# How to do a Comprehensive Banking Reform

## OUR VISION

National Bank of Ukraine is a modern, transparent and independent central bank trusted by the public and integrated into the European community of national central banks.

Mission, Vision and Values were defined in 2014

## MISSION

To ensure price and financial stability contributing to the sustainable economic development of Ukraine

## NBU - Bank of the Nation











**Patriotism** 

Professionalism

Transparency

Integrity

**Partnership** 

## We had to grapple with the main challenges of the Ukraine's economy

#### **AILING ECONOMY**

## AILING BANKING SYSTEM

#### NON-TRANSPARENT AND NON-EFFICIENT CENTRAL BANK

- Military aggression and annexation
- External misbalance (CAB ~10%)
- Devaluation pressure
- Unsustainable fiscal + quasi-fiscal deficit
- Commodity-dependent export
- Weak government institutions
- Insufficient creditors' rights protection

- Fragmented system:
- 185 banks (MkS of 80 smallest banks is less that 5%)
- Related-party lending (bank is a piece in a value chain of oligarchic empires)
- Ineffective and loss making during last 5 years
- Non-transparent ownership
- Hidden NPLs

- 12 000 employees
- 25 regionally decentralized offices
- Top bureaucracy level
- Weak decision-making system
- Critically minimal level of NBU's confidence rating

**TIGHT MONETARY POLICY** 

STRUCTURAL BANKING
SECTOR REFORM

CENTRAL BANK
TRANSFORMATION

#### Ukraine went through the perfect storm in 2014-2015...

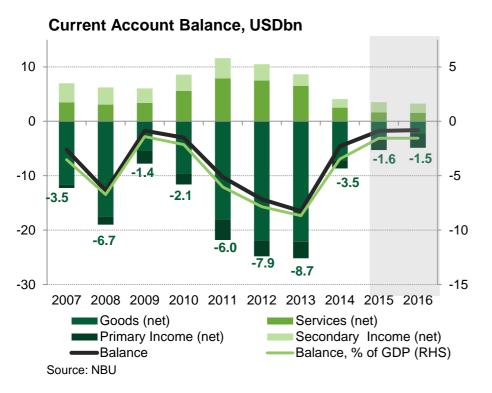
FX and capital controls

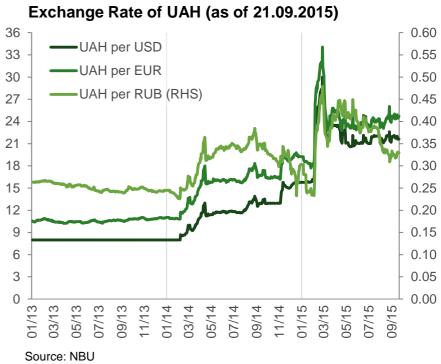
flourishing black FX market

Multiple exchange rate practices amid

Severe economic Bank run recession Interest rates spike Hiking inflation Credit crunch Banking Macro Sharp drop in exports Mounting NPLs Widening budget deficit crisis Capital shortage crisis Disastrous corporate governance Currency crisis Wide BoP deficit Severe confidence crisis

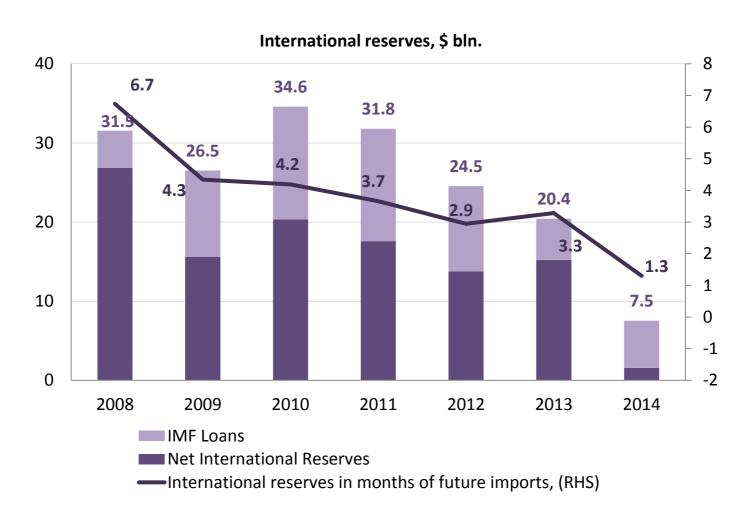
## ... unsustainable current account deficit driven by substantially overvalued exchange rate ...





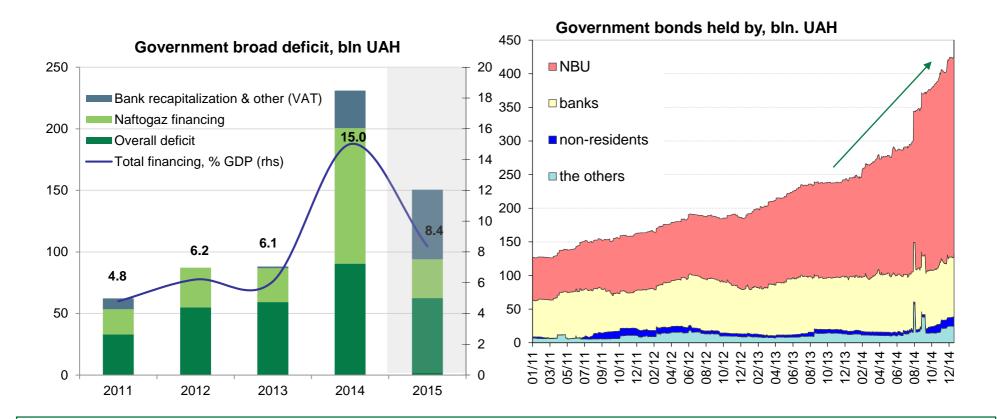
- In 2013 CA deficit reached almost 10% of GDP or 16 bln USD as a result of real overvaluation of UAH
  - Accumulated external imbalances and military conflict in Donbas triggered massive exchange rate adjustment, with UAH lost nearly 60% of its value against USD from Feb 2014 to Feb 2015
- By swift and decisive measures NBU calmed foreign exchange market in Mar-Jul 2015
  - Large-scale exchange rate adjustment during 2014 and the beginning of 2015 prompted long awaited changes in the monetary policy framework

#### ... which led to the depletion of FX reserves



• Financing gap needed to increase reserves to the previous program level in 2015 amount to nearly \$15 bln.

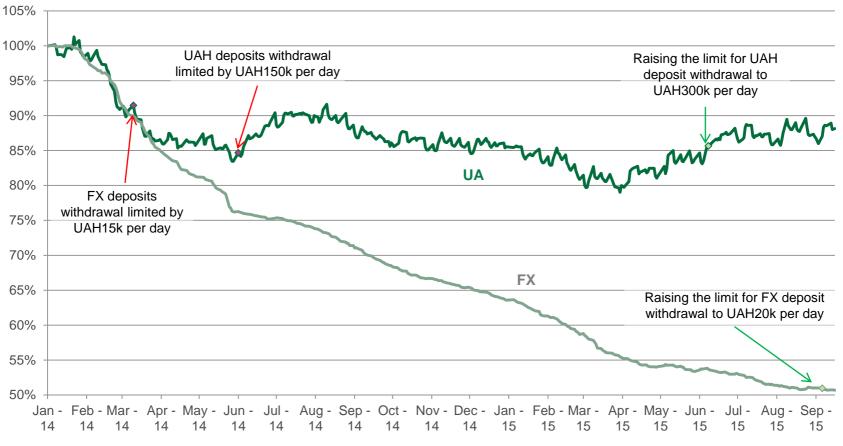
#### 2014 deficit was mostly covered by local QE



- In 2014 budget and quasi-budget deficit grew up to 15% of GDP mainly because of debt service expenditures growth (impact of hryvna devaluation) and increase of defense expenditures caused by military conflict
- The same factors will determine larger part of deficit in 2015.
- Budget consolidation is necessary, but general government deficit optimization requires reforms of sectors with large role of state regulation (energy, transportation etc.).
- By the end of 2014 total govt. bonds holdings were 457.6 bln. UAH with the majority of bonds owned by NBU (69.5%)

#### ... and a significant outflow of households' deposits

#### Households' deposits, 01.01.2014=100%

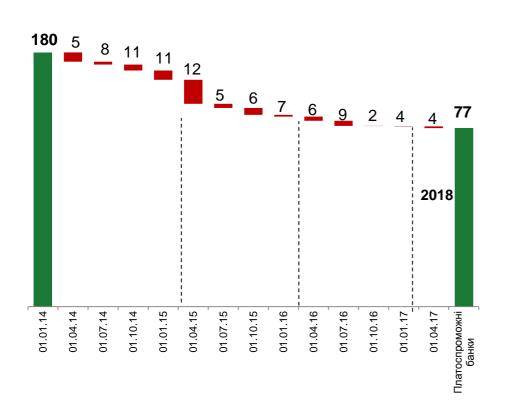


- \*Data for solvent banks
- Since the beginning of 2014 banking system lost nearly 40% of households' deposits (20% of UAH and over 50% of FX deposits)
- In June 2015 UAH deposits started to recover while FX outflows continued

#### In early 2014, there were 180 banks in Ukraine.

Most of them did not disclose real owners and their reporting did not reflect the real state of their balance sheets





Since the beginning of 2014:

**103 banks** were withdrawn from the market, including:

- 16 due to violation of legislation in the field of financial monitoring
- 11 Due to the opaque structure and unsatisfactory business reputation of the owners
- 7 self-liquidation and M&A
- 4 Crimea and ATO zone
- 65 due to violation of norms, including falling of the level of liquidity and capital standards
- The Law №218 of 02.03.2015 about related party loans and criminal responsibility of bank's owners connected to the fraud was adopted.
   108 cases were forwarded to law enforcement agencies during 2015-2016:

89 reports were sent to the bodies for combating organized crime

9 reports on criminal violations were sent to law enforcement agencies

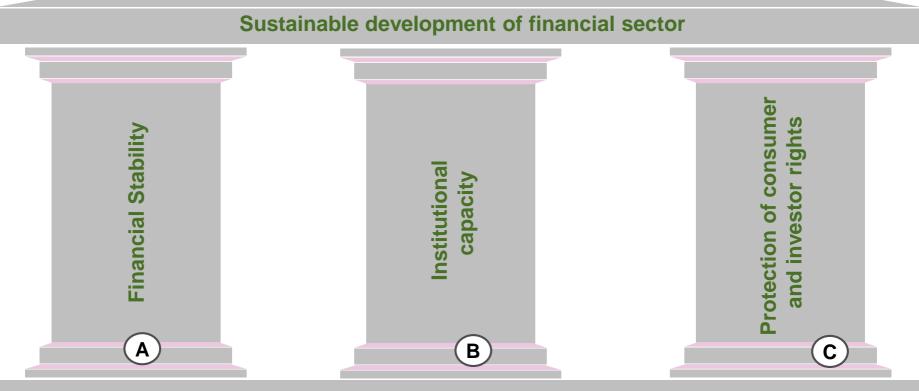
0 owners of banks recognized as insolvent, were convicted

 The biggest private bank with 33% of private individual deposits were nationalized in 2016

Clearing the financial sector is one of the key steps towards a stable and e financial system

## The financial sector reform has been planned along THREE MAIN PILLARS...

Reaching the EU level and meeting EU requirements to the financial sector development

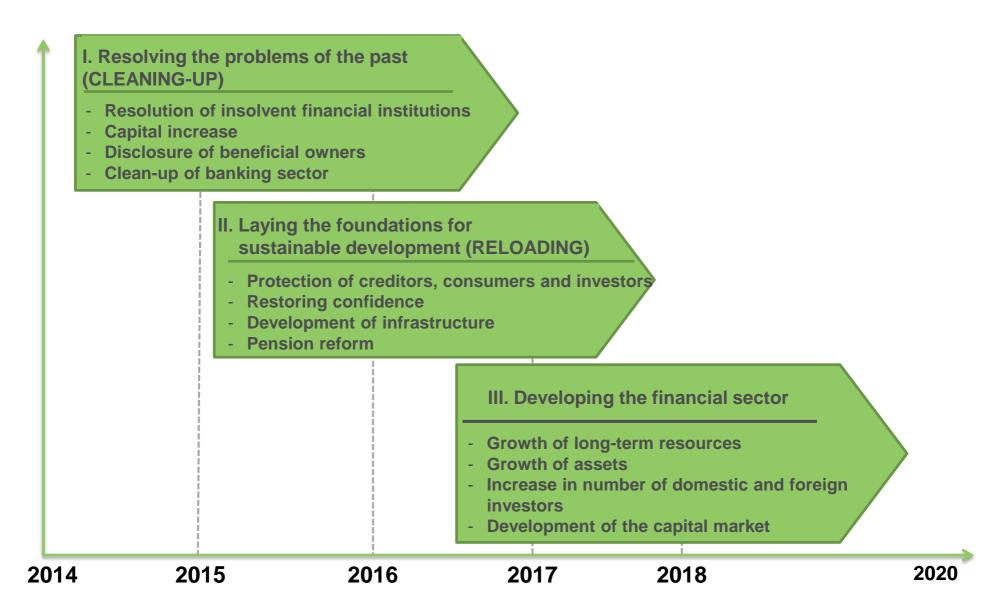


Reaching macroeconomic stability

Resolving the problems of the past

Prerequisites for sustainable development of the financial sector are ensuring macroeconomic stability and resolving the problems of the past

#### ... and its implementation provides for THREE KEY STAGES



#### Financial sector in 2014 required radical reforms



Insufficient capitalization of the financial system



**High dollarization** 



Low corporate governance level



Large number of inefficient financial institutions



Poor creditor rights protection



Lack of transparent reporting from financial sector players



Ceased lending to the economy



High level of lowquality assets



Low financial literacy of population





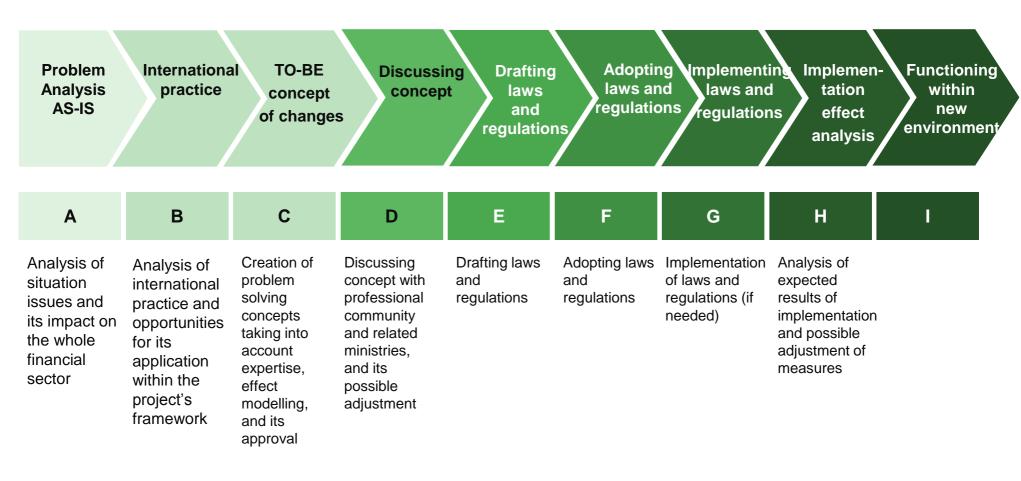
Low level of supervision



Lack of confidence in financial sector

Financial sector has a great number of issues piled-up, which have to be addressed for further efficient development

## We used project management algorithm for turning a comprehensive system from basic into target stage



This process is complicated by: 1) choosing from different scenarios the system is going through while transforming, and 2) the need to use ambiguous logical tools while determining the degree of credibility of decision options in each scenario

## Business Process Management is systematic approach to making an organization's workflow more effective



Methodological.
approach to
process
management

**Optimization of staffing** based on evaluation of its functionality in the processes

Structuring, analysis and documentation of the basic processes

Creating a unified **regulatory framework** of internal documents

Evaluating the **efficiency of processes** 

Organizational. centralized process management

Creation of a **competence center** for modelling, management, optimization and automation of the NBU processes

Technological.
introduction of
new tools for
process
management

Implementation of **software for modelling** and documenting processes

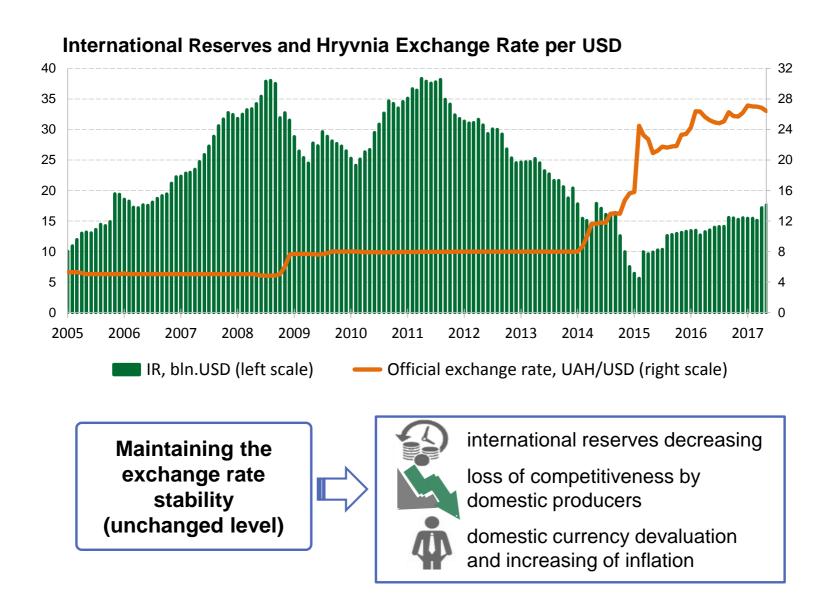
Implementation of software for automation of processes

- To ensure uninterrupted NBU processes
- Implementation of efficient internal control system and risk mitigation
- Creation of the necessary preconditions for further transformation and optimization of processes

Process management division has been established for setting up the methodology, facilitating the efforts and supporting the functions in process re-engineering

## Floating FX and market liberalization road-map

## The past: fixed exchange rate created an illusion of stability... which disappeared with currency crisis



## We launched a floating FX rate regime but in the same time we introduced draconic administrative restrictions to calm FX market

#### FX restrictions introduced in NOV 2014- MAR 2015

#### **FX** cash operations

- •FX cash transfers of individuals abroad limited by an equivalent of UAH 15,000 per day
- Withdrawal of FX cash or investment metals limited by an equivalent of UAH 150,000 per day per customer

#### FX operations of banks – limits by amount

- Advance payments in excess of USD 50,000 are subject to NBU approval
- Letter of credit is required to import contracts exceeding USD 500,000 confirmed by AA banks
- Advance payments in FX for import in excess of USD 50,000 executed on T+4 basis
- Contracts exceeding EUR 25,000 are subject to a price examination

#### FX operations of banks – limits to play from short position in UAH

- Purchase of FX is restricted if client's FX accounts balance exceeds USD 10,000
- Purchase of FX is prohibited if financed by loan in UAH

#### **Export - Import operations**

■Surrender requirements – 75% of FX proceeds received from abroad

#### FX operations of banks – extension of maturity

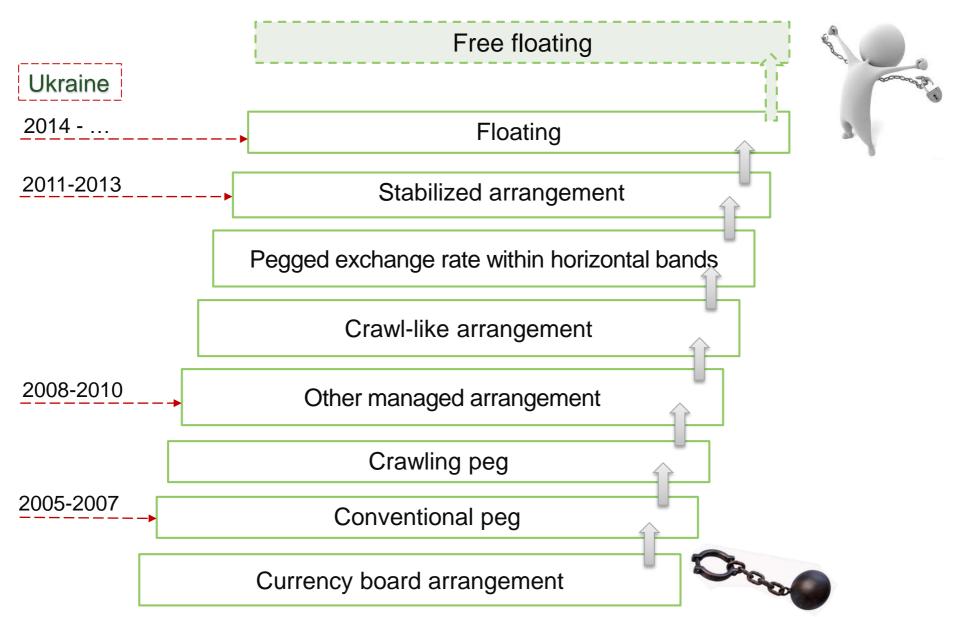
■T+4 regime for purchase of FX on behalf of client



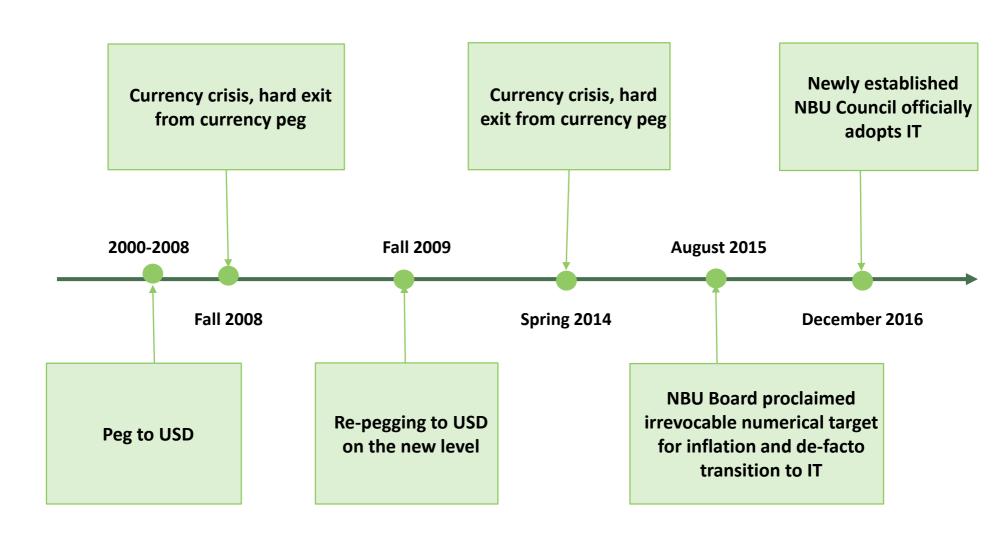
The National Bank of Ukraine has developed a phasing-out plan for gradual liberalization conditioned upon sustained improvements on FX and money markets

Most of the restrictions were eliminated or substantially eased since 2015. The new Currency Law was elaborated by the NBU and adopted by the Parliament in 2018.

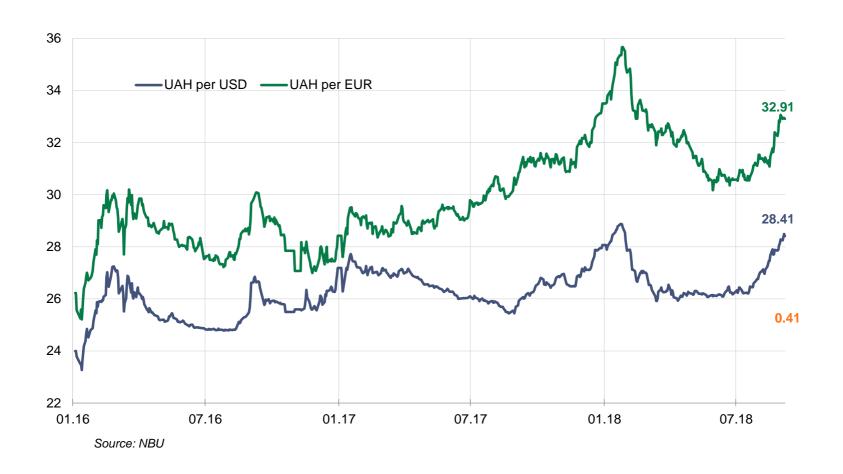
## IMF reclassified Ukraine to countries with floating exchange rates regime in 2014



#### **Evolution of monetary regimes in Ukraine**

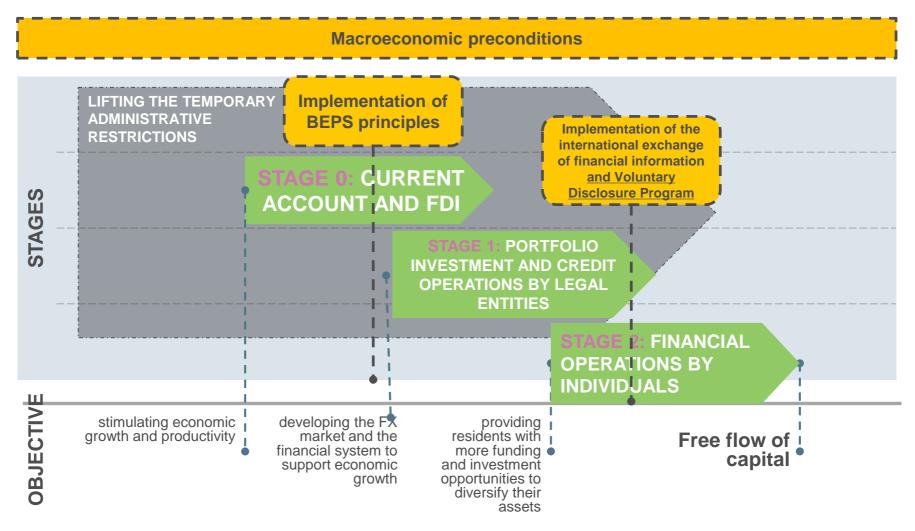


#### Current exchange rate regime: floating exchange rate



The exchange rate is determined by the market forces. This allows economy to find quickly the equilibrium after external and internal conditions has been changed. This also reduces the possibility of sharp exchange rate depreciation, which had been the case in 2008 and 2014

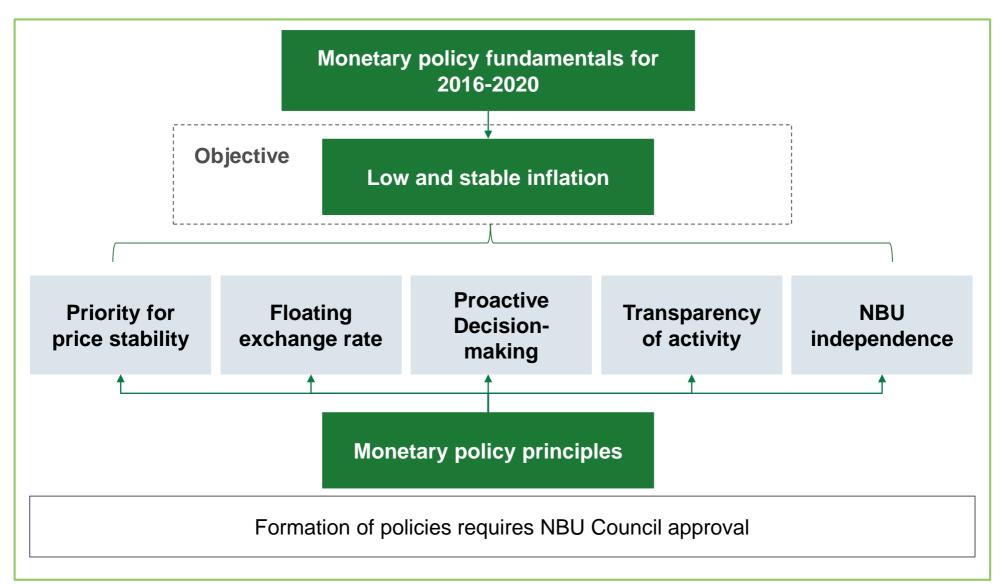
#### Main stages of currency liberalization



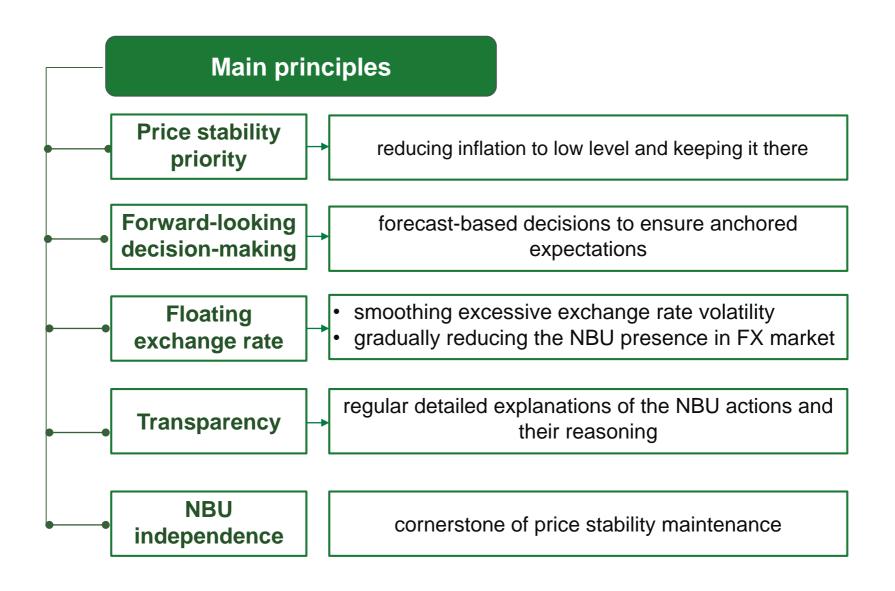
FX liberalization will move to the next stage upon implementation of the OECD's anti-BEPS recommendations and the single standard for automatic financial information exchange

# New Monetary Policy and Implementation of Inflation Targeting Regime

#### New principles of monetary policy were developed to achieve low and stable inflation



#### Main principles of new monetary policy framework



#### The timeline of Inflation Targeting (IT) adoption in Ukraine

# Stage I «Set up of technical preconditions» ☑ Development of macroeconomic models ☑ Establishment of quarterly forecasting cycle ☑ Start of the reform in the NBU

Stage II «Set up of institutional preconditions»	
1 <sup>st</sup> half of 2015	<ul> <li>☑ Changes in the monetary policy decision-making process</li> <li>☑ Monetary Policy Committee established</li> <li>☑ Publication of Inflation Report</li> <li>☑ The Draft of Monetary Policy Strategy for 2016- 2020</li> </ul>

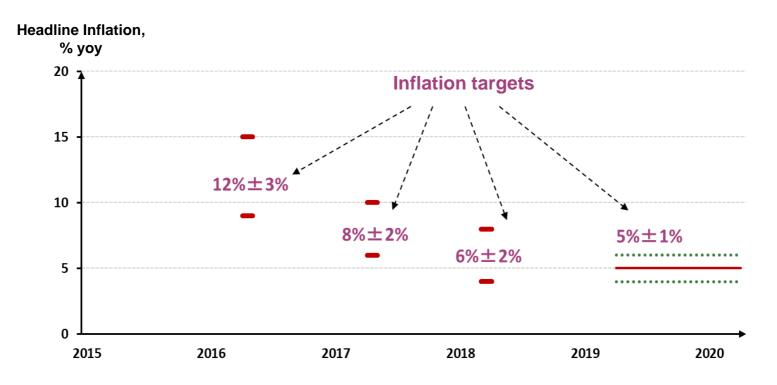
Stage III «Implementation of the inflation targeting regime»	
2 <sup>nd</sup> half of 2015 - 2016	<ul> <li>☑ Approval of the Road Map for Implementation of IT in Ukraine</li> <li>☑ Conducting monetary policy aimed at price stability</li> <li>☑ Decision-making according to preannounced schedule</li> <li>☑ Development of systemic monetary policy communications</li> <li>☑ New operational design of market interest rates management</li> </ul>

Inflation targeting regime was officially launched in 2016

#### Required preconditions for the inflation targeting regime

Price stability as the main goal of monetary policy Crucial Instrumental independence of the central bank at the transition stage No fiscal dominance Accountability, predictability, and transparency of policy Comprehensive analytical support of monetary policy decisions Required for Efficient instruments for policy implementation successful functioning Developed financial markets Reasonably stable financial institutes Almost complete / some Low readiness / long-lasting Complete development is needed improvement is needed

#### The present: The NBU has irrevocable target for inflation



- The adoption of IT was announced by NBU Board in August 2015, officially defined in the Monetary Policy Guidelines for 2017 and the medium-term and confirmed in the Monetary Policy Guidelines for 2018 and the medium-term
- In July 2018 the NBU Council adopted the Monetary Policy Strategy that confirms that the NBU will carry out its monetary policy based on the inflation targeting and its medium term inflation target of 5%
- The mid-term inflation target could be revised only downwards

## Implementation of best practice in communications is bringing central bank to another reality (case of the NBU)

National Bank of Ukraine in **2013**  National Bank of Ukraine in **2016** 



Increase in transparency goes in line with complex reform of the NBU



Strategy of monetary policy: clear numerical targets



Established decision-making & operational design of MP



Regular & proactive monetary policy communications (Press release, Press briefing, Inflation Report, Minutes)



Broad public access to data



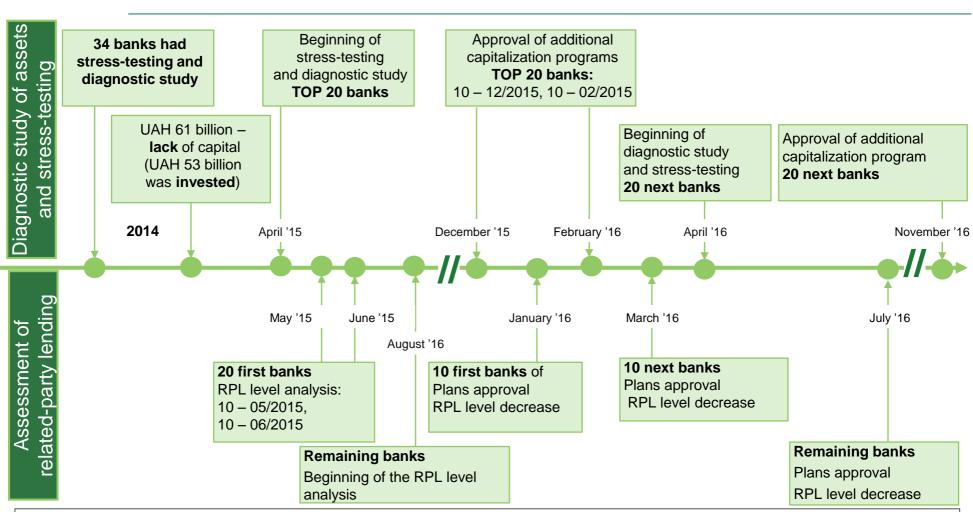
Expanding of communications in non-MP areas (financial stability, banking supervision, payment systems, etc.)



Standard transparency practices of major central banks

### **Revamp of Banking Sector**

#### We've started with an assessment of the real situation in the financial sector



Modern methods of diagnostic study, stress-testing, and assessment of the RPL (related-party lending) level allowed for the assessment of the real situation in the banking system and forecast the risk of banks' assets deterioration.

## ... to this effect, necessary changes in methodologies and performance measures of financial institutions were made

Diagnostic study of the banking system  The new methodology for diagnostic study and stress-testing of banks was approved, and a new diagnostic study of banks began

Assessment of asset transactions with related parties

- Responsibility of bank's related parties was strengthened
- New definitions of bank's related parties were approved, and requirements to bank's operations with related parties were toughened
- The plan for bringing banks' asset operations with related parties into compliance with regulatory requirements was approved
- A list of characteristic features of individuals or legal entities with respect to their attribution to bank's related parties was defined
- Capital ratios H7 and H9 were changed

NBU Board Resolution No. 260 of 15 April 2015

Law of Ukraine No. 218-VIII of 2 March 2015 NBU Board

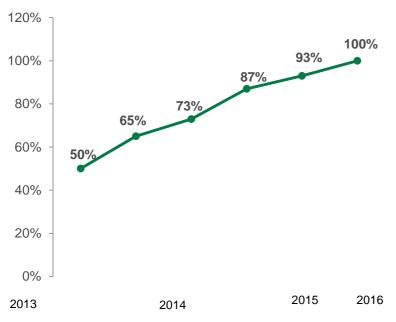
Resolution No. 312 of 12 May 2015

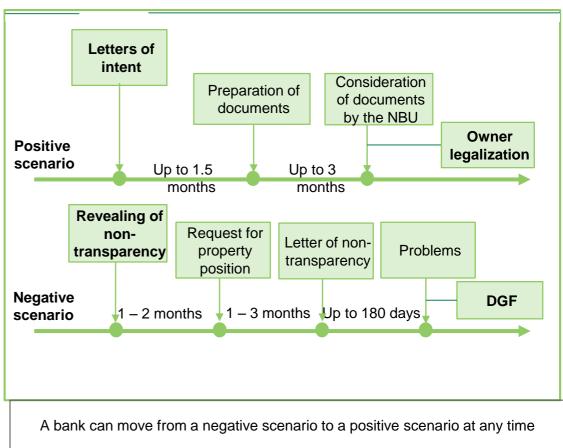
NBU Board Resolution No. 314 of 12 May 2015

NBU Board Resolution No. 315 of 12 May 2015 NBU Board Resolution No. 361 of 8 June 2015

## Disclosure of beneficial owners of financial institutions ensured financial system transparency

"Transparency index" of the banking system by assets (according to available information about banks' owners)





Currently all 100% of the owners of banks are revealed. Banks with non-transparent ownership structure were withdrawn from the market.

## Main steps made towards banking system capitalization and new requirements on capital, ownership, and operations transparency of financial institutions as a prerequisite for financial sector clean-up

Creation of conditions/ requirements for increasing banking system capitalization

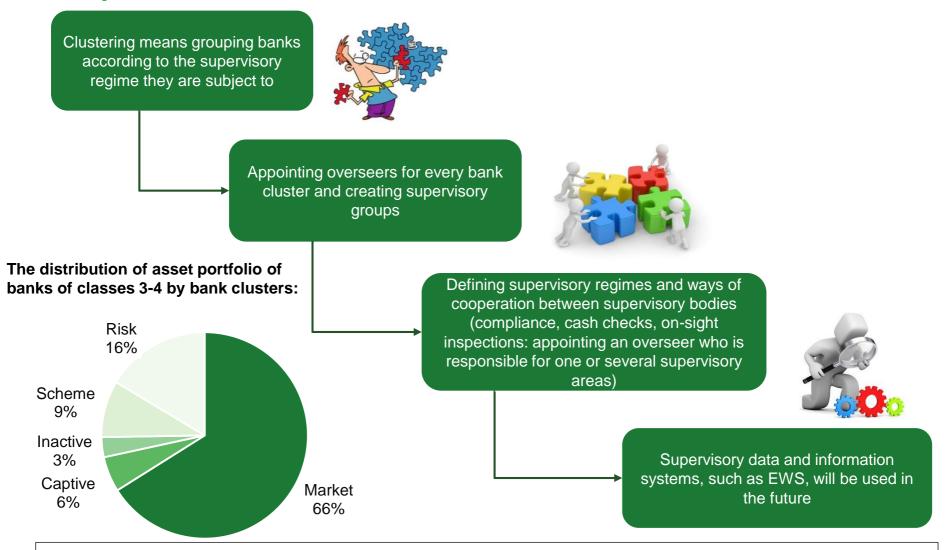
- Requirement for the banks' authorized capital increased to UAH 500 million
- Implemented a simplified procedure for banks' capitalization and reorganization
- Determined specifics of banks capitalization with state participation
- Approved methodology for determination of systemically important banks; the methodology provides for application of a multivariate model and is based on systemic importance criteria
- Introduced requirements for creation of capital buffers and the procedure for banks regulation with respect to special aspects of systemically important banks regulation
- Simplified conditions for additional capitalization of banks by foreign investors
- Developed a mechanism for banks recovery through elimination of devaluation consequences

Resolution of insolvent financial institutions from the market

Cleaning the market of "waste paper"

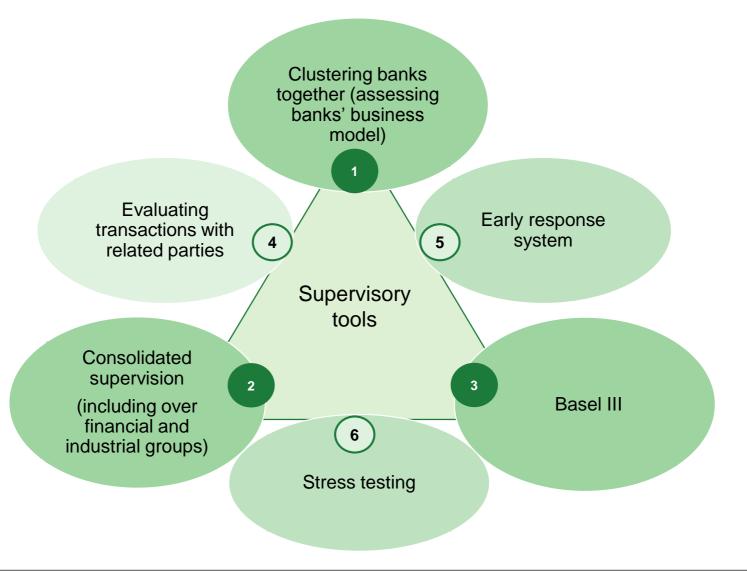
- Improved the process for resolution of insolvent banks from the market and the Household Deposit Guarantee System
- Enhanced requirements for internal financial monitoring of financial institutions
- Measures aimed at facilitating capitalization and banks' restructuring
- Introduced requirements for the creation of capital buffers and procedure for regulation over banks with regard to peculiarities of systemic banks
- Approved the enforcement actions in response to non-compliance of banks' ownership structure with transparency requirements
- Approved new tougher requirements to securities listing
- Developed a new Regulation on the mandatory criteria and adequacy ratios, diversity and quality of insurer's assets
- Specified the attributions of a fictitious securities issuer

## Cluster approach to supervision: The role of clustering in banking supervision



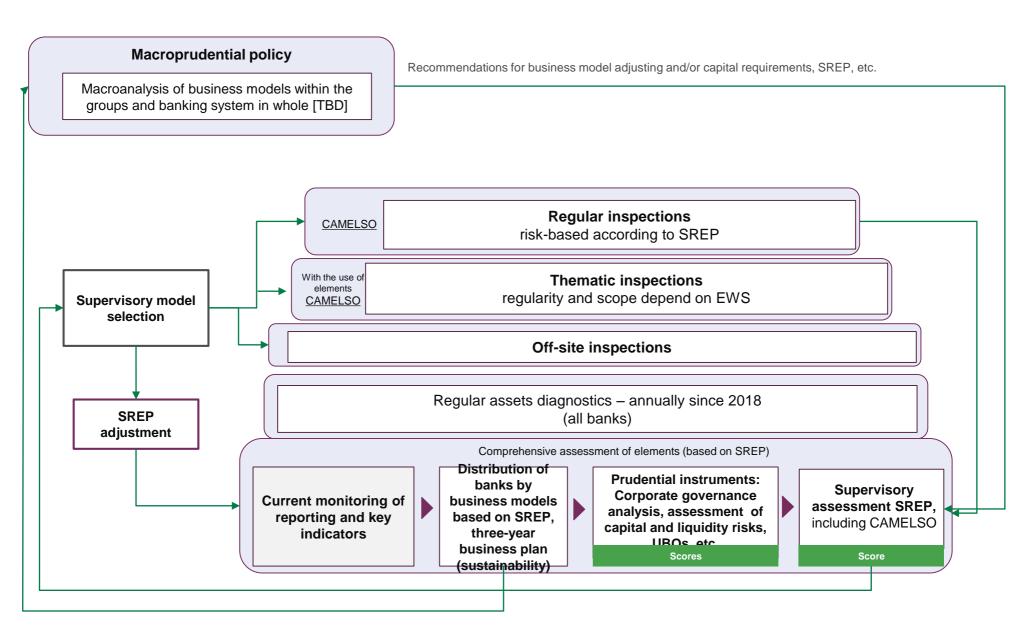
Supervisory clusters are expected to divide supervisory functions between supervisors and overseers, define what banking operations have to be analyzed on a first-priority basis, and coordinate the activities of the bodies that are responsible for supervision, compliance, and foreign exchange regulation.

## Modern risk-oriented supervisory tools making a banking supervision focused and effective



These tools enhance the effectiveness of banking supervision and to prevent risks

#### Modern process of prudential supervision

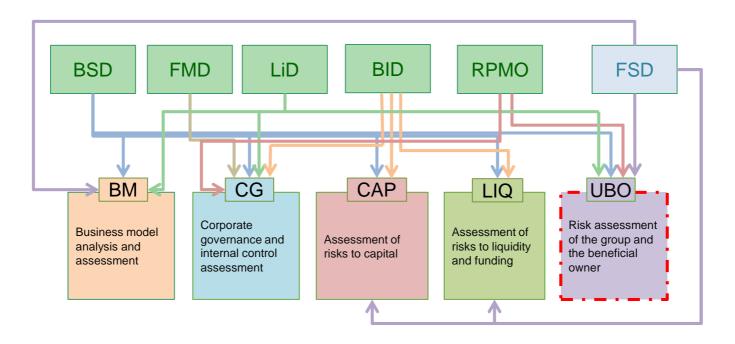


## SREP is the Supervisory Review and Evaluation Process of each bank

**SREP** is the off-site supervision instrument reflecting an actual supervisory authority's report concerning risks based on the analysis of key factors of every SREP element;

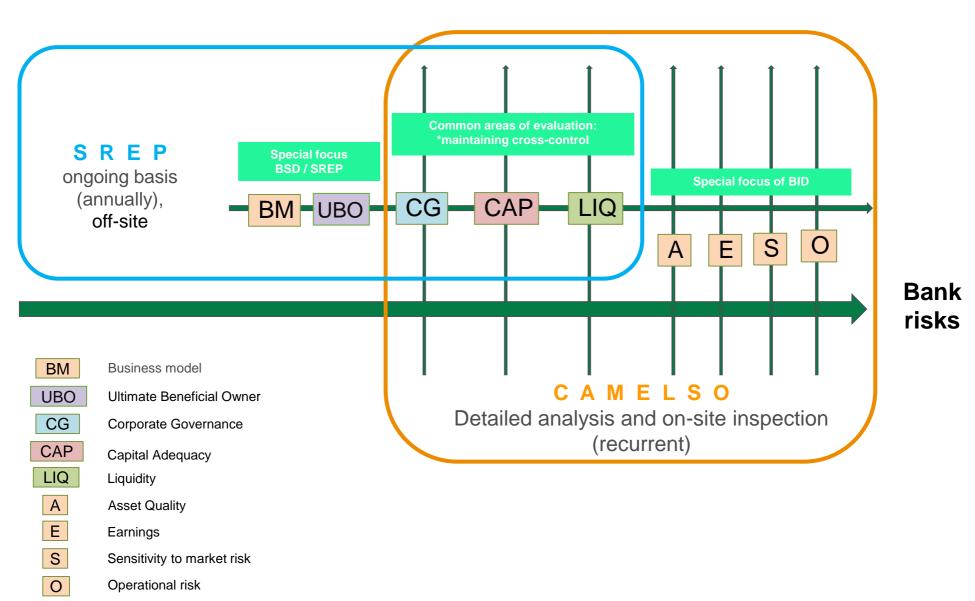
**SREP objective:** - to form, on the ongoing basis (annually), a general evaluation of risks threatening the bank and its viability;

- to ensure proportional distribution of supervisory reserves depending on the level of a bank's risk



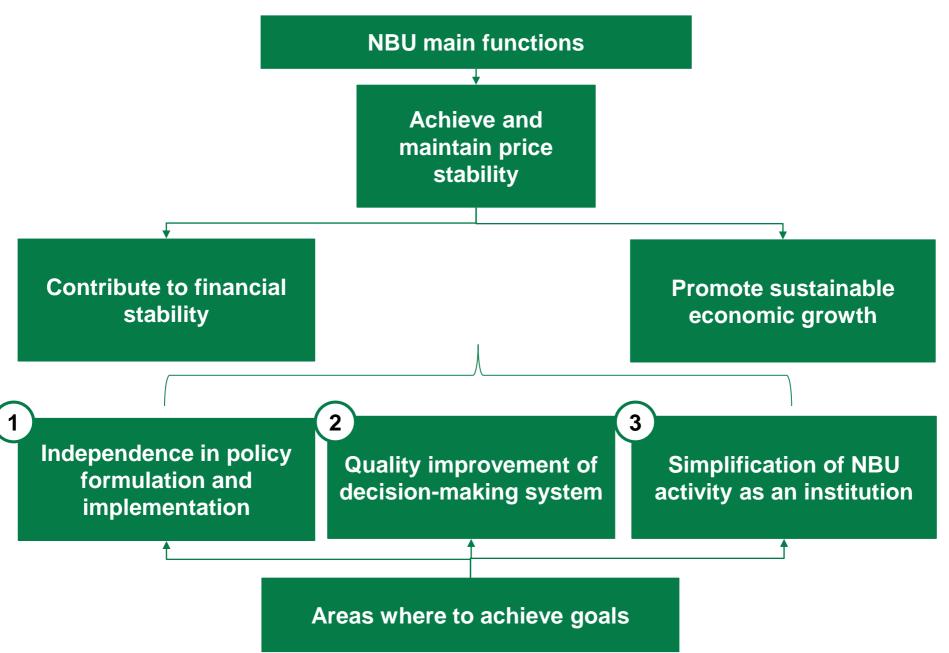
SREP includes the comprehensive analysis of all the elements based on the hindsight analysis (according to statistical reports data) and viability assessment of the bank's current business model based on its ability to generate reasonable profits during the next 12 months and to maintain stable operation within three years based on the analysis of strategic plans for the bank's development

## Comprehensive approach to prudential supervision: illustrative relationship between SREP and CAMELSO

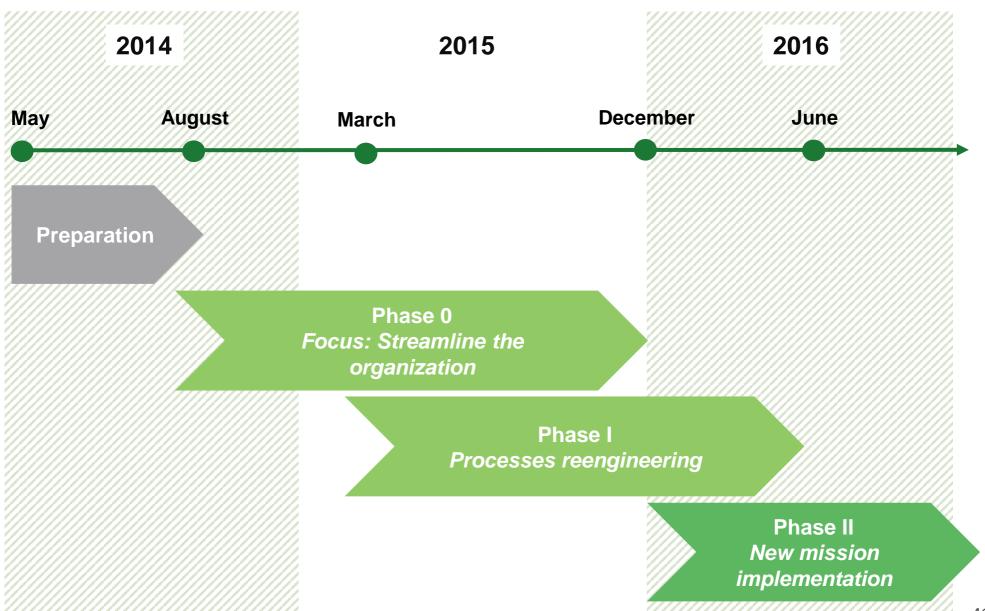


## **Internal Transformation of the NBU**

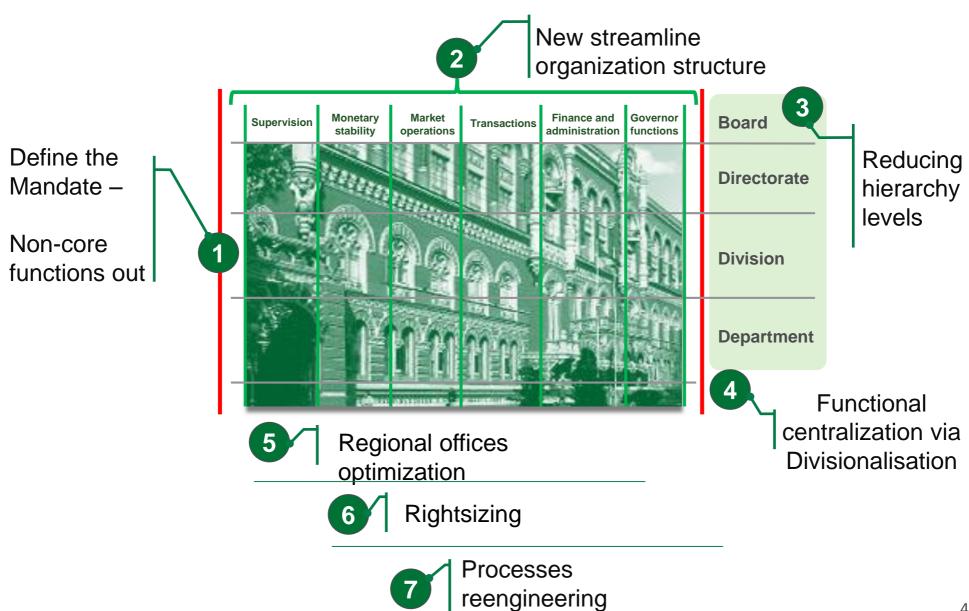
## The key aim of the NBU transformation was to enhance the regulator's ability to exercise its main functions



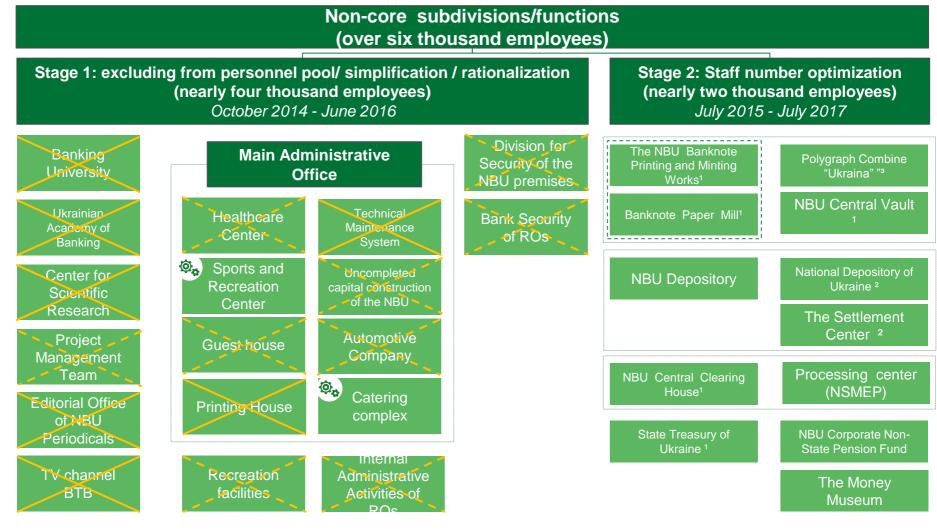
## **NBU** transformation started in 2014 and was planned for 30 months



## High level NBU transformation approach was approved in October 2014 with 7 main directions



#### Central bank non-core functions has been removed from NBU

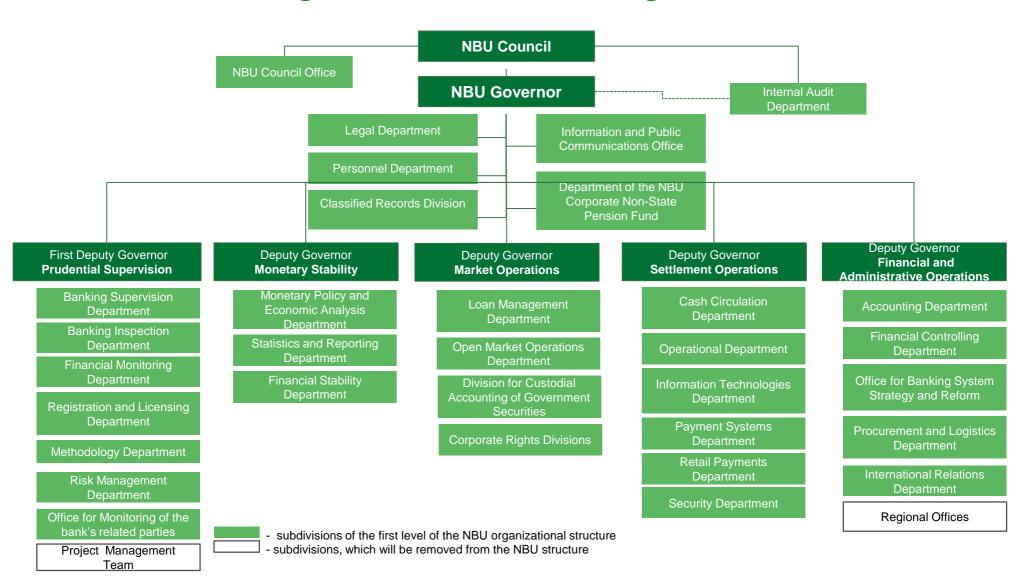


- decision on removal/transformation has been implemented
- general decision has been taken; function is in the process of removal / reorganization / simplification
  - options for removal /reorganization/replacement are being worked out

- <sup>1</sup> stand-alone structural subdivision
- <sup>2</sup> corporate rights ownership
- 3 transferred to the governance area

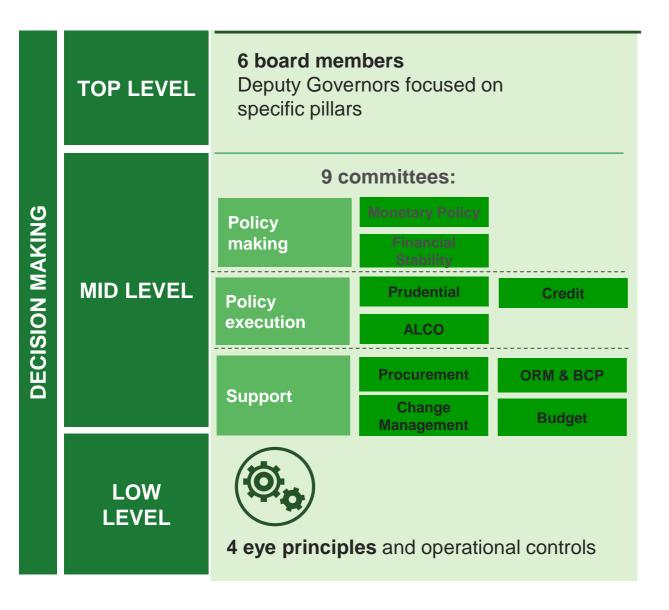
Non-core subdivisions have to be re-structured through outsourcing, removing, or transferring noncore functions to other entities

### New NBU organizational chart focusing on 6 core functions



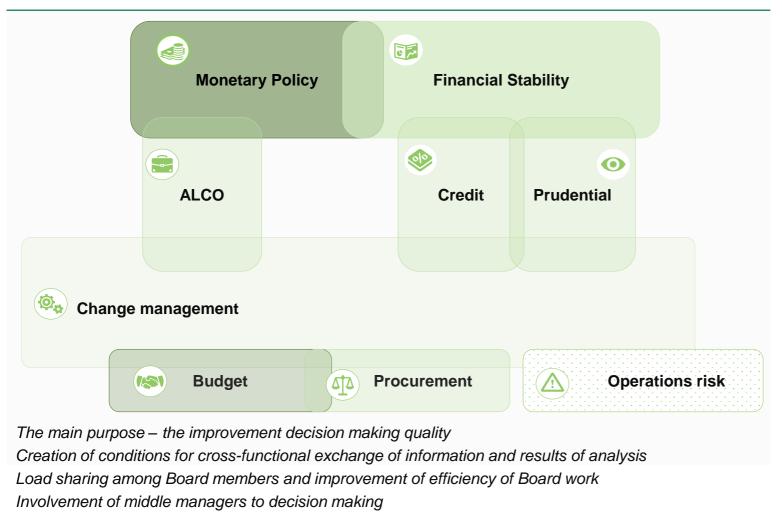
Organizational structure of NBU complies with international standards of central bank organizational structures

## Streamlined decision making via system of committees introduced



### The NBU's new committees are embedding new processes

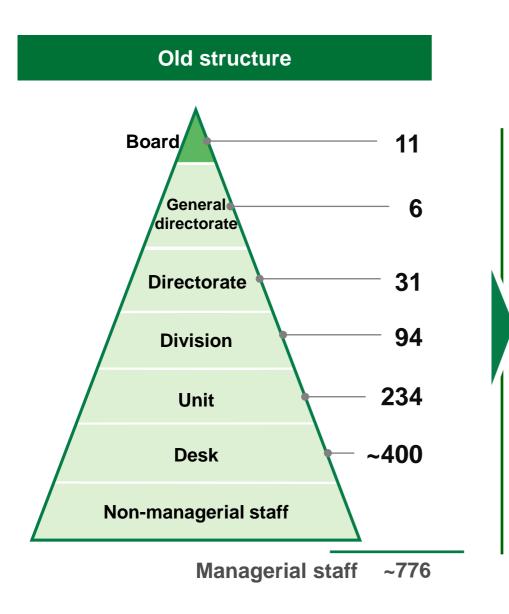
#### List of NBU's committees and functions intersection:

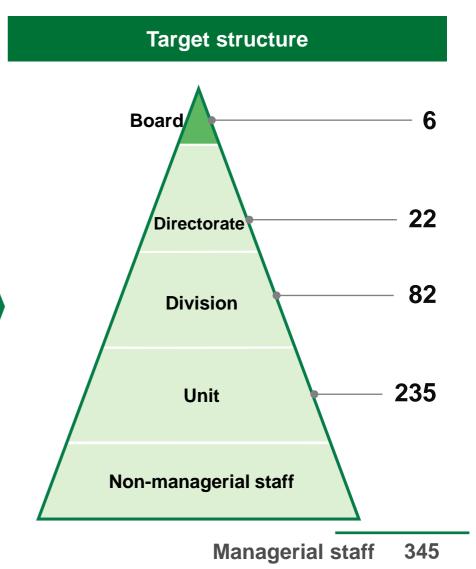


- Within the transformation of NBU the first committees were created according to different recommendations of international organizations, including IMF and create the conditions for professional discuss of questions to delivering on Board
- Implementation of interprocess communications and interaction between committees is current ongoing issue

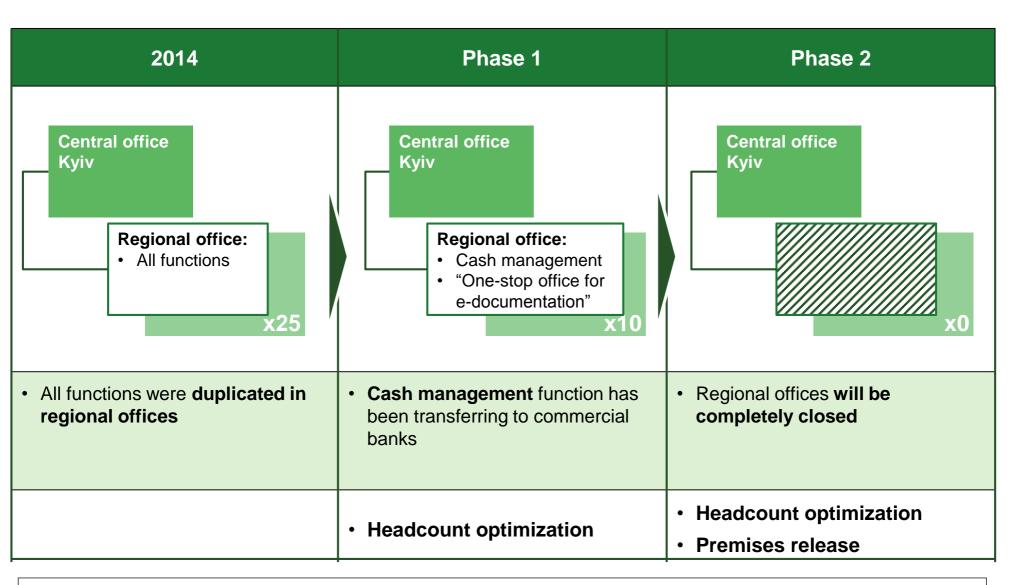
Implementation of the principles of effective management in decision making strengthens the capacity to plan, increases the efficiency of the NBU and its policies

### Reducing hierarchy levels improved governance





### **Closure of 25 regional offices**



Work efficiency of NBU regional structures is planned to be achieved through implementation of the front-line "one-stop-shop"

### **Process reengineering**



We started a complete Processes reengineering project (from March 2015)

## The focus of the NBU's internal reforms on restructuring the central bank's regulatory and supplementary processes

Restructuring the NBU's regulatory **functions** 



**New lending** process



Statistics and reporting



Liberalization of currency regulation



Risk-based supervision



Cluster approach to supervision



Centralizing functions and reforming ROs

Restructuring the NBU's supplementary **functions** 



HR processes



Introducing one bank identifier for NBU regional offices



**Outsourcing** non-core **functions** 





**Drawing up cost** sheets



**Electronic** document flow



Setting up archives



**Decision-taking** with the help of committees



**Project** management



Reorganizing procurement processes



**Project** management

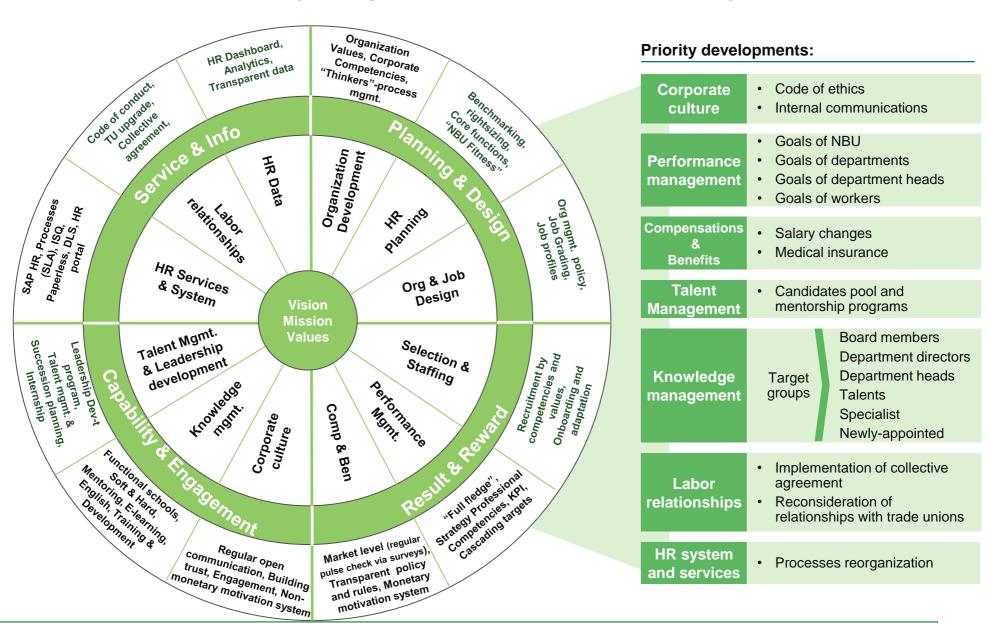


**Business** continuity management



Internal controls

### The NBU has completely restructured all of its HR processes



Our focus is creating a professional team whose members welcome change, and are able to execute the NBU's main functions more effectively

### We have implemented project management approach

Elements of integrated project management model

## Development of project management culture

- developed project management toolkit
- Developing a methodology in the process
- Development of project managers' competencies
- Collection and management of the accrued experience
- Management of competencies required for project management

#### Project portfolio management

- · Identification and choice of projects
- Synchronization of projects within portfolio
- Project reporting system
- Review and termination of projects

#### Strategy implementation

- Established a timeline of strategic vision in a structured portfolio of projects
- Ongoing monitoring of compliance of implementation of the portfolio of projects along the strategic vector of the NBU's development

#### Approach to project management

 Organizational structure of the project and distribution of functions between the roles involved in the project

To build an effective model of project management, it is necessary to achieve sustainable development of each of its four main elements

### **Key elements of process management**

- Standardized approach to documenting processes
- Separation, classification, and approval of top level processes
- Analysis and documenting of priority processes
- Change of approaches to documenting processes (single form)
- · Creation of a unified framework for internal documents

Key elements of concept

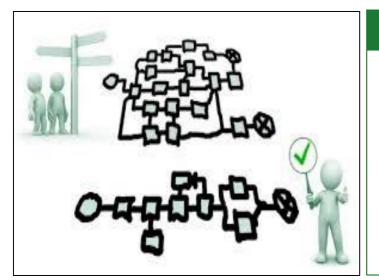


2 Centralized process management

 Creation of special structural unit for modeling, documenting, and managing processes

Introduction of new process management instruments

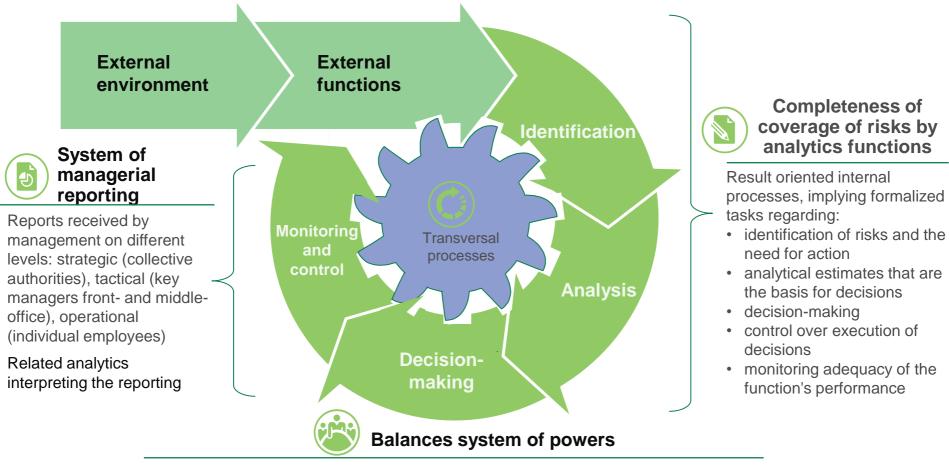
- Introduction of software for modeling and documenting processes
- · Introduction of software for automation of processes



#### FINAL OBJECTIVE

- Determining relations, owners, and participants of processes
- Automatic and standardized documents execution on processes
- Centralized process management
- Opportunity to determine risks and supervision points of NBU activity clearly and transparently
- Transparency and simplicity of monitoring and optimizing processes
- Error minimization when employees perform processes
- · Process automation and reduction of manual operations

# Internal control system to be implemented at all stages of the business process cycle



- Collective bodies for making strategic and key operational (tactical) decisions having significant effect on the function's efficiency
- Definition of managers/staff responsible for tactical decisions on the operational level
- Formalized rules for limiting the powers of collective bodies and managers/staff on the operational level, decision-making principles and policies

The internal control system aims at preventing and management of possible risks

The success of the implemented reforms was acknowledged by all international stakeholders.

IMF report: "The modernization reforms undertaken by the NBU—for the financial system and for the institution—is impressive. The powerful change in focus, structure, and staffing since 2014 is unprecedented in modern central banking, especially taking into account the challenging environment the NBU operates in".

IMF report: "The institutional makeover —with function-oriented organization, streamlining of staffing and focus on core functions — is extraordinary and has a few (if any) superior examples in modern central banking".

## **New Communication Strategy**

## A sound communication policy is an integral part of financial sector reform

Establishing internal processes of information exchange



Introduction of a three-week planning practice for NBU communications with a review and update of tasks each week



Introduction of the practice of preparing message-boxes as an instrument for forming a single information policy of all central authorities

Establishing internal processes of information exchange



Extension of communications channels through the use of social networks – Facebook, Twitter, YouTube, Flickr



Introduction of communication infographic into practice



Introduction of a process for preparing communications with regard to the regulator's actions for different groups of stakeholders



NBU monthly press briefings (including video broadcast) following the results of NBU Board decisions on monetary policy



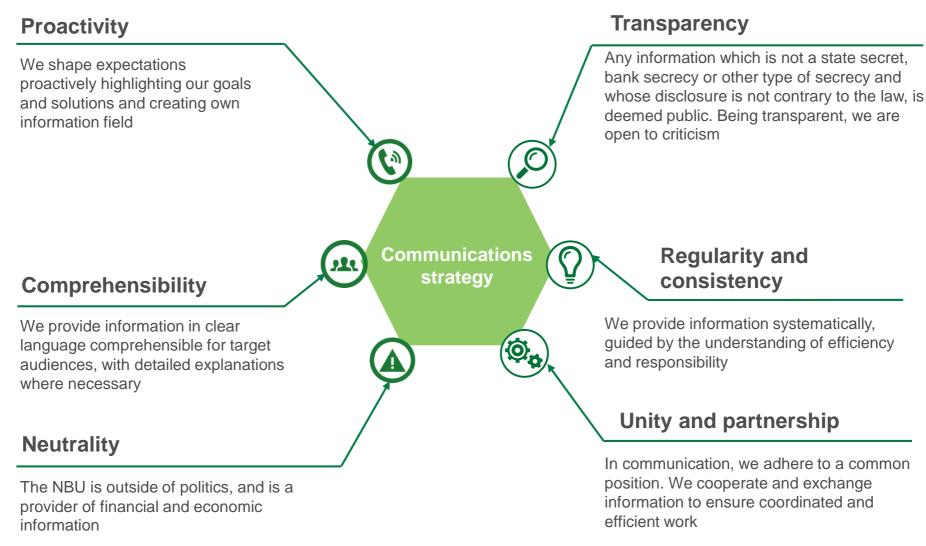
Publication of a press release on the results of NBU Board decisions on monetary policy simultaneously with the start of the press briefing and providing it to informational agencies under embargo



Quarterly publication of Inflation Report

This ensures the *one voice* policy of central authorities. Transparent solutions help to manage inflation expectations of the population and to ensure price stability in the future.

# In implementing a communications strategy, the NBU defines its key principles of information exchange



Key principles of information exchange is the basis for all forms of communication

## New challenges should be addressed with further development of communication with public



Populism



Low credibility



Attacks on CB's independence



Leading role for crisis resolution









"We're speaking to the people we serve first; markets in parallel or second"

Mark Carney, BOE governor

# Independence requires accountability and accountability requires transparency

Independence is sufficient degree of autonomy, when the institution could use necessary instruments to fulfill its mandate and achieve tasks.

Therefore: core mandates, vision, mission, strategy, tasks - everything should be visible and understandable for all stakeholders.

Regular discussion and cooperation with the Government, Parliament need to be established (Financial Stability Board, MinFin, Parliamentarian banking and budget committees etc.)

CB must operate in conjunction with banks, businesses, government agencies, expert community, investors and the media.

To be modern, open, independent and effective central bank an internal transformation is needed. Modernization and effective re-engineering of all processes is required to achieve this task.

The transparency helps to justify and increase mutual support for CB independence from political pressure.

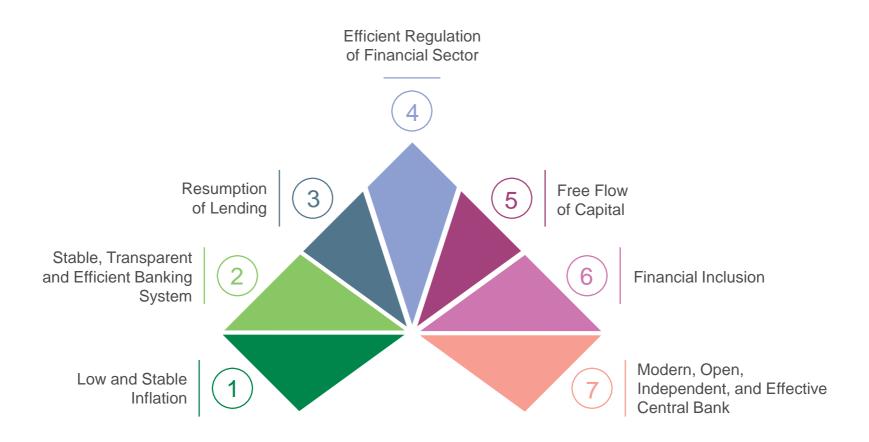
## **AWARDS 2019 by CENTRAL BANKING**

### **Transparency: National Bank of Ukraine**

The Ukrainian central bank has made strong progress in improving its transparency during a highly challenging operating environment



### New Strategy of the NBU was recently presented based on the Mission, Vision and Values defined in 2014



Implementing the central bank's Strategy requires consistent actions that would ensure the achievement of the goals. The NBU identifies these goals in the Action Plan it prepares and publishes every year.

### **Summary**

- Our reform did not happen by chance. There were a comprehensive strategy, dedicated team, project management approach and proper coordination of Technical Assistance and donors.
- I truly believe that a **properly built architecture for reforms** is a recipe for success.
- Transformation of economies is a long and difficult process and the countries need help with reform conceptualization, delivery, process management and donor coordination.
- And the main challenge for us is **How to do reform irreversible?** What kind of Safeguard's mechanism should be introduced by reformer's teams and international stakeholders to prevent a return to the past.