SM/08/146
Correction 1

September 17, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Ukraine—Financial System Stability Assessment—Update**

The following factual corrections to SM/08/146 (5/12/08) have been provided by the staff:

A. Factual Errors not Affecting the Presentation of Staff's Analysis or Views

Page 5, line 3 from bottom: for "shows no signs of abating" read "remains high"

Page 11, para. 5, line 1: for "2005" read "2004"

Page 15, para. 15, bullet 3, line 2: for "introduction of central bank certificate of deposits" read "re-introduction of central bank certificates of deposit"

Page 21, para. 21, line 7: for "realm" read "realm (see for example 2007 NBU Resolutions nos. 83, 168, 248, and 458)"

Page 24, para. 26, line 7: for "13 percent" read "11 percent"

Page 26, para. 32, lines 4–5: for "—to date, there have been no successful compulsory bank reorganizations, despite several attempts that ended in liquidation." read "—to date, there have been few successful compulsory bank reorganizations, and several ended in liquidation."

Page 30, para. 41, bullet 3, lines 6–7: for "holding group, the ideal way of which would be" read "holding group through"

Page 34, Table, row 1, column 2, line 3: for "Minimum capital."
read "Minimum capital was increased to EUR 10 million."

Page 34, Table, row 1, column 2, line 4: for "Tightened definition of capital"
read "Tightened definition of capital by adding requirements on foreign exchange and liquidity risks"

Page 34, Table 2, row 2, column 2, line 2: for "September 7" read "adopted August 27"

Page 35, Table, row 1, column 2, line 3: for "June 12" read "June 21"

Page 35, Table, row 2, column 2, line 2: for "submitted to" read "adopted by"

Page 35, Table, row 4, column 2, row 4, lines 2–3: for "518, December 3, 2003"
read "598, adopted December 7, 2004; maximum exposure limits to related parties were also decreased"

Page 35, Table, row 15, column 2, line 2: for "8" read "18"

Page 36, Table, row 3, column 2, line 7: for "July" read "May"

Page 36, Table, row 4, column 3, line 3: for "1,000" read "17,000"

Page 36, Table, row 6, column 2, line 1: for "Not done."
read "No significant improvements in this area, despite publication of annual monetary and credit policy guidelines."

Page 40, Table, row 12, column 3: for "NBU" read "SCSSM"

Page 40, Table, row 23, column 3: for "/MoF/" read "/Cabinet of Ministers/"

Page 41, Table, row 1, column 3: for "/MoF/" read "/Cabinet of Ministers/"

Page 53, para. 93, line 4: for "25,000 (US$5,000)" read "50,000 (around US$10,000)"

Page 54, para. 96, lines 6–7: remove "to borrowers without FX income"

Page 57, Table, row 8, column 2, lines 6–7: for "while failing"
read "while failing in some cases"

B. Mischaracterization of the Views of the Authorities

Page 62, para. 105, line 3: for "compliance"
read "compliance. The authorities also argued that the licensing criterion regarding impeccable business reputation for prospective bank owners addresses the concern posed by assessors about the absence of a requirement of a clear criminal track record. They also indicated that the called-for strict application of IAS 39 might result in decreased provisions that would not be desirable"

Questions may be referred to Mr. Driessen, MCM (ext. 36257).

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EXECUTIVE SUMMARY

Ukraine's financial system has been transformed since the 2002 FSAP. Bank intermediation has taken off, with credit tripling relative to GDP. Non-bank financial institutions and markets also experienced rapid development. These changes were supported by an overhaul of the financial sector legislative framework, and took place against a backdrop of robust economic growth driven by favorable terms of trade, prudent fiscal policy, and exchange rate stability.

New vulnerabilities have emerged alongside this rapid development, although it is difficult to gauge their magnitude owing to a lack of relevant bank-by-bank data. The main vulnerabilities are:

- **increasing balance-sheet currency mismatches** due to dollarization and high inflation—unhedged households have large, rapidly growing foreign exchange-denominated debt;
- **growing credit risk,** emanating from rapid credit growth;
- **growing liquidity risk** associated with increased dependence on foreign funding;
- **weaknesses in the bank exit framework** in the context of likely consolidation; and
- **banking supervision weaknesses** associated with a more complex financial system.

Greater exchange rate flexibility, a long-standing intention of the authorities, may reduce balance sheet mismatches by increasing borrowers' awareness of the foreign exchange risk they bear. Interest rate differentials between domestic and foreign currency—together with the implicit commitment of the authorities to maintain the de facto peg, rising inflation, and appreciation expectations—have led borrowers, and households in particular, to take on considerable unhedged foreign exchange debt. With significant risk of medium-term exchange rate volatility, this is an important financial sector vulnerability. A gradual increase in exchange rate flexibility, accompanied by a supporting monetary policy framework, should over time reduce balance sheet currency mismatches.

Further prudential strengthening is needed to address credit risk associated with rapid credit growth. The current credit boom (year-on-year credit growth at end-February 2008 stood at 78 percent) is straining commercial banks' risk management practices as well as supervisors' capacity.

Growing liquidity risk needs to be monitored carefully. The recent slowdown in growth in foreign funding has not been fully offset by additional mobilization of deposits, while credit growth remains high~~shows no signs of abating~~ (although there is a notable slowdown in growth of foreign-exchange denominated mortgage loans). Under normal circumstances, this should lead to a welcome slowdown in banks' balance sheet expansion, but bank-by-bank variations in reliance on local deposits, interbank or foreign funding leaves some institutions vulnerable. The National Bank of Ukraine (NBU) should monitor individual banks' liquidity situations intensively, in the current context of global financial turmoil and higher funding costs.

Urgent action is needed to strengthen consolidated supervision and supervisory cooperation. Closer and more effective cooperation with home country supervisors is required to deal with the entry of foreign banks. In addition, to cope with cross-shareholding between the financial and non-financial sectors the authorities need to overcome inadequate consolidated reporting and the inability to trace ownership, which severely hampers effective consolidated supervision of financial conglomerates.

Higher disclosure standards for banks are needed to offset restrictive bank secrecy provisions. These provisions—set in the banking law—prohibit the sharing of data obtained during the supervision process—even if highly summarized—except if that data is already published. Although the quality of financial statements of banks was found to be better than that of other corporations, significant shortcomings remain. Enhanced transparency practices will eventually translate into lower borrowing costs for the banking system, and will help broaden access to international capital markets.

The authorities should remold the bank resolution framework to minimize disruptions during the expected process of bank consolidation. Analysis of available bank-specific data found a large number of small, structurally weak banks that are unlikely to survive in Ukraine's competitive environment. The resolution framework should be based on early corrective action combined with incentives for market-based solutions. Such remedial action would need to be based on forward-looking indicators rather than on current compliance checks, which do not flag emerging problems on time. Non-compliance with agreed corrections should also carry greater consequences—currently, penalties and other regulatory threats are insufficiently strong to ensure bank owners redress weak points or to encourage mergers, steering banks instead toward drawn-out liquidations adversely affecting confidence.

Developmental priorities include strengthening of the overall legal, regulatory, and supervisory frameworks, and removing obstacles to capital market development. While substantial improvements have taken place over the last few years, major hindrances to the development of the financial sector remain. Market regulators need to be granted powers to identify beneficial owners, have full and unrestricted access to information on controllers' economic, fiscal and criminal records, and enhance cooperation with relevant agencies abroad. An overhaul of the legal status of the securities regulator and of the nonbank financial institution regulator is required to establish their independence and financial autonomy. Obstacles to domestic securities market development include (i) the absence of a domestic benchmark rate; (ii) the limited development of the sub-national government debt market; and (iii) weak corporate governance, parts of which are being addressed in a draft law.

5. **The so-called "Orange Revolution" in ~~2005~~2004 ushered in a new era of political competition in Ukraine.** The result has been four governments since early 2005, and with Presidential elections in 2009 expected to be hotly contested, the instability may continue for some time. The most notable impacts of the political shift have been the increasing redistributive role for government, temporary bouts of capital flight, and delays in implementing changes in the monetary policy regime away from the currency peg, which has been viewed as a bulwark for confidence. To date, this inconsistent policy mix has been tempered by the initial undervaluation of Ukraine's currency and by movements in the U.S. dollar-euro exchange rate. Structural reforms have gradually moved forward; external anchors—WTO accession and prospects for a Ukraine-European Union (EU) free trade agreement—have been key factors.

II. Financial Sector Vulnerabilities

6. **The principal financial sector stability concerns, which have been deepened by the global financial turmoil, relate to** (i) insufficiency of information to analyze vulnerabilities in detail; (ii) macro-financial vulnerabilities manifested in balance sheet currency mismatches; (iii) growing banking risks; and (iv) an inadequate banking resolution framework.

A. Information/Transparency

Vulnerabilities

7. **Bank secrecy provisions significantly limited the scope of the assessment of financial system vulnerabilities**. Only publicly available information was used in the stress testing exercise, since legal restrictions prohibited the authorities from sharing data they receive from individual banks. As a result, staff could not exploit this bank-by-bank data on nonperforming loans, classified assets, risk-weighted capital-asset and liquid asset ratios. The results, which are reported in Section II.D, need to be interpreted with these caveats in mind. In addition to impeding staff's detailed stress testing or providing technical assistance in this area, the restrictions hamper inter-agency coordination, and reflect negatively on the transparency and disclosure regime of the Ukrainian banking system.[1]

8. **Absence of consolidated prudential reporting adds to the difficulty to bring out financial sector vulnerabilities**. Under these circumstances, authorities are unable to apply supervisory norms for capital adequacy, large exposures and related party lending on a fully consolidated basis to banking groups, adding uncertainty about risk exposures.

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[1] A December 2006 report by Standard&Poor's similarly finds that commercial banks' disclosure standards are below what would be desirable, given their growing access to capital markets.

Policy response

9. **The NBU should overcome legal restrictions on data sharing by setting high disclosure standards for banks, and require consolidated prudential reporting**. The disclosure practices should be inspired by Basel II's market discipline pillar. In the short term, the NBU should make more information available, or require banks to do so. At a minimum, this would include bank-by-bank information on credit risk, such as non-performing loans and loan/loss provisions, on liquidity and market risk, and on the calculation of risk-weighted capital.[2]

10. **In the medium term, amendments to the Banking Law will be needed to bring the bank secrecy provisions closer to international good practice**. The quality of information should also be improved: although the quality of banks' financial statements was found to be better than that of other corporations, significant shortcomings remain. Enhanced transparency practices will eventually translate into lower borrowing costs for the banking system, and will broaden access to international capital markets. The recent publication by the NBU of ownership information of most banks and the ongoing required transformation of banks into Joint Stock Companies with an improved disclosure regime are encouraging.[3]

B. Macro-Financial Vulnerabilities

11. **A number of factors have provided incentives for extensive dollarized borrowing**. High inflation and the insurance against currency risk provided by the exchange rate peg favored dollar-denominated loans and banks, until recently, did not face any reserve requirements on funds borrowed externally. Moreover, the ready availability of foreign funding to finance banks' expansion—in particular foreign-owned banks and larger domestic banks with access to the Eurobond market—and prudential limits on banks' net open foreign exchange positions (which encouraged banks to balance any foreign liabilities with foreign assets) may also have contributed to dollarization.

Vulnerabilities

12. **The resulting balance sheet mismatches, coupled with the potential for exchange rate movements, poses an important macro-financial vulnerability**. Balance sheet exposures to exchange rate movements are considerable and growing (Figure 2). The corporate sector is partially hedged, given exports (over 35 percent of GDP in 2007) and significant foreign exchange (FX) assets, but the household sector has significant mismatches

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[2] A breakdown of the balance sheet by maturity buckets, on- and off-balance sheet items, and currency (domestic and foreign), as is made available by banks in several countries, would be a good start to map liquidity and market risk.

[3] However, for a large number of banks, owners are registered in off-shore jurisdictions, making identification of beneficial ownership needed for determination of connected lending and other risks difficult.

- The foreign exchange transaction tax (recently reduced to 0.5 percent) should be abolished to allow for the foreign exchange market, including of hedging instruments, to develop further.

- The exchange rate band should be widened enough to encourage agents to take better account of foreign exchange risk in their portfolio decision making.[5]

- A market-based operating framework should be introduced, building on the recent ~~introduction~~ re-introduction of central bank certificates of deposit~~s~~ (CDs; see Figure 3). A gradually narrowing interest rate corridor of NBU deposit and lending facilities linked to a central policy rate should over time bring less interbank rate volatility and strengthen the transmission of monetary policy signals.

- Finally, in the short-term, with a view to the approaching point when inflation concerns dominate exchange rate targeting concerns, the government should amend the NBU law to make price stability its primary mandate, and strengthen its independence.[6]

C. Banking Sector Vulnerabilities

16. **With the rapid development of Ukraine's banking system have come new vulnerabilities that require a determined response by policy makers**. Financial soundness indicators (FSIs) point to a competitive banking sector where prudential buffers are slowly eroding (Table 2; see also Appendix III for a more detailed description of the banking system). Although capitalization is still above regulatory minima for the banking system as a whole, the average capital adequacy ratio is declining.[7] Moreover, the heavy reliance on foreign financing has resulted in net foreign liabilities greater than bank capital. Liquidity is tightening significantly. Credit growth is high, bringing the credit-to-GDP ratio to 61.3 percent at end-2007. Although the share of nonperforming loans in total loans is falling, this is a common phenomenon under high loan growth, and this indicator should be used with care when assessing loan quality.

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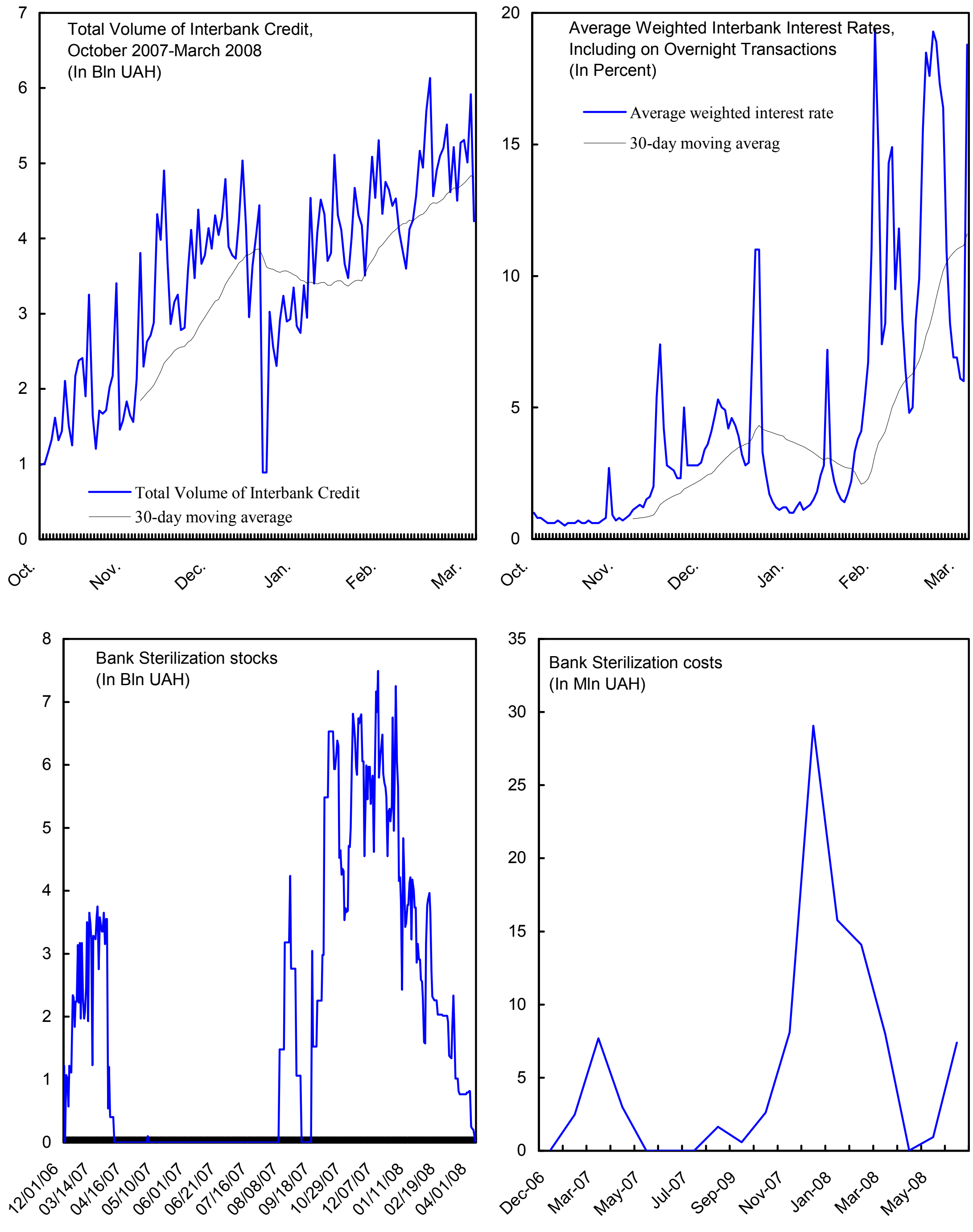
[5] This will also provide additional room to conduct monetary policy.

[6] At the moment, central bank independence is severely limited. For example, the Governor can be removed by the President, and the central bank must formulate and conduct monetary policy on the basis of the government's macroeconomic parameters, even if these are far from realistic.

[7] The ratio of regulatory capital to risk-weighted assets declined to 13.9 percent in 2007; over the previous three years, the average was 15.3 percent.

Figure 3. Ukraine: Interbank Credit and Sterilization, 2007–2008



Source: NBU

Eurobond issuance peaked at about US$1.8 billion; since August 2007, this has slowed to a trickle (see Figure 5). Foreign syndicated loans have compensated this decline somewhat, but the net effect has been a tightening of liquidity of banks, which has also become visible in the interbank market.[9] Also, maturities of liabilities—including foreign— have continued to shorten, while the growing proportion of mortgage loans is extending the maturities of the loan portfolio. Under normal circumstances, the tightening liquidity should lead to a welcome slowdown banks' credit growth, but bank-by-bank variations in funding strategy, as evidenced by differing degrees of dependence on local deposits, interbank or foreign funding, may lead to a rapid deterioration in liquidity in individual institutions—this needs to be monitored closely.

20. **Increases in local bond issues have absorbed part of the foreign funding shock, but issuing firms have comparatively low credit ratings (Figure 6)**. This signals more rapid credit growth for institutions with lower disclosure and corporate governance practices, and lower overall asset quality than banks that have until recently floated Eurobonds. Local bond issue was buoyed in part by foreign demand for hryvnia exposure in the context of appreciation expectations.[10]

Policy response

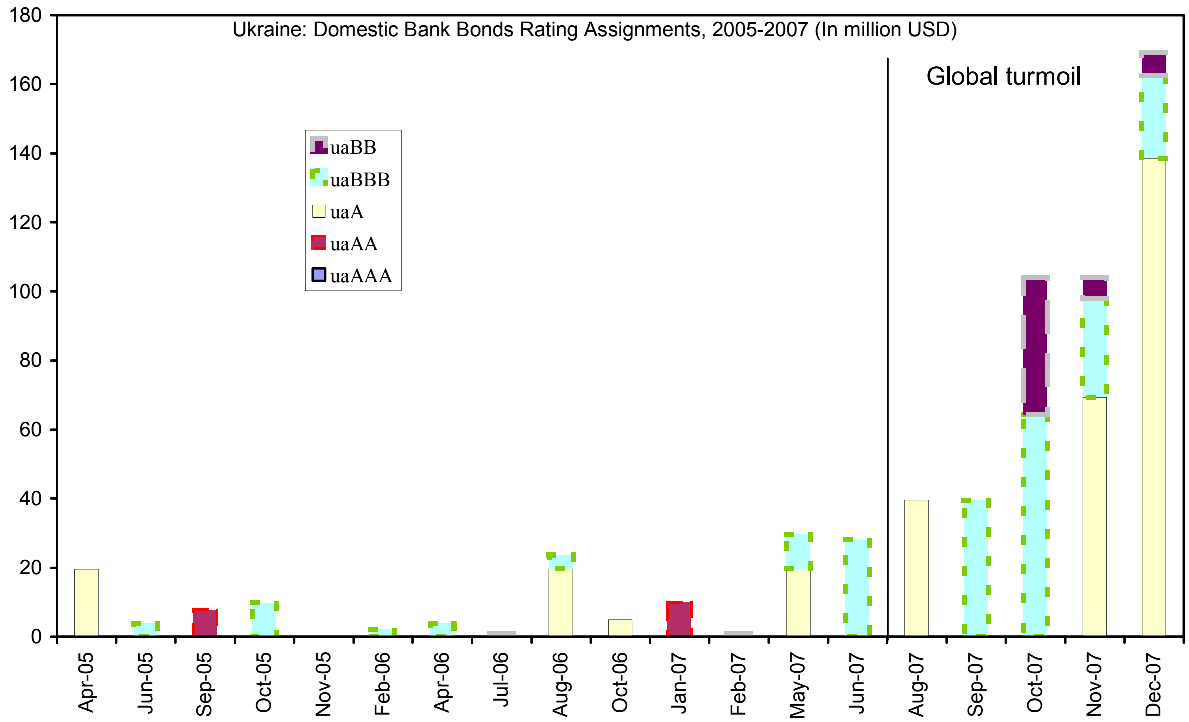
21. **The authorities have implemented several measures to address the vulnerabilities noted above**. To prepare for gradually increasing exchange rate flexibility, they have paved the way for more market-based monetary operations, have allowed greater movements in the interbank foreign exchange market, and lowered the foreign exchange transaction tax that hampers foreign exchange market development; banks are also required to notify customers of the risks involved in borrowing in foreign currency. In the prudential realm (see for example 2007 NBU Resolutions nos. 83, 168, and 458), the NBU has (i) increased minimum capital requirements to EUR 10 million—to facilitate bank consolidation—exceeding the minimum required in the European Union; (ii) introduced greater risk weights on more risky asset categories, including to address indirect foreign exchange-related credit and maturity risk; (iii) extended reserve requirements to foreign borrowing to offset one incentive for foreign exchange lending; (iv) require all banks to be transformed into open joint-stock companies to increase corporate governance.

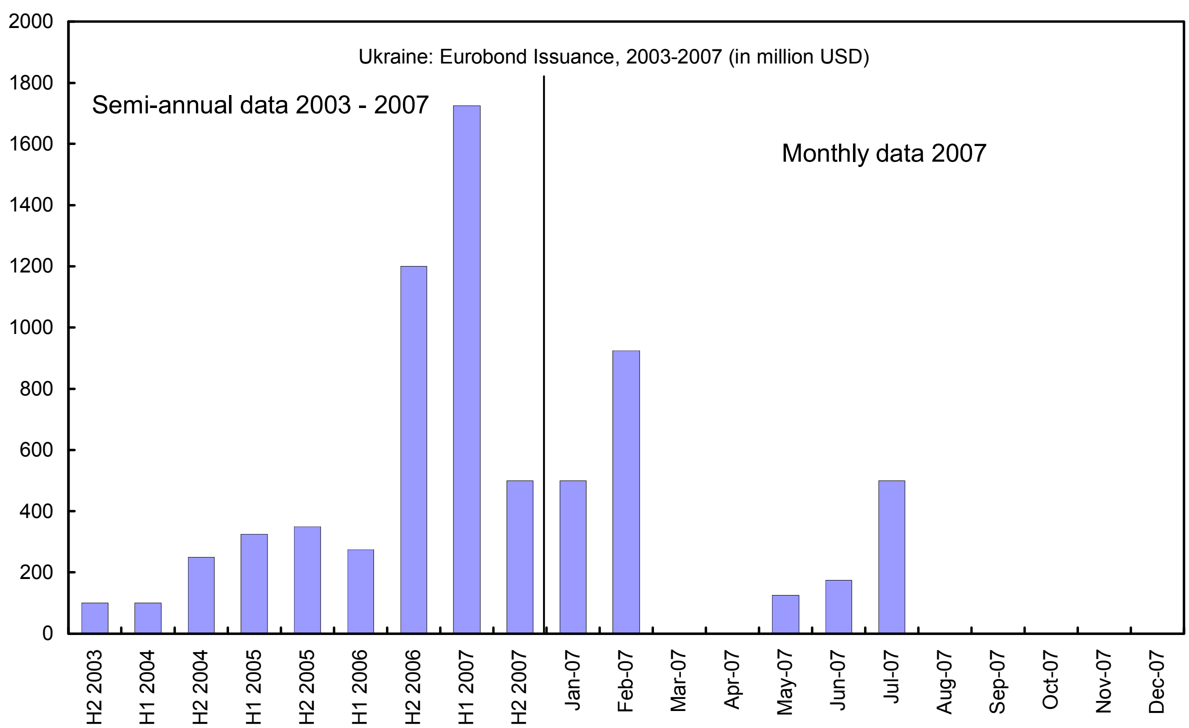
22. **Risk management practices, and supervisory monitoring of these, need to keep pace with the current credit boom**. The NBU should continue to move away from

[9] However, in the first quarter of 2008, world-wide volumes of syndicated loans showed a marked decrease.

[10] A related vulnerability is that local capital markets are currently an important funding source for non-financial corporations as well. The NBU should analyze which banks are vulnerable in case corporations cannot roll over their capital market exposure, increasing credit risk for banks that are lending to these firms.

Figure 6. Ukraine: Domestic Bond Ratings and Issuance Volume, 2003–2007





Sources: Cbonds, Credit Rating.

compliance-driven supervision in favor of risk-based supervision, focusing on detecting weaknesses in banks' risk management practices. Comparative reviews of banks' practices may prove useful in this regard, as well as targeted remedial actions (including higher provisions or capital for certain asset classes, mortgage loan-to-value (LTV), or debt service-to-income ratios) when needed.

23. **Further measures to limit credit risk should be considered, including**: (i) abolishing the foreign exchange transaction tax and relaxing restrictions on foreign exchange derivative transactions to develop the foreign exchange market—this would facilitate hedging; (ii) further increases in provisioning against specific asset categories that carry greater risk, including unhedged foreign currency loans; and (iii) enhance risk management and modeling capacity, which may include the development of credit risk models as well as capacity to conduct scenario analysis and stress tests; this will help identify risk exposures from loan portfolio deterioration due to rapid credit expansion and allow scenario analysis to identify risk exposures from possible currency and real-estate shocks. [11] Examples of specific prudential measures against indirect credit risk related to foreign exchange denominated lending include (i) higher liquidity requirements on foreign currency deposits; and (ii) a higher deposit insurance premium on foreign currency deposits.

24. **Liquidity risk should be addressed by**: (i) focusing supervisory resources on monitoring intensively those institutions that are highly exposed to liquidity risk; (ii) ensuring that banks manage liquidity risk appropriately, and have adequate contingency plans for tight liquidity scenarios; and (iii) explore tightening prudential requirements on the maturity gap further (a less prescriptive approach could be adopted over time as liquidity management capacity is developed).[12]

Stress tests

25. **In the absence of relevant data to conduct detailed stress testing, assumptions have been made that render the results reported below merely illustrative**. As noted above, the NBU was restricted by the bank secrecy provisions to provide information for this exercise—not even summary statistics were provided. This limits the ability to understand

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[11] Consideration was given to increasing the risk-weighted capital-asset ratio from 10 percent to 12 percent. However, although there are good reasons to set the buffer against unexpected losses high in the case of Ukraine, such a level would exceed that of most of its regional peers. Instead, a focus on adequate provisioning for risky assets was encouraged.

[12] In the medium-term, market-based asset transfers, such as through selling mortgage-backed securities, could help alleviate the maturity gap, taking into account lessons learned about the pitfalls of the originate-and distribute model at the center of the current global financial turmoil.

bank-by-bank risk profiles, especially of bank's loan portfolios. The following results should therefore be interpreted with care. The stress-testing exercise was conducted on 173 banks for which end-2007 data was publicly available. Appendix IV provides further details.

26. **Tests of credit risk—the most important risk in the Ukrainian banking system—indicate banks' vulnerability to a deterioration in asset quality** (Table 3). This was simulated with a migration pattern between asset classifications within the loan book. A 10 percent migration rate, uniform within loan categories, shows that an additional eighteen banks (corresponding to 22 percent of banking system assets) fall below the minimum 10 percent capital adequacy ratio (CAR).[13] This migration corresponds to an increase in NPLs from 13.2 to 15 percent. Since mortgages only account for about ~~13~~11 percent of the loan book at end-2007, the impact on banks of a real estate price decline are limited, although the effects are likely to vary greatly across banks according to the different loan-to-value (LTV)

Table 3. Ukraine: Summary Results of Stress Tests

Test	CAR	Number of Banks			Size, in percent of Total Assets		
		< 10	10-12	> 12	< 10	10-12	> 12
End-2007	13.9	7	26	140	3.2	39.0	57.7
Credit Risk							
Deterioration in Asset Quality							
Uniform 10% Migration rates within all Asset Classes	12.8	25	19	129	25.2	31.3	43.5
Real Estate Price Risk in Mortgage Loans							
20% house price drop	13.8	14	21	138	12.0	30.4	57.5
Market Risk							
Direct FX-Risk							
US$, 30% depreciation	13.9	7	25	141	3.2	38.0	58.8
Scenario Analysis:							
Indirect FX-Risk							
US$, 30% depreciation with uniform 10% migration	12.8	25	20	128	34.2	24.4	41.4

ratios and mortgage exposures.[14] No stress tests could be performed on credit concentration risk in the absence of relevant information, but this is likely to be an area of vulnerability, in

[13] The equity ratio (unweighted capital-asset ratio) was used as the starting point in the absence of the bank-specific RWCAR; as a result, it is not possible, strictly speaking, to determine capital adequacy after a stress test shock, unless it is assumed that all assets carry 100 percent risk weight.

[14] There is likely a strong positive covariance between the indirect foreign exchange and real estate price risks, and stress tests could be conducted combining such shocks. Also, loans to construction companies add to banks' exposure to the real estate sector.

particular for smaller banks. It is important to consolidate bank loans to and bonds of individual borrowers.

27. **The results of the credit risk stress test were more pronounced when the exercise was repeated for a set of large banks**. Using publicly available data on levels of non-performing loans from 17 large banks at end-2005, the stress test indicate that three banks would fall below the minimum CAR, given their lower initial CAR levels (10.3 percent equity-to-capital ratio at end-2005, versus 13.9 percent for the banking system as a whole at end-2007).

28. **There is an urgent need for the authorities to collect data on a consolidated reporting basis to conduct detailed liquidity risk stress**. This would help identify unwelcome depositor concentration. Interbank market funding is important for some banks, and continued tightness should be simulated to monitor these banks. Contagion scenarios should be tailored to simulate the effect of bank failures, including through interbank exposure.

29. **While direct FX-risk seems contained, indirect FX-risk should be monitored closely**. Depreciation-induced deterioration in the loan quality of Ukrainian banks is both economically and statistically relevant. Twenty-five banks representing 34 percent of total assets would be below the minimum CAR in case of a simulated depreciation of 30 percent combined with a credit risk shock (modeled as a uniform 10 percent migration across asset classes, as above).

D. Bank Resolution and Crisis Management Framework

Vulnerabilities

30. **Some consolidation of Ukraine's banking sector can be expected**. Analysis of publicly available data identified a sizeable cluster of smaller banks with low capital, liquidity, and profitability. The viability of these institutions is also in question because of (i) issues of identification of ownership and associated connected lending;[15] (ii) the above-mentioned high credit and liquidity risks (including possible reliance on wholesale funds, and domestic bond issuance[16]), as well as concentration risk—both on the asset and liability side; (iii) higher funding costs, and general lack of economies of scale, of smaller banks; (iv) low transparency and weak accounting practices, and lack of financial and managerial support

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[15] Despite the recent publication of ownership information of most banks by the NBU, gaps exist, including significant use of offshore constructions to hide ultimate beneficial owners, increasing potential risk of money laundering.

[16] A recently failed bank was able to raise funds in the domestic bond market; the rating granted to the issue was not the lowest observed. This bank also initially attracted a takeover bid, withdrawn rapidly after due diligence.

from parent financial institutions; (v) the risk of political interference in bank resolution; and (vi) high cost of regulatory compliance.

31. **There are weaknesses in the crisis management framework for contingencies such as large (possibly foreign) bank failures as well as a systemic banking crisis**. Early diagnosis of emerging problems and addressing these through prompt corrective actions to prevent such failures is difficult in light of the difficulties noted above assessing the financial situation of institutions and the reliance on compliance indicators. The growing importance of foreign-owned banks and the current global financial turmoil increases the risk of spillovers from foreign bank failures on Ukrainian subsidiaries, and must be considered in Ukraine's contingency planning. Lastly, the bank resolution and crisis management framework must also encompass preparations for a systemic crisis triggered by macroeconomic events.

32. **The current bank resolution framework is ill-equipped to support these contingencies**. Regulatory and legal constraints and lack of leverage over problem bank owners render the bank resolution process slow to start, long to complete, and usually bypasses the private sector entirely—to date, there have been ~~no~~few ~~-~~successful compulsory bank reorganizations, and several ended in liquidation.~~despite several attempts that ended in liquidation.~~ At that stage, the Deposit Insurance Fund (DIF) becomes involved in the payment to depositors. The current modality of keeping the bank fully operational after the appointment of the temporary administrator leads to further deterioration of asset values and subsequent cost to the DIF; the reputation of the NBU may also suffer, and confidence in the banking system could be affected.

Policy response

33. **In the short run, the NBU should take steps to strengthen the bank resolution framework that do not require changes in the legal framework**. These include: (i) recalibrating its early warning system and existing problem bank monitoring to spot problems banks earlier; (ii) define imprudent banking practices operationally, and set higher capital requirements for such activities; (iii) start formal action and intervention sooner, and for a larger group of problem banks—based on these measures of imprudent practices rather than on narrow compliance indicators; (iv) formally spell out the consequences of non-compliance with remedial actions; (v) develop capacity to assess and document financial viability and to prepare and analyze rehabilitation plans; and (vi) study where the legal framework needs strengthening.

34. **Changes in the legal framework for bank resolution should cover the following issues**:[17] (i) support for enhanced pre-closure market-based solutions such as assisted mergers and acquisitions, and "purchase and assumption" transactions; (ii) substantially increase fines

[17] Both the banking and DIF laws will need to be amended.

- The second stage should commence as soon as macroeconomic developments and the resilience of the financial sector allows and should eliminate the remaining controls.[22]

III. Structural and Development Challenges

A. Bank Supervision Framework

41. **Banking supervision has improved significantly, and the authorities should continue to move from compliance-based to a more risk-based approach**. Section II.C provides an overview of banks' main vulnerabilities that should be monitored intensively. The assessment of the Basel Core Principles of Effective Banking Supervision (BCP) acknowledged the regulatory gains, but pointed to important gaps, including:

- **The NBU should use its existing legal powers to move effectively to consolidated supervision**. Apart from requiring consolidated prudential reporting mentioned above, the NBU should ensure that risk management in banking groups is applied effectively to the operations of entire banking groups, not merely as at present to the banks within such groups only, and carry out risk assessments on a consolidated basis. The NBU should also develop regulations to inspect non-bank subsidiaries of banks.[23] [24]
- **Further steps are needed to conclude supervisory arrangements with foreign banking supervisors and utilize the existing ones as effectively as possible**. This holds for both domestic and international agreements. The practical cooperation and the arrangements have to consider the roles and responsibilities of the home and host supervisors, both for ongoing supervision and bank intervention.[25]
- **Qualitative criteria for major acquisitions or investments by banks should be provided in amendments to the law and regulations**. These criteria should guarantee the transparency of the investment and identify other shareholders—at the moment, the NBU has limited powers to identify beneficial owners. The NBU is

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[22] In case movements of capital cause or threaten to cause serious difficulties for the operation of the exchange rate policy or the monetary policy, Ukraine may temporarily implement controls on capital transactions.

[23] The regulations to inspect nonbank subsidiaries would build on Articles 67 and 71 of the Law of Ukraine on Banks and Banking.

[24] The authorities have set up an interagency working group to draft procedures for consolidated supervision of financial groups whose activities span several financial sector regulators.

[25] Although the NBU has concluded bank supervision cooperation agreements with regulators in eight countries (Cyprus, Belarus, Armenia, Kyrgyz Republic, Lithuania, Latvia, the People's Republic of China, Poland), and draft agreements are under way with the Central Bank of the Russian Federation, Austria, Kazakhstan, Georgia, Sweden and Hungary, some countries with significant bank presence are not covered by these.

recommended to control investments in shares issued by one bank and acquired by another bank in order to create a financial holding group through~~, the ideal way of which would be~~ a licensing procedure for this activity.

42. **The broader legal framework for collateral should be strengthened to improve legal security in financial intermediation**. The implementation of the recently adopted unified system of real estate registration is a priority for more widespread use of real estate assets as collateral. Several remedies for secured claims are now available but collateral enforcement is still problematic: court proceedings are generally cumbersome and lengthy, and enforcement through the State Enforcement Service is highly inefficient. Bankruptcy legislation, providing for both insolvency liquidation and reorganization mechanisms, is generally adequate but there are some areas of concern, including on the treatment of state owned enterprise (SOE), the ease of reorganization of viable enterprises in distress, and the degree of appeals.

B. Capital Market Development

43. **Delays in capital market development hinder the prospects of nonbank financial institutions**. The absence of institutional investors and a benchmark yield curve are common obstacles. Shortcoming in securities market supervision include: (i) lack of operational independence of the supervisor (SCSSM); (ii) lack of clarity of the role of self-regulating organizations (SROs); (iii) limited investigation and enforcement powers; (iv) obstacles to exchange of non-public information with foreign counterparts or to provide assistance to foreign regulators; (v) the protection of the rights of minority shareholders falls short of international standards; (vi) the rules relating to disclosure and valuation of fund assets falls short of international standards for the protection of retail investors; (vii) capital adequacy requirements do not relate to the risks of intermediaries; and (vii) SCSSM oversight of the principal stock exchange PFTS is limited.

44. **The following measures are recommended**: (i) market regulators need to be granted powers for tracing the ultimate controllers of securities market participants and NBFIs, to strengthen the overall legal, regulatory and supervisory framework; (ii) a domestic government bond yield curve must be established, to develop domestic securities markets; (iii) a draft Joint Stock Company (JSC) Law that addresses severe weaknesses in corporate governance and provide a sound foundation for the development of the equity market must be adopted; and (iv) to strengthen market infrastructure, consolidation in trading platforms and clearing and settlement systems is desirable, the registrar system should be reformed, the accounting and auditing framework strengthened in line with the recommendations of the World Bank's 2007 Accounting and Auditing ROSC that is being finalized, and the valuation of infrequently traded securities should be regulated.

45. **The Government should adopt debt and privatization strategies consistent with the development of the capital market.** This is especially relevant given Ukraine's experience with a debt default and the ad hoc nature of its current strategy. The new debt

Appendix I: Follow-Up on Key Recommendations of the 2002 Financial Sector Assessment Program

50. **The 2002 FSAP team found that the improvement in Ukraine's macroeconomic performance had reduced financial sector vulnerabilities, but they remained worrisome.** The prudential regulation and supervision of banks and other financial institutions had improved, but several areas required urgent attention. The banking system was particularly vulnerable to credit risk, and provisioning likely did not adequately reflect true probabilities of default and expected losses in case of default. It was noted that the minimum capital requirement of 8 percent was low given the uncertainties inherent in a transition economy. The banking system had been growing very rapidly despite significant weaknesses in banks' balance sheets and profitability, and high real interest rates. It was concluded that dollarization of bank lending to enterprises and households with limited or no foreign exchange earnings was an increasing source of vulnerability associated with the perceived exchange rate targeting by the NBU. The NBU took several actions to address these concerns, including raising the minimum CAR to 10 percent and increasing the provisioning ratios on foreign currency loans to unhedged borrowers. Appendix II summarizes the main 2002 FSAP recommendations and the actions taken.

51. **The FSAP concluded that more general shortcomings in the economic environment contributed to banking system weaknesses**. Main problems included (i) poor corporate and bank governance; (ii) periodic political interventions that precluded taking banking decisions on purely commercial grounds; (iii) insider lending; (iv) occasional forbearance for activities that are violating sound NBU regulations; (v) weak institutional arrangements for seizing collateral and enforcing contracts; and (vi) poor accounting practices in enterprises, which impeded both loan evaluation and early recognition of loan impairment. The 2005 FSAP follow up found that regulation for related-party lending was strengthened, and the NBU introduced an early warning system (EWS) to detect problems in their early stages.

52. **The nonbank financial sector was too small to pose a systemic threat, but important developmental challenges remained.** The FSAP team recommended that the newly created nonbank financial regulator 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 had considerable scope for development. Securities markets were highly fragmented and did not serve as a channel for diversified investment or a means of disciplining corporate management. Subsequently, the regulator for nonbank financial institutions has become operational, adopted reporting requirements, and signed MoUs with other financial services regulators. Progress in developing the government securities market and market infrastructure has been slow.

53. **The FSAP highlighted areas where institutional arrangements were supportive of financial stability, but where further improvements were needed.** The transparency of monetary and financial policies was found in many regards adequate, but there were important concerns related to conditions under which central bank management could be

replaced, and the rules under which central bank profits were calculated and transferred to government had to be clarified. The deposit insurance system was found to be satisfactory, and the payment and settlement system was deemed reliable and efficient. However, bank resolution needed to be made more efficient, and the deteriorating situation of the Savings Bank required prompt action as a matter of urgency.

<table>
<tr><th>FSAP Recommendations</th><th>Actions Taken</th></tr>
<tr><td></td><td></td></tr>
<tr><th colspan="2">Banking Sector</th></tr>
<tr><td>Increase the minimum risk-weighted CAR to at least 10 percent, and eventually to 12 percent.</td><td>Increase to 10 percent took effect from March 1, 2004. Authorities are not planning any further increase, but are monitoring relatively weaker banks more closely.

Minimum capital was increased to EUR 10 million.~~.~~
Tightened definition of capital by adding requirements on foreign exchange and liquidity risks.

Additional measures:
• draft amendment to limit deposit withdrawals in case of emergency; and
• improved reporting on liquidity risk (September 2006).</td></tr>
<tr><td>Require banks to increase provisioning for foreign currency-denominated credits to borrowers without a reliable source of foreign currency earnings.</td><td>The provisioning ratios on foreign-currency loans to borrowers without foreign currency income have been increased (NBU Board Resolution #411, ~~September 7,~~adopted August 27, 2004). The ratios were increased as follows: 2 percent for “standards” loans (from 1 percent); 7 percent for “watch” loans (from 5 percent); 25 percent for “substandard” loans (from 20 percent); 60 percent for “doubtful” loans (from 20 percent). The changes took effect on July 1, 2005. The provisioning requirements were further strengthened in May 2007, new regulation:

<table>
<tr><th></th><th>Hryvnia</th><th>FX loans
With FX income</th><th>Without FX income</th></tr>
<tr><td>Standard</td><td>1%</td><td>2%</td><td>2%</td></tr>
<tr><td>Watch</td><td>5%</td><td>7%</td><td>10%</td></tr>
<tr><td>Substandard</td><td>20%</td><td>25%</td><td>40%</td></tr>
<tr><td>Doubtful</td><td>50%</td><td>60%</td><td>80%</td></tr>
<tr><td>Loss</td><td>100%</td><td>100%</td><td>100%</td></tr>
</table>

Other measures to contain FX risk:

• Differential reserve requirement (September 06).
• Stress tests on direct FX risk (mid-2006).
• Higher contribution to Deposit Insurance Fund of FX deposits (draft law—not yet effective).
• Open position limits reduced from 35 to 30 percent of capital.
• Limited restrictions on FX transactions.</td></tr>
<tr><td>Strengthen supervisory</td><td>The NBU has strengthened related-party lending by requiring that lending to such</td></tr>
</table>

controls on insider and connected lending.	parties on favorable terms be fully matched by capital set aside and be granted only on the basis of a decision by the supervisory board and/or management board (NBU Board Resolution #192, April, 29 2003). This measure became effective on June ~~12~~21, 2004.
	The draft amendments to the Banking Law, which will eliminate lending to related parties at favorable terms, has been ~~submitted to~~adopted by parliament.
	The NBU has adopted a resolution that prohibits any borrower from participating in loan analysis and decisions (NBU Board Resolution #186, May 20, 2002).
	Banks are required to report all transactions with related parties to the NBU and publicly disclose such lending in their annual reports (NBU Board Resolution #~~518, December 3~~598, adopted December 7, 2004; maximum exposure limits to related parties were also decreased).~~, 2003).~~
	Amendments to the Banking Act, which require identification of bank owners, have been submitted to parliament.
Implement consolidated supervision.	A new procedure was introduced in January 2003 to calculate prudential norms based on consolidated reports; banks are required to compile and submit the appropriate consolidated financial reports; the composition of consolidated association members must be identified.
	The NBU plans to require banks to operate information management systems that enable bank management to view the major risk concentration levels in a timely manner.
Maintain requirement that banks take prompt corrective action to rectify any prudential deficiency and strictly avoid forbearance.	The NBU has introduced, and is constantly improving, an EWS which reveals problems in their early stages.
Pursue the rehabilitation and restructuring of the State Savings Bank.	A Memorandum of Understanding has been signed between the government, the NBU, and the World Bank.
Review and revise the provisioning rates based on empirical evidence of loss rates.	The provisioning ratios on foreign currency loans to borrowers without foreign currency income have been increased (see above).
	Loan classification rules were tightened in 2003 resulting in many "watch" loans moving to "substandard." Another change occurred in 2005 (Resolution #411) which shifted many loans from "standard" to "watch." Other: • revision of loan classification and provisioning requirements for consumer loans (April 2007).
Tighten regulations on bank equity investment.	The NBU has drafted a resolution on criteria and procedures of granting permission for each investment made by banks in the capital of other institutions (previously adopted by NBU Board Resolution #368, August 2001).
Require banks to prepare accounts fully in compliance with IAS (International Accounting Standards).	Audits must be in line with IAS (NBU Board Resolution #389, September 9, 2003).
Integrate the deposits at the state-owned Savings Bank into the deposit insurance system.	Not done.
Modernize the mortgage law, land and building titling, and the law on secured	The Mortgage Law was adopted on June 5, 2003. The law "On Securitization of Creditors' Claims and Registration of Encumbrances" was adopted on November ~~8~~18, 2003.

transactions.	The law "On State Registration of Property Rights to Real Estate and Their Restrictions" was adopted on July 1, 2004.
Anti-Money Laundering	
Make operational the Financial Monetary Department (the financial intelligence unit).	The State Department for Financial Monitoring (SDFM)—in charge of implementing the law "On Preventing and Counteracting Laundering of Money Received by Criminal Actions," which came into effect June 12, 2003—is fully operational. The AML Law includes reference to the prevention of money laundering, the duty to identify clients and the store of documents. The NBU adopted a resolution on "Provisions on Financial Monitoring Held by Banks" (NBU Board Resolution #189, ~~July~~May 14, 2003) which was amended to simplify low-risk client identification procedures (NBU Board Resolution #446, October 14, 2003).
	The NBU can impose fines on banks that perform poor financial monitoring procedures and take some steps against money laundering. Nevertheless, fines of ~~1,000~~17,000 hryvnia appear to be very low.
Monetary Policy	
Phase out the NBU's longer-term refinancing facility, or at least strictly limit refinancing; require the provision of high-quality collateral of matching maturity.	The facility was terminated effective March 2004; however, the NBU continues to provide refinancing for maturities up to 350 days.
Clarify to the public the prioritization of the central bank's domestic and external monetary policy targets.	~~Not done.~~No significant improvements in this area, despite publication of annual monetary and credit policy guidelines.
Determine central bank profit transfers to the government based on realized profits.	Not done.
Appropriately limit the conditions under which central bank management could be replaced.	Not done.
NonBank Financial Sector	
Make operational the new regulatory agency for non-bank financial institutions.	In December 2002, a non-bank supervisory agency was created. A Memorandum of Understanding between the financial services regulators (NBU, State Commission for Securities and the Stock Market and the State Commission for Regulating Financial Markets) was signed in November 2003. Reporting requirements for non-bank financial institutions (required to submit quarterly and annual reports) was adopted in April 2003.
Update and extend regulation for nonbank financial institutions, notably for leasing companies, pension funds and credit unions.	The law "On Mandatory State Pension Insurance" and the law "On Non-State Pension Insurance" came into effect in January 2004.
	Minimum capital requirements for insurers were increased (risk insurers to 500,000 euros in 2003, 1 million euros in 2004; life insurers 750,000 euros in 2003, 1.5 million euros in 2004) in November 2003.

Change legal framework for bank resolution: (i) support for enhanced pre-closure market-based solutions; (ii) substantially increase fines for banks that do not respect corrective action; (iii) limited open-bank assistance alternatives for systemic cases; (iv) increase problem banks' board responsibility; (v) provide a wider set of failed bank resolution alternatives; and (vi) further increases in minimum required capital to encourage consolidation.	Medium term	NBU, Parliament
Strengthen the crisis management framework: (i) improve contingency planning; (ii) consider extension of eligible collateral for refinancing; (iii) discuss amendment on emergency powers to suspend deposit payout during a systemic crisis; (iv) clarify institutional responsibilities in case of an emergency liquidity crisis; and (v) create a Financial Stability Department.	Short – medium term	NBU, Parliament
Insurance		
Subject non life insurers to a proper taxation treatment.	Short term	SCRFSM
Require Ukrainian insurers to use EU accounting conventions.	Short term	SCRFSM
Enact modified version of proposed law 'On amending the Law of Ukraine on Insurance.'	Short term	Parliament
Update SCRFSM information systems and require all insurers to report electronically.	Short term	SCRFSM
Increase supervisory independence of SCRFSM.	Medium term	Cabinet of Ministers
Clarify relationship between the two financial commissions (NBFI and Securities), the President and the Chamber of Ministers.	Medium term	Cabinet of Ministers
Adjust salary structures so as to attract and retain high quality and trained supervisory personnel.	Medium term	SCRFSM
Develop actuarial and basic operating skills.	Medium term	SCRFSM
Considering further reforms that could better integrate all financial sector supervisory activity.	Long term	
Pension Reform		
Amend proposed governance structure of the second pillar: • the Board of the pension fund should consist of a reduced number of technical experts with fixed-term appointments; • unions and employers should only play an advisory role to the Board; • the Board, as well as the asset managers and custodians, should be supervised by the SCRFSM; • the Board should conduct the bidding process and would propose the asset managers to the SCRFSM for approval; and • the investment guidelines should be approved by the SCRFSM.		Cabinet of Ministers
Capital Markets		
Regulation and supervision of securities markets and NBFIs		
Grant market regulators powers for tracing the ultimate controllers of securities market participants and NBFIs, all the way through the chain of control in accordance with international standards, and for carrying out systematic background checks on them.	Short term	Cabinet of Ministers

Enact the proposed new Joint Stock Company (JSC) Law.	Short term	Cabinet of Ministers
Convert all share certificates into dematerialized securities held by custodians.	Short term	SCSSM
Regulate the valuation of infrequently traded securities and private equity transactions in the portfolio of collective investment funds, non-state pension funds and insurance companies.	Short term	SCRFSM
Transform SCSSM and SCRFSM into specialized agencies outside the central executive body, with a legal status similar to the NBU.	Medium term	Cabinet of Ministers
Give SCSSM and SCRFSM autonomy to fix staff salaries and benefits in accordance with private sector benchmarks and to adjust them accordingly.	Medium term	Cabinet of Ministers
Provide SCSSM and SCRFSM staff with the same legal immunity as NBU staff.	Medium term	Cabinet of Ministers
Strengthen the accounting and auditing framework in line with the recommendations of the 2007 Accounting and Auditing ROSC.	Medium term	SCSSM
Revise the Law on Joint Investment Institutions (JIIs) to allow the establishment of investment funds with compartments and funds-of-funds, and allow retail investors to participate in UITs.	Medium term	Cabinet of Ministers
Carry out a full re-licensing of investment funds currently operating in the market.	Medium term	SCRFSM
Government securities, corporate and subnational bond markets.		
Implement a comprehensive state debt management strategy that would lead to the creation of a benchmark yield curve.	Short term	MoF
Support development of the sub-national debt market.	Medium term	MoF
Allow the issuance of direct Eurobonds as opposed to only Loan Participation Notes.	Short term	~~NBU~~SCSSM
Abolish requirement for mandatory credit rating of every bond issue.	Short term	SCSSM
Asset-backed securities.		
Complete and harmonize the work on the legislative framework for the primary and secondary mortgage market including Covered Bond legislation and regulations.	Short term	Cabinet of Ministers
The SMI's bond issuance and refinancing activities should be market-based, it is strongly recommended not to use the SMI as a mechanism for delivering the government's social housing policy by subsidizing primary mortgage markets.	Continuous	MoF/SMI
Improve the operational capacity of the SMI.	Short term	SMI
Adopt a modern securitization law.	Medium term	Cabinet of Ministers
Abolish the requirement that the technical reserves of the insurance companies should be placed into priority sectors including the purchase of SMI securities.	Short term	SCRFSM
Derivatives		
Abolish the FX transaction tax (pension fund contribution).	Immediate	Cabinet of Ministers
Adopt the derivatives law currently in draft.	Short term	Cabinet of Ministers
Design a plan for the development of the derivatives market including exchange-based derivatives.	Medium term	NBU/~~MoF~~Cabinet of Ministers/Stock exchanges/ SCSSM

Facilitate the development of liquid underlying markets for derivatives.	Medium term	NBU/~~MoF~~Cabinet of Ministers/ SCSSM/SCRFSM
Improve the legal and market infrastructure for exchange-based derivatives trading through • implementing a modern trading system, which executes clearing and settlement through a single *central counterparty* and multilateral close-out netting with specific arrangements to manage counterparty risk (for example through margining); • introducing surveillance systems to detect imprudent behavior; • contract standardization consistent with International Swaps and Derivatives Association documentation and uniform contract sizes; • accounting and regulatory standards in specific derivative laws, including the full balance sheet disclosure; • aligning local accounting standards with IFRS; and • market supervision through SROs, especially to ensure reliable dispute resolution mechanism for investor protection.	Medium term	Stock exchanges
Market infrastructure		
Allow PFTS to become the main trading platform for Ukrainian securities	Medium term	PFTS/SCSSM
Support the development of MFS.	Medium term	SCSSM
Legal framework		
Implement and put into operation the single registration system for immovable assets.	Medium term	MoJ
Modify registry regulations to allow direct registration of transfer of ownership clauses established by notarized mortgage contracts of satisfaction of claims.	Medium term	MoJ
Streamline proceedings to enforce judicial orders before the State Enforcement Service.	Medium term	MoJ
Design and implement a plan for improving State Enforcement Officers capacity, integrity and performance.	Medium term	MoJ
Eliminate restrictions to asset realization of SOE in bankruptcy.	Medium term	Authority in charge of SOE regulation / privatization
Do not extend suspension of Part 2 of Article 36 of the Insolvency Law beyond the year 2007.	Medium term	MoF
Payment and Settlement Systems		
Phase out bank branch access to SEP to limit operational risk.	Medium term	NBU

Appendix III: Structure of the Financial Sector

A. Banking Sector: Structure and Ownership

54. Ukraine's financial landscape is dominated by the rapidly expanding banking sector, but nonbank financial institutions are also growing (Table 6). At end-2006, banking sector assets totaled US$71 billion, equivalent to 67 percent of GDP. In comparison, Ukraine's nonbank financial sector faints in size. The insurance sector is the next biggest segment where premiums account for about 3 percent of GDP and assets for 4 percent of GDP. Other financial institutions such as pension funds, credit unions, and leasing companies together have assets accounting for less than 1 percent of GDP.

55. **The influx of foreign banks since the "Orange Revolution" has changed the ownership structure, but the banking system remains fragmented.** As of end-May 2007, 40 banks were foreign-owned (of which 18 fully foreign-owned), accounting for about 28 percent of capital compared to 10 percent at end-2004. Of the largest 25 banks, [10] were foreign owned as of end-May 2007. This trend is set to continue as some acquisitions are still in process. There have been political pressures to cap the foreign share at 50 percent. All foreign banks are subsidiaries, since the Banking Law prohibits opening foreign branches.

56. **Only two banks—Savings Bank and Ukreximbank—are fully state-owned and their role has been on the decline.** Due to its undercapitalization, Savings Bank, which enjoys a full government guarantee for household deposits, was put under a special regime from 2002–07, with World Bank assistance. Since then it has cleaned up its books, has received capital injections from the government, and has shrunk in relative size, now accounting for 3.4 percent of total bank assets (and 7 percent of deposits). The future of Savings Bank is unclear and hinges on the government resolving the "lost savings" issue.[27] Additional uncertainty was created by the government replacing Savings Banks' management team in early 2007. Ukreximbank, the other state-owned bank which originally specialized in trade financing, has been in a better financial position. By end-2006, it accounted for 5.5 percent of total bank assets. Since it does not enjoy an explicit government guarantee, its state-owned status is viewed as less distortionary.

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[27] During the 1993/94 hyperinflation in Ukraine, the savings deposits in the Savings Bank depreciated to almost nothing, but were recognized as a government liability in 1996, amounting to about 160 percent of GDP. However, since the liability was neither indexed nor paid interest, it has shrunk to an estimated 30 percent of GDP. Exact figures are not available since all files are in paper form spread across the thousands of Savings Bank branches. As long as the files have not been computerized and the total stock of liabilities accounted for, it will be difficult to privatize the bank.

II. Preconditions for Effective Banking Supervision

89. **The authorities' current policy of maintaining a stable nominal exchange rate for the hryvnia provides strong incentives for dollarization of the economy and the banking sector. Highly favorable interest rate differentials have led to large inflows of short-term foreign capital.** While these have been advantageous in the short-term, they carry the risk of sudden reversal (precipitated by changes in global market conditions or domestic political developments) which is likely to cause serious difficulties for both the banking sector and wider economy. To meet these flexibly, the authorities have started to put in place the conditions for an inflation targeting regime, a monetary policy framework that can accommodate greater exchange rate flexibility.

90. **Ukraine is making significant progress in the field of collateral legislation.** There is now a modern legal framework for securing financial claims using both movable (tangible and intangible) and immovable assets and lending institutions regard the current possibilities for creating and registering collateral as sufficiently easy and affordable. However, enforcement of collateral is still problematic. The new legislation governing both mortgages and pledges introduced out-of-court enforcement mechanisms. However, in most cases judicial enforcement is needed and court proceedings are generally cumbersome and lengthy. Enforcement of judicial decisions is made by the State Enforcement Service (SES), an administrative body under the Ministry of Justice, which is reported as operating very inefficiently.

91. **As regards credit information**, the Law on Organization of Formation and Circulation of Credit Histories has established a sound legal framework for private sector credit bureaus. Three credit bureaus have been licensed and have started operating.

92. **Bankruptcy legislation, providing for both insolvent liquidation and reorganization, is generally adequate.** However, the assets of many state owned enterprises cannot be realized in bankruptcy proceedings with the result that such enterprises may remain in bankruptcy indefinitely. In addition, the extensive opportunities for a making appeals cause excessive delays in many bankruptcy cases going through the courts.

93. **The deposit insurance system in Ukraine comprises an unlimited government guarantee for household deposits with one state owned bank and a limited guarantee for household deposits at other banks provided by the FGDNP.** The FGDNP is well designed. Maximum coverage is UAH ~~25,000 (US$5,000)~~50,000 (around US$10,000) per person equivalent to about twice per capita GDP.

III. Main Findings

Objectives, independence, powers, transparency, and cooperation (CP 1)

94. **The objectives and responsibilities of the supervisory authority are clearly stated in law.** In general, the NBU has adequate powers to supervise banks' activities and to ensure

that they comply with legal requirements. In performing supervision the NBU also enjoys legal independence from government and the banking industry. Resources for supervision are provided from the income earned by its central banking operations and are generally adequate, although there is some need to devote more resources in order to retain qualified supervisors in the NBU. While they do not enjoy statutory immunity, individual supervisors are protected by the vicarious liability of the NBU in respect of any civil actions which may be taken against them as a result of performing supervisory actions. At the same time, improvements are needed in certain specific areas. Most importantly, while the NBU is able to cooperate with other domestic regulators, its effective ability to cooperate with foreign supervisors is impeded by its inability to refuse the disclosure of confidential information received from foreign supervisors when this is required under any provision of Ukrainian law. In addition, the permissible reasons for dismissing the senior NBU officials responsible for bank supervision and the legal protection provided to individual bank supervisors should be specified in law.

Licensing and structure (CPs 2–5)

95. **The rules limiting access to banking activities are generally satisfactory.** However, while the NBU has generally adequate powers to refuse licences, the licensing process would be strengthened if the NBU had explicit legal powers to require the disclosure of information about the ultimate beneficial owners of proposed banks and to refuse applications in cases where the proposed shareholding structure was not transparent. At the same time the NBU is able to control transfers of significant participations and/or voting rights in existing banks irrespective of whether these are held directly or indirectly. In addition, banks' ability to invest in other enterprises is subject to certain statutory limitations. However, the NBU does not have any criteria against which it can assess the suitability of major investments.

Prudential regulation and requirements (CPs 6–17)

96. **Prudential regulations have been strengthened since the previous FSAP.** In 2004 the required capital ratio was increased from 8 to10 percent. In addition, the limits on large exposures and related party lending (including lending on preferential terms) have been effectively tightened by applying additional capital requirements. Provisioning requirements for loan losses have been tightened. In particular, indirect foreign exchange (FX) risk has been addressed through the imposition of higher provisions against FX loans.~~ to borrowers without FX income.~~

97. **The NBU has also introduced detailed requirements for banks' risk management.** These address comprehensively both the risks inherent in banking activities and the controls required for their prudent management. Responsibility for adequate risk management is placed directly on banks' governing bodies (supervisory councils and management boards). While the regulations closely follow best international practices and the implementation of them is being actively addressed during inspection visits, the adoption

1.1 Responsibilities and objectives	Satisfactory.
1.2 Independence, accountability and transparency	The law does not specify the permitted reasons for dismissing the Deputy Governor with responsibility for banking supervision and/or the head of banking supervision. Nor, in the event of such a dismissal, does it require that the applicable reason(s) is publicly disclosed. The NBU also needs to make further efforts to retain its qualified staff.
1.3 Legal framework	Satisfactory
1.4 Legal powers	Satisfactory subject to the caveat that there is a need for increased scope to update regulations speedily.
1.5 Legal protection	The legislation does not make explicitly clear that all staff of the NBU involved in banking supervision (together with provisional administrators and bank liquidators) have legal protection for actions they take while discharging their duties in good faith.
1.6 Cooperation	Unsatisfactory. Requires urgent attention. There is inadequate cooperation with foreign banking supervisory authorities whose banks play a significant role in the Ukrainian banking system. This is due to a perception by foreign supervisors that current legal provisions are insufficiently clear to ensure the NBU's ability to protect confidential information. To overcome this problem current legal provisions should be re-worded in an explicit manner.
2. Permissible activities	Satisfactory
3. Licensing criteria	There are still some weaknesses in the legal provisions governing licensing: • The NBU's powers to obtain information about the persons who will control a proposed bank are restricted to direct immediate shareholders. The NBU should have power to require information about all significant direct and indirect shareholders, including ultimate beneficial owners, in order to assess their suitability. • The NBU has no explicit power to reject an application on the basis of a non-transparent shareholding structure, or inadequate operational or managerial structure. • There is no legal requirement for all influential shareholders to have a clean criminal track record.
4. Transfer of significant ownership	Satisfactory. However, the criteria for approving transfers of significant ownership do not include a supervisory determination that a transparent shareholding structure will be introduced. The quarterly reports of bank shareholders include details of insignificant minor shareholders, while failing in some cases to include significant beneficial owners of shares.

5. Major acquisitions	Unsatisfactory. Requires attention. There are no clearly defined qualitative criteria for assessing major acquisitions by banks in other entities. These should cover the business rationale for such investments, the financial risks and the ability of banks to manage them prudently.
6. Capital adequacy	Good, but further development of risk-based capital requirements desirable. Specifically, the NBU has still to consider setting individual risk-based capital ratios for banks (which may exceed the current 10 percent required minimum).
7. Risk management process	Good, but anecdotal evidence suggests that risk management in several banks is still not fully effective, and further efforts are required to raise standards across the banking system.
8. Credit risk	Satisfactory
9. Problem assets, provisions, and reserves	Adequate. However, there is a significant divergence between the provisioning requirements for supervisory purposes and those required for financial statements prepared in accordance with IFRS. This indicates that banks' provisions do not reflect realistic repayment and recovery expectations. The NBU is recommended to consider aligning its standards for loan loss provisions more closely with international accounting practices.
10. Large exposure limits	Good, but limits should also be applied on a consolidated basis
11. Exposure to related parties	Good, but different limits are needed for different types of related exposure. Also, these exposures are not supervised on a consolidated basis
12. Country and transfer risks	Satisfactory (while actual risks are relatively small). However, the NBU should encourage banks to develop their own systems for managing this risk.
13. Market risks	Satisfactory (while actual risks are relatively small). In the case of actively traded securities the NBU is recommended to impose some additional capital charges to reflect price risk. In the event of increased FX trading additional capital charges for exchange rate risk should also be considered.
14. Liquidity risk	Satisfactory at present. However, as more foreign banks enter the domestic market the NBU is recommended to evaluate the ability and willingness of foreign parent banks to provide back-up liquidity to their Ukrainian subsidiaries.
15. Operational risk	Satisfactory
16. Interest rate risk in the banking book	Satisfactory, but the interest rate risk in banks' rapidly growing mortgage lending needs to be monitored closely. The NBU is recommended to monitor closely banks' management of this risk.
17. Internal control and audit	Satisfactory

CP 9 Problem assets, provisions and reserves	Align the standards for loan loss provisions more closely with international accounting practices.
CP 10 Large exposure limits	Apply the 25 and 800 percent limits on a consolidated basis.
CP12 Country and transfer risks	Encourage banks to develop their own systems for managing these risks.
CP 13 Market risks	Impose additional capital charges to reflect price risk arising from material holdings of traded securities.
CP 16 Interest rate risk in the banking book	Monitor closely the extent to which banks may be increasing their exposure to this risk and the adequacy o their controls.
CP 18 Abuse of financial services	Introduce a legal requirement to report to the NBU supervisor suspicious activities and incidents of fraud which are material to the safety, soundness or reputation of the bank.
CP 19 Supervisory approach	(1) In the development of risk-based supervision give greater weight to (a) the overall economic and legal environment in which banks operate and (b) the risks and/or benefits which existing owners (or controllers) constitute for individual banks. (2) Place a legal obligation on the management boards of banks to inform the NBU, as soon as they become aware, of any serious deterioration in the financial condition of their bank or any breach of supervisory norms.
CP 21 Supervisory reporting	Use existing legal powers to require the parent companies of all groups (consisting of banks and other financial institutions) to submit prudential reports on a consolidated basis.
CP 22 Accounting and disclosure	Increase the degree of alignment between Ukrainian and International Financial Reporting Standards.
CP 24 Consolidated supervision	(1) Require the parent companies of groups to submit supervisory reports on a consolidated basis (2) Oblige all banking and financial groups to observe supervisory norms for capital adequacy, large exposures and related party lending on a fully consolidated basis. (3) Ensure that effective risk management is applied at group level and to all individual members of banking and financial groups. (4) Give the NBU legal power to inspect banks' nonbank subsidiaries and associates.
CP 25 Home-host relationships	Amend the law to prevent the NBU being obliged to disclose confidential information received from foreign supervisors except for the purpose of assisting the prudential supervision of financial institutions.

Authorities' response to the assessment

105. **The NBU agrees with the preliminary assessments**. However, it also considers that the assessments of CPs 1.6, 21 and 25 do not provide a full picture of the work done by the NBU and consequently do not accurately reflect the degree of compliance. The authorities also argued that the licensing criterion regarding impeccable business reputation for prospective bank owners addresses the concern posed by assessors about the absence of a requirement of a clear criminal track record. They also indicated that the called-for strict application of IAS 39 might result in decreased provisions that would not be desirable.