance. Proceedings on revision of a resolution of the Supreme Commercial Court by the Supreme Court shall be commenced at the consent of at least five judges and shall be considered during a month from the date of receiving a cassation claim. A resolution of the Supreme Court shall be final and shall not be subject to appeal.

A commercial court may revise its own decision, which has come into force, due to newly discovered circumstances, which are substantial for the case and were not known to the claimant.

For more detailed information about judicial system of Ukraine as well as about judicial process, please consult the paper by BC Toms and Co. "Arbitration and Dispute Resolution" (http://www.is.svitonline.com/lawukraine/bctoms/docs/DBU2-6Dispute%20Resolution.pdf)

GENERAL REQUIREMENTS FOR JUDGES OF COMMERCIAL COURTS.

According to LCC Art. 22, minimum requirements for a person to become a commercial court judge are 1) at least 25 years old (30 years for a candidate to a position at an appeal court), 2) higher legal education (For detailed information on legal education in Ukraine, please see "Background on Legal Education in Ukraine" by Commercial Law Center http://www.commerciallaw.com.ua/eng/professional/education/) 3) at least five years' professional experience (for a judge of the Superior Commercial Court, requirements are stricter - at least 30 years old, higher education, at least 10 years professional experience.). A person that has either previous convictions or a limited capability or recognized to be incapable by a court decision may not be a judge.

Judges cannot belong to the political parties and trade unions, take part in any political activities, have a Parliamentary mandate, have any other paid official place of work, do any other kind of paid work except scholarly, professorial and creative work (Constitution)

Persons with professional training in issues of jurisdiction of specialised courts may be judges of these courts. These judges administer justice only as members of a collegium of judges.

LSJ Art 7(5), LQC Art. 27 and 28 indicate that a necessary requirement for a candidate to a judge position is to successfully pass a qualification examination. The same requirement is applied to those who used to work as judges but than had a break in their career for over 11 years.

GUALIFICATION COMMISSION (BOARD OF EXPERTS)

For candidates to judge positions at a commercial court, the examination body is the Qualification Commission for Judges of Commercial Courts (Art.2, LQC).

LQC Art. 3 defines that to the Qualification Commission for Judges of Commercial Courts consists of the head, his deputy and nine members of the Commission. Among them, there should be eight judges, one person with higher legal education elected by the Parliament of Ukraine, one person with higher legal education assigned by the Ministry of Justice, and one person with a scientific degree in the field of jurisprudence representing scientific institutions or institutions of higher learning. Members of the Commission are elected the Parliament of Ukraine (Art. 4 (6), LQC).

GUALIFICATION EXAMINATION

For those interested in working as judges of a commercial court, the qualification examination consists of candidate's submitting a synopsis on some specific topic of economic law prepared in advance, interview on the topic of the synopsis, answering oral questions on civil and other areas of law. Then, the Qualification Commission makes a conclusion as to results of the examination and readiness of a candidate for a judge position at a commercial court. Here, not only specialized knowledge, but also personal and moral qualities are taken into consideration. The qualification commission recommends a certain number of candidates (a number sufficient to fill openings for judge positions at courts) that have displayed the best knowledge for work as judges at commercial courts (Art 8 (5-8), LSJ). Persons that have passed the examination, but are not recommended for judge positions due to lack of vacancies, should be taken into consideration for three years as candidates for new openings for judge positions.

If a person failed to pass the examination, he can take it again not earlier than in a year. Persons that work in a general court and wish to work at a commercial court are exempted from preparation of a synopsis and an interview, though are still required to answer questions on civil and other areas of law.

ATTESTATION OF JUDGES

According to LQC Art. 15, attestation of judges is carried out by qualification commissions of judges (in our case, Qualification Commission for Judges of Commercial Courts) in order to evaluate and promote the growth of professional qualification of judges, increase their responsibility for observing legislation when considering court cases.

Persons selected for a judge position for the first time undergo attestation within six month after they are selected. (Art. 20, LQC)

Depending on the position, experience, level of professional knowledge, one of six qualification classes is assigned to a judge: the highest, the first, the second, the third, the forth, and the fifth. The minimum period of holding a qualification class entitling a judge to obtain the next

qualification class is established as follows: for the firth and forth class - 3 years, for the third and second class - 5 years (Art. 19, LQC)

Qualification attestation of a judge is taking place within one month since the period of his holding a previous class is over (Art. 20, LQC). Pre-scheduled attestation can be held not earlier than in two years after the last attestation.

The procedure for attestation of judges is described in LQC Art. 21 as follows:

1) The head of the relevant court draws up a letter of reference for the judge, where he describes his business and moral qualities, and provides evaluation of his professional activity. Letters of Reference for heads of courts are drawn up by heads of higher-level courts.

2) Judge should be familiarized with a letter of reference at least 15 days before attestation.

3) Attestation is taking place, within one month since the application was submitted, in the presence of the judge to be attested.

4) In case a judge failed to attend the Attestation Commission meeting for good reasons, the judge can be attested in distance if the Commission considers it possible.

Depending on the level of professional knowledge, experience and position that a judge holds, the Qualification Commission takes one of the following decisions: 1) to assign a qualification class to a judge; 2) to raise a qualification class; 3) to leave the same qualification class; 4) to postpone attestation for the period of not more than six month (in case, insufficient professional knowledge are displayed). If after the postponement period is over, the Qualification Commission again discovers judge's insufficient professional knowledge, they may dismiss a judge. (Art. 23, LQC)

A judge that disagrees with a decision of the Qualification Commission as to his attestation may appeal it within 10 days at the Higher Qualification Commission of Judges of Ukraine. (Art. 24, LQC)

TRAINING OF JUDGES

The Ministry of Justice of Ukraine organizes and coordinates the work on improving the qualification of the corps of judges. The department for professional training of judges at the Yaroslav Mudryi National Law Academy of Ukraine was established. The Ukrainian Academy of Judges under the Ministry of Justice of Ukraine was also established.

The judicial training is actively provided by the Supreme Court Training Center, a beneficiary of the two projects in Ukraine by the Center of International Legal Cooperation.

<u>Strengthening the Judiciary Project</u>

This train-the-trainer program for the Ukrainian Supreme Court is funded by the Dutch Ministry of Foreign Affairs' Matra Pre-accession Program. CILC's project partners are SSR and the Netherlands Helsinki Committee.

According to CILC Year 2001 Report (http://www.cilc.nl/AnRep2001.pdf), the project, which started up in late 1999, gained momentum in 2001. Ukrainian legal experts were twinned with trainers from the Netherlands with whom they developed training programs and course material. In May, the first series of training seminars took place in Zhitomir (court management) and Vinnytsia (the European Convention on Human Rights and European Court of Human Rights case law), and in June in Chernihiv (civil law). At this stage the Dutch trainers played a leading role in developing the "train-the trainer" concept together with their Ukrainian colleagues. When a new round of seminars kicked off in Kirovohrad and Cherkasy in December (civil law), the contribution of the Dutch trainers was largely confined to observing and evaluating the Ukrainian trainers' performance.

There were also a criminal law seminar in January 2002 and a conference on the jurisprudence of the European Court on Human Rights in Kyiv.

Strengthening the Capacity of the Judicial System Project

Officially launched in August 2000, this two-year EU/Tacis-funded project only began its activities in June 2001. CILC's project partners are the Ukrainian Legal Foundation, SSR, the Bonn-based Stiftung fur Internationale Rechtliche Zusammenarbeit (IRZ), and L'ecole Nationale de Magistrature. As with the project on strengthening the Ukrainian judiciary, the local beneficiary is the Ukrainian Supreme Court. The reason for the project's late start was a disagreement between the partners and the European Commission over the compensation of the participating judges.

The overall aim of the project is the development of an efficient training system for Ukrainian judges. The immediate goals are to improve the management and training capabilities of the Supreme Court Training Center (SCTC) and four new regional training centers, as well as to train a number of judges' trainers from the Commercial Court Training Center. The project is coordinated with the "Strengthening the Judiciary" project to avoid overlap and optimize mutual benefits.

In April and November, Ukrainian judges visited Western Europe to study training methodology and the design of training curricula in six different subjects. Seminars were held in Kyiv in June and November on drawing up a national training policy paper and a national training center management plan. At these seminars EU experts and Ukrainian judges exchanged views and determined which methodologies and curricula to implement. Four regional training centers were established, equipped and staffed, and the SCTC was upgraded with additional equipment and staff training.

RISK-BASED SUPERVISION CONCERNS

As to the current lack of judges' competence as an impediment for implementation and enforcement of risk-based supervision, in some cases, it may be a problem. The NBU is to move from legal and regulatory language based on compliance with specific ratios and numbers, toward a system that is more judgmental. As we move more toward a risk-focused supervision approach, the legislative and regulatory texts will necessarily become more indefinite, crowded with terms like "adequate", "sufficient", "safe and sound", etc., and will require the NBU to use more judgment, both is analyzing facts, and in developing supervisory responses to those facts.

Code of Commercial Court Procedure in Ukraine states the following:

Art. 4-7: A judge shall take a court order based on results of discussions of all facts of the case.

Art. 33: Each of the parties must prove those facts it refers to as a ground for its claims and denials. Evidence is furnished by the parties and other participants in litigation.

Art. 43: Commercial Court, being governed by the law, evaluate evidence in its judgement based on comprehensive, full and objective consideration of facts of the case in aggregate.

All this applies to litigation between the NBU and a commercial bank.

Thus, in the situation where a bank appealed against the NBU's "inadequate risk-management system correction" order in court, a court would require evidence from the NBU proving that the bank's risk-management system is "inadequate". If it is satisfied with the NBU evidence, the NBU will win the case. Definitely, so that judges would able to evaluate sophisticated evidence, they should have profound knowledge in the field of finance, banking and bank supervision. In this connection, some focused training of commercial court judges would be very useful. However, whatever training is provided, it is hard to believe that even highly specialied commercial court judges will be able to accurately evaluate those sophisticated pieces of evidence in a manner that professional and reasonable bank supervisors would do.

For this reason, it is very important to promote a regulatory environment where the NBU judgement in issues of "adequacy" or "inadequacy" of internal control and risk-management systems would be decisive for courts. There should be a limit to the amount of sophisticated analysis that the judge has to engage in. In other words, the judge should not be expected to review and analyze the bank's internal controls, policies and procedures, etc. as if he or she were the NBU - all the judge should have to do is know enough about the process to be able to determine whether the NBU has made a reasonable decision in making its evaluation of a given situation.

One of the steps towards this goal would be to promote some supportive language in the Law on Banks and Banking. For example, the first paragraph of Article 72 "Enforcement Measures" could be further amended to state that "In case a bank or other persons (entities) under the National Bank of Ukraine supervision in compliance with this Law, violate the banking legislation of Ukraine, any normative-legal act of the National Bank of Ukraine, *lack or, in opinion of the National Bank of Ukraine, have an inadequate risk-management systems,* or

perform risky operations, which threaten the interests of the bank's depositors or other creditors, the National Bank of Ukraine has the right to use *preventive or compulsory enforcement measures it finds adequate to correct violations or drawbacks*". (The undelined material is something that we can additionally recommend; material in italic is wording that BSD has submitted to the Legal Department after BSD round-table discussions on BBL amendments).

Another important step is to establish in NBU Regulation(s) some specific regulatory criteria based on which inadequacy of bank's risk-management system (if it has place) would be obvious even for poorly trained judges. Those regulation(s) should also lay down that there may be other reasons and criteria to rate bank's system as inadequate subject to the NBU judgement.

Ukrainian judges usually tend to strictly follow rules and regulations (if not too much influenced). Accordingly, provided amendments to BBL are made, and the NBU issues a specific regulation on Risk-management systems in banks laying down specific minimum requirements for commercial banks (to be further tailor-made by banks), commercial courts will tend to support the NBU during possible proceedings. Also, some additional training of judges on issues what bank supervisors do and how courts should treat appeals against decisions of the bank supervisor would be helpful.

One of the concern is also an independence of judges. Though, their independence is clearly declared in the Constitution as a major principle of justice, the reality is different. Judges are dependant on low salaries, and the cases of briberies or political pressure are frequent. Obviously, some commercial banks will be able to influence commercial court judges' decisions..

CONCLUSION

Constitution and relevant laws of Ukraine generally emphasize the importance of ensuring adequate professional level of court judges and provide necessary mechanism for selection of judges and on-going control of their professional knowledge (accreditation). Obviously, some of the provisions could be better. In particular, it would make sense to require more thorough and frequent attestation – at least once a year. For commercial court judges, clear requirement for adequate knowledge in the field of economics and finance should by placed in the law.

Within the current framework, efficient implementation of selection and attestation of judges depends on those who will be in charge of those processes. In particular, the role of the Qualification Commission for Judges of Commercial Courts is tremendous. If during examinations and attestations, they will be also intensively and thorough checking and promoting the knowledge in the field of banking law, finance, issues of corporate governance (even if it is not clearly required in the law so far), we will have much more professional economic court judges.

For the purposes of risk-based bank supervision, it is important to promote a regulatory environment where the NBU judgement in issues of "adequacy" or "inadequacy" of internal control and risk-management systems would be decisive for courts. Also, some additional

training of judges engaged in bank-related issues would be helpful. They should at least clearly know what bank supervisors do, and how they should treat appeals against decisions of the bank supervisor.

BearingPoint.
Formerly KPMG Consulting

MEMO

TO: Frank Blimling, Senior Advisor
FROM: Raya Ladokhina, Program Specialist
Marina Antonova, Training Specialist
DATE: December 18, 2002
REF: BSD personnel training in the NBU

Based on the information obtained as a result of the trip to the Sumy Banking Academy and a series of meeting with the Personnel Department, a conclusion can be made, that the formal training process for the BSD still remains in the stage of evolution.

The NBU BSD area has yet no well structured formalized training process, that would include a meaningful needs analysis, selection of trainees, well developed curricula, etc. The needs analysis performed now is very superficial, since it takes into consideration only an official position of a trainee. The database that, as the Personnel Department claims, has recently been developed, does not seem to be widely used, the access to it appears to be limited.

The NBU does not have consistently structured, well developed programs and training materials for the BSD training, which could be used by the BSD experts, who train their colleagues (as it was suggested in our previous proposals). The training materials that were provided to the BSD-NBU in the end the previous contract do not seem to be widely used.

The BSD experts that went through the Train the Trainers course or have teaching experience and skills, are not willing to be actively involved in the training process. The primary reason is, again, the lack of commitment of the BSD managers, who do not allow their best employees to leave for a period of time needed for the delivery of a training course. Additionally, even when they provide training, it is done very randomly, as it seems appropriate to them, rather then based on consistent developed training programs, which are lacking (see the paragraph above).

Programs offered in the Sumy Academy and in Kiev Training Center are supposedly based on the list of courses recommended in the BSD Training Concept. However, they give only a very general idea of activities and approaches employed by the BSD. This is not sufficient, since there should be more detailed technical seminars offered to the BSD employees. However, the NBU still relies on outside trainers to deliver such courses, which, consequently, are not properly scheduled and, due to the lack of needs analysis, do not cover everybody who should participate. The use of the Sumy Academy teachers for technical training does not seem

to be a solution, since there is a concern, that their expertise may not be appropriate for the BSD purposes, because they do not have a relevant practical experience.

On the other hand, some positive trends should be mentioned, which prove that there is a movement of the NBU towards a more structured training process.

The fact, that the Sumy Academy was selected by the Personnel Department as one of the basis for the BSD training, should be considered positive. In time the Sumy Academy (as well as the Kiev Training Center of the NBU) may be expected to become one of national (or even international) BSD training centers.

The teachers of the Sumy Academy, even though at the moment they do not seem to have appropriate expertise for the BSD training, have teaching and academic background, which may be developed and properly used. They may be taught to train some theoretical aspects of banking supervision, which may be complimented by practical training (specific banking supervision topics, case studies, etc.) provided by the BSD experts.

The Sumy Academy teachers use tests to check the knowledge of the BSD trainees. Even though these tests are prepared inconsistently by every teacher to accommodate his/her specific course, they, however, seem to be an important initiative. If they are further developed, properly structured and used, they may become a part of the future accreditation program.

Recommendations to the NBU

We would recommend the following:

1) In order to make the BSD training efficient the Personnel area and the Sumy Academy should make training programs more technically specific. The training curricula should include not only orientation seminars, but also specific technical seminars on key banking supervision topics. This will require a lot of assistance in terms of training programs development, training teachers, and structuring the training schedule

2) Closer, more consistent and regular contacts between the Sumy Academy teachers and the BSD Central Office and regional experts should be established in order to share their practical experience with the Academy teachers and provide for more consistent and technically sound approach to training seminars for the BSD in Sumy

3) The selection of trainees should be improved, more thorough needs analysis should be performed in order to have the level of trainee knowledge and interests relevant to the nature of a seminar they are offered

4) Testing should be further developed and promoted. This will also require assistance in the development of testing guidelines, a properly used database and a consistent test format as well as in the initial launching of testing

5) The BSD should not only have their input in the training schedule, but also commit the participation of their staff in the training events (both as trainees, and trainers)

Recommendations to BearingPoint

In order to strengthen our efforts aimed at ensuring that the formal training program for banking supervision is implemented,

1) The Personnel Department should be more emphasized as a major counterpart in our work in the BSD training area, where we could act as a link between the BSD and the Personnel that would allow to facilitate closer and more efficient relationship

2) The Sumy Banking Academy as one of potential training centers for the BSD should become one of the focuses of our assistance

3) The idea of testing should be promoted as one of the first steps towards the accreditation-certification process

4) BearingPoint should equally concentrate on facilitating more active involvement of the BSD in the organization of the training process

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МЕМО

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Від: **Френка Блімлінга,** Головного радника, керівника проекту "Розвиток банківського нагляду" Bearing Point/USAID
Раїси Ладохіної, спеціаліста з розроблення програм
Марини Антонової, спеціаліста з тренингу

Копія: **Іваненко Н.В.,** заступнику директора Генерального департаменту банківського нагляду

Дата: 20 січня 2003 року

Тема: ***Подальше співробітництво між Національнм банком України та компанією BearingPoint в галузі підготовки персоналу служби банківського нагляду (з використанням інформації, отриманої під час відвідання Української академії банківської справи м.Суми)***

Інформація, отримана в результаті бесід із представниками Департаменту персоналу та поїздки до Української академії банківської справи у Сумах, дозволяє зробити висновок, що процес підготовки персоналу служби банківського нагляду продовжує успішно розвиватись. Прогрес у цій сфері є очевидним, хоча існує і ряд аспектів, що потребують вдосконалення. Однак слід зазначити, що ці аспекти є природніми, зважаючи на відносну молодість служби банківського нагляду, рівень робочого навантаження працівників Департаменту персоналу, обмеженість фінансування та інші проблеми, вирішення яких потребує часу.

По-перше, видається досить позитивним той факт, що Департамент персоналу обрав Українську академію банківської справи центром для фахової підготовки працівників служби банківського нагляду. Взагалі, ідея спеціалізації навчальних закладів НБУ (у Сумах, Львові, Харкові, Черкасах) за різними сферами центральної банківської діяльності видається плідною. Що стосується Української академії банківської справи в Сумах, то, зважаючи на потенціал та матеріальну базу цього закладу, можна очікувати, що з часом в неї є шанси стати національним (а може, й міжнародним) центром підготовки банківських наглядовців.

Викладачі Української академії банківської справи володіють викладацькими та академічними знаннями та вміннями, які мають бути відповідним чином використані, хоча і слід зазначити, що особливості їхньої кваліфікації на даному етапі не завжди повністю відповідають вимогам підготовки банківських наглядовців, оскільки їм бракує практичного досвіду в галузі банківського нагляду. Однак вони можуть бути підготовлені до навчання теоретичних аспектів банківської справи, у той час як практична сторона навчання (розгляд практичних прикладів типу "кейс стадіз", проведення семінарів на специфічні наглядові теми, як то система рейтингу CAMELS, Уніфікований звіт тощо) може здійснюватися досвідченими працівниками служби банківського нагляду.

Ще одним надзвичайно позитивним фактором є те, що викладачі Української академії банківської справи в Сумах розробляють, використовують та зберігають тести для перевірки засвоєних знань слухачів – працівників НБУ. Ці тести не готують за єдиними схемами, а кожен викладач пропонує свої власні тести, пристосовані до його/її курсу, однак ця ініціатива є дуже важливою. У разі, якщо ці тести удосконалити, відповідним чином структурувати, аби вони готувалися за єдиним форматом, та ефективно використовувати, вони могли б стати підґрунтям для запровадження в майбутньому організованої системи перевірки та підтвердження знань банківських наглядовців.

Серед питань, над якими ще треба працювати, найважливішим є подальше запровадження та вдосконалення комплексної програми підготовки персоналу банківського нагляду. Для цього треба буде:

- налагодити більш послідовний аналіз потреб;
- удосконалити відбір учасників;
- розробити більш обґрунтовані графіки навчання тощо.

На даному етапі аналіз потреб та відбір учасників здійснюється в основному за одним основним критерієм – за посадою, яку обіймає той чи інший працівник. Вважаємо, що цього не досить. Але для того, щоб більш розширений та обґрунтований аналіз потреб та відбір став можливий, потрібна докладна та розгалужена база даних щодо підготовки персоналу. Як повідомили представники керівництва Департаменту персоналу, створення такої бази даних майже закінчено. Запровадження її очікується в наступному році. Зі свого боку, наш проект готовий надати консультації щодо міжнародного досвіду в проведенні аналізу потреб та виробленні найефективніших підходів до використання бази даних.

Необхідно також розробити та запровадити програми навчальних курсів спеціально для служби нагляду. Ці курси повинні бути розроблені в єдиному форматі, бути достатньо докладними і такими, щоб ними могли користуватися викладачі-експерти служби нагляду під час підготовки до семінарів. Навчальні матеріали, які проект "Вдосконалення банківського нагляду" надав Національному банкові наприкінці травня на початку червня, поки що не використовуються досить широко. Крім того, ми усвідомлюємо, що ці

матеріали, підготовлені різними радниками, потребують зведення до єдиного формату і певного розширення та систематизації. Однак, їх можна було б використати як початкову базу для створення належного банку навчальних матеріалів. Звичайно, ця робота повинна бути зосереджена в першу чергу в Генеральному департаменті банківського нагляду з використанням відповідної допомоги Департаменту персоналу.

Фахівці служби банківського нагляду, які прослухали семінар "Навчи вчителя" або мають досвід та навички викладацької роботи, не бажають активно брати участь у процесі навчання своїх колег. Основна причина цього знову ж таки в тому, що керівництво служби нагляду не бере на себе зобов"язання щодо забезпечення відповідного функціонування процесу тренингу та не схвалює, коли кращі працівники відсутні протягом періоду, необхідного для проведення навчального курсу. Крім того, навіть коли навчання проводиться, це робиться досить довільно, на розсуд викладачів, без визначених єдиних для всіх стандартних програм (див. вище).

Програми, які пропонують Українська академія банківської справи та Навчальний центр НБУ в Києві, базуються на переліку курсів, попередньо рекомендованих у концепції Комплексної програми з підвищення кваліфікації працівників банківського нагляду (Постанова Правління № 153 від 25 квітня 2002 року). Слід зазначити, що ці програми структуровані так, що дають лише загальне уявлення про види діяльності та підходи, що їх застосовують у службі банківського нагляду. Ми розуміємо, що це необхідно і відбувається у відповідності з Указом Президента "Про комплексну програму підготовки державних службовців" № N 1212/2000, який наголошує на наявності в урядових органах різних видів навчання персоналу. Зокрема, в Указі зазначається, що навчання здійснюється "за програмами тематичних постійно діючих та короткотермінових семінарів, що проводяться з урахуванням потреб у підвищенні ефективності виконання посадових обов'язків і результатів щорічного проведення оцінки професійної діяльності державних службовців".

На нашу думку, це положення слід тлумачити так: Національний банк повинен забезпечувати для працівникам служби нагляду постійно діючі відповідно розроблені курси як загального, так і більш вузького технічного характеру. На жаль, для курсів другого типу НБУ, як і раніше, покладається на лекторів зі сторони (в основному, іноземних радників). Тому такі курси часто неможливо внести до графіку навчальних заходів заздалегідь, під час його підготовки. Крім того, через дещо обмежений аналіз потреб та нерівномірне робоче завантаження в них не беруть участі всі працівники, яким вони потрібні. Використання викладачів Української академії банківської справи для проведення семінарів вузькотехнічного характеру може допомогти вирішити цю проблему, але лише частково. Як вже зазначалося, їхні знання не завжди повністю відповідають потребам служби нагляду, оскільки в них немає практичного досвіду.

Рекомендації для НБУ

Ми можемо рекомендувати наступне:

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1) Аби забезпечити подальше підвищення ефективності навчання персоналу служби нагляду, Департамент персоналу та Українська академія банківської справи за участю Генерального департаменту служби нагляду мають запровадити регулярні навчальні програми більш вузькотехнічного характеру. Графіки навчальних заходів повинні включати не лише семінари загального – орієнтовного – характеру, але і докладні семінари з основних питань банківського нагляду у відповідності з програмою, запропонованою в Концепції програми підвищення кваліфікації працівників банківського нагляду (Постанова Правління № 153 від 25 квітня 2002 року). Для цього знадобиться технічна допомога щодо розроблення програм навчання, підготовки викладачів та структурування графіків навчання.

2) Необхідно встановити тісніші та більш регулярні контакти між викладачами Українiської академії банківської справи та фахівцями Генерального департаменту банківського нагляду та обласних управлінь, аби останні поділилися своїм практичним досвідом із викладачами Академії, забезпечивши в такий спосіб більш послідовний підхід до навчальних семінарів для працівників банківського нагляду, що проводяться в Сумах.

3) Відбір учасників семінарів повинен бути вдосконалений: необхідно проводити більш докладний аналіз потреб для визначення рівня підготовки та сфери інтересів кожного учасника, які відповідали б рівню, темі та характеру кожного семінару, який пропонується

4) Необхідно продовжувати розвиток та розширювати та вдосконалювати застосування тестування. Для цього також знадобиться додаткова допомога щодо розроблення вказівок з проведення тестування, запровадження та правильного використання бази даних, розроблення тестів у єдиному форматі та започаткування системи регулярних тестувань

5) Генеральний департамент банківського нагляду повинен не лише робити свій вклад у розроблення графіку навчальний заходів та семінарів, але також брати на себе зобов"язання щодо обов"язкового забезпечення участі в них відповідних працівників (як в якості слухачів, так і викладачів)

Подальше співробітництво між НБУ та BearingPoint

З метою подальшого зміцнення спільних зусиль НБУ та BearingPoint, спрямованих на запровадження повноцінної, добре структурованої програми підготовки персоналу служби банківського нагляду, пропонуємо зробити акцент на таких моментах нашого співробітництва:

1) Приділяти більшу увагу Українській академії банківської справи як потенційно одного з тренингових центрів для банківських наглядовців

2) Ідею тестування слід всіляко розвивати, оскільки запровадження перевірки та підтвердження знань, навичок та вмінь банківських наглядовців як логічне завершення навчальних заходів є надзвичайно важливим завданням, над яким необхідно працювати

3) Необхідно більш активно залучати керівників підрозділів та відповідних працівників служби банківського нагляду до участі в організації процесу навчання персоналу служби нагляду.

4) Ми гадаємо, що ініціатива BearingPoint щодо проведення курсів типу "Навчи вчителя" була позитивною. Такі курси варто і подальшому пропонувати вибраним працівникам служби нагляду, які в перспективі повинні стати наставниками своїх колег. Вважаємо також, що необхідно, з одного боку, враховувати в робочому навантаженні таких працівників їхню участь у семінарах в якості викладачів, а з другого боку, розглянути можливість запровадження додаткових винагород для таких працівників

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Memorandum of January, 20, 2003 on the further development of the formal training process in the BSD area of the NBU, addressed to the Director of the Personnel Department and the Deputy Director of the General Banking Supervision Department

SUMMERY

The given memo generally mirrors the memo as of December 18, since it includes all major recommendations developed based on the information obtained as a result of our trip to the Sumy Banking Academy.

However, since this memo is addressed to the Department of Personnel, we somewhat changed the emphasis of our comments. In particular, this memo is started with positive, rather then negative aspects of the current training process in the BSD. We begin with the statement that our general conclusion is that the personnel training process for the BSD employees continues to develop and improve, even though that there are some issues that require further work. .

First, positive is the fact the Sumy Academy was chosen as a center for professional training of banking supervisors, since we believe that the potential of this institution is such that it has chances to become a national (or even international) training centers for banking supervisor in the region.

Second, the Sumy Academy staff has academic and teaching knowledge and skills, that, if properly used, could be very beneficial for the BSD. For example, they could teach theoretical aspects, while the BSD experts would address practical issues of banking supervision (e.g., CAMELS, UBPR, case studies, etc.)

Another positive factor is testing employed by the Sumy Academy teachers. This could be used as a beginning of the certification program in the BSD.

On the other hand, issues that require further work are the introduction of a more meaningful needs analysis, proper selection of course participants, development of more substantiated schedules of training, etc. For this end, a comprehensive database should be developed. Under the information provided by the Personnel Department, such a database is in the process of development. We offered our assistance in how to most efficiently use this database.

Another issue that needs to be addressed is the development and use of training materials available for the BSD. We suggest that the materials provided by us to the BSD in summer and to the Sumy Academy in December could be used as a basis for the development of a comprehensive library of training materials.

A problem is also the use of bank supervision employees, who had gone through the Train the Trainer course, to teach their colleagues. The main issue here is the lack of commitment on the part of the BSD management, as well as the lack of standardized programs.

Training programs offered by the Sumy Academy, even though they follow the list of courses recommended in the Concept of the Formal BSD Personnel Training (Resolution # 153 of April, 25, 2002), are of orientation nature, which is important, but not sufficient. We suggest that technical courses are also taught, justifying this need by some provisions of the Decree of the President of Ukraine "On the Overall Program of Training Civil Servants" # N 1212/2000. Our interpretation of this Program is that the NBU should offer the BSD employees courses of both orientation and technical nature.

In the end we list recommendations to the NBU and suggestions concerning the future cooperation between the NBU Personnel and BSD areas and BearingPoint (see our memorandum of December, 18).

BearingPoint.
Formerly KPMG Consulting

MEMO

TO:	Frank Blimling, Senior Advisor
FROM:	Raya Ladokhina, Program Specialist Marina Antonova, Training Specialist
CC:	Jay Doeden, Senior Manager
DATE:	December 18, 2002
REF:	Role of the Sumy Banking Academy in BSD personnel training

TRIP TO SUMY BANKING ACADEMY

We visited the Sumy Banking Academy December 4 – 5, 2002. The purpose of the trip was to develop a clear picture of the role and function of the Sumy Banking Academy in the NBU – BSD personnel training process, as well as to find out how the Sumy Academy is coordinated and managed by the Personnel Department of the NBU. Given our objective to ensure that the formal training process together with the BSD personnel certification is developed, we set the following tasks for the business trip:

- Find out more about the Academy, its status and role
- Find out how the program for the BSD is structured, focusing on:
  - how much training is offered to the BSD versus other NBU areas;
  - how long the Sumy Banking Academy has been involved in BSD training and how often the courses are provided;
  - how trainees are selected;
  - how training staff is developed (guest lecturers versus Academy staff members, etc.)
  - what materials are used
- Have a look at the Sumy Academy facility in order to evaluate how appropriate it is for the BSD training purposes
- Determine the place of the Academy in the general NBU staff training process and see how it may be used in future for the BSD formal training program

In order to obtain answers to these questions, contacts were established with appropriate people via the Personnel Department of the NBU. These were the Vice Principal of the Academy Vladimir Nechepurenko and the Director of the Research Center Sergiy Zelensky. From the meeting with both of them, which included a tour around the Academy buildings, we obtained the following information.

SUMY BANKING ACADEMY

The Sumy Banking Academy ("the Academy") was founded in 1996 as an initiative of the NBU Governor and the Governor of the Sumy Region. Till 2000, the Academy was a regular educational establishment under the jurisdiction of the Ministry of Education. In 2000, under the Decree of the Cabinet of Ministers, it was moved to the NBU, having become its structural subdivision financed from the NBU budget. As of now, the Academy remains primarily a university type educational establishment, with three "faculties', teaching students in 7 subjects in the areas of regional economics, banking, finance, accounting, management of foreign economic activity, law and IT.

The Academy has a Research Center, which is in charge of all research work in the Academy, including post graduate and senior doctorate courses. It also runs all training programs for the NBU employees and offers some training courses to bankers in the region.

BSD TRAINING PROGRAM IN SUMY ACADEMY

The NBU staff training is one of the functions of the Research Center. Its Director, Sergiy Zelensky, stated that in 2002 the Center delivered 200 hours of training to the NBU employees, including 4 or 5 courses for the banking supervision area. For year 2003, about 8 seminars for the BSD personnel is planned. He also stated that, since banking supervision is one of the major functions of the NBU, the training of its employees takes the majority of the NBU staff training hours in the Academy. However, he was not more specific.

The NBU began to use the Academy as its training base after it had been taken over by the NBU about two years ago. In the current year the NBU staff training has been quite extensive. Plans are to further intensify training of bank examiners (especially regional and low level) in the Academy. Courses for the BSD are normally provided on the quarterly basis.

The Academy is not involved in selecting BSD employees to be trained in their facility. This is done by the NBU Personnel Department. However, the Academy representatives understand that they need to be involved in selecting trainees in order to make their seminars meaningful. Therefore, they have now started sending seminar programs to regional offices of the NBU, so that BSD managers would know what seminars are offered. Regions usually call back to find out who from the NBU Central Office is going to be a guest lecturer and send people from appropriate areas.

Trainers are from two sources – teachers of the Academy and employees of the NBU Central Office, mostly managers. Mr. Zelensky said that they plan to more extensively involve

managers and top experts from regional offices in teaching. Actually, during our stay in Sumy a BSD seminar was going on, at which a medium level manager from L'viv had a presentation. The Academy representatives have come to understanding that teaching should be differentiated by topics. Therefore, when they have NBU managers teaching, they send seminar programs to the NBU beforehand, then the BSD selects the topic for the presentation and sends an appropriate expert. The Academy understands the need in making their seminars more differentiated and specialized, however, as of now they have to rely on what is offered to them by the Personnel Department (development of programs) and the BSD (guest lecturers, usually selected based on "who is available").

The NBU Central Office employees that teach at BSD training seminars in Sumy usually have one day or a day and half for their session. The selection of topics is done on an ad hoc basis. There is no guidance on how to structure the presentation, or how to make its content consistent with other topics delivered during the given week. One of such sessions was going on during our stay. The Central Office representative was the Deputy Manager of the Liquidation Division Liudmila Donchenko, therefore, her presentation was devoted to bank liquidation issues, which was not necessarily relevant to the interests of the audience. Additionally, she was distracted from teaching by the local BSD unit manager, who wanted her involved in other issues not related to training. Such situation seems typical.

Local Sumy teachers also participate in the training of BSD employees. They are motivated, since for them it is considered extracurricular activities, which are paid separately in addition to their regular salaries. However, these teachers do not have practical banking supervision experience.

Materials used by teachers are available in the Academy library, which is rather good (about 100 000 books) and has all the latest publications in relevant areas in Ukrainian and Russian. The usage of English publications is limited, because 1) their number is not very big, since they are expensive for the Academy. What is available is mostly what was donated by different donor agencies, foreign guest lecturers or foreign government organizations; 2) the knowledge of English by the Academy teachers is limited.

We presented the Academy with the CD-rom with training materials for the BSD developed by BearingPoint advisors who worked in Kiev between 1996-2002. We also donated a number of different courses in banking, personnel management, accounting, etc. developed and delivered between 1995-2001 by guest lecturers within the Bankers' Training project.

The Academy representatives said that they were going to use what we donated to start an electronic library to be used by both teachers, trainees, and students. They were also going to introduce a requirement that NBU trainees prepare surveys and synopses on different banking supervision topics.

However, it should be mentioned that the library has a very limited number of the NBU regulations. It also does not regularly and consistently receive new and updated NBU regulations on a continuous basis. There is a concern, that the Academy teachers who participate in training

NBU employees may have no sufficiently in-depth knowledge of NBU regulations and technical aspects of banking supervision.

Training courses for NBU employees in the Academy are finished with the testing of participants. For each topic covered at a seminar about 40 questions are developed. However, this is done by every teacher independently based on the topic of his/her presentation. There is also no pool of such questions, database, or any set procedure for the structuring of such tests. Each teacher does it the way he/she thinks appropriate.

After the seminar results of the tests are sent to the Personnel Department. It is not clear what is done with these results there. Management of the training area of the Personnel Department could not give us a meaningful answer to this question.

SUMY ACADEMY FACILITY

The Academy has a possibility to facilitate the training function for a significant number of the NBU employees. For the NBU staff training, there is a special room, properly equipped with modern training devices, where 25-30 people could be accommodated at once. It was also stated that, if needed, at least one regular classroom for students may be provided for the NBU training purposes.

Under the information provided by the Academy representatives, they can accommodate about 50 NBU employees at once in their hostels. Additionally, another Academy hotel is under the construction, which allows to significantly increase the number of people being trained at a time.

ROLE OF SUMY ACADEMY IN NBU TRAINING PROCESS

The Personnel Department (Mr. Bezugly, manager of the training area, and Ms. Pshenichna, his deputy) told us about their plans for the BSD staff training. Having analyzed facilities available in relation to the number of employees of different levels, they came to a conclusion that it was physically impossible to accommodate all BSD employees in the NBU Banking Academy in Kiev. Therefore, they decided to devote the facility in Kiev (Abdreyevska street) to the training of managers (beginning from the sector managers level) and other Central Office employees, while the Academy facility is to be used for "rank and file" employees from regional BSD units.

The facilities in L'viv, Cherkasy and Kharkiv are planned to be ultimately devoted to the training of other NBU areas.

The Personnel Department say, that they have a recently developed database, which also includes all information on the training of each NBU employee, including the BSD. However, it was not shown to us. Therefore, it is not clear 1) how the database is structured, 2) if the information included is comprehensive enough, 3) what time period is covered for the training history of each employee, as well as whether there are such training histories. Consequently, it is

not clear whether the Personnel or any other area of the NBU properly performs the needs analysis in the BSD, taking into consideration what seminars should be offered to employees of different levels. As of now, positions are the main criterion based on which the level of the course – basic, advanced, etc. – is determined.

Nevertheless, the personnel representatives advised us to perform our own analysis of the BSD personnel position structure for the purposes of our work, without offering to use their database, which may be the indicator that 1) they either do not have a proper database, that they claim they have; 2) they have it, but do not use properly.

Another concern is related to the structuring of BSD seminars in Sumy. Before we left for Sumy, the Personnel Department shared with us a seminar program prepared in the Academy and approved by the Personnel area (see attached). The topics included comply with the preliminary recommendations in the BSD Training Concept. However, the concern is that the NBU tries to teach a number of rather extensive and broad concepts, each of which may take a few days and even weeks, in just one week. The Personnel representatives explained that the purpose of this program was to meet the requirements of the President's Decree "On Civil Servant Training", which declares that " training program for experts ... is of interdisciplinary nature aimed at mastering knowledge and skills needed for professional activities in a given area". The Personnel Department interprets it as a requirement to regularly provide seminars that would give a very general idea of how different areas of banking supervision function. In other words, these seminars are of orientation, rather then technical nature.

The personnel Department agrees that more technical and specific seminars are needed, but there are impediments. In particular, 1) experienced NBU employees are not willing to deliver such seminars, because their management does not support their being away their work places for the time period needed for such seminars; 2) sometimes NBU people do not have sufficient expertise to deliver such seminars; 3) training materials are not always readily available; 4) the NBU still relies on foreign advisors in this area.

Sumy Program (courses will be conducted on November 18-22 and December 2-6).

Basic Course for Banking Supervision employees

##	Course	Classroom hours	Homework
1	Організаційна структура, основні напрямки банківської діяльності	4	2
1.1	Основні напрямки та завдання		
1.2	Базові принципи ефективного нагляду за банківською діяльнстю	2	
1.3	Правове забезпечення державного управління та державної служби в установах НБУ	1	1
2.	Основні міжанродних стандартів бухгалтерського обліку та внутрішнього аудиту у банках	6	2
2.1	Методичне і нормативно-правове забезпечення бухгалтерського обліку	2	1
2.2	Організація внутрішнього контролю у банку, зовнішній аудит	4	1
3	Методи безвиїзного аналізу	4	2
3.1	UBPR	2	1
3.2	Організація безвиїзного нагляду	2	1
4	Рейтингова оцінка діяльності комерційного банку	6	2
4.1	Методологічні підходи до рейтингової оцінки комерційних банків у світовій практиці	2	1
4.2	CAMEL		
5	Управління ризиками в банківській діяльності	6	4
5.1	Класифікація ризиків та методи управління ними	2	1
5.2	Управління активно-пасивними операціями та позабалансовою діяльністю	2	2
5.3	Валютні ризики	2	2
6	Організація інспектування	2	2
6.1	Порядок проведення виїзного нагляду		
6.2	Інспектування та підготовка звітів		
7.	Правове забезпечення банківського нагляду та банківської таємниці	4	2
7.1	Банківська таємниця та захист банків. Інформаційні технології	2	1
7.2	Фінансові злочини. Відмивання брудних грошей	2	1

Sumy Program (courses will be conducted on November 18-22 and December 2-6).

Basic Course for Banking Supervision employees

##	Course	Classroom hours	Homework
1	Organizational structure, main banking activities	4	2
1.1	Main directions and activities		
1.2	Basic principles of efficient banking supervision	2	
1.3	Legal framework for state administration and civil service at the institutions of the National Bank of Ukraine	1	1
2.	Basics of international accounting standards and international auditing standards in banking	6	2
2.1	Accounting laws, regulations and practices	2	1
2.2	Organization of internal control at banks, external audit	4	1
3	Off site supervision methods	4	2
3.1	UBPR	2	1
3.2	Organization of off-site supervision	2	1
4	Rating evaluation of commercial bank performance	6	2
4.1	International methodological approaches to rating evaluation of commercial banks	2	1
4.2	CAMEL		
5	Bank risk management	6	4
5.1	Classification of risks and methods of its management	2	1
5.2	Management of assets and liabilities and off-balance sheet items	2	2
5.3	Foreign exchange risks	2	2
6	Organization of inspection	2	2
6.1	The order of on-site inspection		
6.2	Inspection and preparation of reports		
7.	Legal aspects of banking supervision and of bank secrecy principle	4	2
7.1	Bank confidentiality and protection of banks. Information technology.	2	1
7.2	Financial crimes. Money laundering.	2	1

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Дата: 20 грудня 2002 року

Тема: Юридичне обґрунтування можливості запровадження процесу сертифікації працівників банківського нагляду Національного банку України

Вступ

Згідно з робочим планом проекту "Вдосконалення банківського нагляду", одне із трьох основних завдань проекту формулюється наступним чином: "Генеральний департамент банківського нагляду запроваджує програму підготовки персоналу, розвитку кар"єр та сертифікацію працівників служби банківського нагляду".

Під сертифікацією ми розуміємо **процес** підтвердження працівниками служби нагляду відповідності їхніх знань рівню наглядових обов"язків та функцій, які вони виконують. Сертифікація працівників служби банківського нагляду – це, по суті, надання офіційного дозволу на виконання наглядових завдань певного рівня складності. Вона спирається на "Комплексну програму з підвищення кваліфікації працівників банківського нагляду" (Постанова Правління НБУ № 153 від 25.04.2002) та на перевірку якості роботи працівників, а її результати впливають на просування працівників по службі та покликані забезпечувати упорядкований розвиток їхніх кар'єр у Національному банку.

На нашу думку, процес сертифікації необхідний саме у службі банківського нагляду тому, що характер роботи банківських наглядовців – виїзних інспекторів і аналітиків – передбачає регулярні і часто досить інтенсивні контакти з комерційними банками. Наглядовець, який працює з комерційним банком, є офіційним представником Національного банку України. Національний банк повинен бути упевненим, що особа, яка офіційно виступає від його імені, має відповідні знання та кваліфікацію.

Процес сертифікації не протирічить процесу атестації і не заміняє його. Атестація - це в першу чергу оцінка якості виконання функціональних обов'язків, яка передбачає також оцінку сумлінності працівника, його дисциплінованості, вміння працювати в колективі тощо. Частота та характер проведення атестацій не передбачають глибокої перевірки конкретних знань працівника.

Зі свого боку, сертифікація – це саме процес перевірки конкретних знань, якими повинен володіти працівник, аби бути спроможним виконувати завдання технічного характеру відповідного рівня. Сертифікація можлива лише за умови проходження працівником певного обсягу навчання, як у класі, так і на робочому місці. Таким чином, сертифікація безпосередньо пов'язана з процесом навчання персоналу.

Ще однією особливістю процесу сертифікації є те, що в кінцевому своєму вигляді він передбачає наймання на роботу на конкурсній основі, а також просування по службі та підвищення заробітної плати з урахуванням результатів як атестації, так і сертифікації.

Ми здійснили огляд законодавчих та нормативних актів України, які, на наш погляд, дають підстави для розгляду можливості розроблення та запровадження процесу сертифікації працівників банківського нагляду НБУ на основі комплексної програми підготовки персоналу служби банківського нагляду.

Обґрунтування можливості створення та запровадження процесу сертифікації працівників сліжби банківського нагляду

Працівники Національного банку України мають статус державних службовців. Відповідно до Ст. 64 Закону "Про Національний банк України", "умови найму, звільнення, оплати праці, надання відпусток, службові обов'язки та права, система дисциплінарних стягнень, питання соціального захисту службовців Національного банку визначаються Законом України "Про державну службу"... Службовці Національного банку є державними службовцями, і до них застосовуються норми Закону України "Про державну службу", якщо цей Закон не встановлює іншого."

Ст. 4 Закону "Про державну службу" передбачає, що "право на державну службу мають громадяни України ..., які одержали відповідну освіту і професійну підготовку та пройшли у встановленому порядку конкурсний відбір". Крім того, відповідно до Ст. 18 цього ж Закону, "при прийнятті на державну службу може встановлюватися випробування терміном до шести місяців". Як вже зазначалося, наймання на роботу на конкурсній основі є елементом процесу сертифікаціїї, оскільки передбачає оцінку знань. Термін випробування, у свою чергу, передбачає набуття певного рівня знань за відповідний період і підтвердження їх в той чи інший спосіб.

Відповідно до законодавства України, є три способи оцінюваання державних службовців:

1) **Атестація**, що проводиться *раз на три роки* відповідно до Положення КМУ "Про проведення атестації державних службовців" №1922 від 28.12.2000. Під час атестації "оцінюються результати роботи, ділові та професійні якості, виявлені працівниками при виконанні службових обов'язків, визначених типовими професійно-кваліфікаційними характеристиками посад і відображених у посадових інструкціях, що затверджуються керівниками державних органів відповідно до Закону України "Про державну службу" та інших нормативно-правових актів".
2) **"Щорічна оцінка** виконання державними службовцями покладених на них завдань та обов'язків у порядку, визначеному керівником, який призначає на посади та звільняє з посад зазначених осіб, з урахуванням цього Положення та особливостей кожного державного органу. Така оцінка проводиться безпосередньо керівниками структурних підрозділів, де працюють державні службовці , під час підбиття підсумків роботи за рік" (Положення КМУ №1922).
3) **Іспити** для "здійснення незалежної та неупередженої оцінки якості професійного навчання державних службовців і професійної придатності до державної служби на певних посадах" (Указ Президента "Про комплексну програму підготовки державних службовців" № N 1212/2000). В Указі також зазначається, що "вивчення та ефективне використання іноземного досвіду з питань професійного навчання державних службовців є одним із засобів європейської та світової інтеграції України". Причому "пріоритетними напрямами міжнародного співробітництва з питань професійного навчання державних службовців з використанням міжнародної технічної допомоги є", зокрема, "розроблення концептуальних засад визначення змісту іспитів та методики їх проведення ".

По суті, ця остання цитата обґрунтовує процес сертифікації, який не протирічить і повинен поєднуватись із процесом атестації та щорічної оцінки виконання працівниками служби нагляду їхніх службових обов'язків. Сертифікація за своєю суттю передбачає проходження певного тестування або іспитів для перевірки відповідності знань та вмінь працівника стандартам, встановленим для виконання тих чи інших професійних функцій.

Крім того, оскільки Указ Президента № N 1212/2000 визначає розроблення концепції, змісту та методики проведення іспитів як пріоритетних напрямів міжнародного співробітництва з питань професійного навчання, це дає можливість Національному банкові України широко використовувати міжародний досвід. Відповідну інформацію та допомогу можна отримати як через постійних радників, так і з інших джерел, наприклад, через мережу Інтернет тощо.

Обґрунтування необхідності зміцнення процесу навчання персоналу служби банківського нагляду

Відповідно до Ст. 3 Закону "Про державну службу", одним з основних принципів державної служби є "професіоналізм та компетентность" державних службовців. Для працівників банківського нагляду наявність професіоналізму та компетентності може бути забезпечена лише шляхом постійного тренінгу та навчання працівників та частої регулярної перевірки їхніх знань, навичок та

вмінь. Тільки так можна забезпечити адекватний рівень "професіоналізму та компетентності", необхідний для ефективного виконання їхніх функцій. Знання, навички та вміння, що були отримані працівниками банківського нагляду у вищих учбових закладах, не можуть бути достатніми для їхньої роботи. Ця галузь дуже специфічна і потребує окремого навчання, що має бути забезпечене в процесі виконання конкретних наглядових функцій. Практика постійного навчання працівників банківського нагляду та регулярної перевірки їхніх знань, навичок та вмінь існує в усіх розвинених країнах світу. Це необхідний компонент забезпечення стабільності банківської системи

Крім того, ст.10 Закону "Про державну службу" вказує на те, що одним із обов'язків державних службовців є "постійне вдосконалення організації своєї роботи і підвищення професійної кваліфікації". Далі, у ст. 29 "Навчання і підвищення кваліфікації державних службовців" визначається, що "державним службовцям створюються умови для навчання і підвищення кваліфікації у відповідних навчальних закладах (на факультетах) та шляхом самоосвіти. Державні службовці підвищують свою кваліфікацію постійно, *у тому числі* через навчання у відповідних навчальних закладах, як правило, не рідше одного разу на п'ять років. Результати навчання і підвищення кваліфікації є однією з підстав для просування по службі". Слова "у тому числі" означають, що повинні існувати різні види постійного навчання державних службовців (включаючи працівників банківського нагляду), причому для них мають створюватися належні умови для цього навчання та підвищення кваліфікації.

Указ Президента "Про комплексну програму підготовки державних службовців" № N 1212/2000 визначає, що "навчання за професійними програмами підвищення кваліфікації державних службовців має здійснюватися в разі: зарахування до кадрового резерву; прийняття на державну службу; зайняття посади вищої категорії (протягом першого року); перед черговою атестацією державного службовця; наявності виробничих потреб." Зрозуміло, що прийняття на державну службу, як правило, означає, що такий працівник не має досвіду роботи в даній галузі та вимагає професійної підготовки. Така підготовка повинна поєднувати курси як орієнтаційного характеру, які дають загальне уявлення про те, чим займається дана організація, так і серію курсів суто технічної спрямованості, аби працівник навчився виконувати конкретну роботу відповідно до виробничих потреб. Очевидно, що до виробничих потреб треба віднести отримання спеціальних знань в галузі методів та підходів банківського нагляду.

Указ також визначає, що "до основних видів підвищення кваліфікації державних службовців, що мають забезпечити його безперервність, належить навчання: за програмами тематичних постійно діючих та короткотермінових семінарів, що проводяться з урахуванням потреб у підвищенні ефективності виконання посадових обов'язків і результатів щорічного проведення оцінки професійної діяльності державних службовців." Тобто, тут існує прямий зв'язок із принципами, викладеними в "Концепції підготовки персоналу банківського нагляду", які наголошують на безперервності навчання та його різноманітності. Під різноманітністю розуміється поєднання різних видів навчання – у класі, на робочому місці, а також наявність навчальних курсів як вузько технічного, так і загального оглядового характеру. Все це, очевидно, визначається конкретними потребами даної структури.

Особливості інтерпретації законодавчих актів щодо навчання та підтвердження кваліфікації державних службовців

Ст. 6 Закону "Про державну службу" визначає, що "питання функціонування державної служби в інших державних органах, правове становище яких регулюється спеціальними законами України, вирішуються цими органами". Тобто, Закон "Про державну службу" є досить гнучким і передбачає, що наявність окремого Закону "Про Національний банк України" надає НБУ можливість вирішувати ці питання з урахуванням особливостей державної служби в НБУ та цілей та завдань Національного банку (зокрема, цілей ефективного банківського нагляду).

Таким чином, існують всі юридичні підстави для запровадження процесу сертифікації працівників банківського нагляду. Більш того, для виконання норм законодавства України Національний банк України має вдосконалити систему навчання та перевірки знань, навичок та вмінь працівників банківського нагляду.

Introduction

Under the BearingPoint Banking Supervision Project Work Plan, one of the three main components of the Project is the following: "The NBU Bank Supervision Department implements an institutionalized program for training, career advancement and certification of bank supervision officials".

The certification is understood as a **process** of the confirmation by banking supervisors of the compliance of their professional knowledge and skills with the level of their supervisory responsibilities and functions. The certification of banking supervisors is, essentially, the issuance of an official permit to perform supervisory assignments of a certain complexity level. It follows the Comprehensive Professional Development Program (Resolution # 153) and the evaluation of the quality of work of personnel, while its results should influence their career growth and be aimed at ensuring an organized development of their careers with the NBU.

In our opinion, the certification process is particularly needed in the banking supervision area, because the nature of work of banking regulators (examiners and analysts) includes regular and rather extensive contacts with commercial banks. A supervisor, who works with a commercial bank, officially represents the NBU. The NBU, therefore, should ensure that a person that officially acts on its behalf has appropriate knowledge and qualifications.

The certification process neither contradicts the attestation process, nor is meant to replace it. The attestation is primarily an evaluation of the employee's performance, which includes also the assessment of his/her working ethics, discipline, teamwork abilities, etc. The frequency and nature of attestations do not involve any in-depth testing of specific knowledge of the employee.

On the other hand, the certification is a process aimed at the testing of specific knowledge, that employees should have in order to be able to perform technical assignments of appropriate levels. The certification is possible only under the condition that employees go through a certain amount of training, both formal and on the job. Therefore, the certification is directly related to the personnel training process.

Another feature of the certification process is that in its ultimate form it includes hiring on a competitive basis, as well as career development and compensation growth taking into consideration results of both attestation and certification.

We completed the review of laws and regulations of Ukraine, which seem to give a basis to discuss the possibility of the development and implementation of the certification process for the NBU banking supervision area supported by the formal personnel training program.

Legal Justification of the Development and Implementation of the Certification Process in BS

The NBU employees have a status of civil servants. Under Article 64 of the Law on the NBU, "Terms of hiring, firing of, compensation to, vacations, professional rights

and responsibilities, disciplinary fines, social security issues of the NBU employees are determined by the Law on Civil Service... The NBU employees are considered civil servants and are subject to terms and conditions of the Law on Civil Service, unless otherwise provided for in this Law".

Article 4 of the Law on Civil Service provides that " the right to civil service is the right of citizens of Ukraine who have an appropriate education and professional training and are selected on a competitive basis... ." Additionally, under Article 18 of this Law, "when hired to the civil service, a trial term up to six months may be established". As it has been stated, hiring on a competitive basis is an element of the certification process, since it includes the testing of knowledge. The trial term, also, implies, that during a specific period of time a certain level of knowledge is to be obtained and confirmed in some way.

Under the Law of Ukraine, there are three ways of assessment of civil servants:

4) **Attestation**, which in compliance with the Policy of the Cabinet of Ministers On the Attestation of Civil Servants "is performed once in three years". During the attestation "employees' performance and professional qualities are evaluated, that he/she demonstrated in the course of the fulfillment of functional responsibilities, determined in standard professional and qualification characteristics of jobs and relevant job descriptions approved by managers of government bodies in compliance with the Law of Ukraine on Civil Service and other regulations".
5) "**Annual evaluation** of employees' performance in compliance with a procedure determined by the manager, who appoints them to or dismisses from positions, taking into consideration this Policy and the nature of a specific government institution. Such evaluation is performed directly by supervisors (managers) of units in the course of the preparation of a conclusion on the annual performance results " (Policy of the Cabinet of Ministers)
6) **Examinations** "to obtain an independent and objective assessment of the quality of professional training of civil servants and of the professional qualification to occupy specific civil service positions " (Decree of the President On the Comprehensive Training Program for Civil Servants № N 1212/2000). The Decree also states that "the studying and efficient use of international experience in the area of professional training for civil servants is a means of European and global integration for Ukraine." At the same time, "a priority in the area of civil servants' professional training with the use of international assistance is the development of a concept and content of examinations as well as their methodology ".

Essentially, the latter substantiates the certification process, which does not contradict and should be combined with both attestation and annual evaluation. Certification implies that certain tests or examinations are taken in order to verify the compliance of knowledge and skills of employees to standards that they are to meet in order to be able to perform specific professional functions.

Additionally, since the President's Decree names the development of the concept, content and methodology of examinations priorities in the international cooperation in the professional training area, this should allow the NBU to widely use international

experience. Appropriate information and assistance may be obtained from both permanent advisors, and other sources, e.g. via Internet.

Justification of the Need in Strengthening of the BS Personnel Training Process

Under Article 3 of the Law on Civil Service, one of major principles of civil service is "professionalism and competence". For banking supervisors professionalism and competence may only be ensured through ongoing training of personnel and regular verification of their knowledge and skills. This is the only way to ensure an adequate level of professionalism and competence, needed for them to efficiently perform their functions. Knowledge and skills, received by banking supervisors in higher educational establishments, may not be considered sufficient for the work. This area is rather unique, thus requiring specific training, which should be ensured in the process of performing supervisory functions. The practice of ongoing training and regular verification of knowledge and skills of banking supervisors exists in all developed countries. This is a necessary component for ensuring a stable banking system.

Additionally, Article 10 of the Law on Civil Service states that one of responsibilities of civil servants is an "continuing improvement of the organization of their work and enhancement of professional qualifications ". Further, Article 29 "Training of Civil Servants" of the same Law states, that "civil servants have adequate conditions for learning and training in appropriate educational institutions (faculties) and through self-education. Civil servants shall enhance their qualifications on an ongoing basis, *including* training in appropriate educational institutions, usually at least once in five years. Results of training and the enhancement of qualifications are one of bases for the career development." The word "including" means, that there should be different types of ongoing training for civil servants (including banking supervisors), with appropriate conditions being available.

The Decree of the President On the Comprehensive Training Program for Civil Servants states, that "training based on professional programs for civil servants should be provided in the following cases: admission to the "personnel reserve"; admission to the civil service; occupying a position of a higher category (during the first year); before a next civil servant attestation, availability of needs for the job". Obviously, admission to the civil service usually means that an employer requires professional training. Such training should combine courses of both orientation nature, that give a general idea of the organization activities, and a series of technical courses, in order to teach the employee to perform specific functions in compliance with needs for the job. Obviously, needs for the job include special knowledge in the area of banking supervision methods and approaches.

The Decree also states, that "main types civil servant training, aimed at ensuring its continuity, include training on the basis of programs of specific ongoing and short term seminars, held based on the needs in the enhancement of the efficiency of the function performed as well as results of the annual evaluation of civil servant activities ". In other words, here is a direct relation between the principles listed in the Concept of Comprehensive Professional Development Program for Banking Supervision, that stress continuity and variety. The latter is understood as the combination of different types of training – in the classroom, on the job, as well as different courses of both specific technical and general overview nature. All this, obviously, is determined by specific needs of a given agency.

Interpretations of Laws and Regulations on Training and Confirmation of Civil Servant Qualifications

Article 6 of the Law on Civil Service states, that "the issue of civil service functioning in other government bodies, the legal status of which is addressed in specific laws of Ukraine, shall be resolved by these bodies". This means that the Law on Civil Service is rather flexible, allowing the NBU, based on the Law on the NBU, to address these issues taking into consideration specific features of civil service in the NBU and the purpose and objectives of the NBU (in particular, the efficiency of banking supervision).

Therefore, there are all legal foundations for the implementation of a certification process in the BSD. Moreover, in order to meet the requirements of law of Ukraine the NBU has to improve the system of training and confirmation of knowledge and skills of banking supervisors.

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MEMO

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DATE:	December 20, 2002
REF:	Overview of International Practice on Regulatory Requirements for Risk-Management Systems and Internal Control at Banks:

OVERVIEW OF INTERNATIONAL PRACTICE ON REGULATORY REQUIREMENTS FOR RISK-MANAGEMENT SYSTEMS AND INTERNAL CONTROL AT BANKS.

THE USA

Section 39(a) of the Federal Deposit Insurance Act (FDI Act) 12 U.S.C. 1831p-1 requires each Federal banking agency to establish operational and managerial standards, in the following areas, for all depository institutions that it supervises:

- internal controls, information systems, and internal audit systems,
- loan documentation;
- credit underwriting;
- interest rate exposure;
- asset growth; and
- compensation, fees, and benefits, and
- such other operational and managerial standards as the agency determines to be appropriate.

When a bank fails to meet any of those standards, the banking agency may require the bank's management to submit a plan to address deficiencies. If the bank fails to submit a satisfactory plan within the time allowed by the agency, or fails in any material respect to implement an accepted

plan, the agency must, by order, require the bank to correct the deficiency. These orders and directives can be enforced in the following ways:

- *Judicial remedies.* Whenever a bank fails to comply with an order issued under section 39, the agency may seek enforcement of the order in the appropriate United States district court.
- *Failure to comply with order.* The agency may assess a civil money penalty against any bank that violates or otherwise fails to comply with any final order issued under section 39 and against any "institution-affiliated party" who participates in such violation or noncompliance.
- *Other enforcement action.* In addition to the actions described above, the agency may seek enforcement through any other judicial or administrative proceeding authorized by law.

Following the requirements of section 39, the U.S. bank regulatory agencies have promulgated the "Interagency Guidelines Establishing Standards for Safety and Soundness" which is located at Part 364 of the Code of Federal Regulations.

Appendix A to Part 364 contains standards in each of the areas set forth in Section 39. The highlights are as follows:

Internal controls and information systems. Each institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

- An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
- Effective risk assessment;
- Timely and accurate financial, operational and regulatory reports;
- Adequate procedures to safeguard and manage assets; and
- Compliance with applicable laws and regulations.

Internal audit system. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:

- Adequate monitoring of the system of internal controls through an internal audit function. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
- Independence and objectivity;
- Qualified persons;
- Adequate testing and review of information systems;

- Adequate documentation of tests and findings and any corrective
- actions;
- Verification and review of management actions to address material
- weaknesses; and
- Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

Loan documentation. An institution should establish and maintain loan documentation practices that:

- Enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis;
- Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
- Ensure that any claim against a borrower is legally enforceable;
- Demonstrate appropriate administration and monitoring of a loan; and
- Take account of the size and complexity of a loan.

Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that:

- Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
- Consider the nature of the markets in which loans will be made;
- Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- Establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors;
- Take adequate account of concentration of credit risk; and
- Are appropriate to the size of the institution and the nature and scope of its activities.

Interest rate exposure. An institution should:

- Manage interest rate risk in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and
- Provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk.

Asset growth. An institution's asset growth should be prudent and consider:

- The source, volatility and use of the funds that support asset growth;
- Any increase in credit risk or interest rate risk as a result of growth; and
- The effect of growth on the institution's capital.

Asset quality. An institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

- Conduct periodic asset quality reviews to identify problem assets;
- Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
- Compare problem asset totals to capital;
- Take appropriate corrective action to resolve problem assets;
- Consider the size and potential risks of material asset concentrations; and
- Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

Earnings. An institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and
- Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

Compensation, fees and benefits. An institution should maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institution.

With regard to internal controls and the internal audit function, Section 39 also makes reference to Section 36 of the FDIA, 12 U.S.C. 1831m. Pursuant to sections 36 and 39, the agencies have issued a separate provision on these items, which is contained in Part 363 of the Code of Federal Regulations.

According to Part 363, each institution should determine its own standards for establishing, maintaining, and assessing the effectiveness of its internal controls. In considering what information is needed on safeguarding of assets and standards for internal controls, management is encouraged to review guidelines and handbooks provided by its regulatory agency, as well as standards published by professional accounting and auditing organizations and financial institution trade associations.

Each insured depository institution is required to establish an independent audit committee of its board of directors. The members of the committee must be "outside" directors, i.e., directors who are independent of management of the institution. The duties of the committee include reviewing with management and the independent public accountant the basis for the reports issued under Part 363.[1] The audit committee of any large institution (defined as having total assets of more than $3 billion) must include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this requirement, the holding company audit committee cannot include any members who are large customers of the subsidiary institution.

Each of the federal regulatory agencies has provided guidance on responsibilities for individuals who serve as directors of financial institutions. These guidances review generally the responsibilities and liabilities under statutory, regulatory and case law for directors. Directors may reference these guidelines as follows: Office of the Comptroller of the Currency ("OCC"), The Director's Book, March 1997, and Red Flags in Board Reports, September 2000; Federal Reserve Board ("Federal Reserve"), Basics for Bank Directors, November 1998; Federal Deposit Insurance Corporation ("FDIC"), DOS Manual of Exam Policies on Management/Administration, February 2000; Office of Thrift Supervision ("OTS"), Oversight by the Board of Directors, June 1999;

Importantly, directors are also alerted by the regulators as to current heightened areas of responsibility. For instance, the FDIC has clearly stated in its examination manuals that the policies and directives of the Board of Directors should include "provisions for adherence" to the Interagency Guidelines Establishing Standards for Safety and Soundness. These provisions have been specifically adopted by the OCC, Federal Reserve, FDIC, and OTS, and the NCUA also has authority to pursue comparable standards in enforcement actions.

Agencies indicate in their manuals that these standards are to be viewed as the "minimum requirements" with the methods to achieve compliance remaining to be established by each institution. Only the directors can establish these methods and the directors must focus on these minimum requirements first and be certain that they are adopted in a manner which is tailored to fit their institution.

One of the interesting guidelines is The Director's Book (March 1998). http://www.occ.treas.gov/director.pdf This book provides general guidance to directors of national

[1] Part 363 requires each institution to submit an annual report, signed by the institution's president and chief financial officer, evaluating the institution's internal controls.

banks. It outlines the responsibilities of the board, highlighting areas of particular concern, and addresses in broad terms the duties and liabilities of the individual director.

"Board committees typically oversee the bank's risk management by ensuring that management has implemented:

- Sound policies and procedures, either written or unwritten.
- Accurate and reliable risk measurement systems.
- Timely and meaningful risk reporting processes.
- Effective risk controls such as policy limits, authorizations, and product approvals."

CANADA

The Canada Deposit Insurance Act, Section 11(2)(e), gives the Board of the Canadian Deposit Insurance Corporation ("CDIC") the authority to adopt bylaws "respecting standards of sound business and financial practices for member institutions."

In August 1993, the CDIC enacted eight by-laws relating to *Standards of Sound Business and Financial Practices* for deposit-taking institutions. These by-laws set out the minimum policies and procedures that CDIC member institutions should have in place to manage and control their risks prudently. Monitoring adherence to these standards is seen as an important risk assessment tool. The bylaws prescribed management standards relating to:

- interest rate risk
- credit risk
- foreign exchange risk
- securities portfolio
- liquidity
- real estate appraisals
- capital adequacy; and
- internal controls.

In October 2001, the CDIC replaced these 8 individual bylaws with a single, comprehensive bylaw entitled *"Standards Of Sound Business And Financial Practices."*

http://lois.justice.gc.ca/en/C-3/SOR-2001-299/text.html Section 12 of the Standards (Risk Management Process) states:

"It is a sound business and financial practice for the senior management of a member institution to ensure that the institution has an ongoing, appropriate and effective risk management process for:

(a) identifying the risks to which the institution is or will be exposed, whether on- or off balance sheet and whether directly or through one or more of its subsidiaries, in conducting its current and planned operations, and measuring those risks on an aggregate basis;
(b) measuring, on an aggregate basis, the different types of risk to which the institution is or will be exposed in relation to a single counterparty or issuer and groups of associated counterparties or issuers;
(c) assessing whether the risks that are identified constitute significant risks;
(d) developing appropriate and prudent risk management policies, including policies on aggregate exposure limits, submitting to the board of directors of the institution for its consideration and approval policies for managing significant risks, including the policies referred to in sections 13 to 17, as applicable, and reviewing the institution's risk management policies at least once a year to ensure that they remain appropriate and prudent;
(e) managing the risks to which the institution is exposed in accordance with the institution's risk management policies;
(f) establishing appropriate and effective procedures and controls for managing the risks to which the institution is exposed, including the procedures and controls referred to in sections 13 to 17, as applicable, monitoring adherence to those procedures and controls, and reviewing them on a regular basis to ensure that they remain appropriate and effective;
(g) providing the board of directors with timely, relevant, accurate and complete reports on the management of significant risks and on the procedures and controls for managing those risks;
(h) dealing with extraordinary events; and
(i) providing the board of directors with timely, relevant, accurate and complete reports that will enable it to assess whether the institution has an ongoing, appropriate and effective risk management process."

Subsequent sections (13 through 17) of the Standards deal specifically with various types of risk, including credit risk, market risk, structural risk, fiduciary risk, and operational risk.

For credit risk, section 13 of the Standards provides:

(1) It is a sound business and financial practice for a member institution that is exposed to significant credit risk to have

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a. appropriate and prudent policies on the areas and types of credit, both on- and off-balance sheet, in which the institution is willing to engage; and

b. appropriate and prudent policies on exposure limits for a single counterparty, for groups of associated counterparties, for industries or economic sectors, for geographic regions and for other credit exposures warranting aggregation, that take into account all other risks, both on- and off-balance sheet, to which the institution is exposed.

(2) It is a sound business and financial practice for a member institution that is exposed to significant credit risk to have procedures and controls for managing that risk, including

c. defined and prudent levels of decision-making authority for approving credit exposures;

d. an effective assessment and rating system for credit risk;

e. an ongoing, appropriate and effective process for managing credit exposures that warrant special attention; and

f. an effective methodology for identifying, estimating, providing for and recording credit impairments.

For market risk, section 14 provides:

(1) It is a sound business and financial practice for a member institution that is exposed to significant
market risk to have

a. appropriate and prudent policies on the types of financial instruments and other investments, both on- and off-balance sheet, in which the institution is willing to trade or take positions; and

b. appropriate and prudent policies on exposure limits for a single issuer, for groups of associated issuers, for types of financial instruments and other investments or assets, for industries or economic sectors, for geographic regions and for other market exposures warranting aggregation, that take into account all other risks, both on- and off-balance sheet, to which the institution is exposed.

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(2) It is a sound business and financial practice for a member institution that is exposed to significant market risk to have procedures and controls for managing that risk, including

c. defined and prudent levels of decision-making authority for approving market exposures;

d. fixed quality and return expectations for market exposures;

e. a list of suitably qualified securities dealers and other counterparties with whom the institution is willing to deal;

f. reliable data and effective techniques, such as stress testing and shock testing, for assessing the nature, quality and value of the institution's market exposures and for evaluating the extent of market risk to which the institution is or will be exposed under current and reasonably foreseeable scenarios;

g. effective techniques for back-testing against actual results the assessments and evaluations made using the data and techniques referred to in paragraph (*d*); and

h. an effective methodology for identifying, estimating, providing for and recording market impairments.

For structural risk, paragraph 15 provides:

(1) It is a sound business and financial practice for a member institution to have appropriate and prudent policies on the types and extent of structural risk to which it is willing to be exposed.

(2) It is a sound business and financial practice for a member institution to have procedures and controls for managing structural risk, including

a. defined and prudent levels of decision-making authority; and

b. effective techniques, such as stress testing and shock testing, for measuring the institution's structural risk positions and for evaluating the impact on those positions of changes in underlying factors under current and reasonably foreseeable scenarios.

For fiduciary risk, the Standards provide:

(1) It is a sound business and financial practice for a member institution to have appropriate and prudent policies on the types of fiduciary activities in which it is willing

to engage.

(2) It is a sound business and financial practice for a member institution that is exposed to significant fiduciary risk to have procedures and controls for managing that risk, including

a. an ongoing, appropriate and effective process for ensuring that assets held, administered, managed or invested on behalf of other persons are dealt with prudently and in accordance with the agreements and arrangements made between the institution and those persons; and

b. an ongoing, appropriate and effective process for ensuring that the investment advice provided to other persons is suitably represented and appropriate in light of their risk tolerances and reward expectations.

For operational risk, Section 17 provides:

(1) It is a sound business and financial practice for a member institution to have

a. appropriate and prudent policies on the operational risk that is inherent in the operations of the institution; and

b. if the institution uses outsourced services in conducting significant operations, appropriate and prudent policies on

i. the circumstances in which outsourced services may be used,

ii. the selection of capable and reliable service providers,

iii. the standards of quality for outsourced services, including standards relating to accuracy, security and timeliness, and

iv. the monitoring of the performance of, and the risks associated with, service providers.

(2) It is a sound business and financial practice for a member institution to have procedures and controls for managing the operational risk that is inherent in the operations of the institution, including

c. a human resource management program that encompasses

i. an ongoing, appropriate and effective process to attract and retain a sufficient number of qualified personnel to achieve the institution's

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business objectives and implement the institution's business strategy and business plans,

ii. defined and prudent levels of decision-making authority,

iii. the segregation of incompatible functional responsibilities,

iv. the clear communication to personnel of their responsibilities, and

v. the effective supervision of personnel;

d. documentation of the institution's significant processes, policies, procedures and controls;

e. valuation methods and accounting principles for the appropriate valuation of and accounting for the institution's assets and liabilities, both on- and off-balance sheet;

f. accurate and complete records of financial and other key information;

g. management information systems that provide timely, relevant, accurate and complete information to facilitate the day-to-day management of the institution's operations and of the risks to which the institution is exposed;

h. ongoing, appropriate and effective technology development and maintenance processes for ensuring that the institution's technology is, and continues to be, aligned with its business objectives, business strategy, business plans, operational needs and management of the risks to which it is exposed, that the institution's technology is authorized, tested and documented before it is introduced, and that the institution's technology is updated when necessary;

i. appropriate and effective security procedures and controls for safeguarding the institution's records of financial and other key information, the institution's technology and the information recorded, processed, reported and stored using that technology, including procedures and controls for safeguarding their integrity; and

j. ongoing, appropriate and effective business continuity plans, including backup and recovery processes and standby arrangements for dealing with the loss of availability or the destruction of critical information or critical technology.

As is readily apparent, the legal and regulatory terminology pertaining to risk management is rather indefinite. The standards consistently refer to the requirement that a bank's risk management practices in a given area be "appropriate and prudent," "effective," and so forth. The Standards do provide definitions of some of these relatively imprecise terms, but even these definitions depend largely on an analysis of facts and circumstances. Thus, for example:

- "appropriate," in relation to a thing so described, means that a knowledgeable individual in the financial institutions industry would conclude that it is suitable for its intended purpose, having regard to the nature, magnitude, complexity and implications of the matter in question.

- "prudent" in relation to a thing so described, means that a knowledgeable individual in the financial institutions industry would conclude that it is the product of the exercise of careful and practical judgment, having regard to business objectives, risks, the business and economic environment, and the quantity, quality and sustainability of earnings, liquidity, funding, capital and other resources.

- "effective" is defined as meaning that "a knowledgeable individual in the financial institutions industry would conclude that [a procedure or practice] is achieving, or can reasonably be expected to achieve, its intended purpose."

It is also important to note that the responsibility for ensuring that a bank has such appropriate and prudent risk management policies and procedures is on the board of directors (in Ukraine, the equivalent body would be the council). See Section 12 (d), (g) and (i).

Internal Controls

Until 2001, the CDIC had a separate Bylaw on Internal Control Standards. As of October 2001, that Bylaw was repealed and its substance is now incorporated into the *Standards of Sound Business and Financial Practices* http://lois.justice.gc.ca/en/C-3/SOR-2001-299/text.html. The Standards now refer to an institution's "control environment," which is defined as "the environment that results from the following factors: approach to governance, management style, organizational structure, resource commitments, communication style, procedures and controls and the level of adherence thereto, the conduct of personnel, and human resource policies and practices." Section 20 of the Standards provides:

> It is a sound business and financial practice for the senior management of a member institution to ensure that

a. the institution has a control environment that supports the appropriate, effective and prudent management of its operations and of the risks to which it is exposed, and that contributes to the achievement of its business objectives; and

b. the board of directors of the institution is provided with timely, relevant, accurate and complete reports that will enable it to assess whether the institution has such a control environment.

In September 1995, the CICA issued the document *Guidance on Control* as an addition to its Handbook. This document offers a framework for making judgments about controls and includes a definition of control and twenty "criteria of control." This document addresses conditions that can significantly affect the effectiveness of internal controls and the degree of audit risk.

A bank's Chief Auditor/Inspector works with the rest of the institution's internal audit staff, who comprise bankers secunded from relevant lines of business and/or chartered accountants with expertise in auditing. The independence of the internal audit function is established through the reporting relationship of the Chief Auditor/Inspector to the Audit Committee of the bank's Board of Directors.

The *Bank Act* requires external audits for banks chartered in Canada. Each bank must employ at least one external audit firm to conduct the external audit; major banks employ two external audit firms. The external auditors perform a quarterly review of key financial information and conduct an annual full-scope examination of the systems and controls in place that ensure proper safeguarding of assets and appropriate recording of the economic transactions of the bank under examination. A typical annual external audit includes an examination of the controls over the credit, market, and operating risks of a bank.

External auditors place significant reliance on the work of the internal audit departments of Canadian banks during the conduct of an external audit. A bank's external auditors verify the adequacy of internal audit functions through an examination of the internal audit work program of the past year, discussions with various internal audit staff, and reperformance of internal audit procedures on a test basis. The external auditors also assess the skills, qualifications, and expertise of the bank's internal audit department in determining how much reliance they can place on its work.

The internal audit processes of a non-domestic bank in Canada are a function of the internal audit standards of the home jurisdiction of the non-domestic bank in question. Although the overall audit methodology for the external audit of a non-domestic bank is driven by the external audit standards of the non-domestic bank's home country, all banks chartered in Canada, including Canadian bank subsidiaries of non-domestic banks, are visited once a year by external auditors resident in Canada. Therefore, the application of Canadian external audit standards would ensure consistency of domestic and non-domestic bank audits carried out in Canada.

The amendment to Section 29 of the CDIC Act in Bill C-8 that recently came into force requires CDIC's examiners to provide, among other things, an assessment of the safety and soundness of the member institution and to comment on its operations taking into account the CDIC's *Standards.*

OSFI requires that banks have internal controls in place that are adequate for the nature and scale of their business. Sound internal control practices are also addressed in CDIC's Standards which require risk identification, evaluation and management systems to assist in prudential management of a bank's operations.

Internal control policies and procedures need to be approved by the board of directors, and their effectiveness assessed by an independent internal audit/inspection function, on an annual basis.

The *Standards* apply to each CDIC member institution. However, there is an expectation that a member will manage itself on an enterprise-wide basis. In this context, operations conducted through subsidiaries that could have a significant impact should be considered in reaching conclusions about that member's adherence to the *Standards*. As one example, the risk management process is expected to take into account any significant risks related to the operations of subsidiaries.

OSFI requires that for the validation of banks' Value-at-Risk (VAR) models for reporting market risk capital, such models accurately measure, monitor and adequately control market risks. OSFI requires that banks have comprehensive and robust scenario and stress testing programs and contingency plans, and that they perform such tests at least once a month (most Canadian banks do this weekly, while some banks do them even daily).

Enforcement

Section 645 of the Canadian Bank Act prescribes enforcement measures that may be taken in cases of violations. According to section 645, if a bank, or a person with respect to a bank, is committing, or is about to commit, an act that is an "unsafe or unsound practice" in conducting the business of the bank, or is pursuing or is about to pursue any course of conduct that is an unsafe or unsound practice in conducting the business of the bank, the Superintendent may direct the bank or person to

(a) cease or refrain from committing the act or pursuing the course of conduct; and

(b) perform such acts as, in the opinion of the Superintendent, are necessary to remedy the situation.

Since compliance with the Standards is expressly deemed to be a "sound business and financial practice," a determination that a bank was not in compliance with the Standards would be deemed to be an "unsafe or unsound" practice, which could result in a "direction" (i.e., a compulsory order) from the Superintendent.

Sanctions are also possible where an institution does not follow the Standards, such as imposition of a premium surcharge or, potentially, termination of deposit insurance. See sections 30 and 31 of the Canadian Deposit Insurance Corporation Act.

Reporting

In late 1994, the CDIC finalized a Standards Assessment and Reporting Program (SARP) that required management to determine whether its institution is following the standards.. Deposit-taking institutions were required to report under the SARP for the first time by July 31, 1995. These assessment and reporting requirements are now incorporated into the current version of the *Standards.*

Part 2 of the Standards By-law requires member institutions to report to CDIC on adherence to the Standards. Each year, each institution must submit to the CDIC:

- a senior management representation letter;
- a resolution of the board of directors concerning the letter; and
- a "Standards Report."

~~It~~ Part 2 describes the reporting requirements, sets the parameters for the contents of the senior management representation letter, the resolution of the board of directors and the Standards report and addresses the frequency and timing of reporting.

The senior management representation letter must be addressed to the board of directors of the institution and to the CDIC, and must be signed by the chief executive officer of the institution and by another member of senior management who is not a member of the board of directors. The letter must contain

- a statement to the effect that the senior management of the institution are familiar with the CDIC standards and acknowledge their responsibilities under those standards;

- a statement indicating whether senior management are fulfilling their responsibilities under the CDIC standards;

- a statement setting out senior management's conclusion as to whether the operations of the institution are being managed in accordance with the CDIC standards;

- if senior management have concluded that the operations of the institution are not being managed in accordance with the CDIC standards, or that the operations are being managed in accordance with the CDIC standards except for identified deficiencies the letter must contain:

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- an explanation of the reasons for that conclusion,

- a statement confirming that an action plan to correct any identified deficiencies has been prepared and is being implemented, and

- a statement confirming that a copy of the action plan has been or will be submitted to the institution's examiner; and

- when the institution is required to submit a standards report at the same time that it submits the senior management representation letter, an opinion as to whether the contents of the standards report are accurate and fairly presented.

The board of directors' resolution must be addressed to the CDIC and must contain:

- a statement to the effect that the board of directors is familiar with the CDIC standards and acknowledges its responsibilities under those standards;

- a statement indicating whether the board of directors is fulfilling its responsibilities under the CDIC standards;

- a statement indicating whether the board of directors has carefully considered the senior management representation letter and other information relevant to forming an opinion as to whether the institution is following the CDIC standards;

- a statement setting out the board of directors' opinion as to whether the institution is following the CDIC standards;

- if the board of directors is of the opinion that the institution is not following the CDIC standards, or that the institution is following the CDIC standards except for identified deficiencies:

  - an explanation of the reasons for the opinion that relate to deficiencies other than those identified in the senior management representation letter,

  - a statement confirming that an action plan to correct those other deficiencies has been prepared and is being implemented, and

  - a statement confirming that a copy of the action plan has been or will be submitted to the institution's examiner; and

- when the institution is required to submit a standards report at the same time that it submits the board of directors' resolution, a statement to the effect that the board of directors has carefully considered the standards report and approves it on behalf of the institution.

The Standards Report must contain:

- an explanation of how senior management arrived at their conclusion as to whether the operations of the institution are being managed in accordance with the CDIC standards, including a description of

  - the criteria, methods and other means used by senior management to determine which of the current and planned operations of the institution are significant operations, and how those criteria, methods and other means were explained to the board of directors,

  - the criteria, methods and other means used by senior management to assess which of the risks to which the institution is or will be exposed constitute significant risks, and how those criteria, methods and other means were explained to the board of directors,

  - how senior management assessed the appropriateness and effectiveness of the institution's processes, procedures and controls, and

  - the criteria, methods and other means used in bringing to the attention of senior management and the board of directors significant weaknesses or breakdowns relating to the institution's processes, policies, procedures and controls;

- an explanation of how the board of directors arrived at its opinion as to whether the institution is following the CDIC standards, including a description of how the board

  - evaluated its effectiveness in fulfilling its responsibilities under the CDIC standards and dealt with any significant inadequacies or failures relating to the fulfillment of those responsibilities,

  - assessed the appropriateness and prudence of the institution's policies, and

  - assessed whether it was provided with timely, relevant, accurate and complete reports in accordance with the CDIC standards; and

- a copy of all information, directly related to the making of the board of directors' resolution, that was provided to the board at the time the resolution was made.

NETHERLANDS

Section 22(1) of the Act on the Supervision of the Credit System 1992, ASCS 1992 (*Wet toezicht kredietwezen 1992, Wtk 1992*) states that "the Bank may give the credit institutions recommendations or general directives for the conduct of their business in regard to the administrative organization, including the financial accounting system and internal control, as well as with a view to preventing conflicts of interest."

Accordingly, in 2001 the Regulation on Organization and Control (ROC) (http://www.dnb.nl/english/e_toezicht/wet_regelgeving/hbwtk/pdf/4201e.pdf) became effective. The purpose of this regulation is to provide directives and recommendations for the organization and control of business processes within institutions. The principle is that institutions are responsible for organizing and controlling their business processes in such a way that their business is conducted in a controlled and sound manner.

The regulation deals with controlling risks to which institutions are exposed, including the risks arising from non-compliance, or inadequate compliance, with regulations and from breaches of sound business conduct. The risks concerned are material risks, in other words, risks that may have a significant adverse effect on the financial performance, financial position, continuity or reputation of an institution. The principle is that the institution itself is responsible for drawing up procedures, rules and standards, for embedding these in the business processes and for monitoring their effectiveness and compliance therewith. The management board of the institution must ensure this is achieved in practice. The regulation focuses on the following elements: risk control, organizational measures, information, communication and examination, evaluation and rectification. The correct emphasis on these elements should result in effective steering and control of business processes.

"1.2.2 Risk control
Article 7
An institution shall have clearly formulated policies that are aimed at risk control and sound business practices.

In order to implement its objectives and strategy, an institution must formulate clear policies that are aimed at risk control and at conducting its business in a controlled and sound manner. Underlying this is the promotion of a corporate culture in which risk control and sound business practices are embedded.

The policies define the manner in which business processes are arranged and implemented and are instrumental in shaping infrastructural elements, such as the staffing, information and communication systems and corporate culture of an institution.

The policies must have regard to relevant legislation and regulations, contractual

obligations and social standards regarding sound business practices. This includes the regulations of the Bank, including the solvency and liquidity requirements.

The policies must be documented, for example, in the form of a policy plan, and must be approved by the management board and the supervisory board pursuant to this regulation (section 1.3). If a number of policy plans or sub-plans are developed, these must form an integral part of the control mechanism of the institution as a whole.

The policies must require the establishment of, *inter alia*:
- a system of exposure limits that reflects the chosen risk profile and has regard to relevant legislation and regulations;
- a system of procedures and measures for emergency situations;
- a system of standards aimed at sound business practices to be exercised by all personnel of the institution;
- a recruitment policy that sets high standards for the suitability, expertise and integrity of its staff.

Article 8
An institution shall ensure that risk analysis is performed systematically with the aim of identifying, measuring and evaluating all risks.

The purpose of the analysis is to gain insight into the risks to which an institution is exposed and to establish whether these are consistent with the objectives, strategy and policies of the institution. The analysis must therefore be performed on a continuous basis, both on an institution-wide basis and at the level of individual business divisions and must comprise the identification, measurement, monitoring and evaluation of all risks. Based upon the results, the management board can establish whether the organizational arrangement and the control mechanism are adequate for the purpose of controlling the risks to which the institution is exposed. The risk analysis must address all business processes, which means that it must cover all products, services and auxiliary processes of the institution, and must be performed in both qualitative and, to the extent possible, quantitative terms. The analysis must take account of both controllable and uncontrollable risks, potential extreme scenarios (stress scenarios) and any correlation between the various risks.

Risk analysis is a continuous process, which means that account must systematically be taken of:
. changing internal and external circumstances;
. new products, services and auxiliary processes; and
. future plans.

If significant changes have taken place, such as technological developments, that affect a risk analysis performed previously, the effects of these must be investigated. Products and services that are new to the institution or the market must be subjected to a thorough risk analysis. The principle is that the institution must introduce new products and services in such a way that (the risks of) any losses are limited in magnitude.

The risk analysis may lead to the conclusion that the risks to which the institution is exposed are not, or are no longer, consistent with the chosen risk profile or that the chosen risk profile is not, or is no longer, consistent with the objectives and strategy of the institution. It is also possible that the organizational arrangement and the control mechanism are not, or are no longer, consistent with changes in the risk profile. The evaluation of risks therefore needs to be linked to the process of revising the objectives, the chosen strategy and the established organizational arrangement and control mechanism.

The risk analysis may identify (residual) risks that have not been recognized previously and/or that cannot be mitigated by the control procedures and measures. In such cases, institutions will need to decide on the acceptability of these risks or on whether the underlying business activities should not be carried out or should cease. It is important that the risk analysis highlights all risks and that the management board is aware of these.

Article 9
The risk analysis shall be performed or supervised by experts who are independent of the functions that are accountable for commercial and/or financial performance.

An institution must ensure that the risk analysis is not affected by commercial or other conflicts of interest. The risk analysis must therefore be performed and its results reported without being influenced by management that is accountable for performance. The risk analysis must be performed or supervised by experts in the field or area concerned, such as the capital markets or information technology.

Recommendation
For the larger and more complex institutions it is recommended that an independent department be established that is responsible for risk analysis and that operates under the direct control of the management board. The role of such a department would be to obtain an overview of the risks to which the institution is exposed and to establish whether these are consistent with the chosen risk profile ensuing from the objectives and strategy of the institution and with the relevant legislation and regulations. The need for an independent department will depend in part on the authority delegated to the commercial and finance departments and the applicable reporting lines.

The regulation, together with the policy rules of the Nederlandsche Bank (the supervisor), aims at creating a framework which is to be elaborated on by institutions themselves. This approach allows room for an interpretation that reflects appropriately the individual circumstances of an institution and new developments.

GERMANY

German Banking Law specifies in Art. 25a "Particular organizational duties of institutions" the following:

"(1) An institution must

1. have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements by means of which the institution's financial situation can be gauged with sufficient accuracy at all times;

2. have a proper business organisation, an appropriate internal control system and adequate security precautions for the deployment of electronic data processing;

3. ensure that the records of executed business transactions permit full and unbroken supervision by the Federal Banking Supervisory Office for its area of responsibility; the requisite records shall be retained for six years; section 257 (3) and (5) of the Commercial Code applies as appropriate."

All activities of German banks are subject to detailed controls on a permanent basis by internal audit groups which are independent of existing bank control procedures in internal supervision and reporting. When auditing annual accounts, which is mandatory, external auditors have to examine the adequacy of internal control and audit procedures. Bank regulators are generally entitled to undertake special audits of banks, also through professional auditors or accounting firms. There is no different treatment of domestic and non-domestic banks and their branches.

FRANCE

French Banking Law requires "a suitable system of internal controls enabling them to measure the risks":

"Article 51

Credit institutions shall be required, subject to conditions laid down by the *Comité de la Réglementation Bancaire et Financière*, to observe management standards designed to safeguard their liquidity and solvency in relation to depositors and, more generally, third parties, and the equilibrium of their financial structure.

They must in particular observe risk-asset and risk-diversification ratios.

Credit institutions must also have a suitable system of internal controls enabling them *inter alia* to measure the risks and profitability of their activity. When supervision is exercised on the basis of a consolidated financial situation, financial groups must adopt internal control procedures suitable for the production of information relevant to the exercise of such supervision. A regulation of the *Comité de la Réglementation Bancaire et Financière* shall define the conditions for implementing the provisions set forth in this paragraph.

Failure to comply with the obligations established under the present Article shall lead to implementation of the procedure described in Article 45.

[Note also that the above provisions apply to "financial holding companies"]:

Article 72

Financial holding companies ("compagnies financières") are financial institutions, as defined in point 4. of Article 71-1 of the present Act, whose subsidiaries are mainly or wholly one or more credit institutions, investment firms or financial institutions. At least one of the subsidiaries is a credit institution.

Article 73

Financial holding companies shall be subject to the provisions of Articles 13, 17, first paragraph, 40, 41, 43, 44, 45, 46, 51, 53 to 55, 75, 76 and 79 under conditions set forth in a regulation of the *Comité de la Réglementation Bancaire et Financière.*

The auditors of the above-mentioned companies shall also be subject to all the provisions of this Act applicable to the auditors of credit institutions and investment firms."

French banks are subject to annual audit requirements by an accredited accounting firm. Auditing requirements, also applies to branches of non-domestic banks and to international branches of French banks.

BASEL

The Core Principles seek to address the key risks faced by banks, by establishing standards regarding capital adequacy (principle six), credit risk (principles seven, eight, nine, ten), country and transfer risk (principle 11), market risk (principle 12) and other risks such as interest rate, liquidity, yield and operational risks (principle 13). Supervisory authorities must ensure not only that banks comply with minimum prudential standards but also that they conduct their business in accordance with the rules and policies adopted by the banks' boards of directors. Thus, another important part of the operational requirements is the establishment of appropriate internal control mechanisms. The Basle Committee addresses this issue in principle 14.

In addition to Core Principles, Basel Committee developed a wide range of detailed guidelines related to risk management and internal control. The full list of risk-related Basel documents can be found on http://risk.ifci.ch/BIS.htm

EU

As far as the independence (and functions) of the Risk Control Unit, the guidelines contained in the Directive 98/31/EC[2] (market risk capital guidelines) are of some interest. Actually, the annex VIII to the Directive gives the possibility to competent European authorities to allow financial institutions to calculate their capital requirements for position risk, foreign exchange risk and/or commodities risk using their own internal risk management models (instead or in combination with those described by the same directive). However, the release of the authorisation of internal models (authorisation that must be explicit) is subject to the presence of some qualitative standards, including:

"...

(i) the internal risk-measurement model is closely integrated into the daily risk-management process of the institution and serves as the basis for reporting risk exposures to senior management of the institution;

(ii) ***the institution has a risk control unit*** *that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the institution's risk-management system. It shall produce and analyse daily reports on the output of the risk-measurement model and on the appropriate measures to be taken in terms of trading limits;*

(iii) the institution's board of directors and senior management are actively involved in the risk-control process and the daily reports produced by the risk-control unit are reviewed by a level of management with sufficient authority to enforce both reductions of positions taken by individual traders as well as in the institution's overall risk exposure;

(iv) the institution has sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk-control, audit and back-office areas;

(v) the institution has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk-measurement system;

(vi) the institution's models have a proven track record of reasonable accuracy in measuring risks;

(vii) the institution frequently conduct a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets;

(viii) the institution must conduct, as part of its regular internal auditing process, an independent review of its risk-measurement system. This review must include both the activities of the business trading units and of the independent risk-control unit. At least once a year, the institution must conduct a review of its overall risk-management process. The review must consider:

- the adequacy of the documentation of the risk-management system and process and the organisation of the risk-control unit,

- the integration of market risk measures into daily risk management and the integrity of the management information system,

- the process the institution employs for approving risk-pricing models and valuation systems that are used by front and back-office personnel,

- the scope of market risks captured by the risk-measurement model and the validation of

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[2] http://www.europefesco.org/DOCUMENTS/Directives/Dir-98-31.pdf

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any significant changes in the risk-measurement process,
- the accuracy and completeness of position data, the accuracy and appropriateness of volatility and correlation assumptions, and the accuracy of valuation and risk sensitivity calculations,
- the verification process the institution employs to evaluate the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources,
and
- the verification process the institution uses to evaluate back-testing that is conducted to assess the model's accuracy.
... "

CONCLUSION

Most Western countries require commercial banks to have risk-management/internal control systems that should be "adequate", "suitably arranged", etc. The essence of those suitable arrangements or systems is typically not defined in laws and implemented through various agencies' regulations (standards, guidelines, bylaws, etc) that, in particular, require banks to have tailor-made internal risk-management policies and procedures and observe them. It is then left to the bank supervisory agency to determine if a bank's risk management practices are "adequate," "suitable," "prudent", based on their analysis of bank's risk-management practices and the size, operational sophistication, and business orientation of the bank. In many cases, even the agencies' regulations are relatively non-specific, because the suitability of a bank's risk management practices can only be determined by viewing the characeristics of the bank. Thus, the substance of the agencies' practices in this area are often found in examination manuals or guidelines. The guidelines in the manuals etc. are then used to determine whether a bank's risk management practices are "adequate" "suitable," etc.

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MEMO

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FROM:	Gary Gegenheimer, Senior Legal Advisor Yevhen Telychko, Legal and Economic Specialist
CC:	Alex Kutsenko, Economic Specialist Marina Antonova, Program Specialist Raya Ladokhina, Program Specialist
DATE:	December 28, 2002
REF:	Ukrainian Legal Framework: Requirements for On-going Risk-Management Systems in Banks

UKRAINIAN LEGAL FRAMEWORK: REQUIREMENTS FOR ON-GOING RISK-MANAGEMENT SYSTEMS IN BANKS.

In current Ukrainian law, provisions related to requirement for on-going risk management systems in banks are contained in Article 44 "Risk Management" of Law "On Banks and Banking" (BBL):

"The bank shall set up a standing unit of analysis and management of risks, which would be responsible for setting limits in respect to specific operations, risk limits for counterparts, countries of contra parties, and balance sheet structure in accordance with resolutions of the Board (Board of Directors) on the issues of risk policy and profitability of bank operations.

In order to ensure additional measures of risk management, the banks shall create standing committees, in particular:

1) *A credit committee, which evaluates the quality of bank assets on a monthly basis and prepares proposals on the formation of reserves for possible losses resulting from their devaluation.*
2) *An assets and liabilities management committee, which, on a monthly basis, reviews the cost of liabilities and the profitability of assets, and takes decision on interest margin policy, reviews decisions on matching maturity of assets and liabilities, and provides relevant bank units with recommendations on the elimination of arising time differences.*

3) *A tariff committee, which, on a monthly basis, analyzes a correlation between the cost of services and the competitiveness of existing tariffs, and is responsible for the bank's policy in the are of operational income.*

Banks should independently take decisions on setting up bodies of financial risk management in order to ensure favorable financial conditions for the protection of interests of depositors and other creditors."

Though, as one can see, the Article is quite "raw", it is a large development. In fact, in most Western countries, banking laws do not have specific articles on risk-management, and risk-management units are not clearly required.

For example, German banking law only states that a bank should *"have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements by means of which the institution's financial situation can be gauged with sufficient accuracy at all times"*. Similarly, French banking law only requires *"a suitable system of internal controls enabling them to measure the risks"*. The essence of those suitable arrangements or systems is typically not defined in law and implemented through various regulations (standards) that, in particular, require banks to have tailor-made internal risk-management policies or procedures. It is then left to the bank supervisory agency to determine if a bank's risk management practices are "adequate," "suitable," "prudent", based on their analysis of bank's risk-management practices and the size, operational sophistication, and business orientation of the bank. In many cases, even the agencies' regulations are relatively non-specific, because the suitability of a bank's risk management practices can only be determined by viewing the characeristics of the bank. Thus, the substance of the agencies' practices in this area are often found in examination manuals or guidelines. The guidelines in the manuals etc. are then used to determine whether a bank's risk management practices are "adequate" "suitable," etc.

This system works pretty well in Western countries, but for Ukraine, more specific approach is recommended. The reason is that judicial system in Ukraine sometimes can be a handicap for objectives of bank supervision. (See our memo System of Commercial Courts and Competence of Judges in Ukraine: Overview of Legal Framework dated 12/15/2002)

In this connection, it is preferable to have some specific requirements (more specific than Western countries place in their banking laws) on risk-management systems in Law on Banks and Banking. In particular, it makes sense to slightly amend BBL Art 44 making it more specific and explicitly requiring all banks to develop internal risk-management policies and procedures.

During work group meetings of General Department of Bank Supervision (GDBS) on amendments to BBL that took place in September – November 2002, we convinced the GDBS to suggest the NBU Legal Department more specific wording of Article 44 (para 1):

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"The bank shall create comprehensive and adequate risk management system for establishing, monitoring and control of all risks. With this purpose, a standing risk-management unit is set up. The unit shall be responsible for establishing risk limits for specific operations, risk limits for counterparts, countries of contra parties,, limits for other risks; responsible for development of procedures for evaluation, monitoring and control of risks of balance sheet structure in accordance with resolutions by Supervisory Council and Management Board on issues of risk policy and profitability of bank operations."

A necessary step for the NBU would be to develop specific regulations on risk-management systems that would guide banks in creating their own tailor-made internal risk-management policies and procedures.

Good examples of regulations from International practice are:

1) Canada Deposit Insurance Corporation Standards of Sound Business and Financial Practices By-law (SOR/2001-299). http://lois.justice.gc.ca/en/C-3/SOR-2001-299/text.html

2) Regulation on Organization and Control (Netherlands)
http://www.dnb.nl/english/e_toezicht/wet_regelgeving/hbwtk/pdf/4201e.pdf

The NBU regulation(s) should give criteria for defining "adequate" or "inadequate" systems and lay down that there may be other reasons and criteria to rate bank's system as inadequate subject to the NBU judgement. Regulation(s) should state that they are mandatory "minimum requirements" for institutions with the methods to achieve compliance to be established by each institution.

It is also very important to ensure that there is regulatory mechanism for enforcing adequate risk-management systems in banks. Current BBL Article 73. "Enforcement Measures" states that "*In case a bank or other persons (entities) under the National Bank of Ukraine supervision in compliance with this Law, violate the banking legislation of Ukraine, any normative-legal act of the National Bank of Ukraine, or perform risky operations, which threaten the interests of the bank's depositors or other creditors, the National Bank of Ukraine has the right to use the adequate enforcement measures*".

Though, even a current wording enables the NBU to apply enforcement measures in case a bank "*performs risky operations which threaten the interests of the bank's depositors or other creditors*", more specific wording on "unsafe and unsound practices" or "inadequate risk-management systems" is recommended.

As a result of November BSD work group meeting on BBL amendments, the BSD recommended the Legal Department the following language:

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"In case a bank or other persons (entities) under the National Bank of Ukraine supervision in compliance with this Law, violate the banking legislation of Ukraine, any normative-legal act of the National Bank of Ukraine, lack or have an inadequate risk-management systems, or perform risky operations, which threaten the interests of the bank's depositors or other creditors, the National Bank of Ukraine has the right to use preventive or compulsory enforcement measures"

Given possible problems with economic court judges, a better wording would be: "In case a bank or other persons (entities) under the National Bank of Ukraine supervision in compliance with this Law, violate the banking legislation of Ukraine, any normative-legal act of the National Bank of Ukraine, *lack or, in opinion of the National Bank of Ukraine, have an inadequate risk-management systems,* or perform risky operations, which threaten the interests of the bank's depositors or other creditors, the National Bank of Ukraine has the right to use *preventive or compulsory enforcement measures it finds adequate to correct violations or drawbacks*".

CONCLUSION

The law on Banks and Banking should be more specific in terms of requiring "adequate" risk-management systems in banks. If, in NBU's opinion, bank's risk-management system is "inadequate", the Law should give the NBU full authorities to take pro-active and after-the-fact actions it finds reasonable. Detailed NBU regulation(s) on risk-management systems giving specific criteria on "adequacy" of risk-management systems should be developed. The regulation(s) should lay down that there may be other reasons and criteria to rate bank's system as inadequate subject to the NBU judgement. Relevant changes in licensing and corporate governance will also be needed.

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