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UKRAINE

Financial System Stability Assessment

Prepared by Monetary and Exchange Affairs and European II Departments

Approved by Stefan Ingves and John Odling-Smee

April 22, 2003

- This Financial System Stability Assessment report is based primarily on work undertaken during two visits to Ukraine during April and May 2002, as part of the joint Bank-Fund Financial Sector Assessment Program (FSAP). The FSAP findings were discussed with the authorities during the Article IV consultation mission in February 2003. Developments until then have been reflected in this report to the extent possible.

- The FSAP team comprised Khaled Sherif (World Bank, Mission Leader), Daniel Hardy (IMF, Deputy Mission Leader), Peter Kyle, Rodrigo Chaves, Gabriella Ferencz, John Hegarty, Alan Roe, Gregorio Impavido, Melinda Roth, Angana Shah, Irina Astrakhan, Alexander Pankov, Allan Schott, Angela Prigozhina, Alexander Berg, Victoria Korogodon, Alexandra Gross, Tatiana Segal, Anna Sukiasyan, and Rozzy Garner (Team Assistant) (all World Bank), Peter Lohmus, Stephen Swaray, Andrea Schaechter, Nadia Rendak (all IMF), Krzysztof Senderowicz (National Bank of Poland), Paul van Sluijs (Netherlands Bank), and Terje Prøsch (Norges Bank).

- The FSAP team met with senior officials of the Government, including the Minister of Finance and the Minister of Economy; the National Bank of Ukraine (NBU), including then Governor Stelmakh; other government agencies; and representatives of the private sector.

- The Ukrainian financial system has been growing rapidly as the macroeconomic environment has stabilized and general confidence has returned, but important vulnerabilities remain. The authorities have strengthened the prudential regulation of banks and other financial sectors, supporting institutional reforms are also progressing, and some soundness indicators show improvement. However, a large share of loans are nonperforming, credit—much of which is denominated in foreign currency—has been growing very rapidly, and real interest rates are high. Hence, credit risk remains a major threat to financial stability. Further efforts are needed to improve the capitalization and operational efficiency of the state-owned banks. Nonbank financial institutions have also been growing rapidly and their supervision needs to be strengthened before they become of systemic concern. Reform of corporate governance and accounting, and improved creditors' rights are essential for the sound development of the financial system.

- The main authors of this report are Mr. Daniel Hardy, Ms. Nadia Rendak, and Mr. Stephen Swaray.

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I. OVERALL STABILITY ASSESSMENT

1. **The improvement in Ukraine's macroeconomic performance over the last four years has reduced financial sector vulnerabilities, but they remain worrisome.** The maintenance of substantial positive real growth and the decline in inflation have given the financial sector a respite from the difficult conditions of the earlier phase of transition—culminating in the 1998–99 crisis—which has facilitated some restoration of financial strength and the build up of institutional capacities. The banking system has been growing especially quickly, with both loans and deposits increasing by about 50 percent in 2002 alone. Nonbank financial institutions, notably the insurance sector, have also been growing rapidly. This rapid growth reflects a welcome return of confidence, but also brings with it important risks. Indictors of the soundness of the banking system showed some improvement in 2001 and 2002, but are still at levels that give rise to concern.

2. **The authorities have made efforts to strengthen institutional arrangements supportive of financial sector stability.** The transparency of monetary and financial policies is in many regards adequate, although there are still important concerns related to the conditions under which central bank management can be replaced, and the calculation of central bank profits. In this connection, the new longer term refinance facility must be seen as a step backwards. The central bank could also make more effort to clarify the prioritization of its domestic and external monetary policy targets. The deposit insurance scheme is satisfactory. The payment and settlement system is reliable and efficient.

3. **The prudential regulation and supervision of banks and other financial institutions has improved, though more needs to be done.** Much of the regulatory framework is in place; recent improvements (in part prompted by the FSAP assessment) include, for example, the strengthening of regulations on connected lending, consolidated reporting, and major shareholdings. However, the minimum capital requirement, at 8 percent, is low given the uncertainties inherent in a transition economy, and provisioning may not adequately reflect true probabilities of default and expected losses in case of default. Given the level of dollarization of lending, supervisory action is needed to reduce banks' exposure to the exchange rate risk assumed by borrowers. The National Bank of Ukraine (NBU) needs to establish the practice of requiring prompt corrective action when weakness is found in any commercial bank, and earn a reputation for speed and decisiveness in resolving failed banks. As the financial system develops, a risk-based approach to supervision and issues such as market and country risk will become increasingly important. A significant new development was the establishment of a financial intelligence unit and the passage, in late-2002, of comprehensive legislation on anti-money laundering and combating the financing of terrorism.

4. **Considerable vulnerabilities remain, especially due to credit risk in the banking system.** More than one fifth of the loans in the banking system are nonperforming, and about two fifth are under "watch."[1] Average ex post real interest rates on hryvnia-denominated loans are still over 15 percent, in part because of credit risk, and in part because of banks' high

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[1] Sub-standard, doubtful and loss loans are here categorized as nonperforming. In Ukrainian usage, only the last two are classified as nonperforming, and amounted to 7.2 percent of total loans at end-2002.

operating costs; projects that can afford financing at such a rate are likely to be speculative. The fast pace of credit expansion must have placed great strain on the banks' ability to evaluate loan applications with due care. Furthermore, over 40 percent of loans are denominated in foreign currency; many borrowers without a reliable stream of foreign currency earnings seem to have taken on this exchange rate risk.[2] Therefore, a deterioration in macroeconomic conditions, such as even a mild recession or depreciation of the exchange rate, could place severe strain on the banking system. These vulnerabilities and weaknesses are especially pronounced in certain major banks, which continues to be under-capitalized and inadequately profitable, and which demands the authorities' urgent attention.

5. **Other financial sectors are still too small to pose a systemic threat except if difficulties in one of those sectors affected overall confidence, but important developmental challenges remain.** The newly created nonbank financial regulator will need to be made fully operational and act quickly to strengthen the regulation and supervision of the insurance and other nonbank sectors. The market for government securities has considerable scope for development. Securities markets are highly fragmented, and do not serve as a channel for diversified investment or a means of disciplining corporate management.

6. **Many of the vulnerabilities of the financial system in Ukraine are the product of weaknesses in the enterprise sector.** Inadequate accounting standards in enterprises hinders the evaluation of creditworthiness. Corporate governance is generally acknowledged to be non-transparent and open to abuse. The overall framework for creditors' rights and insolvency in Ukraine has improved in recent years, but continues to be weak.

II. Overview of the Financial System

A. Structure and Ownership

7. **The Ukrainian financial sector remains small, but has begun to grow rapidly as confidence has returned (Table 1)**. Since 1999, both bank deposits and bank lending have been expanding at exceptionally high rates, and also the insurance sector has been growing rapidly. Commercial banks dominate the financial system: assets in Ukraine's 157 active banks at end-2002 totaled UAH 68 billion, equivalent to 31 percent of GDP. The two wholly state-owned banks account for 12 percent of total bank assets. The capital markets are small, with capitalization equal to less than 3 percent of GDP. The other financial sub-sector of significance is insurance, where premiums accounted to about 1.9 percent of GDP in 2002. Assets of other financial institutions such as pension funds, credit unions, and leasing companies together account for less than 1 percent of GDP.

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[2] The exchange rate between the U.S. dollar and the Ukrainian hryvnia (UAH) has been very stable since the start of 2000, but the authorities would argue that this is more a by-produce of their monetary program rather than a nominal anchor to which they are fully committed.

8. **One major bank is in a dominant position in the collection of household deposits,** because of the full government guarantee on its deposit liabilities and its inherited branch network.[3] Relatively few other banks compete nationwide for these deposits, and those that do must offer higher interest rates.

Table 1. Ukraine: Structure of the Financial Sector, 1999–2002

	1999	2000	2001	2002
Banking				
Number of active banks	162	153	152	157
Total assets (millions of UAH)	25,603	36,827	47,204	67,774
Assets as a share of GDP (percent)	19.6	21.7	23.4	31.1
Insurance				
Number of insurance companies	263	283	328	338
Total assets (millions of UAH)	...	...	3,007	5,300
Premium revenue (millions of UAH)	1,164	2,136	3,031	4,442
Other financial institutions				
Number of investment funds and mutual funds of investment companies	229	397	362	...
Total assets (millions of UAH)	...	373	...	...
Number of pension funds	...	21	15	23
Total assets (millions of UAH)	...	23	60	55
Number of credit unions	...	> 350	> 400	>450
Total assets (millions of UAH)	...	37	50	90
Number of leasing companies 1/	...	22	>40	>50
Total assets (millions of UAH)	...	327	280	210
Number of securities traders	835	839	859	...
Number of securities custodians	75	84	86	...

Source: NBU; Ukraine, Ministry of Finance; State Commission on Securities and Stock Market.
The data refer to December of each year.
1/ Estimated number of active leasing companies.

9. **Foreign bank involvement has been modest, particularly in comparison to other transition countries.** The 20 foreign banks at end-2002 had UAH 11.0 billion in assets, about 16 percent of the total. There are seven wholly foreign-owned banks, and another 13 banks are partly foreign-owned. The foreign participation in many of these banks originates in Russia. In the recent past, one foreign-owned bank has grown to be among the largest banks in Ukraine.

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[3] Another major bank, which does not enjoy an explicit government guarantee, is specialized in foreign trade-related financing, and does not have a large retail deposit base.

10. **The banking system is relatively fragmented (Table 2)**. The fragmentation of the banking system may in part be attributable to the status of many small banks as "pocket banks" of enterprise groups, which use them for treasury operations, and as sources of cheap liquidity and equity investment. Connected and insider dealing between banks, enterprises and major entrepreneurs is difficult to monitor because information on ownership structures has been difficult to obtain, especially where ownership has been "layered" through several companies.[4]

Table 2. Ukraine: Structure of the Banking Sector, December 2002
(In percent except where indicated)

	All banks	Largest 10 banks 1/	Upper mid-sized banks 2/	Lower mid-sized banks 3/	Other banks
Number of banks	157	10	12	34	101
Shares					
Capital	100.0	39.2	11.2	21.8	27.8
Assets	100.0	54.1	14.7	17.4	13.8
Deposits	100.0	59.7	14.4	15.2	10.7
Loans	100.0	52.9	15.7	17.6	13.8

Source: NBU, and staff estimates.
1/ As defined at December, 2002.
2/ Banks with assets over UAH 500 million other than the 10 largest.
3/ Banks with assets over UAH 200 million and less than UAH 500 million.

Nonbank Financial Institutions (NBFIs)

11. **The nonbank component of Ukraine's financial system is limited in terms of volume of activity, range and quality of its products and services, and degree of market penetration.** Whereas the banking system could build upon the institutions inherited from the Soviet period and always had to be maintained in order for transactions to be carried out, the nonbank sector started from a lower base, and has received less active policy support.

12. **The insurance sector in Ukraine is small, despite the large number of companies, but is growing quickly.** Aggregate revenues were about 1.9 percent of GDP in 2002, and density is approximately UAH 85 per capita. There are 338 licensed companies, which is high for the volume of annual premium revenues generated. Gross premium income has been growing at an average rate of over 50 percent for the last six years. This is in part the result of regulatory and tax arbitrage relative to the banking sector: many insurance companies are

[4] Moreover, small banks usually do not have audit reports produced in compliance with international standards.

linked to banks or corporations, which can find it attractive (largely for tax reasons) to transfer some operations or assets to their insurance subsidiaries.

13. **Despite recent growth, the role in financial intermediation of other NBFIs remains negligible, with total assets estimated at less than 1 percent of GDP.**[5] A number of privately run pension schemes are in operation, but they exist with (as yet) no regulatory or legislative support. There are no reliable data on the sector. It is estimated that 23 schemes are active, with total estimated assets amounting to UAH 55 million at the end of 2002. Credit unions are generally limited in their resource base and lending flows.[6] Housing finance and commercial property development have increased recently. However, most of this financing is derived from personal sources, sources outside the formal sector, or use of mandatory pension funds for housing construction. The leasing sector is dominated by public-sector institutions, and in particular the company devoted to leasing agricultural equipment; private-sector leasing activity remains modest.

Financial markets

14. **The inter-bank money market in Ukraine is thin, but volatility has decreased since mid-2001.** The previously large day to day fluctuations in hryvnia inter-bank interest rates were moderated by the introduction of averaging of required reserves over monthly holding periods, and the maintenance of generally ample bank liquidity. However, some individual banks whose creditworthiness is in doubt need to pay risk premiums of up to 10 percentage points to obtain interbank funds. The interbank foreign exchange market generally seems to operate smoothly.

15. **The market for Ukrainian government domestic securities is also thin, and the volume of securities suitable for secondary market trading is small.** This situation is in large measure a hang-over from the 1989–99 crisis, but also reflects certain current institutional weaknesses. Banks, companies, and households combined own under UAH 2 billion (less than 1 percent of GDP) of government securities. Most domestic government securities consist of restructured bills (about UAH 9 billion are outstanding), almost all of which are held by the NBU. Furthermore, this small stock is distributed over numerous maturity dates.[7]

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[5] Confidence in this sector has been affected by a number of episodes where fraudulent schemes were established. The financial volumes were not large, but the reputational effect seems to have been significant.

[6] At end-2002, the National Association of Credit Unions comprised 126 institutions with 171,000 members and UAH 79 million in assets.

[7] For example, in the first quarter of 2002 alone, the government auctioned treasury bills with 20 different maturity dates; the largest single issue was only UAH 212 million.

16. **The Government should develop the government securities market to lower its borrowing costs over the medium term, promote financial market deepening, and provide banks with a low-risk asset.** A functioning market would reduce dependence on foreign borrowing, which brings with it special vulnerabilities. At the same time, investors and especially banks have a need for a low-risk investment instrument. A prerequisite for the sound development of a government securities market is that the government maintains discipline over the budget deficit and the stock of its debt, and ensures that it has no domestic arrears, such as VAT refunds. In addition, more technical measures can be taken, in three areas: (i) increasing the size and concentration of stock of government securities outstanding, initially focused on short maturities;[8] (ii) simplifying the auction process and making it more transparent;[9] and, in due course, (iii) maintaining a liquid secondary market.

17. **While the securities market has been growing, market capitalization is low, and most significant trading occurs off-market.**[10] The securities markets and associated infrastructure are complex relative to trade volumes and market capitalization: there are seven licensed stock exchanges and two trading systems, four depositories, 86 licensed custodians, more than 300 registrars, and 859 licensed brokers in what is an underdeveloped and illiquid market for stocks, bonds, promissory notes, bills of exchange, and derivatives. To promote deeper and more efficient market, the number of markets, registrars, depositories, and brokers should be consolidated. Increased disclosure requirements should also be enacted, for example, by requiring prompt disclosure of the acquisition of 10 percent of any listed company, and of legal insider buying and selling. Fit and proper tests and risk-based liquid asset requirements also need to be implemented for licensed market intermediaries.

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[8] This can be achieved by: (i) issuing more securities than the government needs to meet current financing needs (and using the excess to retire restructured bills at the NBU); (ii) concentrating on just a few maturity dates, or issuing bills with just one maturity; and (iii) reducing the frequency of auctions to just once per month. These measures should also help to stimulate the secondary market.

[9] The current arrangement of bidding in two rounds for an uncertain quantity of bills discourages participation. It would be more effective to pre-announce the quantity on offer, and hold one round of bidding. A detailed prospectus specifying all features of the bills is needed.

[10] Market activity has increased in recent years. However, only 172 of 456 issuers were actually traded in 2001 on licensed markets. Meanwhile, significant trading in unlisted companies occurs off-market under non-transparent conditions.

B. NBU Instruments and Operations

18. **The NBU's monetary instruments are broadly adequate.** They include:

- Required reserves, which must be held on an average basis over a month-long holding period; unremunerated deposits at the NBU or up to half of cash in vault are eligible assets. The NBU has been lowering reserve requirements from an average of 13.0 percent at end-2001 to 7.9 percent at end-2002. Reserve ratios are differentiated by the maturity and currency denomination of deposit liabilities: the range at end-2002 was from zero to twelve percent.

- The discount rate announced by the NBU to serve as a benchmark interest rate; no transactions are carried out at the discount rate itself.

- NBU certificates of deposit (CDs), which are issued to commercial banks on an auction basis with maturities ranging from 1 to 180 days. CDs are issued when the NBU believes there is excess liquidity in the banking system as a whole, and are therefore used to manage long-term trends in liquidity. CDs can be purchased and sold by commercial banks on the inter-bank market, and can be used as collateral in the inter-bank lending market.

- Three types of regular refinancing facilities available to commercial banks, namely, overnight loans, refinancing for up to 14 days, and refinancing for up to 270 days. (In addition, the NBU may provide a "stabilization loan" to a bank undergoing rehabilitation). All refinancing is undertaken through either quantity or price tenders, depending on the strength of the interest rate signal that the NBU wishes to convey. Collateral can take the form primarily of government securities, but in 2002 the NBU started offering refinancing without collateral. To use these facilities, banks must meet specific conditions relating to capital, solvency and a good track record of loan repayment to the NBU. The amount of refinancing cannot exceed 50 percent of the commercial bank's paid up capital.

19. **The NBU could take a number of measures to help better manage systemic liquidity.** These could include: (i) improving the NBU's short-term liquidity forecasting, including through better coordination with the Ministry of Finance, and more actively intervening in the domestic money market to smooth exogenous shocks; (ii) refining the design of its money market instruments (for example, by making CDs eligible to be collateral for NBU refinancing); (iii) ensuring the speedy processing in liquidation cases of securities pledged as collateral (which would also reinforce the payments system); and (iv) possibly refining the design of its reserve requirements by introducing a carry-over provision.

20. **In addition to these monetary instruments, in 2002 the NBU introduced a longer term refinance facility.** Banks can now obtain refinancing for up to three years, priced at the discount rate and collateralized by various assets such as excess reserves and corporate bonds. In 2002, UAH 121.5 million was provided under this facility. While this facility is not a

major potential source of instability, it could be seen as a return to directed credits, and exposes the NBU to credit, interest rate, and reputational risks. If the facility is retained, it should be modified to reduce the risks to the NBU, for example, by tightening collateral requirements. More generally, structural and institutional reforms would be a better method for promoting the availability of affordable, longer-term financing.

21. **The Electronic Interbank Payment System (EIPS) is operated by the NBU and used for all inter-bank transactions.** It operates essentially as a gross settlement system in batch mode. The current system seems to be efficient, reliable, and inexpensive (see Part II of this report). The NBU has initiated a program to introduce an on-line real time gross settlement system, and, in cooperation with some commercial banks, it is also developing new retail means of payment, such as "smart cards."

C. Legal, Regulatory, and Supervisory Framework

22. **The legal framework for the banking system is broadly adequate, and recent legislation has corrected some weaknesses, but inefficiencies in the overall legal system hinders financial sector development and stability.** The Law on the NBU and the Law on Banks and Banking Activity, which date from 1999 and 2000, respectively, are in most regards satisfactory, although they have deficiencies in such areas as provisions for effective and transparent governance. These laws have been supplemented by a large number of NBU regulations. Recently, laws have been passed covering such areas as bankruptcy proceedings, the supervision of NBFIs, and anti-money laundering measures; a new public debt law is currently before parliament. However, the legal framework covering NBFIs, governance, and ownership rights is in many regards weak and confused (see below).

23. **The NBU has made progress in strengthening banking supervision, but deficiencies remain (see Part II of this report)**. Some of these weaknesses are being addressed through new regulations (for example, on consolidated supervision); some recent amendments (for example, on identifying loans to connected parties and the assessment of exposure to market risk) were prompted by the assessment undertaken in May 2002 as part of the FSAP. Regulations on capital adequacy, provisioning and risk management by banks are broadly satisfactory in structural terms, but do not take enough account of the level of risk in quantitative terms (see below). Further enhancements are needed in such areas as: (i) strengthening the NBU's regulatory control over all significant bank investments, including equity investments in other banks and NBFIs; (ii) further strengthening supervisory controls on connected and insider lending; (iii) streamlining reporting requirements; and (iv) accelerating development of capacity to conduct consolidated supervision. Yet, perhaps more important than new regulations is the need to improve the NBU's supervisory practice and reputation, and rigor in ensuring that emerging problems are dealt with promptly.

24. **Banks, and in particularly the larger banks, prepare accounts according to IAS, with some deviations, but the quality of data is believed to be uneven among the smaller banks.** An important task for the NBU is to require that all banks prepare accounts fully in accordance with IAS. The NBU devotes considerable efforts to verifying the accuracy of

banks' accounts through on-site supervision. The publication of some statistics is subject to long lags. The reliability of data for the enterprise sector is questionable.

25. **The process of resolving failed banks has typically been protracted.** The banking law provides a range of measures that the NBU can take discipline and eventually intervene in a bank that displays signs of distress, such as inability to meet prudential norms or other serious financial and operational weaknesses. The NBU has applied these sanctions, and recently has been successful in completing the resolution of a number of small failed banks, albeit a long time after the initial intervention. However, the NBU has not always used effectively the legal powers it has to mandate corrective action by distressed banks or to resolve quickly cases of insolvency. In at least two recent cases, delays or mishandling have added significant costs to the resolution process.

26. **Bank resolution needs to be made more efficient and effective.** It should be guided by principles of prompt corrective action, least-cost reorganization, deposit safety, and systemic stability. Laws and regulations are in place granting the NBU the requisite powers. What is needed is for the NBU consistently to act as soon as it has information to indicate that a bank is in violation of prudential and regulatory requirements. Without exception, the NBU has to require banks to rectify any failure to meet prudential requirements, under threat of increasingly onerous penalties. In particular, it should not support a seriously under-capitalized bank unless a viable restructuring plan is being implemented, and new or existing shareholders are willing to support the plan financially. If the bank fails to take adequate action, the NBU has to be pro-active in seeking a resolution, for example, by replacing management, seeking a take-over, or eventually closing the bank.

27. **The deposit insurance system in Ukraine comprises an unlimited government guarantee on household deposits at one major bank, and a limited coverage guarantee on household deposits at other banks administered through the Fund for the Guarantee of Deposits of Natural Persons (FGDNP).** The FGDNP is new but generally well designed. Maximum coverage is UAH 1,200 (slightly more than US$200 per depositor, equivalent to about 30 percent of GDP per head), which provides full coverage to the vast majority of household deposits outside the major bank. Current financial reserves should be sufficient to meet claims in case one major bank or several small banks fail. The guarantee on deposits at the major bank is mandated by law, but is not backed by reserves or an administrative apparatus.

28. **In accordance with the new Law on Financial Services, an independent supervisory and regulatory body for nonbank financial institutions was established in 2002.** The effective operation of this body, which is responsible for the insurance, pension fund, leasing, credit union sectors and other nonbank financial sectors, is urgently needed, since the regulatory and supervisory regime for NBFIs remains inadequate or nonexistent, and because of the potential

for rapid growth in unregulated activities.[11] The new supervisory agency is not yet staffed and has not yet prepared any procedures or regulations. However, once established, it will offer many advantages, for example, in ensuring that information is shared between supervisors for various sectors (including the banking sector), and in promoting full transparency in the regulation and supervision of different financial institutions.

III. Macroeconomic Environment

A. Macroeconomic Developments

29. **The general macroeconomic situation has improved significantly starting in the latter part of 1999 (Table 3)**. Real GDP growth has been substantial, while inflation fell to zero. The budgetary situation also strengthened in 2000-02. The current account surplus increased to US$3.2 billion in 2002, or 7.6 percent of GDP, while international reserves reached US$4.4 billion, equivalent to 2.3 months of imports. The exchange rate against the U.S. dollar has been stable or slightly appreciating since 2000.

30. **This performance represents a major turn-around compared with Ukraine's experience in the 1990s.** Ukraine's transition from the socialist system was associated with an especially severe contraction in output, high inflation, and balance of payments weakness. Demand for financial assets largely collapsed. Although there was some recovery starting in the mid-1990s, the government debt crisis in 1998–99 represented a relapse, from which the financial system is only now recovering.

31. **The gains the NBU has recently achieved in lowering inflation and building up international reserves need to be secured through greater transparency in monetary policy.** The National Bank could be more active in clarifying its policy objectives and priorities to all market participants. In particular, the NBU could reinforce the message that its overriding objective is domestic price stability, and that the stability of the U.S. dollar exchange rate is temporary and coincidental to the achievement of that goal.

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[11] As of May, 2002, there was no regulatory oversight at all of pension funds, credit unions, leasing companies, and other financial institutions. Insurance had only limited regulation and supervision. Such a vacuum creates the serious risk of regulatory arbitrage, with NBFIs potentially being misused in fraudulent schemes or as vehicles for insider and related-party lending/investment.

Table 3. Ukraine: Selected Macroeconomic Indicators, 1998-2002
(Percent change except were indicated)

Total population (end-2002)	48,457,000
GDP per capita (U.S. dollars, 2002)	850

	1998	1999	2000	2001	2002 Preliminary
Real Sector					
GDP (percentage change)	-1.9	-0.2	5.9	9.2	4.6
GDP (in million hryvnia)	102,593	130,442	170,070	204,190	220,556
Consumer price index (e.o.p.)	20.0	22.9	22.7	6.1	-0.6
Private savings ratio (in percent)	18.9	25.0	23.3	24.7	24.2
Monetary and credit data (change in annual averages)					
Monetary base	21.9	39.2	40.1	37.4	33.6
Money (M1) deposit + cash in circulation	36.3	10.8	47.0	43.1	56.2
Broad money (M3)	25.3	40.4	45.4	42.0	41.7
Credit to the economy	16.7	38.6	63.8	41.0	47.5
Reference bank lending rate (level) 1/	61.6	50.0	30.6	19.7	8.0
Spread on Ukrainian bonds over reference rate (level, e.o.p.) 2/	...	...	18.26	9.33	7.47
Stock market index (percent change, end of period)	-73.1	81.2	42.1	-21.5	23.2
Public finances (in percent of GDP)					
Central government financial balance	-2.8	-2.4	-1.3	-1.6	0.5
Central government domestic debt	15.3	16.0	12.8	10.7	10.1
External sector (levels in millions of U.S. dollars, unless otherwise indicated)					
Exchange rate (UAH per U.S. dollar, end of period)	3.4	5.2	5.4	5.3	5.3
Trade balance	-2,584	244	779	198	710
Current account	-1,296	1,658	1,481	1,402	3,173
Foreign direct investment (net)	747	489	594	769	698
Portfolio investment (net)	224	124	-195	-735	-1,957
Gross official reserves (end period)	795	1,094	1,505	3,089	4,417
Reserve cover (months of imports) 3/	0.6	0.7	0.9	1.7	2.5
Total external public debt (in percent of GDP)	27.5	39.4	33.1	26.6	24.6

Sources: NBU, and staff estimates.
1/ NBU discount rate.
2/ Difference between the yield on Ukrainian Eurobonds and that on US treasury bills.
3/ Imports of goods and services (excluding factor income).

32. **The National Bank also needs to work with the government in clarifying the relationship between them, for example, by making more objective the conditions under**

which senior management can be dismissed, and by specifying objective rules under which realized central bank profits are calculated and transferred to government.[12] Such improvements in transparency and central bank independence would ultimately translate into greater macroeconomic and financial sector stability.

B. Macroeconomic Sources of Risk to Financial Stability

33. **Notwithstanding the recent good macro performance, the financial system remains susceptible to a range of potential macroeconomic shocks:**

- **In the short term, growth is likely to slow somewhat from the very high levels seen in 2000 and 2001.** Furthermore, the Ukrainian economy is open, so a slowdown in key foreign markets would be felt rapidly.[13] Ukrainian exports are also vulnerable to the imposition of trade restrictions. Certain important sectors such as electricity generation and metallurgy are also vulnerable to a sustained rise in oil and gas prices.

- **The recovery in confidence has been associated with very strong growth in deposits and credit, which suggests that credit risk may be rising (Table 4)**. Such rapid expansion puts in doubt the quality of the newly extended loans (see below). Furthermore, many borrowers may have come to rely on the ready availability of ever more credit. If macroeconomic conditions deteriorate and credit conditions tighten, loan defaults could rise.

- **Ukrainian interest rates on hryvnia-denominated loans have remained high,** despite much lower inflation. As a result, average *ex-post* real interest rates on credits rose to more than 20 percent in early 2002, and towards the end of the year were still above 15 percent.[14] These high rates are in part the result of unexpectedly low inflation, but they also reflect risk premia, banks' high operating costs, and, for some banks, high funding costs (see below).[15] First, much of this credit probably went to finance very risky projects; a project able to generate a real return above 15 percent is likely to be highly speculative. Hence, a large proportion of loans are likely to become

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[12] Currently, the central bank transfers to government an amount based on its projected profits, with an *ex post* correction. This system has led to controversy.

[13] The share of exports and imports of goods and services accounted for 108 percent of GDP at end-2002.

[14] These averages reportedly mask large variations between the rates available to prime borrowers and those that must be paid by others.

[15] Private banks have to offer relatively high interest rates on deposits to compete with one major bank in obtaining liquidity. These costs are passed on to borrowers.

nonperforming, even if conditions remain unchanged. Second, developments that necessitate an increase in interest rates, such as a resurgence of inflation, could rapidly put additional pressure on credit quality.[16]

- **Because exchange rate stability and high hryvnia interest rates have induced a large increase in dollar-denominated lending even to non-exporting firms and to households, an exchange rate reversal could have a major adverse effect on loan quality.** There has been some decline in the share of loans denominated in dollars, but not as much as the decline in the share of deposits in dollars; at the end of 2002, 34 percent of deposits and 43 percent of bank loans to the enterprise sector were denominated in foreign currencies. However, the absolute amount of dollar-denominated loans has continued to grow by close to 40 percent per year, and the ratio of such loans to GDP has been rising correspondingly. Hence, a substantial depreciation could increase loan servicing costs dramatically, and many enterprises would be unable to meet their obligations to banks.

IV. Vulnerabilities and Soundness of the Financial System

A. Commercial Banks

34. **Weaknesses in banks' balance sheets and profitability, and in institutional arrangements inside and outside the banking sector, suggest that resilience of the banking system to macroeconomic and other risks is low.** Loan quality problems, especially at the largest banks and those expanding lending very rapidly, point to significant structural problems that could potentially develop into widespread financial sector distress.

Indicators of banks' financial soundness

35. **Data indicate that all but two banks currently fulfill the 8 percent risk-weighted capital adequacy requirement (Tables 4 and 5).** Nevertheless, for some of the largest banks, the capital adequacy ratios are only just above the minimum requirement. Nearly all medium and smaller banks appear to be well capitalized, with a CAR above 20 percent, compared to an average below 15 percent for the largest 22 banks, but some of this difference may represent less accurate reporting by the smaller banks. However, the 8 percent minimum level is low given the uncertainties faced by individual banks and the banking system; a minimum capital adequacy ratio of at least 10 percent and perhaps 12 percent (which is common in transition countries) seems warranted.[17]

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[16] Inflation has already edged up in early 2003.

[17] The authorities have recently indicated their intention to increase the CAR to 10 percent.

Table 4. Ukraine: Banking Sector Trends, 1999-2002
(In percent, unless otherwise indicated)

	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002 Preliminary
Number of banks	162	153	152	157
Total assets (in millions of UAH)	25,603	36,827	47,204	67,774
Capital (in millions of UAH)	5,891	6,502	7,909	9,983
Loans				
Total (in millions of UAH)	11,891	19,188	27,923	40,656
Percentage change from previous year	...	61.4	45.5	45.6
Percent of total assets	46.4	52.1	59.2	60.0
In foreign currency (in millions of UAH)	6,068	8,899	12,357	16,979
Percentage change from previous year	...	46.7	38.9	37.4
Percent of total assets	23.7	24.2	26.2	25.1
Deposits				
Total (in millions of UAH)	12,468	18,943	26,052	38,865
Percentage change from previous year	...	51.9	37.5	49.2
Percent of total assets	48.7	51.4	55.2	60.8
In foreign currency (in millions of UAH)	5,326	7,152	8,220	13,366
Percentage change from previous year	...	34.3	14.9	52.7
Percent of total assets	20.8	19.4	17.4	20.9
Interest rate spreads (in percentage points)				
Between loans and deposits in domestic currency	32.7	26.8	20.7	17.0
Between loans and deposits in foreign currency	12.0	11.2	7.5	5.9
Between loans in domestic and foreign currency	32.5	23.3	18.8	12.9
Between deposits in domestic and foreign currency	11.7	7.7	5.6	1.8
Performance indicators				
Regulatory capital to risk-weighted assets	19.6	15.5	18.3	18.6
Return on assets (after tax; end-of-period)	2.0	-0.1	1.2	1.2
Return on equity (after tax; end-of-period)	8.7	-0.5	7.5	8.0
Net interest margin to total assets 1/	6.5	5.7	6.2	5.6
NPLs to total loans 2/	35.8	29.6	25.1	21.9
NPLs (including category "watch") to total loans	53.8	58.4	61.0	62.4
NPLs net of provisions to capital 2/	58.6	74.2	65.8	...
Number of banks not complying with banking regulations				
Not meeting capital adequacy requirements for Tier I capital	7	7	5	1
Not meeting large exposure limits	6	7	4	1
Not meeting limits on foreign currency open positions	23	20	11	2

Source: NBU, and staff estimates.

1/ For 2000, the data excludes intrabank activity.
2/ NPL = non-performing loans (comprising loans classified as substandard, doubtful, and loss)

Table 5. Ukraine: Financial Stability and Performance Indicators of the Banking Sector, December 2002

(In percent, unless otherwise indicated)

	All banks	Largest 10 banks	Upper mid-sized banks 1/	Lower mid-sized banks 2/	Others
Capital Adequacy					
Regulatory Tier I capital to risk-weighted assets	14.0	8.9	12.5	17.3	28.4
Regulatory capital to risk-weighted assets	18.6	12.5	16.0	22.4	35.8
Asset Quality					
Doubtful and loss to total loans	7.2	9.9	2.8	4.5	5.5
Sub-standard, doubtful, and loss to total loans	21.9	23.0	13.4	24.6	24.1
Watch, sub-standard, doubtful, and loss to total loans	62.4	64.8	53.0	63.8	62.3
Actual provisions to required provisions 3/	98.8	98.0	100.0	100.0	100.8
NPLs net of provisions to capital 4/	-1.1	4.7	-6.4	-6.6	-1.8
Earnings and Profitability					
Return on assets (after tax; end-of-period)	1.2	0.9	0.9	1.8	0.9
Return on assets (before tax; end-of-period)	1.5	1.2	1.3	2.6	1.4
Return on equity (after tax; end-of-period)	8.0	12.8	9.1	11.5	3.0
Net interest margin to total assets	5.1	5.1	3.1	6.1	5.8
Noninterest income to total assets	5.6	6.3	4.5	4.8	4.9
Operating cost to total assets	8.1	9.1	5.3	7.7	8.0
Provisioning to total assets	1.4	1.4	1.4	1.4	1.8
Liquidity					
Highly liquid assets to total assets	13.3	12.1	12.5	16.9	14.4
Highly liquid assets to short-term liabilities	37.0	27.9	39.3	48.9	57.7
Open foreign exchange position to regulatory capital 5/	21.4	30.5	22.4	19.6	12.9
Number of banks	157	10	12	34	101

Sources: NBU, and staff estimates.

1/ Banks other than the largest ten with assets over UAH 500 million.

2/ Banks with assets over UAH 200 million and under UAH 500 million.

3/ For all loans.

4/ Only for loans classified as doubtful and loss.

5/ Absolute sum of short and long positions. Limit is 35 percent of regulatory capital.

36. **The credit portfolio is generally poor for many of the largest banks in the banking system and could deteriorate further.** The average non-performing loans (NPL) ratio has come down, but is still high at 22 percent of total loans at end-2002;[18] the fall in this ratio is attributable not only to macroeconomic recovery, but also to the high and rising rate of growth in total credit, since an ever-larger share of loans are too new to meet the criteria to be deemed nonperforming.[19] The NPL ratio could rise sharply if the quality of the many loans under "watch" were to deteriorate. The top seven banks have NPL ratios higher than the system's average, although the difference diminished in 2002.

37. **Provisioning has improved, but required provisioning rates may be unrealistically low, especially given recent rapid credit growth, and the difficulty of recovering assets in Ukraine.[20]** Provisioning has increased over the past three years, and has reported reached over 90 percent of required provisions at end-2002 (the ratio was 84 percent at end-2001), despite the forbearance provided to one major bank.[21] High provisioning in many small banks offset some provision shortfalls in larger banks. However, loan workout and bankruptcy procedures are poorly developed (see below). The numerous difficulties in seizing collateral considerably reduce its true value. Historically, it seems that a large proportion of "standard" and "watch" loans have eventually become nonperforming. Hence, the required provisioning rate for each loan class (based on empirically-based expected recovery rates) may be too low.[22] Therefore, the true provisioning deficiency may be larger.

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[18] Loans are classified as nonperforming on the basis of whether they are overdue, and other criteria. A loans over 90 days past due is always classified as "sub-standard;" one over 180 days past due is always "doubtful;" and one considered unrecoverable is "loss." A loan is categorized as "watch" if there are some significant grounds to question the creditworthiness of the borrower. The authorities use a tighter definition of nonperforming loans that includes only doubtful and loss loans.

[19] The NPL ratio fell from 25 percent at end-2001 to 22 percent at end-2002, while credit grew by about 50 percent. Hence, under certain assumptions, roughly 16 percent of loans granted in 2002 became nonperforming the same year.

[20] Provisioning rates are 2 percent, 5 percent, 20 percent, 50 percent, and 100 percent for standard, watch, sub-standard, doubtful, and loss loans, respectively.

[21] Required provisions are calculated by applying mandatory provisioning rates to reported loans by category.

[22] The ultimate solution to this issue involves the improvement of creditor rights and collateral regulations, and also the tightening of internal lending controls and the consistent application of prudential regulations.

38. **In these circumstances, required provisioning rates should be reexamined based on available statistical evidence, and minimum provisioning rates raised to reflect true expected recovery rates.** Moreover, the NBU should encourage banks to provision on a forward looking basis: a bank should make provisions above the minimum required levels when it has good reason to suppose that the risk of non-repayment has risen.

39. **The banking system reportedly returned to profitability in 2001 after experiencing losses in 2000, but profitability remains low overall.**[23] Returns on assets and equity in 2002 are reported as 1.2 and 8 percent, respectively, with medium-sized banks being the most profitable. Low earnings suggest that many banks do not have adequate earnings to cover for a decline in the value of their loan portfolio, or even to main current capitalization levels in the face of rapid credit growth without a capital injection.

40. **Banks' costs are high, which leads to high spreads between lending and deposit rates.** While non-earning assets have fallen from 25 percent of total assets in 1999 to 16 percent in 2001, they are still substantial. Administrative and other non-interest expenses are also very high, particularly in large banks. Banks have been slow to cut costs and raise efficiency in preparation for a more competitive environment and the declining net interest margins characteristic of a lower inflation environment. Together with the high costs for loan loss provisions, this explains the large average net interest spreads of 17 percent and 6 percent for domestic currency and foreign currency loans, respectively. Banks differ considerably in their cost and revenue efficiency. Performance of certain "best practice" banks suggest there is considerable scope for banks to improve lending methods and increase efficiency, thus permitting a substantial fall in interest rate spreads.

41. **The liquidity of banks has fallen continuously over the past three years, although it is still relatively high.** Highly liquid assets account for 13 percent of total assets and 37 percent of short-term liabilities at end-2002;[24] at end-1999 the ratios were 25 percent and 61 percent, respectively. Liquidity is tighter for the seven largest banks, with the two liquidity ratios being 12 and 28 percent.

42. **The condition of one major bank represents the largest single challenge to the system, although it has recently begun to address some of the difficulties it faces.** This bank, which holds 14.4 percent of total household deposits, saw its credit portfolio more than triple in the two years to end-2001 and rise at similar rates through mid-2002.[25] Such rapid development of an active and growing corporate credit portfolio puts strain on decision-

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[23] The profitability of the enterprise sector appears to be even lower.

[24] Cash, NBU funds, correspondent accounts balances, and amounts in settlement by payment cards.

[25] The high credit growth rate is partly explained by the July 2000 removal of the moratorium on extending new corporate loans.

making processes and credit risk management practices at this major bank, which until recently was a relatively narrow savings bank investing almost exclusively in government securities. This rapid growth has sharply worsened the bank's financial situation. Adjusting for necessary provisioning, the bank has a substantial shortfall of capital relative to the NBU's 8 percent capital adequacy rule. Furthermore, the bank suffered large losses in 1998–2000, primarily due to its lending operations and the high costs of its extensive branch network and large number of staff. However, the bank appears to have broken even in 2001 and 2002 (i.e., made about zero profits), the government provided some additional capital, and from mid-2002 the stock of loans outstanding has stabilized. These apparent improvements need to be confirmed by on-going NBU on-site supervision and an external audit. Conducting a "due diligence" is crucial to ascertain the exact amount of capital deficiency.

43. **The weakened situation of this bank requires prompt action.** Failure to improve its performance in the near term risks a drastic restructuring in the future, which would be very costly to the budget. Recommended short-term measures include the maintenance of a strict credit policy to reduce loan portfolio exposure and risk, vigorous action to reduce operating costs, and a reduction in the cost of funding by reducing the share of expensive term deposits in total liabilities. Following the completion of the "due diligence" evaluation of the portfolio, the authorities will need to determine what conditions should be in place before considering further capital injections into the bank. The estimated capital shortfall is significant, yet equivalent to less than 0.2 percent of GDP, which seems manageable.[26] Once the authorities have begun implementing a sound business plan for the major bank, and this bank is clearly on the path to financial soundness, the blanket guarantee on its household deposit liabilities should be removed in order to level the playing field with other banks; insurance for deposits at the major bank should be provided by the FGDNP on the same terms as for other banks.

44. **Another major bank that is of concern appears less prone to risk, and is of less systemic importance.** This bank's credit growth (38 percent in 2001, for example) has been below the banking sector's average, and its capital was reported to be far less impaired. The bank has been able to generate small profits during the past three years, and operates under the tightest interest rate spreads of the system (largely because its operations are mostly dollar-denominated). It has also managed to keep its overhead expenses down, for example, because of its small branch network. Nonetheless, profitability is still very low, and the bank may be vulnerable to credit risk due to the exposure of its borrowers to exchange rate movements or trade barriers abroad.

[26] This estimate may be subject to large revision once the due diligence review of the portfolio is completed.

Stress testing results

45. **Stress tests confirm that the potential vulnerabilities for the Ukrainian banking system lie predominantly in credit risk (Table 6)**.[27] Based on the observations of rapid credit growth, the large share of loans classified as "watch" (37 percent at end-2001 and over 40 percent at end-2002), and the high share of foreign currency lending, a substantial but not implausibly large deterioration in loan quality would put significant pressure on many banks, especially the largest banks. Four to six private banks among the largest 20 are especially vulnerable.

46. **The risk for banks from a change in the foreign exchange rate is mostly through credit risk rather than through direct exposure.** The open foreign currency positions of banks are subject to NBU regulations,[28] but at end-2001 11 banks were not complying with the requirements. Stress tests suggest that even a large depreciation with all banks at the maximum short position would have reduced bank capitalization by only a few percent. Most banks seem to have long positions though, and would benefit from a hryvnia depreciation. However, they are exposed should the hryvnia appreciate. It is more important that a significant proportion of borrowers do not have foreign currency earnings, that is, the exchange risk is carried by unhedged borrowers.

47. **Increases in short-term domestic and foreign interest rates also present some risk for most of the largest 10 banks.**[29] Except for two banks, the cumulative maturity gap is negative up to a maturity of 183 days (and in many cases even up to one year) in domestic as well as in foreign currency. Maturities of interest-sensitive assets and liabilities are very short, with the bulk falling into the category 1-7 days (81 percent of liabilities and 56 percent of assets), in which the gap is by far the largest. A rise in interest rates across all maturities and currencies would be manageable by most banks, but would cause difficulties in the short run for two banks.

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[27] Stress testing was undertaken using end-2001 data. Preliminary calculations using available end-2002 suggest that the qualitative results are still valid.

[28] The sum of long and short open positions is not allowed to exceed 35 percent of regulatory Tier II capital; the long open position cannot be more than 30 percent, and the short position cannot exceed 5 percent of capital.

[29] The mission received information only for the largest 10 banks.

Table 6. Ukraine: Summary of Stress Test Results

(percent, except where otherwise indicated; based on December, 2001 data)

	All banks	7 largest banks 1/	10 largest banks	Banks 8–20
Actual values				
Capital adequacy ratio (CAR)	18.3	10.0	10.8	15.1
Number of banks below 10 percent CAR	6	4	4	1
Credit risk scenario: full mandatory provisioning, plus all doubtful loans move to loss, 20% of substandard to doubtful, 10% of watch to substandard, 10% of standard to watch, and standard increases by 10%				
CAR adjusting for substandard, doubtful, and loss	14.6	4.8	...	13.2
Number of banks below 10 percent CAR	11	4	...	4
CAR adjusting for watch, substandard, doubtful, and loss	13.3	3.4	...	11.8
Number of banks below 10 percent CAR	13	4	...	4
Interest rate scenario: all domestic interest rates rise by 10.5 percentage points across all maturities for one month				
CAR	...	...	8.8	...
Number of banks below 10 percent CAR	...	...	6	...
Interest margin scenario: 40 percent reduction in net interest margin 2/				
CAR	15.1	6.6	...	13.3
Number of banks below 8 percent CAR	8	4	...	2
Scenario: 30 percent reduction in value of fixed assets				
Actual fixed assets to total assets	7.6	9.3	...	4.8
Capital adequacy ratio (CAR)	16.1	6.9	...	13.8
Number of banks below 10 percent CAR	9	4	...	4

Sources: NBU and staff estimates.

1/ As of December 2001.
2/ Net interest margin for the banking system as a whole falls from 6.2 percent to 3.7 percent.

48. **A reduction in interest rate margins is a risk predominantly for the largest seven banks, most of which have high administrative expenses.** In a scenario in which banks' net interest margins tighten while all other factors remain constant, the average capital adequacy ratio would fall significantly. The banking system's robustness against other shocks would be correspondingly weakened.

49. **A few banks have large exposure to the real estate sector: a fall in real estate prices would have a significant effect on the capitalization of at least two of the major banks.** Other sectoral risks seem to be of less systemic importance, though individual banks may be severely affected.

Institutional and structural factors in banking sector vulnerability

50. **Institutional and structural shortcomings contribute to the weakened condition of many banks, and increase the vulnerability of the system to shocks.** While the system appears to be improving, there are still many perceived weaknesses regarding: (i) the quality of information supplied by borrowers; (ii) banks' bases for decision-making; (iii) credit risk evaluation capacity, particularly as lending volume increases; (iv) general risk management practices, and capacity for future growth and contingency planning; and (v) capacity of management and boards to utilize the information available for strategic planning purposes.

51. **Most importantly, risk management capacity is still developing in most banks.** The rapid growth in the sector may be outpacing the weak management capacity, internal controls, management information systems, and credit assessment capabilities of Ukrainian banks. Credit expansion has been even faster than the expansion in deposits,[30] and the ratio of lending to deposits has been rising, from 95 percent at the end of 1999 to 120 percent at the end of 2002. The increase has been particularly large in one major bank. All banks except for the smallest have participated in the surge of activity over the past few years. Ten of the 20 largest banks have experienced credit growth exceeding 70 percent annually since 1999. While some of the increase in credit reflects pent-up demand and the low base of lending throughout most of the 1990s, the rapid relative increase raises questions about the ability of the banks to manage this expansion. Such management capacity varies from bank to bank, but it remains an point of vulnerability. This management capacity risk appears to be of particular concern at one major bank. The NBU therefore has to ensure that banks' loan evaluation procedures are forward looking and take into account all risks. In particular, banks need to be encouraged (for example, in the course of on-site supervision) to consider a borrower's capacity to repay if credit conditions tighten and growth slows.

52. **The continued high proportion of loans that are denominated in foreign currency is another sign of poor risk management.** The market's view of the authorities' commitment to nominal stability or appreciation of the exchange rate against the U.S. dollar has encouraged substantial amounts of foreign currency-denominated lending to enterprises and households with limited or no foreign exchange earnings. The apparently widespread disregard (by both banks and borrowers) of borrowers' exposure to foreign exchange risk, and the still-high level of dollarization of deposits could potentially harm individual banks, the banking system, and economy if circumstances worsen. A priority for prudential supervision should be to ensure that banks take borrowers' exchange rate exposure fully into account in making lending decisions.

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[30] For instance, in 2002 net loans increased UAH 18.8 billion, while deposits increased UAH 12.7 billion.

53. **More general shortcomings in the economic environment contribute to banking system weaknesses.** While these systemic problems are found in many transition economies, they seem to be especially acute in Ukraine. Main problems include:

- **The quality of governance is still questionable for many banks and enterprises.** In most market systems, qualified boards are expected to provide effective oversight of management performance. But in several banks in Ukraine, ownership and management are in the hands of the same limited number of people, and standard governance checks and balances are absent. Increasing the powers of supervisory boards and requirements on the qualifications of board members would be desirable (see below on corporate governance).

- **The close ownership ties between banks and certain enterprises may give rise to insider lending.** Although reliable data is not available, it appears that many banks lend disproportionately to companies owned by their major shareholders. The ownership connection between banks and enterprises has strengthened as banks have tended to acquire shares through the privatization process.

- **Risks related to the links between banks and nonbanks are not well informed by available data and supervisory arrangements.** At a minimum, this presents a credit risk issue for the banks to the extent that they are lending to and providing guarantees for unregulated activities via NBFIs.

- **Accounting arrangements make the true creditworthiness of borrowers difficult to discern.** Both loan evaluation and early recognition of loan impairment are impeded. Even audited financial statements are unreliable due to the absence or incompleteness of notes.[31]

- **Institutional arrangements to seize collateral and enforce contracts are weak (see below)**. The court system is reportedly very slow and erratic in its decisions. Titling and registering of movable and real property are still being developed. The State Execution Service that has had a monopoly on collecting collateral is widely seen as inefficient and expensive.

B. Nonbank Financial Institutions

54. **The NBFI sector is still too small to present a systemic risk, but may itself be vulnerable to a number of factors.** Both collectively and individually the NBFIs are small,

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[31] The majority of potential clients lack audited financial statements consistent with IAS. This has meant that credit assessments traditionally had to rely excessively on close and long-standing relationships with borrowers. This approach becomes less reliable as credit volumes and the numbers of clients increase.

even relative to the Ukrainian banking system. Perhaps the main threat stemming from NBFIs that could affect the system as a whole relates to reputation risk, that is, the possibility that a prominent failure could affect the public's confidence in financial institutions generally, especially if fraud is involved.

55. **Even the insurance sector, the largest segment of the NBFIs, does not represent a systemic source of vulnerability for the financial system, its sound development is important to stability of the financial system in the long term.** Companies have grown very quickly in the last five years, and there are concerns about their ability to manage the expanded underwriting risk. Asset risk is limited, as investment regulations considerably limit investment in shares. Interest rate risk could be a problem due to the limited supply of assets with adequate long-term maturities. Concerns arise about the concentration of reserves in bank deposits, which currently represent 60 percent of reserves. Credit risk is high. Companies are encouraged to reinsure locally, and no mechanism is in place to ensure quality in the use of reinsurance companies. Overall, reputation risk is very high in the market.[32] These risk factors together seriously limit prospects for growth in the market, as well as the likelihood of attracting foreign capital in the form of qualified players in the insurance sector.

V. Creditors' Rights, Insolvency, and Corporate Governance

56. **Many of the difficulties faced by the Ukrainian financial system are a reflection of institutional shortcomings in financial relationships that are pervasive in all sectors of the economy.** Hindrances to the speedy and economical enforcement of contracts and property rights affect commercial banks, NBFIs, enterprises, and households. The sometimes obscure and collusive ownership relationships and the weaknesses in governance that are found in some banks are considered to be prevalent in the enterprise sector.

57. **The overall framework for creditors' rights and insolvency in Ukraine has improved in recent years, but is still weak.** There is a reasonably robust Law on Pledge. The new Bankruptcy Law that came into effect in 2000 offers major improvements in this area. The new law places stronger emphasis on creditors' rights and enterprise rehabilitation, and recognition of their improved rights has resulted in a wider use of the process by creditors to collect debts.[33] However, its applicability to certain types of enterprises, particularly state-owned enterprises, is limited, and time delays can be excessive. Furthermore, there is no modern mortgage law, and land and building titling problems persist. With respect to movable assets, a new law on secured transactions is under consideration and

[32] This is worsened by the presence of a large number of captive and tax avoidance companies, and by a general lack of transparency and information disclosure.

[33] The new law mandates an examination of the prospects for reorganization before liquidation proceeding can commence. Most restructurings now involve some degree of debt reduction, debt rescheduling and, in a few cases, conversion of debt to equity.

should benefit from the state-of-the-art pledge registry created in 1999.[34] Furthermore, the court system is widely viewed as slow, unpredictable, and insufficiently familiar with the new commercial law. Thus, while most loans tend to be collateralized, lenders do not regard these devices as reducing non-performance risk. This limits the flow of bank credit in the economy.

58. **The State Execution Service poses a particular obstacle to achieving effective and efficient enforcement procedures.** This Service used to have sole responsibility for executing on a debtor's assets with respect to both unsecured and secured debt, or where a judgment has been obtained. While this monopoly has recently been lifted, the Service remains in a dominant position in this field. There is a widespread perception that the Service is understaffed, inefficient, and inclined to abuse its position, with reports of inappropriate seizure of valuable assets, collusion with debtors, and long delays in execution. The Service' fees seem to be high and generate inappropriate incentives, because they are based on the book value of the assets resolved, not on the value achieved.

59. **The basic legal and institutional framework of corporate governance in Ukraine requires significant improvement.** The Law on Companies provides the basic framework for joint stock company governance, and has its origin in the civil law system. However, the law permits an extraordinary delegation of power to management, for example, to refuse the right to vote, to adjust quorum requirements, or to authorize share issues without shareholder approval. An important area in need of improvement concerns the roles and responsibilities of the supervisory and management boards (including their fiduciary liability), and the duties, obligations, liabilities and conflict of interest requirements of directors, which are poorly defined.[35]

60. **The new Law on Joint Stock Companies should be adopted as soon as possible.** The revised law could include provisions to discourage the proliferation of joint stock companies and favor simpler corporate structures, for example, by setting differentiated minimum capital requirements. Shareholders should have access to shareholder lists, and it should be obligatory to disclose large shareholdings. Company documents should be freely available in enterprise registers. As a complement to the creation of the basic legislative framework, work on the development and implementation of a Ukrainian Code of Corporate Governance should be accelerated.

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[34] In the current system, registration is voluntary and does not encompass all security interests. This limits its utility in giving notice of prior claims or rights. Moreover, tax claims always have priority over other secured claims, even if unrecorded, rendering collateral unreliable.

[35] In addition, in a number of related respects, the Securities Law could use improvements so as to define and regulate insider trading or tenders, and to create "tag-along" rights or other similar protections for minority shareholders.

VI. Anti-Money Laundering and Combating the Financing of Terrorism

61. **The Ukrainian authorities took several important steps in late 2002 and early 2003 to improve the anti money laundering legislative and regulatory framework.** Until recently, Ukraine's ability to undertake anti-money laundering and combating the financing of terrorism (AML/CFT) was severely constrained by its lack of a comprehensive anti–money laundering statutory framework and an operational financial intelligence unit (FIU) with proper staffing and resources.[36] As summarized below, many of these constraints have been alleviated. The main challenge now lies in ensuring effective implementation of the new legislation.

62. **On November 28, 2002, a new, comprehensive anti–money laundering law (the "AML Law") was passed by parliament.**[37] The new law becomes effective six months following its publication, i.e., on June 10, 2003. The AML Law established a comprehensive framework for combating money laundering and the financing of terrorism in Ukraine, broadly in line with the existing international standards and FATF (40+8) recommendations.[38] The new AML Law defines the offence of money laundering and predicate offences,[39] specifies a wide range of institutions subject to the AML regime, describes the procedure for monitoring suspicious transactions by covered institutions, mandates customer identification and record keeping standards, and establishes liability for violating the Law.

[36] The need for improvement was highlighted by an unfavorable report issued in 2001 by the Financial Action Task Force (FATF), which placed Ukraine on its list of noncooperating countries and territories.

[37] The Law was further amended in December 2002 and February 2003 to lower the threshold for reporting of suspicious transactions, clarify indemnity provisions for employees of financial institutions, and provide political independence of the Financial Monitoring Department.

[38] The recent changes in Ukraine's AML/CFT regime received a positive response from FATF which, at its February 2003 plenary session, decided to withdraw the application of additional counter-measures.

[39] Predicate offences include acts punishable under Ukrainian criminal law by imprisonment of three years or more, or acts that constitute a criminal offence under the criminal law of a foreign state and that of Ukraine, with the exception of crimes set out in Articles 207 and 212 of the Penal Code (i.e., failure to make tax and some other payments, and failure to repatriate hard currency proceeds in accordance with the legislation).

63. **The Law confirmed the status of the Financial Monitoring Department (FMD)[40] within the Ministry of Finance as the lead government agency responsible for coordinating AML efforts in Ukraine.** The FMD is expected to be fully staffed[41] and to become operational by June 2003. The FMD is given broad powers to implement the law, including the power to pass regulations in this area. The Law also includes provisions on international cooperation in information sharing and enforcement. The new AML Law addresses the issues of terrorism financing by including terrorism and terrorist financing among predicate crimes for money laundering, and by bringing combating the financing of terrorism into the AML framework. The Law requires mandatory reporting of all transactions suspected of being targeted at, or related to the financing of terrorism to the FMD and to law enforcement authorities.

64. **Supporting legislation has also been passed.** In September 2002, Ukraine ratified the International Convention on Suppressing the Financing of Terrorism. The Penal Code, the Law on Banks and Banking, and the Law on Financial Services and State Regulation of the Market for Financial Services were amended to be consistent with the AML Law. Amendments to the Law on Combating Terrorism, consistent with the FATF 8 recommendations, and amendments to the Penal Code that would strengthen penalties for terrorism financing are currently under consideration by parliament.

65. **Now that the new legal framework for AML/CFT is largely in place, the main task is to ensure its implementation.** The government agencies involved in combating money laundering and the financing of terrorism must be adequately staffed and funded. Implementing regulations must be passed without undue delay. Education programs should be developed for government officials, and for the private sector and the general public. Coordination among government agencies should be improved, and a dialogue established between the government and the private sector. Most critical, the Government must ensure that the bank, securities, and insurance regulators build the capacity and expertise needed to enforce the rules aimed at combating money laundering and the financing of terrorism. Once fully operational, the FMD should join the Egmont Group of FIUs, as the authorities intend. In due course, consideration could be given to making the FMD an independent agency, outside of the Ministry of Finance, in order to enhance its reputation for objectivity and independence.

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[40] The Department of Financial Monitoring was initially established by a presidential decree in February 2002, to avoid parliamentary delays with the passage of a comprehensive anti money laundering law.

[41] The FMD has a budget for sixty staff, including the chairman and his four deputies.

VII. SUMMARY OF RECOMMENDATIONS

66. The main recommendations for promoting the stability and sound development of the Ukrainian financial system can be divided between those of immediate importance which are readily implementable, and those requiring more preparation.

Short term, rapidly implementable:

- Increase the minimum risk-weighted capital adequacy ratio for banks to at least 10 percent (as intended) and preferably eventually to 12 percent.
- Require banks through prudential supervision to limit foreign currency-denominated credits to borrowers without a reliable source of foreign currency earnings.
- Further strengthen supervisory controls on insider and connected lending; implement consolidated supervision.
- Maintain requirement that banks take prompt corrective action to rectify any prudential deficiency, and strictly avoid forbearance.
- Pursue vigorously the rehabilitation and restructuring of a major bank.
- Clarify to the public the prioritization of the central banks domestic and external monetary policy targets.
- Phase out the NBU’s longer-term refinancing facility, or, at a minimum, strictly limit refinancing provided under the facility, and require that only high-quality collateral of matching maturity be provided.
- Make operational the new regulatory agency for nonbank financial institutions.
- Increase the size and concentration of the issues of domestic government debt.
- Make operational the Financial Monetary Department (the financial intelligence unit).

Medium term, possibly requiring amendments to laws and regulations, or other extensive preparations:

- Review and revise provisioning rates based on empirical evidence of loss rates.
- Tighten regulations on bank equity investment.
- Require banks to prepare accounts fully in compliance with IAS.

- Integrate the insurance of deposits at a major bank into the FGDNP system.
- Appropriately limit the conditions under which central bank management can be replaced; and determine central bank profit transfers to government on the basis of realized profits.
- Update and extend regulation for nonbank financial institutions, notably for leasing companies, pension funds and credit unions.
- Simplify auction procedures for government securities.
- Consolidate securities exchanges, registrars, and depositories; increase disclosure requirements.
- Modernize the mortgage law, land and building titling, and the law on secured transactions.
- Strengthen shareholder rights by increasing access to corporate information, moving towards international standards in corporate accounting and audit, facilitating shareholder control of management, and reinforcing supervisory boards (including of banks).
- Update and extend anti-money laundering regulations, for example, on recognizing unusual or suspicious transactions.

SECTION II: SUMMARY ASSESSMENT OF THE OBSERVANCE OF FINANCIAL SECTOR STANDARDS

This section of the Financial System Stability Report for Ukraine contains information on the observance of international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system. It also provides an assessment of the transparency practices regarding monetary and financial policies.

As part of the FSAP, the following detailed assessments of standards was undertaken: Basel Core Principles for Effective Banking Supervision (Gabriella Ferencz, World Bank, and Paul van Sluijs, Netherlands Bank); Committee on Payment and Settlement Systems Core Principles for Systemically Important Payment Systems (Krzysztof Senderowicz, National Bank of Poland); and the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (Mr. Stephen Swaray, IMF). An assessment of the legal, regulatory, and institutional system for AML/CFT was undertaken (Ms. Nadia Rendak, IMF, and Mr. Allan Schott, World Bank) using the methodology available at the time. However, as indicated in the first section of this report, that assessment has since been superceded, and is therefore not summarized here. The assessments were based on the authorities' self-assessments, answers to questionnaires and documentation provided, and discussions during the FSAP missions in April and May 2002, and the follow-up mission in February 2003.

Ukraine continues to make progress in strengthening the prudential regulation and supervision of the banking system, although some weaknesses remain, and further improvements will be needed as the financial system develops. The payments system is reliable and efficient. Transparency practices regarding monetary and financial policies are generally adequate, although some important shortcomings have been identified, for example, concerning the public awareness of the central bank's policy priorities, and in the determination of central bank profits.

VIII. Compliance with the Basel Core Principles for Effective Banking Supervision

A. General

67. **Ukraine's observance of the Basel Core Principles for Effective Banking Supervision was assessed in May 2002 as part of the FSAP, undertaken jointly by the World Bank and the International Monetary Fund.**[42] The focus was on the policies and practices of the institution responsible for banking supervision—the National Bank of Ukraine (NBU).

68. **The assessment was based on: (i) an examination of key documents, laws and regulations, notably the NBU Law and the Law on Banks and Banking, in force at the time the assessment was made; (ii) a review of policies, procedures and their actual implementation; and (iii) discussions with the supervisory authorities and other participants in the financial sectors.** These materials were reviewed according to the Core Principles Methodology.

69. **The authorities were fully cooperative, and provided ample information and documentation.** Their reaction to the assessment is summarized below, where also information is provided on the important initiatives the authorities have undertaken since the time of the assessment was made and in part in reaction to the assessment.

B. Institutional and Macroprudential Setting, Market Structure

70. **The legal framework for banking supervision in Ukraine is based primarily on the NBU Law and the Law on Banks and Banking.** These laws grant the NBU extensive powers to license, regulate, supervise, and intervene in all commercial banks. The NBU's responsibilities in this area are mostly carried out by its Banking Supervision Department, which has several hundred staff in Kyiv and around the country, and which has an active program to train those staff.

71. **The banking sector is fragmented and relatively small, but it has been growing rapidly (see Section I of this report).** [43] The average capitalization ratio is above ten percent, and banks are generally liquid, but more than one fifth of loans are nonperforming (as of end-2002). Banks returned to profitability in 2001, and preliminary results suggest that profitability was generally maintained in 2002.

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[42] The assessment was initially prepared in May 2002 by Ms. Gabrielle Ferencz of the World Bank and Mr. Paul van Sluijs of the Netherlands Bank.

[43] Nonbank financial institutions and organized financial markets in Ukraine are small.

C. General Preconditions for Effective Banking Supervision

72. **The Ukrainian authorities have made progress in establishing some of the general preconditions for effective banking supervision (see Section I of this report).** The substantial weaknesses that remain are most pronounced in the enterprise sector, and are thus beyond the direct influence of the supervisors.

73. **Ukraine's macroeconomic performance since 1999 has been relatively strong.** The remonetization of the economy has been rapid. However, real interest rates on loans, especially those denominated in hryvnia, are high, and dollarization remains pronounced. While there are some shortcomings in the financial sector "safety net" available in Ukraine, the combination of the formal deposit insurance scheme for most banks and the NBU's lender of last capacity seems broadly adequate.

74. **Ukraine has in place important parts of the legislative framework needed to support a strong credit culture, but important weaknesses remain in such areas as the availability and realizability of collateral.** The court system seems to be lacking in expertise in commercial matters, which results in long delays in settling cases and legal uncertainty. Perhaps the greatest impediment to market discipline in Ukraine today is the financial and ownership structure of many enterprises, which is not always transparent, and therefore can results in poor corporate governance. Accounting standards in the enterprise sector appear to be far from international best practices, so it is very difficult for the banks to monitor the health of the institutions to which they lend.

D. Main Findings

75. **The main findings summarized below represent the state of banking supervision in Ukraine at the time the assessment was made in May, 2002.** Developments since then are reported in the section on the authorities' reaction.

76. **The findings are conditioned on an assessment of what are currently major issues facing the Ukrainian banking system.** Most banks are still engaged primarily in traditional banking activities, and many are small and locally-based. Some activities and issues, such as trading on own-account in market instruments, derivatives trading, and foreign operations, are currently of relatively minor concern. As the system develops, the NBU will have to evolve regulations and techniques to supervise such new activities in larger and more complex institutions, and supervisory staff will have to acquire the necessary expertise.

Objectives, autonomy, powers, and resources (CP 1)

77. **The legal framework for banking supervision in Ukraine provides the NBU with a broad range of powers and responsibilities for the promulgation of prudential regulations for banks.** The legislation defines the general principles of banking activity, licensing banks, procedures for performing bank oversight and for bank reporting, carrying out enforcement actions for violations of banking legislation and regulations, ensuring

the stability of the banking system, protecting the interests of depositors, and dealing with banks in difficulties.

78. **Banking supervision is conducted by an operationally independent unit within the NBU, which also conducts all other central banking functions.** Available resources are adequate to fulfill current supervisory responsibilities.

79. **NBU staff have the legal protection of civil servants in carrying out their duties, although non-staff members engaged in connected activities, such as provisional administrators of failed banks, do not have the same level of protection.** There have been some reports of legal action being taken against supervisors in the past, and there may continue to be scope for legal harassment. The NBU has formal agreements in place with the securities regulators, tax administrators, and all enforcement agencies with regard to information exchange.

Licensing and structure (CPs 2–5)

80. **The Banking Law sets out permissible bank activities and licensing criteria, which include, *inter alia*, a minimum capital requirement (€5 million for fully licensed banks), standards for the qualifications and integrity of bank managers, and information on the financial strength of major shareholders (defined as those holding at least 10 percent of shares).** Changes in major shareholdings require NBU approval. However, the NBU has had limited powers to identify the ultimate beneficiaries of shareholdings, and the transparency of the shareholding structure has not been specified as grounds to reject an application for a bank license or change in major shareholding.

81. **A bank's participation in any one nonfinancial enterprise is limited in relation to the bank's capital, as is its total participation in nonfinancial enterprises.** There are no explicit requirements that such participation be restricted to industries related to the bank's core activities, or that participation maintains a transparent ownership structure. Participation in financial institutions, including other banks, is not so limited.

Prudential regulations and requirements (CPs 6–15)

82. **Prudential regulations include an 8 percent minimum risk-weighted capital adequacy ratio.** Other requirements cover the establishment of procedures to manage credit and other risks; provisions for making general and specific provisions; a limit on the exposure to any one client and higher capital requirements for when the sum of large exposures exceeds a threshold; limits on loans to related parties such as bank managers and major shareholders; and a requirement to establish an internal audit department.

83. **At the time of the assessment, no specific regulations were in place on the management of country risk, market risk, or interest rate risk, although the NBU does review interest rate risk management practices by larger banks.** Country and market risk are relatively minor for Ukrainian banks at this time. The Banking Law allows related parties

to obtain preferential interest rates and fees on banking services provided that the bank is profitable enough that doing so is not detrimental to the bank's financial condition. At a more general level, the very rapid growth in loans outstanding over the past three years must have placed strain on the commercial banks' ability to assess and manage credit risk.

84. **At the time of the FSAP mission in May 2002, banks were subject to requirements under the Banking Law to report suspicious transactions and to identify customers, but there was no comprehensive legal and institutional framework for AML/CFT.** This has largely changed with the passage of the AML Law in late-2002 (see below and elsewhere in this report).

Methods of ongoing supervision (CPs16–20)

85. **Compliance with prudential regulations is verified through off-site monitoring and during on-site inspections.** A CAMELS-type methodology for on-site inspections has been developed. Inspections usually involve the examination of a large proportion of credit files and, in some banks, extensive efforts to establish the accuracy of reported data. Contact between the NBU and bank managers is concentrated around the on-site inspections and, for some banks, focuses on a review of the findings of the on-site inspection. Banks must comply with detailed reporting requirements, and furnish additional information as requested by the NBU. Reporting on a consolidated basis is due to start in 2003. The NBU lacks authority to inspect, regulate or demand information directly from institutions associated with a licensed bank, such as nonbank financial subsidiaries.

Information requirement (CP 21)

86. **It is one of the duties of the bank management to submit required reports to the NBU on a timely basis.** The reports to the supervisor as well as the published annual accounts are largely on the basis of International Accounting Standards (IAS), with some deficiencies. However, there is no detailed standard for the layout of the annual accounts.

87. **A bank's the annual accounts have to be audited by an external auditor, who has received a certificate from the NBU, and published.** The NBU has set some limited guidelines covering the scope and conduct of audit programs.

Formal powers of supervisors (CP 22)

88. **The NBU has the legal authority to take corrective measures.** There is a broad range of measures defined in the Banking Law. In order to increase the effectiveness of the measures taken, a dedicated enforcement division within the supervision department was formed in April 2002.

Cross-border banking (CPs 23–25)

89. **Banks require the written permission of the NBU to establish operations abroad, and only in countries for which the NBU has entered into a Memorandum of Understanding with the host supervisor.** To date, only one Ukrainian bank has a subsidiary abroad.

90. **Foreign banks can establish subsidiaries, not branches in Ukraine.** Once established, the local subsidiaries of foreign banks are subject to the same supervisory standards as local banks. The Banking Law grants the NBU the authority to share information with the home country supervisors, who have the right to do on-site examinations of their banks' Ukrainian operations.

E. Recommended Actions

91. **The assessment has determined a number of areas where the authorities could take action in order to improve compliance with the Basel Core Principles.** A summary of the recommended actions is presented below.

Table 7. Main Recommended Actions to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
Objectives, Autonomy, Powers and Resources	The NBU Law could be amended to provide explicit protection of bank supervisors, liquidators and provisional administrators, whether or not they are civil servants.
Licensing and Structure	With regard to shareholders, the NBU should set stricter requirements on the financial strength of shareholders, the transparency of the shareholding structure, and disclosure of the ultimate beneficiary. The NBU should have the right to reject a shareholder not only on the basis of insufficient financial strength, but also on the basis of a non-transparent shareholding structure. The NBU needs to set limits on the types of investments banks can make so as to not allow banks to take undue risks in industries that they may not understand well or know how to manage. There should be no exemption for written permission or notification for investments in entities engaged in providing financial services, including in other banks.

Reference Principle	Recommended Action
Prudential Regulations and Requirements	The calculation of the solvency ratio on a consolidated basis should be implemented. Consideration should be given to increasing the minimum CAR from the current 8 percent, which seems low given the various macroeconomic and microeconomic uncertainties faced by banks in Ukraine. Provisioning rates need to be evaluated on the basis of empirical evidence to ensure that they correspond to actual default rates and losses in case of default experienced in Ukraine. The limit for aggregate large exposures can be considered relatively high, and therefore the NBU should consider not allowing any excess of this limit. The NBU should promulgate regulations and guidelines on country and transfer risk, and the monitoring and management of interest rate risk. The new AML Law will have to be implemented, for example, by issuing updated regulations on identifying unusual transactions.
Methods of On-going Supervision	The NBU needs to incorporate a more risk-based approach to its supervisory process. The NBU should streamline its reporting requirements. Regular meetings should be held with all banks, including the smaller banks. The NBU should proceed with its plans to introduce consolidated supervision in 2003.
Information Requirements	The quality of the work of the external auditor needs improvement. Standards for the layout of the published annual accounts, to be based on IAS, need to be developed.
Cross-Border Banking	The NBU should use the occasion of a request for information from foreign supervisory agency to request reciprocity in information exchange.

F. Authorities' Response to the Assessment

92. **Since the initial assessment in May 2002, the authorities have issued amendments to exiting laws and regulations and have issued new laws and regulations.** In particular, the legal basis for measures against money laundering and terrorist financing has been transformed.

93. **In December 2002, the Law on Prevention and Counteraction to Legalization (Laundering) of Proceeds from Crime was adopted by Parliament, and will come into force (after amendment) in June 2003.** This law introduces financial monitoring by banks and other financial and nonfinancial institutions, and oversight by the National Bank of Ukraine, the State Securities and Stock Exchange Commission and the new nonbank financial institutions regulator. The central organization and financial intelligence unit is the

Financial Monitoring Department, which falls under the Ministry of Finance. The law describes its tasks in detail.

94. **As a consequence of the introduction of this new law, certain other laws had to be changed.** In the Law on Banks and Banking, a number of articles were introduced or amended, among others relating to the identification of customers for the opening of accounts and the documenting of financial transactions. The Criminal Code of Ukraine was also changed.

95. **The new legislation contains the legal basis for the prevention of money laundering.** The next step will be to implement the system in Ukraine. As far as the NBU is concerned, in cooperation with the commercial banks, systems will have to be set up in the banks to comply with the legal obligations of the law, and staff in the banks will have to be trained. In the NBU, the supervision department will have to set up an inspection framework for adequately supervising the banks with regard to the practical aspects of the legislation against money laundering, and NBU staff will need to be trained.

96. **As a result of the initial assessment in May 2002 of the Basle Core Principles, the NBU amended and extended a number of existing regulations in order to remove to some extent the shortcomings identified:**

- in May 2002, an amendment to the existing Regulation of Activities of Banks in Ukraine was introduced in order to ensure that banks have information systems to identify loans to connected and related parties in order to monitor these loans;
- also in May 2002, a new edition to the existing Regulation on Rating Procedures was introduced, strengthening provisions for banking inspectors to assess banks for vulnerability to market risk;
- amendments were introduced to the procedures of compilation and submission to the NBU of consolidated financial statements;
- with regard to strengthening the rules for prior approval of capital investments by banks, draft changes were made to the Law on Banking and Banks. Under the amendments, the NBU would determine criteria of assessing investments and the availability of sufficient bank resources for the investment, and would have the right to refuse approval in order to avoid undesirable risks. Moreover, approval could be withheld on the grounds that the shareholder structure lacks transparency;
- with regard to the calculation of the capital adequacy ratio, a change to the existing regulation is currently under discussion in order to explicitly exclude the revaluation reserve of fixed assets from the capital base; and

- the authorities have indicated their intention to increase the minimum capital adequacy ratio to at least 10 percent.

IX. IMF Code of Good Practices on Transparency in Monetary and Financial Policies

A. General

97. **This assessment of Ukraine's observance of good transparency practices in monetary and financial policies, including payments system oversight, banking supervision and deposit insurance supervision, was undertaken in accordance with the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code).*** The assessment was carried out as part of the joint Bank-Fund Financial Sector Assessment Program (FSAP) mission that visited Kiev in May 2002.[44] Since the initial assessment in May, a number of financial policy and financial stability activities have taken place, including the issuance by the authorities of amendments to exiting laws and regulations, and the issuance of new laws and regulations. These recent developments have also been reflected in this assessment.

B. Institutional and Market Structure—Overview

98. **Under the Constitution of Ukraine, the Law of Ukraine on the National Bank of Ukraine (the NBU Law), and other supporting legislation, the National Bank of Ukraine (NBU) has responsibility for the formulation and conduct of monetary policy, and is also the financial agency responsible for the oversight of the payment systems and the supervision of banks.** The NBU's basic function, according to the Constitution, "… is to provide for the stability of the monetary unit of Ukraine." According to the NBU Law, within this framework, the NBU is to maintain the stability of the banking system and, within the limits of its authority, of prices. The NBU Law defines a number of subsidiary functions that are undertaken to achieve the primary objective of monetary stability. The NBU currently conducts monetary policy within a reserve money framework, subject to which it also seeks to build up international reserves to a more comfortable level, and maintain the stability of the exchange rate.

99. **The institutional framework of monetary policy is provided in the Constitution and in the NBU law.** According to both, the Council, which is composed entirely of either appointed or elected political figures, and includes Advisors to the President, Members of Parliament (including chairpersons of Parliamentary committees), a Vice Prime Minister and

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[44] The assessment of the monetary policy portion was prepared by Stephen M. Swaray of the IMF. The assessment of the financial policies portion was prepared by Daniel Hardy (IMF), Krzysytof Senderowicz (National Bank of Poland), Ms. Gabrielle Ferencz (World Bank), and Mr. Paul van Sluijs (Netherlands Bank).

the Minister of Finance of the NBU, is responsible for developing the "basic principles of money and credit policy." The responsibility of the Board of Directors is to ensure the implementation of the policy developed by the Council. The Board comprises the Governor, Deputy Governors, and the executive heads of the bank's various departments. The NBU Law gives operational responsibility for the conduct of monetary policy to the NBU, including the authority to use a range of specified monetary policy instruments, and to take other measures as necessary, to achieve its objective. The functioning of the various available instruments is specified in detail in NBU regulations and resolutions.

100. **The NBU plays the principal role in establishing principles and basic rules governing the functioning of the payment system (see below).** Consistent with the law, the NBU outlines the directions for development of state-of-the-art electronic banking technologies, and coordinates and exercises control over the creation of electronic payment instruments, settlement systems, automation of banking activities and the facilities for banking data securities.

101. **The Constitution of the Ukraine grants the NBU the authority to develop banking legislation and regulations.** Accordingly, the NBU issues regulations for banks, defines the general principles of banking activity, creates procedures for performing bank oversight, carries out enforcement actions for violations of banking legislation, ensures the stability of the banking system and protects the interests of depositors. There is a broad base of laws and supporting regulations that provides an adequate framework of minimum prudential standards that banks must meet. Problem bank resolution is the responsibility of the NBU. With regard to exchanging information on banks for purposes of enhancing banking supervision, the NBU coordinates with the Fund for the Guarantee of Deposits of Natural Persons (FGDNP).

102. **The FGDNP administers the deposit insurance system.** It has existed since 1998, and in September 2001 its mandate and functioning were revised and codified by the passage of the Law of Ukraine On the Fund for the Guaranteeing of Deposits of Natural Persons. The FGDNP insures only household deposits, up to UAH 1200 per depositor, in commercial banks with the exception of one bank. The FGDNP is a specialized state institution, with its own Board of Administration, Managing Board of Directors, and staff. The FGDNP has built up a reserve fund, out of which it meets its operating expenses and makes pay-outs on deposits as needed. The FGDNP law contains requirements to inform the public about the deposit insurance scheme and the functioning of the FGDNP, and to ensure the accountability of the FGDNP. One major bank is not covered by the FGDNP, but household deposits in this institution are explicitly guaranteed in the Law on Banks and Banking. No further regulations or other orders govern the insurance of household deposits at this bank, nor are there any related institutional arrangements besides prudential supervision by the NBU and the government's general oversight of the bank, which is undertaken by the Ministry of Finance. The bank does not pay insurance premiums, and there is no dedicated government reserve fund to cover any of the potential liability.

C. Transparency of Monetary Policy

Main findings: Summary

103. **With the passage of the revised NBU Law in 1999, the legal framework for monetary policy formulation and implementation in Ukraine has been substantially enhanced.** The objectives of monetary policy; the responsibilities, procedures for, and terms of appointment of the NBU's governing bodies; the NBU's relationship with the government; and broad modalities of accountability are defined by the law. The law is supplemented by the resolutions and regulations that define the procedures and practices governing monetary policy instruments and the framework within which monetary policy is to be implemented. Through its publication program, the NBU endeavors to bring its monetary policy objectives and decisions to the attention of market participants and to the public at large. Thus, the NBU's monetary policy framework is in many regards transparent, but, as reflected below, a number of critical areas remain in which further improvements would be highly desirable.

Principle 1: Clarity of Roles, Responsibilities, and Objectives of the NBU for Monetary Policy

104. **The ultimate objective of monetary policy, the instruments of monetary policy, and responsibilities for the implementation of monetary policy are defined in law.** The objective of monetary policy is to ensure the stability of the Ukrainian monetary unit. The law does not provide any clear indication, however, of what the priority of the NBU should be if there is a conflict between achieving price stability and exchange rate stability. The NBU has interpreted its main objective to be the maintenance of price stability; in order to achieve that objective, it has recently ensured that the exchange rate (and in particular the rate between the hryvnia and the US dollar) has remained stable. The law also suggests that the NBU has other objectives, such as social and economic development, which in the short term may conflict with the monetary stability objective.

105. **The responsibilities of the Council and the Board of Directors of the NBU in implementing monetary policy are also defined by law.** The Council is responsible for formulating the broad framework of monetary policy while it is the responsibility of the Board to implement the policy devised by the Council. Although, by law, the governance structure for monetary policy in Ukraine appears appropriate, in practice, it has raised some concerns among observers and commentators, because the NBU is perceived as not being autonomous of government in its implementation of monetary policy, notwithstanding the legal provision of operational independence.

106. **Clarity in the institutional relationships between monetary and fiscal policy is mixed.** There are clearly defined agency relationships between the NBU and the government. There are also clear provisions that the NBU should not provide direct credits, loans or advances to the government. However, the manner of allocation of the profits of the NBU is complicated, creating the impression that the NBU indirectly and in a non-transparent manner finances the government's budget.

Principle 2: Open Process for Formulating and Reporting on Monetary Policy Decisions

107. **There is some degree of ex-ante and ex-post disclosure of the monetary policy framework and instruments in the General Principles of Monetary Policy, the annual report and the quarterly bulletin published by the NBU.** Procedures and practices governing monetary policy instruments and their operations are defined in various resolutions and regulations, and changes in the settings of monetary policy instruments and the rationale underlying them are also disclosed to the public. In addition, market participants, particularly banks, are consulted on substantive technical changes to the NBU's operations. However, the General Principles are not reader-friendly to the public, nor does the published analysis of current economic developments and trends fully support the policy conclusions. The schedule of policy meetings of the NBU is not disclosed to the public in advance. These shortcomings are mitigated by the fact that the Governor regularly appears before Parliament and the Cabinet of Ministers to account for the Bank's monetary policy decisions.

Principle 3: Pubic Availability of Information on Monetary Policy

108. **On January 10, 2003, Ukraine subscribed to the IMF's Special Data Dissemination Standards (SDDS).** Its data publication has since then been consistent with both the General Data Dissemination Standards (GDDS) and the SDDS in terms of coverage, periodicity and content. The area in which the NBU faces its greatest challenge in making information on its policies and operations available to the public is in the timeliness of publication. The major publications of the Bank include the annual report, the monthly bulletin, the quarterly statistical bulletin, and the monthly magazine. These publications are published with some lag. The balance sheet of the NBU is published with a delay of approximately five months, and data for its analytical accounts and the analytical accounts of the banking sector are made available with a delay of about five weeks. The NBU does not disclose information on emergency support provided to individual banks either ex-ante or ex-post, although consolidated amounts of such support are disclosed.

Principle 4: ***Accountability and Assurances of Integrity by the NBU***

109. **The Bank furnishes information on the conduct of monetary policy to the President and the Parliament.** It also consults with, and submits information to, the Cabinet of Ministers on issues of monetary and credit policies. The Governor and other senior officials of the NBU also appear frequently before these bodies.

110. **The NBU publishes its audited annual financial statements according to a schedule contained in the Law on Accounting.** These statements are published on the NBU's website and in its Annual Report, albeit with an average delay of five months. The financial statements are audited by an independent auditor, in accordance with International Standards on Auditing (ISA). The accounting policies of the Bank are published as part of the financial statements.

111. **The Board of Directors, from time to time, issues internal governance procedures to the Internal Audit Department in the form of resolutions.** Resolution 29 of February 23, 2000, for example, sets out directives that the auditing department is to follow in 2000. These resolutions are publicly disclosed on the Bank's website.

112. **The NBU Law states that officials of the NBU are public servants and to that end the Law of Ukraine On the Public Service defines their terms of employment, rights, and duties.** There are provisions in both the NBU Law and the Law on the Public Service that prevent the exploitation of conflict of interest by officials of the Bank.

113. **The NBU law prohibits any interference of the state legislature and executive bodies or officials of these bodies into the exercise of the functions and powers of the NBU, its Council, or Board of Directors.** The Bank also has a legal right of access to information regarding any or all of its activities. Since NBU staff are covered by the Law on the Civil Service, they have some legal protection when acting in an official capacity. However, the NBU Law does not provide staff with an explicit statutory immunity or legal protection for bona fide actions or omissions undertaken in the conduct of their official functions

Recommended actions

114. **There is need to guarantee further the political autonomy of the NBU in its implementation of monetary policy since, in the view of many observers and commentators, the NBU is not politically independent of the government, notwithstanding the legal provision of operational independence.** The rationale for monetary policy decisions as well as the overall framework of monetary policy could also be made more analytical and more thoroughly explained. Such an improvement in the public's understanding of monetary policy objectives and decisions would enhance policy effectiveness.

Table 8. Ukraine: Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	The overriding objective of the NBU should be clarified in law and to the public. Responsibility for determination of the exchange regime should be explicitly assigned. The relationship between the government and the NBU should be reviewed with the objective of granting the NBU greater autonomy in the implementation of monetary policy. In particular, the dismissal of the Governor and members of the Council should require that objective criteria be met, and that a full public explanation be provided. The NBU Law should be amended to simplify the manner in which the Bank's profits are calculated and allocated. Profit transfers to government should be based only on realized, historical profits, calculated according to accepted accounting standards.
II. Open Process for Formulating and Reporting Monetary Policy Decisions	Although the NBU has a strong view to the contrary, it may wish to reconsider the possibility of disclosing in advance to the public the dates of upcoming policy meetings of the Council of the Bank. Considerations underlying monetary policy decisions should be more thoroughly and regularly explained, so as to increase understanding by the public of the rationale for policy decisions and, thereby, help enhance policy effectiveness.
IV. Accountability and Assurances of Integrity by the Central Bank	The NBU should work with the government to amend the NBU Law to provide stronger legal protection to staff of the Bank and others hired for such purposes in respect of their bona fide actions or omissions in the conduct of their official functions.

Authorities' response to the assessment

115. **The authorities were in broad agreement with the mission's assessment.** However, the following specific comments were made on some of the mission's findings and recommendations:

- First, the NBU observed that many of the key issues on which recommendations have been made, especially those relating to the granting of greater autonomy to the NBU in the conduct of monetary policy, are political in nature and therefore outside the direct control of the NBU.

- Second, the authorities do not agree that the lack of clear explanation of the NBU's priorities when a conflict arises between maintaining the internal and external value of the currency is an element of non-transparency of monetary policy. The NBU's view is that its constitutional mandate of promoting the "stability of the national currency" implies the need to ensure the stability of both the internal and external value of the currency, and, specifically, both domestic price stability and a stable exchange rate. In that context, the NBU must perceive as its function creating conditions such that contradictions between the two do not arise. Should a contradiction arise, the NBU's objective should be to eliminate the contradiction, rather than choose between the separate components of national currency stability.

- Third, the NBU would accept that the manner in which it calculates and allocates the profits that are transferred to government is complex. An amendment to the NBU Law would be needed to change these procedures. However, the NBU does not accept that the impression is given that the NBU provides indirect financing of government.

D. Transparency of Financial Policies

Main findings: Summary

116. **Overall, the NBU displays a high degree of transparency in its oversight of the payment systems and in the supervision of banks.** The main objectives and responsibilities of the NBU for the functioning of the payment system and for the supervision of banks are clearly defined in legislation and publicly disclosed in the Annual Report, the NBU journal, and the NBU website. The process of formulating and implementing payment system policy and banking supervision policy, regulations and directives is itself generally open and transparent.

117. **With regard to deposit insurance, the FGDNP operates in a generally transparent manner, and the overwhelming majority of principles are fully observed for this part of the deposit insurance system.** The FGDNP consciously attempts to achieve transparency in its activities. The government guarantee on household deposits at one major bank, on the other hand, while assured by law in general terms is lacking in specifics. The objectives are not spelled out, the modalities for making the guarantee effective are not defined, and responsibility for implementing and administering the guarantee is not explicitly assigned to a particular institution

118. **The deposit guarantee at the major bank aside, the main material weakness in the NBU's (as well as the FGDNP's) observance of good transparency practices in financial policies is that the internal control procedures and provisions to prevent conflicts of interest for management and staff are not made public.** In addition, the provisions that grant legal protection to officials and staff of financial agencies in the conduct of their official duties are not very strong, but this appears to be a general problem in Ukraine.

Principle 5: Clarity of Roles, Responsibilities, and Objectives of Financial Agencies

119. **The NBU is the sole agency responsible to operate the payment systems and to supervise and regulate banks in Ukraine.** The broad objectives and institutional framework in either case are set out in various Laws of Ukraine, including the NBU Law, the Law on Banks and Banking, the Law on Financial Services and the Government Control of Financial Services Market, and the draft Law on Financial Control in Ukraine. The NBU law, which specifies the objectives of the payment system and banking supervision, is available on the website of the Bank. These objectives are explained further in the Bank's annual report and in the quarterly Herald.

120. **The NBU Law also specifies the responsibilities of the NBU as they relate to the payments system and to banking supervision.** The broad modalities of accountability are set out in the same law. For all activities conferred on the Bank by law, it accountable to the President and Supreme Council of Ukraine (Parliament) within their constitutional jurisdiction. The Governor and his colleagues, from time to time, appear before these bodies. They also host frequent press conferences, and issue press releases. In order to further enhance transparency of its banking stability activities, the Bank publishes and issues various reports and bulletins.

121. **With respect to the deposit insurance scheme, the public seems to be aware of the guarantee on household deposits at the state-owned Savings Bank, but there are no supporting financial policies or institutions, and both the objectives of the guarantee and its precise functioning are not stated explicitly.** The FGDNP, on the other hand, is governed by a special law, the Law of Ukraine On the Fund for the Guaranteeing of Deposits of Natural Persons, which defines the scope and operations of the deposit guarantee scheme in Ukraine. This law provides information on the establishment and organization of the FGDNP, and its functions and responsibilities. The FGDNP has clearly defined roles, responsibilities, and objectives.

Principle 6: Open Process for Formulating and Reporting of Financial Policies

122. **In addition to the NBU Law and regulations issued under it, there is also a Law on Payment System and Monetary Transfers in Ukraine (the PSL), which contains detailed operating procedures regarding payments system activities.** This and all subsidiary laws and regulations are available on the NBU web site. The web site also includes the payments system legislative framework (primary and secondary legislation) and reports. Criteria for access to the payment system are described in regulations and instructions that are also publicly disclosed. The NBU law contains general provisions on the scope and limits of information sharing with other domestic and international institutions. There do not seem to be publicized, formal procedures for sharing information with other financial agencies when the need arises, but, since the NBU is the sole supervisor of the payments system in Ukraine, the need for information sharing with other institutions is limited.

123. **The NBU Law and the Law on Banks and Banking stipulate a number of provisions governing the activities of banks.** They also specify the measures and sanctions to be taken by the NBU with respect to banking supervision. In addition, the NBU issues regulations and resolutions relating to financial institutions. All these regulations and resolutions, as well as the NBU's regulatory framework and operational procedures, are publicly disclosed on the Bank's website and in official documents.

124. **Currently, there is no obligation in law for the NBU to consult the public or the Bankers Association on substantive changes in the structure of banking regulations.** However, in practice, essential changes in legislation and/or banking regulations are routinely discussed beforehand with the Association of Ukrainian Banks. While this practice is encouraging, it would be better to codify it in law. As a first step, the Law on Banks and Banking should include among its provisions an obligation for the NBU to consult the Bankers Association in cases of changes in banking regulations and reporting requirements. The next step could be a process of public consultation, whereby the public should be allowed to comment, within an appropriate period, on substantive changes in banking regulations. These proposed changes are likely to be implemented when the draft "Law on Financial Control" comes into force.

125. **The Law of Ukraine "On the Fund for the Guaranteeing of Deposits of Natural Persons" provides an open and transparent framework for deposit guarantee policies for participating banks.**

Principle 7: Pubic Availability of Information on Financial Policies

126. **The NBU publishes material on developments in financial policies, including new financial instruments or patterns of exposures on payment system developments, and on domestic regulatory changes.** These are published in the Herald of the National Bank of Ukraine (a periodical journal). The journal is available on the NBU website. The NBU has also published a book on the payment system. This publication program is supplemented by an active speaking program by senior officials of the Bank.

127. **Aggregate financial data are disseminated using a variety of delivery channels, including the annual report and monthly bulletin.** There are, however, publication lags, which can be long and variable. It is recommended that more use be made of the NBU website to eliminate these lags as well as to issue periodic public information on the major developments in the banking system.

128. **The NBU does not publicly disclose emergency financial support to banks, neither at an individual nor at an aggregate level.** It is questionable, however, whether, under the present circumstances of Ukraine, this kind of information should be disclosed even at an aggregate level soon after the assistance is provided, as it is likely that the aggregated information can be "disaggregated" for individual banks. However, there is no reason not to make such information available after the assistance is provided, and once the situation that prompted it has passed.

129. **The relevant laws and regulations of the FGDNP are readily available.** Participating commercial banks must keep depositors informed. The public is aware of the guarantee on household deposits at the Savings Bank, but its modalities are not defined.

Principle 8: Accountability and Assurances of Integrity by Financial Agencies

130. **Consistent with Principle 4, the NBU observes most of the elements relating to accountability and assurances of integrity by financial agencies in respect of its oversight of the payment system and the supervision of banks.** Further, the NBU has developed a Code of Professional Ethics of Bank Supervisors, which contains the standards for the conduct of personal financial affairs of officials and staff of banking supervision. However, legal protection for officials and staff is not explicitly included in the Law on Banks and Banking or in the NBU Law, but follows implicitly from the Law on Civil Servants, since officials and staff of the NBU are subject to the Law on Civil Servants in the performance of their functions.

131. **Mechanisms, including reporting requirements, exist to ensure the accountability of the FGDNP, and some provisions assuring integrity are in place.**

Recommended actions

132. **Further strengthening is needed in such areas as enhancing legal protection for bank officials and staff.** It is advisable that the NBU Law explicitly include legal protection for officials, staff and also all those hired by the NBU for related purposes in the performance of their legitimate duties, and that the existence of such protection be publicly disclosed.

133. **In the area of deposit insurance, a distinction needs to be made between the government guarantee of all household deposits at one major bank, and the limited guarantee of household deposits at other banks administered through the FGDNP.** The functioning and institutional arrangements for the former are essentially non-transparent. As part of the government's plans to reform that major bank, the functioning of the guarantee on deposits at that bank and responsibility for its implementation could be made more transparent, possibly by transferring responsibility to the FGDNP. Such a shift would, however, require a substantial increase in the FGDNP's resources, and, as such, would be inappropriate until the financial position, structure, and operations of the bank have improved considerably.

Table 9. Ukraine: Recommended Actions to Improve Observance of MFP Transparency Code Practices—Financial Policies

Reference Practice	Recommended Action and Timeframe
V. Clarity of roles, responsibilities and objectives of deposit insurance agencies	Explicit legal protection could be provided to all those engaged in financial sector regulation and supervision for actions undertaken in an official capacity. Cooperation with other supervisors in Ukraine: The new Law on Financial Services and Government Control of Financial Services Market will formalize the cooperation between supervisors in Ukraine. Adequate procedures should be developed and implemented in this respect to make the cooperation work. This will be done as soon as the authorized executive body is set up The functioning of the guarantee on deposits at a major bank and responsibility for its implementation could be made more transparent. Eventually, deposits at the reformed bank could be guaranteed under the FGDNP, one advantage of which would be the increase in transparency that would be achieved.
VII. Public availability of information on deposit insurance policies	Disclosure of aggregate emergency financial support to banks: The desirability or otherwise to disclose on an aggregate basis financial support to banks should be reviewed.

Authorities' response to the assessment

134. **The authorities were in agreement with the mission's assessment regarding its transparency practices in financial policies, and they indicated their willingness to address most of the recommendations made.** In particular, the authorities indicated that a Memorandum of Understanding spelling out the institutional and operational arrangements of the guarantee of household deposits at the major bank and its eventual reform is currently being worked out between the Government, the NBU, and the World Bank. In due course, these arrangements are expected to be codified into law.

X. Summary Assessment of Observance of the CPSS Core Principles for Systemically Important Payment Systems

A. General

135. **The assessment of the observance by the Ukrainian payment and settlement system of the Basel Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems was focused on the Electronic Inter-bank**

Payment System (EIPS) operated by the NBU. [45] The EIPS has been identified as a systemically important payment system because it is the only payment system in the country used by all banks. The EIPS handles all inter-bank payments in Ukraine regardless of the value of transaction. The EIPS is used for the settlement of capital market transactions and payment cards transactions.

136. **The assessment was based on Ukrainian legislation applying to payment activities, including: the Law on the National Bank of Ukraine, the Law on Banks and Banking, the Bankruptcy Law, the Law on Payment Systems and Money Transfers in Ukraine, and the Law on Restoration of Solvency of the Debtor or Application of Bankruptcy Procedures.** Use was also made use of various NBU directives and resolutions, the results of discussions with staff of the NBU and commercial banks, and answers to the IMF questionnaire with regard to payment systems. NBU staff and other institutions cooperated fully with the assessment and provided all necessary clarifications and documents.

B. Institutional and Market Structure

137. **Credit transfers are the major payment instruments, particularly among legal entities, although cash is still the major retail payment instrument.** The active commercial banks provide most of the payment services to the general public. However, inter-bank payments are settled by the EIPS, which is established through the Law on Payment Systems and Money Transfers in Ukraine, and is owned, managed and operated by the NBU. For banks involved in inter-bank payments, participation in EIPS is mandatory. The EIPS commenced operations on 1 January 1994. In 2002, 164 million transactions with a gross value of hryvnia 1.34 trillion (more than six times GDP) were carried out through EIPS.

Payment systems infrastructure and procedures

138. **Participants in the system include branches of the NBU, commercial banks, some branches of commercial banks, and State Treasury units.** Although currently for most commercial banks only the head office is a member of the EIPS, for some banks, each bank branch is a member, although subject to an overall limit matching the balance of the bank's correspondent account with the NBU.

139. **The system is operated by special units of the National Bank of Ukraine—the Central and Regional Accounting Houses (CAH and RAH, respectively).** All transactions are processed on gross basis from 8:00 a.m. to 8:00 p.m. At the beginning of the banking day, the system creates a "technical account" for each participant, which is used to record credits and debits during the day, and which is initially credited with the balance in the participant's

[45] The assessment was prepared by Krzysztof Senderowicz (Deputy Director, Payment Systems Department of the National Bank of Poland).

correspondent account. The technical accounts are not on the books of the NBU but are used for payment processing purposes.

140. **Participating banks aggregate payment documents into packages, which are sent via e-mail to RAHs.** RAHs work in cycles lasting 15-30 minutes: first, the RAH receives payment documents packages sent by participating banks and by other RAHs, and other technical data. During the reception phase, the technical correspondent account of the payer's bank held by the NBU is debited Payments initiated by a bank are accepted only within the current balance of its technical correspondent account. Second, payment documents stored during reception phase are aggregated into separate packages for each receiving bank sent to the receiver. Each participant is also informed of the current balance of its technical correspondent account at this stage

141. **The payee's bank receives the information package from the RAH about the payment and verifies the information.** If the result of the verification is positive, the payee's bank sends an acknowledgment to the RAH, and its technical correspondent account is credited. The processing and settlement of credit transfers, from debiting the payer's account at one bank to crediting the beneficiary's account at the other bank, generally takes from a few minutes to two hours. At the end of day, the results of settlements are reflected in banks' actual correspondent accounts at the NBU.

Development of the system

142. **The main project under way is the introduction of procedures allowing for on-line real time gross settlement (RTGS).** It is expected that the EIPS will stay in operation until 2010 at least. The NBU, in cooperation with some commercial banks, is also developing new retail means of payment, such as the introduction of "smart cards."

C. Main Findings

143. **The design and functioning of the EIPS makes the system generally secure, reliable, and efficient.** Areas for improvement identified through the assessment of CPSS core principles were narrowly focused.

Legal foundation (CP I)

144. **The legal basis of the EIPS consists of various laws, notices, decrees of the NBU, internal regulations of the NBU, contracts, agreements, and other regulations.** This legal foundation provides the NBU fully adequate powers to operate and regulate the system.

145. **Existing laws do not exclude from insolvency procedures collateral security provided in connection with participation in the payment system or in the framework of operations with the central bank.** According to Article 26 of the Law on Restoration of Solvency of the Debtor or Application of Bankruptcy Procedures, collaterized assets of the bankrupt are included into the bankruptcy procedures but are used exclusively for

compensation to the pledgee as the first priority. Thus, there is at least a potential liquidity risk for the pledgee in the case of the bankruptcy of the pledgor, because the bankruptcy procedures takes time.

146. **Current legislation does not contain provisions ensuring that transfer orders are protected from insolvency law provisions from the moment they enter a designated payment system.** This conclusion holds even though the NBU Directive on Interbank Settlements states that interbank electronic settlement documents received by the EIPS may not be revoked, because this provision in an NBU Directive must have less legal force than provisions in the Bankruptcy Law, which is primary legislation passed by parliament..

Understanding and management of risks (CPs II–III)

147. **The laws and regulations governing the payment system provide all necessary information for understanding the functioning of the system.** The NBU also provides training and other support services to commercial banks to ensure that they understand and can manage all risks.

148. **Procedures for the management of credit risks and liquidity risks, and the respective responsibilities of the NBU and the participants, are well defined.** Incentives to manage and contain those risks are adequate. The credit and liquidity risks are to a large extent limited by the features of the system described above. However, within a business day, the inter-bank money market is the only source of liquidity for banks. This does not seem to be a problem at the moment since liquidity in the banking system is high.

Settlement (CPs IV–VI)

149. **Settlement is generally prompt and reliable, although in principle situations could arise in which transactions are not finally settled during the day of the acceptance of the payment instruction.** The assets used for settlement are claims on the central bank.

Security and operational reliability, and contingency arrangements (CP VII)

150. **The EIPS has a high degree of security, with many mutually-reinforcing security features, and is operationally reliable.** There has not been any security incident since the EIPS was introduced in January 1994.

Efficiency and practicality of the system (CP VIII)

151. **The EIPS is practical and efficient.** Transactions are settled promptly, reliably, and at low cost.

Criteria for participation (CP IX)

152. **Any credit and finance institution may become a participant of the EIPS if it has correspondent accounts with one of the NBU regional branches, and meets technological and operational requirements of the electronic payments system.**

Governance of the payment system (CP X)

153. **The EIPS system is owned, managed, and operated by the NBU, whose responsibilities in this area are laid down in law.** Detailed information on responsibilities and rights concerning the governance of the system is established in published regulations.

Central Bank Responsibilities in applying the CPs

154. **The responsibilities and powers of the NBU to oversee the EIPS are laid down in the NBU Law and in the Law on Payment Systems and Money Transfers in Ukraine.** The NBU is also promotes the development of the payment system on a safe and efficient basis. To this end it cooperates with central banks in other countries and with the CPSS.

Table 10. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities—The Electronic Inter-bank Payment System

Reference principle	Recommended Action
Legal foundation – Principle 1	It is recommended to implement new regulations providing that: • transfer orders and collateral securities be explicitly protected from insolvency law provisions from the moment they enter a designated system; • the retroactive effects of insolvency rules on rights and obligations in system be explicitly prohibited.
Management of risk – Principle 3	Intra-day liquidity management measures (for example, credit facilities) could be introduced to improve risk management, especially in the context of a new on-line RTGS system.
Criteria for participation – Principle 4	Measures to ensure the final settlement for all payments at least at the end of the business day should be considered.

D. Authorities' Response to the Assessment

155. **The authorities were in broad agreement with the assessment, which, they noted, was generally positive.** They maintained, however, that the protection of transfer orders from insolvency proceedings (relevant for Principle 1) is indeed adequate because of provisions contained in NBU directives.