THE PROSPECTS FOR RISK-BASED SUPERVISION IN UKRAINE

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1. Risk-based Versus Rule-Based Supervision.

Over recent years, risk-based supervision has become an international standard, endorsed by the International Association of Insurance, the World Bank, the Bank of International Settlements (Basel) and the Inter-American Development Bank amongst others. It may be helpful at this stage to define risk-based supervision. Supervisory authorities around the world in developing as well as developed countries have put in place more formal, structured and risk-based procedures for supervising financial institutions. It is a structured process aimed at identifying the most critical risks that face each financial services company and through a focused review by the supervisor to assess the company's management of those risks and the company's financial vulnerability to severe constraints on its business and ultimately to the collapse of the company. The focus is on risk profiles and risk management capabilities of individual financial services companies so that supervisors have an early warning system of any rapid changes in the company's financial position.

The range of risks which the supervisors should take into account include financial risk (credit, market, liquidity, and for insurance companies, actuarial and reinsurance risks) and non-financial risks such as operational, transactional and reputational risks). It takes account of the general aims of regulation, which are to ensure that the institutions are financially strong and in a position to meet all their obligations to their customers, such as paying out when their long-term investments have matured (life insurance companies) or ensuring the safety of bank deposits, protecting investors, and maintaining confidence in the financial system. Such supervision also requires compliance with rules.

However, the difference between risk-based supervision and rules-based supervision is that the latter is often characterised by numerous, detailed rules and that the purpose of

monitoring visits or off-site monitoring, the examination of financial and other returns with the aim of finding contraventions of laws and regulations, regardless of the relevance of these breaches to the ability of the company to meet all its obligations, including solvency requirements. It is the significance of the breaches which matters. The rules-based approach may also involve a detailed examination of information submitted to the regulatory authority, but the focus may well be on reconciling data, or perhaps counting the number of securities or being concerned with the lateness of the financial report rather than seeing that the report indicates that the company may be heading for serious financial difficulties.

Risk-based supervision does not operate without rules. The supervisory authorities who have developed and continued to develop the principles of risk-based supervision also have detailed rule books, such as the FSA's Handbook. Firms also receive the Supervision Handbook, which sets out what the regulator expects to find when they visit firms and what they can expect from the supervisor regarding the whole process of the on-site visits. Companies are fined for breaches of rules; for example, breaches of conduct of business rules, where the company had placed a significant number of their customers at the risk of losing all their savings; failed to make sure that their customers understood the risks of the product nor did they make sure that it was a suitable recommendation to the customer. The FSA not only fined the company, but ordered the company to pay £3.5 m in compensation. The evidence for that lay in an analysis of the nature of the product and examining the records of all the sales, which the companies are obliged to keep.

The rules have to be in accordance with the objectives of regulation and should not overburden the companies with excessive demands for information or unwieldy procedures. That does happen when the emphasis is on the rules and not on estimating the risks to which the regulated companies are exposed or to their failure to meet their obligations to their customers. For example, repeated late filing of required financial information and frequent inaccuracies in that information are not just breaches of rules, but are very likely to signify that the company is in serious trouble. What has to be tested

is the nature and content of the rules against the objectives of regulation and then the whole process of supervision should be examined with a view to ensuring that risks have been identified and can be mitigated. The mitigation may take the form of enforcement and requiring a company to cease conducting its business in certain ways.

Risk-based supervision is designed to identify high levels of risk in a particular company and to be in a position to take prompt action. The identification of risk does involve a question of judgement, since absolutely precise measures of risk are not available. But the degree of objectivity can be increased by the use of risk models, which are now well-established both in banking and insurance and the use of tools such as risk benchmarking. These models enable the supervisors to look at every source of risk, such as credit or liquidity risk, which is generally used by banking supervisors. In the case of insurance, it is important to review all aspects of the company in order to find the different components of risk. Considering credit risk for insurers involves examining its reinsurance activities, its investments, amounts due from brokers, amounts due from policy holders and so on. The training provided for the regulatory authorities in Ukraine should take account of possible different approaches to risk-based supervision used in assessing the risks involved in the type of companies they supervise.

2. The Supervisory Approach in Ukraine.

The regulatory process in Ukraine adopted by each of the regulatory authorities would seem entirely familiar to regulatory authorities in developed countries at first sight. The process begins with licensing or authorisation of a company, based on payment of a fee, having sufficient capital to meet the capital requirements laid down in the law, and meeting the 'fit and proper' requirements. Companies have to submit quarterly financial reports to the regulator and meet other mandatory reporting requirements.

The regulatory authorities monitor the activities of the companies, and as part of that activity, they arrange on-site visits, which may either be full-scope visits or visits directed

at specific aspects of the company.[1] These are described as scheduled full-scope on-site visits and unscheduled targeted on-site visits. The laws give the staff of the regulatory authorities the right to enter the company's offices and examine documents either on pre-arranged visits or unannounced. The two Commissions and the NBU have on-site and off-site staff in two separate units with insufficient contact between the units. The off-site staff examine the reports of various kinds which the companies have to submit, but it is not clear to what extent the on-site staff have access to this information and how much preparation is undertaken prior to the visit.

The on-site staff write a report following the visit, which is presented to the senior management of the company. The report may indicate that the company should undertake remedial action in a given period or may recommend enforcement action. The authorities do have certain enforcement powers, limited though they may be. Enforcement action in the form of a fine or more serious actions may follow.

The procedures adopted by the Commissions and the National Bank of Ukraine all form part of the processes involved in risk-based supervision. It will at least provide some kind of basis for training, even though the supervisory guide-lines for the conduct of off-site preparation and on-site by the staff of the two Commissions are largely procedural.
What is missing from the whole process is any recognition of the need to identify the key risks to which individual companies are exposed or at the company's management of risk, still less at the company's capital in relation to risk. The laws and regulations are themselves inadequate to the task of risk-based supervision with very significant gaps, including the inability to identify the beneficial owners of financial institutions and to ensure that inactive companies left the market. The NBU, as will be discussed in more detail in the next section, has benefited from extensive training in risk-based supervision, It also suffers from gaps in laws and regulations, including once again the inability to identify the ultimate or beneficial owners.

[1] The terms, 'examination' and 'on-site visits' are used interchangeably in Ukrainian, so it has been decided to use the term, on-site visit, throughout, since the term, 'examination' conveys a different meaning to regulators in developed countries and would give a misleading impression of the nature of supervision in Ukraine,

3. The Approach Adopted by Each of the Regulatory Authorities

Each of the three regulatory authorities, the State Commission for the Regulation of Financial Services Markets, the Securities and Stock Market State Commission and the National Bank of Ukraine carry out on-site visits and off-site examinations or reviews.

(i) The Securities and Stock Market State Commission.

In the case of the latter, the Commission bases its programme of on-site visits on the three major pieces of legislation, underpinning the SSMSC's access to the companies and exchanges it regulates. These are the Law on the State Regulation of the Securities Market in Ukraine, the National Depository System and Electronic Circulation of Securities in Ukraine and the Law on Securities and the Stock Market. These laws give the regulatory authority the right to require companies to provide them with information and the right to enter their offices in order to conduct announced and unannounced visits. The Commission also has the right under the laws to issue its own regulations and to enforce its decisions on corrective measures. Its regulations set out the procedures for overseeing licensing requirements; issuers and SROs; mutual investment institutions, stock exchanges and securities markets participants. It is responsible for ensuring compliance of these institutions with money laundering requirements, and procedures for the conduct of on-site visits.

The Commission also has to monitor almost 30,000 joint stock companies in terms of monitoring the general meetings of shareholdings, receiving and monitoring annual reports, reports and reports on major shareholders, which is undoubtedly a distraction from its major task of supervising the securities market and the stock exchanges. The obligation to publish their financial reports according to international standards and make them publicly accessible within three months after the end of their financial year should be introduced and enforced. Companies are only obliged to publish financial reports according to Ukrainian law within nine months after the end of their financial year, which

is used to deny shareholders proper access to information at the AGM). An examination of the regulations shows that these are largely procedural, dealing with the length of on-site visits (a maximum of 20 days), possible extensions (up to 10 days) on production of a letter from the manager; requirement for the Chairman's approval of a visit schedule, and the requirement that at least two members of staff must take part in an on-site visit. The visit schedule itself is prepared by the Department of Legal Control. The regional offices carry out a programme of visits on a quarterly programme, once it has been agreed by the Chairman.

There are also additional rules covering the staff of regional offices, who may also conduct unannounced visits, provided these are authorised by the regional manager. These can take place provided the regional manager has received a written notification from one of the following authorities: State Security Service, the Prosecutor's Office, the State Anti-Economic Crime Department, the Central Anti-Organised Crime Department, court orders or police investigators' requests. Otherwise, the regional manager has to obtain permission from central office for an unscheduled visit.

The target is to visit each regulated institution once a year. Given the number of institutions the Commission has to regulate, the target is unlikely to be met if the on-site visits did last for the permissible length of time. This was confirmed by discussions with the staff of the SSMSC suggest that on-site visits are much shorter than the time allowed, generally two to three days. It also explains the number and the analysis of visits made during the year, which the Commission is able to complete. In 2005, the Commission undertook a total of 1159 scheduled on-site visits, of which 30 were conducted by the staff of the central office and the remainder by central office staff. In addition, a further 366 unscheduled visits were undertaken. Almost half (47%) the companies visited were securities issuers, 36% were independent registrars and 15% were securities brokers. None of the investment funds and companies received an on-site visit.

The target cannot be reached, given the number of institutions, Reference has already been made to the number of joint stock companies, where the Commission has certain

responsibilities, whereas they should be concerned (through the stock exchanges) with the 262 listed companies, of which only about 40 seem to be regularly traded.

The SSMSC has licensed 794 securities traders, 370 independent registrars, 143 custodians, 10 trade organisations, 8 of which are registered as stock exchanges and 2 registered as trade information systems (electronic trading systems), all of which are well in excess of the needs of the capital market. The two most active trade organisations are PFTS, an electronic trading system, which accounts for more than 86% of all trading volumes and the Ukrainian Stock Exchange, which accounts for about 13% of the trading volume. The remaining 8 stock exchanges including one other electronic trading system are virtually inactive, but with random trading, which further fragments the market and adversely affects both prices and liquidity. PFTS has recently been recognised as a stock exchange, which opens up the possibility of closing the other exchanges and providing a modern electronic trading system and the supervisory advantages that brings.

The SSMSC's approach to supervision does not include any consideration of reducing the number of companies it supervises. Steps have been taken recently to raise the minimum capital required for securities firms, which may be effective in reducing the number of companies applying for licensing. That should require careful examination of the source of the capital and checking to see that the company continues to maintain that capital. The new requirement is not applied retrospectively (which may have its own problems). There is clearly no concept of relating capital to risk, since otherwise at least some, if not many, of the securities companies would have been de-licensed. Other criteria, such as being able to demonstrate that the securities company had been actively engaged in business throughout the financial year and could present financial accounts which demonstrated the level of activity, would also reduce the number of companies the SSMSC has to supervise.

Interviews with the Commission indicated that many small firms are not properly covered by the supervisory process. They only receive a visit on an ad hoc basis, which might well be instigated by a police report of a violation, which may well indicate that the

securities company is involved in money laundering. The Commission is aware of the need to revoke licenses and draft legislation is under consideration, which would give the Commission the power to revoke licenses for a number of reasons. It appears that the decisions (which take the form of a Resolution), could be challenged by the Entrepreneurship Committee.

A similar issue arises in the case of independent registrars. An amendment to the existing laws in 2003, required all joint stock companies with more than 500 shareholders were required to use the services of external 'independent' share registrars, which resulted in the creation of a significant number of small, often 'pocket' registrars, which act as registrars for a single enterprise and do not maintain records in an electronic format.[2] Clearly, the number of registrars should be reduced and this could be achieved in a variety of ways, such as requiring a registrar to serve a number of companies and to reach a suitable size so that they can demonstrate their economic independence from any individual company and would have the resources to provide a proper service for their customers. It appears the some of the large law firms act as registrars for many clients, which *might* indicate a way forward.

The existence of a large number of securities companies, whose existence cannot be justified in a capital market characterised by low liquidity amongst other reasons and the excess of registrars places an unnecessarily heavy burden on the Commission. It also provides an insight into the conduct of supervision and the lack of appropriate regulations. This is illustrated by the length and the outcome of on-site visits. Although the legislation allows for full scope visits lasting for up to 20 days, but in fact visits often only take 2 to 3 days. Unscheduled visits are based on notifications of violations by shareholders or the police, or the Commission may decide on such a visit based on an analysis of the financial reports and other mandatory reports. The Commission is seeking to focus on working companies in its supervisory work, which is all the more reason for removal of the license from inactive companies and exchanges.

[2] ECSPF, The Development of Non-Bank Financial Institutions in Ukraine: Policy Reform Strategy and Action Plan, October, 2005, p. 26

The Commission provided an analysis of its enforcement actions in 2005, which involved reviewing 7,619 violations of the law by securities market participants, which led to 7,301 reports of violations of the law and 65 reports of administrative breaches being prepared. Fines of USD 994,723 were imposed and collected. The Commission also provided details of its enforcement actions, which typically involved the failure on the part of issuers to publish proper notification of the AGM, ignoring the demands of shareholders owning more than 10% of the shares to convene a general meeting or additional items to the agenda; failing to meet the requirements on proxy voting or to hold regular shareholder meetings; failure to publish business reports in the media and to advise shareholders. Brokers and dealers were fined for failing keep proper records or to comply with the rules for registering contracts. Registrars were fined for failing to keep registers properly, registers were not properly stored or the accounts of registered securities holders were not opened on a timely basis, nor were shareholders issued with certificates of ownership. Some of these breaches on the part of brokers/ dealers and registrars should act as risk indicators and should lead to further action, unless they are due to an oversight of some kind. But there is no indication of follow-up actions or any kind of risk assessment of the companies concerned.

(ii) The State Commission for the Regulation of the Financial Services Market.

The FSR provided the following information about its programme of on-site visits during interviews and a questionnaire. The central Credit Union Department together with staff in the regional offices conducted 947 on-site visits (which then included pawn shops) over the past eighteen months. Other staff also conducted 41 on-site visits to financial companies, including 22 unannounced visits plus a further 13 visits to leasing companies. Between November, 2004 and May, 2006, the Commission undertook 69 visits to non-state pension funds for a variety of reasons, including checking compliance with financial services regulations or money laundering requirements or to check the accuracy of the information provided in the license application and compliance with the Law of Non-State Pension Provision.

This year's schedule of visits, to be completed by December, 2006, is intended to cover 181 credit unions and 186 insurance companies plus 16 on-site visits, 15 of which are concerned with compliance with financial services legislation and one for compliance with money laundering requirements. The number of staff taking part in such visits varies from 2/3 for financial and insurance companies; credit institutions require at least 3 members of staff from the Department of Credit Institutions, 2 members of staff for non-state pension institutions for compliance with money laundering requirements.

The visits are conducted in accordance with the procedural Guidelines for the Department of Examination Schedules, which were adopted in July, 2005. These Guidelines set the criteria for including firms in the schedule and the procedure for developing the schedule. The main reason for including a financial institution in the programme of visits is the date of the last visit. The guide-lines require the Commission to undertake a full-scope visit to every financial institution it supervises every two years. The Guidelines are focussed on procedural matters, such as submitting the proposed schedule to the Unit of Financial Monitoring and Internal Audit in time, giving sufficient notice (10 days) to the company to be visited and getting the report to a Commission official within three days of the visit if there is a breach of the rules, leading to a fine. The Guidelines do not contain any reference to assessing the risks involved in the way in which the company conducts its business.

The staff do prepare for the on-site visit; for example, preparing for a full-scope visit to a non-state pension fund takes five days. The registration documents are studied and any reports received since the last visit as well as the report of the previous visit. Decisions regarding any enforcement actions have to be submitted to a Commission official within a specified time. Enforcement action ranges from remedial action; requiring a special shareholders' meeting; fines; suspending, restricting or revoking a license; removing the management and appointing a provisional administration; approving a firm's financial rehabilitation or initiating the liquidation of the company.

What is a matter of concern is that despite the recognition and the preventative actions taken against insurance companies the number has not been reduced in any significant way. At the end of 2004, at least one third of the 387 insurance companies established in Ukraine were established for tax evasion purposes, mostly through the transfer of funds abroad through reinsurance. The FSR estimated that at least 20 of the top fifty insurance companies are captive insurers, established by banks, or they are part of the large industrial and financial conglomerates. Cross-ownership in these cases allows for extensive capital misrepresentation by banks and insurance companies, creating problems for both supervisors with different tax regimes.

The number of insurance companies has in fact increased to 398 at the beginning of 2006, although the insurance market was already extremely fragmented with a large number of small and inefficient companies. The FSR can argue that its hands are tied until there is a new insurance law. One such law is in preparation and the first draft of the proposed insurance law will be presented to the Cabinet of Ministers in September. It will lay down not only minimum capital entry requirements but also solvency requirements. It is hoped that these changes in the law will reduce the number of companies through mergers and acquisition. It is true that the FSR certainly does need a vastly improved legal framework in which to operate but the approach to supervision means that the emphasis is on compliance with specific rules without any element of prudential or risk-based supervision. It is in part for this reason that Ukraine still has such a large number of insurance companies, many of which are quite possibly not viable.

Out of the 200 or so staff in the central office, there are only about 20 staff directly concerned with practical supervision: 5 on analysis; 5 concerned with licensing and 2 other units of 5 staff each for regulation and supervision. The regulation laid down by the Cabinet of Ministers states that a unit should have only 5 members of staff. Other departments in the central office consist of the department of methodology, the function of which is to develop laws, employing 22 staff (which is too many, according to senior management); 5 staff employed in government relations and a further 15 working on integration with the European Union. Other staff are required to co-ordinate the work of

the central office with the regional offices employing some 90 staff. The FSR is quite clear that there is no prudential supervision: the initial capital is checked by the licensing department and the quarterly reports are checked by the analysts in the insurance unit. There are four departments are structured on industry lines, covering insurance, credit unions, leasing and non-state pension funds. The interview indicated that the Cabinet of Ministers sets out the internal structure of the regulatory authority, which means that the Commission cannot deploy its staff in the most effective way.

The work is further hampered by the very high turnover of staff; for example, in 2005, 64 staff were hired and 69 quit, and in 2004, 87 staff joined and 64 left. A member of staff who stays for longer than three months is an 'old' employee, and only then receives any benefits. Staff are expected to learn 'on the job' and are taught by the older employees, given that they want to teach them. Although the staff are young and well-qualified, they lack experience and do not remain long enough to receive adequate training. The Securities Commission suffers from similar staffing problems.

(iii) The National Bank of Ukraine.

The NBU supervises 165 banks, which are ranked in terms of total assets. The central office supervises tier 1 and tier 2 banks, and tier 3 and 4 banks are the responsibility of staff in the regional offices at present. Twenty-one banks are in the process of being liquidated and a further twenty banks are still registered but are not yet licensed. The number of banks is declining gradually, but the supervisory task is made more onerous by the requirement for a bank to apply for permission to open a branch and, once the branch is opened, it is the responsibility of the regional staff to visit the branch. This practice did persist in some EU member states until the beginning of the 1990s. The opening of a branch should be a commercial decision on the part of the bank, and the responsibility for ensuring that the local branch is properly managed should lie with the senior staff of the head office (with the assistance of internal audit). This would have the effect of reducing the number of regional office staff of approximately 1000.

Supervision takes the form of receiving daily, monthly, quarterly and annual reports, which may be delivered in electronic or paper form. The details of the information required is set out in Resolution No 368, 'Instructions on the Procedure for the Regulation of Activities of Banks in Ukraine', 2001. Financial reporting must conform to IAS standards. The reports, together with the reports of the previous on-site visit, are analysed by the off-site staff, responsible for preparing the supervisory strategy for the next on-site visit. Problems discovered by the on-site team are also relayed to the external auditors for further investigations. If the problems are serious, then an agreement will be made between the supervisors and the senior management or the CEO of the bank to carry out the appropriate improvements. The agreement has to be signed by the deputy Governor and the CEO, and the latter has to provide explanations of the remedial action by letter and through meetings. Both the off-site analysts and the on-site supervisory staff have the responsibility of checking that the improvements have been carried out. The NBU is trying to introduce a system of having certain supervisors in charge of specific banks.

However, there are difficulties for the NBU in supervising banks in this way. For example, with regard to one particular bank, the NBU requires the bank to raise more capital by July 1st, but this requires the approval of the Anti-Monopoly Committee. The interviewee raised the question as to why the AMC has to give its approval to a bank raising more capital, given that the bank would have to raise an enormous amount of capital in order for the bank to be in a monopoly position. The interviewee indicated that the reference and the delay in the response was probably due to the desire to postpone the moment of dissolution. The NBU is still unable to identify the ultimate owners of the banks. The point is, however, that the legal framework still makes it difficult for the NBU to apply the principles of risk-based supervision fully, and more particularly, to ensure that the appropriate remedies are carried out.

The CAMELS rating system (without sensitivity to market risks) was adopted initially at the end of 1996, when the Guidelines for the Examination of Banks and Banking Institutions in Ukraine were adopted, and the sensitivity component was introduced in

2001. The Guidelines consist of specific procedures focused on such as asset quality, capital, loan loss provisions, liquidity, earnings, internal controls, management, market risk sensitivity; in other words the CAMEL components, and are basically detailed procedures for examiners for examiners on how to look at different aspects of bank operations. These are contained in Resolution No 368, which sets out the requirements for capital, regulations covering credit, procedures for calculating a bank's regulatory capital and so on in detail. These provided the NBU with a means of determining a bank's financial position, enabling the supervisors to identify a problem bank and the causes of its difficulties and potential bankruptcy.

In 2002, the risk assessment system was developed and was officially developed in 2004, as Resolution No 104, 'On Approval of the Methodological Guidelines for bank examinations, the 'Risk Assessment System', which was accompanied by intensive training in risk-based supervision, which meant that a fully comprehensive supervisory handbook, 'Guidelines for the Onsite Examination of Banks and Banking Institutions in Ukraine' was produced. It led to changes in the methods of supervising banks; for example, the supervisory staff prepare separate reports on every aspect of risk the bank faces. This ranges from the quality of management, the way in which the risks are changing, the quality of risk management, and credit and liquidity risk, which is possible only through a comprehensive on-site visit in order to fully understand what the managers' tolerance for risk is and the nature of their risk-management approach. Most banks only have one on-site visit every two years, but Tier 1 banks receive a visit every year, regardless of its risk rating. A rating system was introduced, which enables the NBU to assess the general stability of the banking system. The NBU aims to incorporate the risks identified in the CAMELS system with the system of risk-based supervision so that one model can be used.

However, the banking supervisory staff are still limited in the actions they can take; for example, an unannounced visit or one which is not included in the programme still has to be justified to the bank in question. The bank has the right to challenge the reason for the unannounced visit and in fact the NBU is actually preparing depositions to deal with

challenges from various banks in the courts. A recent court decision cancelled the decisions which had already been taken regarding the liquidation of a bank. Other restrictions also place difficulties in the way of licensing banks by restricting the amount of information the NBU can request from those proposing to establish the bank.

The NBU seeks to apply the principles of risk-based supervision, even though it is still hampered by the legal framework. The structure of the NBU also militates against making the best use of the staff as the internal organisation does not encourage staff to exchange information or to develop and learn. The on-site and off-site staff are quite separate units. The need to bring staff together so that off-site staff can take part in full-scope on-site visits has been recognised by the NBU. The current arrangements allow for one off-site staff to focus on three or four banks and so he or she cannot participate in one on-site visit. The changes that some would like to make would include closer co-operation between the on-site and off-site units with an off-site analyst either in charge of the team or at least a lead member of it. This has been explained to the Governor, who plans to discuss this with the Board and perhaps to make a Resolution to make these changes. This is an example both of the bureaucratic approach to matters of internal organisation, which should not require a Resolution of the Council of the NBU. It is a matter of making risk-based supervision effective.

The same point applies to another organisational matter. In addition to the on-site and off-site units, there is a further department of some 60 staff, the Department of Methodology. This is the policy department, which is responsible for developing regulatory concepts, such as accounting for subordinated debt or evaluating fixed assets. It is also involved in understanding and considering how best to apply Basel II. The problem here is that the Department is quite separate from other advisory units, and it appears that there is little communication between them. The department develops banking regulations so there should be an opportunity for supervisory staff to have some input into that process. All the supervisory staff should, for example, be studying Basel II and the possibility or necessity of applying these concepts to supervising banks in Ukraine.

As has already been indicated, NBU staff received very intensive training in 2003, but since then it has suffered a high turnover of professional staff for the following reasons:

(a) salaries are lower than those available in the market for the same level of experience.

(b) On-site staff are closer to the banks. If the report is good, they may have an offer from a bank. One chairman of a bank admitted that they picked out a good member of the NBU staff and offer him or her a managerial position on higher pay.

(c) Constant reorganisation.

Training is a problem for the NBU in terms of staff finding the available time. The NBU is also trying to follow the team approach, which was recommended to them. They have tried to follow this approach by including on-site staff from regional offices to accompany central office staff on a visit in order to provide them with training. The NBU supervisory staff are seeking to reorganise the supervisory staff so that they are not encased in silos but do work together as teams. Central office consists of 230 staff of which 113 are on-site, off-site and problem unit staff with some 800 staff in the regional offices. A large segment of central office staff, some 27 people, are concentrated on the Tier 1 and Tier 2 banks and the problem bank unit consists of 10 people.

The NBU suffers from the loss of trained staff. Those who have joined the NBU since 2003 may not fully understand risk-based supervision, despite working with staff who were trained in 2003. The Guidelines are extremely detailed running into some 600 pages, but may not be fully understood or properly applied by newcomers.

4. Developing Risk-Based Supervision.

In considering the prospects for the introduction of risk-based supervision, the problems in the way of a proper and effective introduction of risk-based supervision should be

taken into account. For all three regulatory bodies, developing risk-based supervision is made more difficult in the present circumstances by the high turnover of staff and the lack of an appropriate legal and regulatory framework. This includes the difficulties arising from the lack of effective enforcement powers, and the fact that, even when appropriate enforcement action is taken, the decisions can be repeatedly challenged in the courts.

In Part I, the framework of an enabling bill was set out, together with the necessity of revising current regulations and developing a Supervisory and Regulatory Handbook, which would reflect international standards and meet the objectives of regulation set out in the Enabling Law. That would provide a suitable context for developing risk-based supervision. In practical terms, the issue of high staff turnover would have to be addressed; otherwise, much time and effort will be spent in training staff, who leave for more lucrative jobs in the financial services industry, but may not even be able to benefit those who employ them by helping to develop risk management for their employers in the private sector as they left too quickly to be properly trained. Removing inactive companies, exchanges and weak insurance companies so that the regulatory authorities can focus their efforts on the financial institutions, which really are players in the market.[3]

If the moves towards a single regulator are undertaken in the ways outlined in Part I and the problems outlined above are in the process of being tackled, then work on the moves to risk-based supervision would begin. One great advantage is that the processes involved in risk-based supervision are already in place. This includes receiving daily, monthly, quarterly and annual reports from companies. The information is reviewed and analysed by the off-site units; off-site reviews; reporting back to the company; agreeing a remedial programme with the senior management of the company; checking to see if that programme has been completed in the allotted time and taking enforcement actions.

For the move to risk-based supervision to be successful, an intensive training programme will be required. Its introduction would require a review of the information required in terms of its relevance to understanding the risks the company faces, and what additional information should be required from the regulated entities and why. The review of all regulations and their incorporation into the Handbook will also provide an opportunity to deepen the knowledge and understanding of the supervisory staff and would improve the prospects for introducing risk-based supervision.

The methods of collecting information will also have to be improved and a suitable format for collecting data especially if the content is changed; for example, if the requirement to produce financial reports in accordance with full IAS standards is applied and enforced across the financial services industry (it applies to the financial reports required by the NBU from banks at present). The FRS approved a single reporting form for insurance companies in 2005 and was developing a new insurance law, which would meet IAIS standards and would conform to EU Directives on capital adequacy and solvency. This work has been suspended but should be reinstated as part of the preparation of requiring appropriate information from the regulated entities as a basis for risk-based supervision. The three regulatory authorities should have the appropriate technology in place to receive reports in a timely and trouble-free fashion. The ECSPF report published in 2005 concluded that the existing technological support of the regulators, that is, the two Commissions, does not allow timely collection and analysis of data(even mandatory regulatory reports) which affects the quality and timeliness of the regulatory analysis and corrective actions. Risk-based supervision will not be effective unless the quality of the underlying technology is improved. The establishment of a single regulator as set out in Part I allows for ensuring that the appropriate systems are in place. In the longer term and when the appropriate arrangements are in place, the use of xbrl (extensive business reporting) systems and the use of these by companies and regulators for both financial reporting and for full compliance reporting. This system should a vital aid in conducting risk-based supervision.

Other forms of preparatory work should be undertaken so that the risk-based supervision system will be used effectively. An important part of the decision to adopt risk-based supervision is that comprehensive risk-management is crucial for the sound management of financial institutions as they are exposed to many risks which are difficult to forecast and manage because of uncertainty in the financial markets. The first step is the creation of a benchmark to identify the risks and the ability to manage risks on the part of the financial institutions. Some of that work has already taken place. The NBU has already taken that step and is currently improving its risk assessment model. Risk-based capital requirements for banks, insurance companies and securities companies should be developed in line with Basel II and appropriate solvency requirements for insurance companies and securities companies. Another stage of the process of preparation is to review the risk management systems of non-bank financial institutions and encourage them to implement appropriate risk management systems.

A final stage in the preparation for establishing risk-based supervision is to overcome the cultural barriers to risk-based supervision. The traditional supervisory approach has been to review the operations of the company to ensure that the company is in compliance with the regulations and to ensure that the financial statements that have been prepared by the company meet the requirements of the reporting methodology and to ensure that the results are accurate. A good regulator should be able to identify a significant error or misstatement in the audit process. Overcoming the cultural barrier would involve enabling the existing staff to see that the risk-based supervision takes the process further and focuses the review effort on the areas of risk in the company's operation which could impair the viability of the company. The focus is on the risks in the business and on the management processes for dealing with those risks, especially on the management of these key risk areas and attends to critical net risk exposures. The process is designed to identify the risks, the management processes, the volatility of the result and the impact on the company. It is a systematic and structured process because it examines in turn the key aspects of a company's business and within each looks at the risks to those areas of operation.

5. Conclusions.

It is possible to introduce risk-based supervision. It will require intensive and demanding training which should be addressed both the managers as well as front-line staff should be an essential part of the programme, ensuring that managers are involved in developing the supervisory handbooks. The training programme will best be pursued in the context of the moves towards a single regulator and the processes involved in that.

The introduction of risk-based supervision should build on the procedures already used by the professional staff of the two Commissions. NBU on-site and off-site staff who received the original training and have, presumably, been engaged in applying risk-based supervision should take part in as trainers in the programme. The moves towards risk-based supervision can be achieved by reviewing the current information requirements; enabling staff to interpret and analyse the reports in terms of the risks posed; enable on-site and off-site staff to communicate; identifying the risks during an on-site visit and assessing the quality of risk-management; report-writing, remedial and enforcement actions.

Success in the introduction of risk-based supervision will be achieved if the traditional special review approach is taken further so that the process identifies and focuses the review on the aspects of a company's operations which could affect its viability. The aim is to identify the risks in the business and on the way in which the management handles the risks. Risk-based supervision examines each of the risks that the company faces through a structured process identifies the risks that are most crucial to the business and highlights critical net risk exposures. The on-site visit and subsequent reports will be entirely concerned with the risks, management, the volatility of the result and the impact of the company. The process will assess the risk mitigation procedures the company has in place. The regulator will then concentrate in following on-site visits on the most critical net exposures. Regulatory guide-lines may be used at this stage in development to set limits, internal controls which companies should have in place and even prior approval of the regulator in certain situations. Developing risk-based supervision to this

extent would be a valuable step forward in supervision, even for NBU's supervisory staff due to the high staff turnover. To sum up: it is possible to introduce risk-based supervision provided that the regulatory authorities have the appropriate status, independence and powers, that the introduction of risk-based supervision builds on the procedures already in place and if risk-based supervision develops as outlined above.