



---

## **ARMENIA – THE CENTRAL BANK OF ARMENIA Final Report**



Contractor: BearingPoint (Emerging Markets Sector)  
Contract Number: 111-C-00-02-00038-00  
Country: Armenia  
Title of Task Order: Bank Supervision, Phase II  
Reporting Period: 06/10/02 to 1/07/05  
USAID Cognizant Technical Office: Yerevan, Republic of Armenia  
USAID Cognizant Technical Officer: Haikanush Bagratunyan

Strategic Objective: 1.4

---

## I. EXECUTIVE SUMMARY

Over the course of the two and a half years of Phase II of the Central Bank of Armenia Bank (CBA) Supervision Project, the BearingPoint team confronted a number of challenges, as detailed throughout the final report, but overall the project was successful. From the standpoint of subject matter covered, the work of the project was wide-ranging and ambitious and the advisors contributed to the development of a number of work products and capacities that can be leveraged by the CBA going forward, including:

- A road map for approaching and implementing risk-based supervision and detailed assessments, primarily regarding weaknesses in risk-based application of off-site supervision, to move toward full implementation.
- An examiners' accreditation program, which includes an extensive library of training materials.
- The capacity to undertake a self-assessment under the Basel Core Principles in combination with an external review.
- A risk matrix methodology for analyzing risk exposure of banks.
- Manuals and procedures for on-site and off-site supervision, interim administration and liquidation.
- A policy on problem bank identification and a least cost test methodology for choosing among failure resolution alternatives.
- An improved legal and regulatory framework with a full range of critical areas addressed, including bankruptcy and liquidation, non-bank credit institutions, deposit insurance and anti-money laundering.
- Training materials on consolidated supervision and the advantages and disadvantages of a unified supervisor.
- A revised and improved uniform bank performance report (UBPR).
- Training materials and policies and procedures on key accounting issues of current importance including income tax, leasing and financial instruments.
- A public outreach program for implementation by the press relations department.

## II. INTRODUCTION

The [proposal](#) submitted by BearingPoint<sup>1</sup> in March 2002 for Phase II of the Bank Supervision Project anticipated that a number of major events would be of importance to the Central Bank of Armenia (CBA) over the course of the proposed task order and beyond. Primary among these events were:

- Implementation of risk-based supervision.
- Phased-in increase in capital requirements for commercial banks.
- Implementation of deposit insurance and writing of underlying regulations.
- Implementation of laws and writing of regulations for core banking laws.
- Implementation of an examiner accreditation program.

---

<sup>1</sup> At that time BearingPoint was named KPMG Consulting.

- Passage of law and implementation of regulations for a non-bank financial credit institutions' charter.
- Ongoing implementation and refinement of International Accounting Standards (IAS).

Looking back on the past two and a half years these major events have indeed dominated the activities of the CBA, as detailed further in this final report and many have not been fully resolved as of the end date of this task order. The sections that immediately follow briefly summarize the major areas of change. Additionally, a few issues that were not anticipated at the time of the proposal also presented challenges for the CBA during the time period of the task order. The chapters and sections that follow track the various tasks and benchmarks for the project and describe how BearingPoint addressed each throughout the timeframe of the task order.

## A. IMPLEMENTATION OF RISK-BASED SUPERVISION

The CBA committed to a risk-based approach in its bank supervision strategy in Phase I of the Bank Supervision Program and since that time the practices and methods of the supervision process at the CBA continue to advance. The phase-in of risk-based supervision has begun, but it is still in process and additional progress is needed over the coming years. Much of the focus during the current phase was on implementing risk-based concepts in off-site supervision, but as detailed further in the relevant section of the final report, much work remains. Additional changes are still needed in the on-site examination and off-site monitoring manuals to incorporate such an approach, which will then need to be incorporated into the on-site and off-site processes.

## B. INCREASED CAPITAL REQUIREMENTS AND INDUSTRY CONSOLIDATION

The upcoming change in the capital requirement is a major development for the banking system in Armenia. While banks that determine they are in need of a capital infusion undertake actions in this regard, the CBA has tracked the future normative standing of the banks. The CBA requires each bank to annually provide a moving-horizon strategic three-year plan. The plan includes analysis of capital position in light of the toughening of the capital requirement. However, the plan does not include an outline of an alternative scenario in case a bank is not in compliance by the required date.

The banking system currently consists of 19 banks operating under a normal regime, 12 of which may need some form of capital replenishment. In light of the present levels of capital, deficient asset quality and weak earnings performance in some banks, it is obvious that all banking institutions will not be able to reach the required \$5 million level of capital on their own by the phase in date of July 2005. Of primary importance is a tier of smaller banks that are most vulnerable to the upcoming change to the nominal requirement. At present, there are eight banks that are unlikely to accumulate the needed capital by the deadline as their current level is in the range of \$2 to \$4 million. Another subgroup includes four banks that presently hold capital in the range of \$4 million to \$5 million. As most of them are profitable, a continued pace of earnings accumulation allows for the possibility of meeting the new capital requirements through

earnings retention. Beyond earnings retention, alternatives for these banks in danger of falling short of the capital requirement include raising funds from existing shareholders, concession of some shareholding rights to an outside investor, merger or acquisition with another bank, conversion to a non-bank credit institution charter or self-liquidation.

### C. IMPLEMENTATION OF DEPOSIT INSURANCE

Effective July 1, 2003 banks began making deposit insurance premium payments to the newly established deposit insurance fund. Premium payments are calculated on the basis of 0.5% of “deposits attracted.” The fund will begin to provide insurance coverage on July 1, 2005. A revised deposit insurance law was approved in the later months of 2004. A promised capital contribution to the fund of 3 million Euros is to be made shortly by the German Development Bank, KfW, which was contingent upon the new law being approved by the National Assembly and signed into law.

### D. CREATION OF NON-BANK CREDIT INSTITUTIONS CHARTER

The Law on Credit Organizations was adopted on May 29, 2002 and creates the regulatory framework for non-bank credit institutions. A number of regulations have been promulgated to supplement the noted law. As of late 2004, eight institutions have been licensed under the new charter, including five universal credit institutions, two credit leasing companies and one credit union. The number of institutions is expected to increase as the 1 July 2005 date for the increase in minimum capital requirements approaches due to the demand for an alternative to the commercial bank charter.

## III. TASKS AND BENCHMARKS

The Bank Supervision Phase II Project began 10 June 2002 with an initial ending date of 9 June 2004. The major task areas included:

- Risk-based on-site inspections and off-site monitoring (Task 1)
- Bank consolidation and problem bank resolution (Task 2)
- Supervision strategy (Task 3)
- Legal reform (Task 4)
- Accounting procedures strengthening (Task 5)
- Targeted Assistance (Task 6)

As is standard practice with such projects, the work under the contract was continually reassessed in light of changes in the working environment of the project and contract modifications were agreed to as summarized in Table 1 below.

Table 1: Contract modifications

Contract Modification	Summary of Modification
#1	<ul style="list-style-type: none"> <li>Name new contracting officer (Brown)</li> <li>Changes in key personnel (Warmington, Abejdid)</li> <li>Adjustments to timing and substance of benchmarks</li> </ul>
#2	<ul style="list-style-type: none"> <li>Adjustments to timing and substance of benchmarks</li> </ul>
#3	<ul style="list-style-type: none"> <li>Expand the scope of Task 2 (Bank Consolidation and Problem Bank Resolution)</li> <li>Increase funding ceiling to \$3,591,207</li> </ul>
#4	<ul style="list-style-type: none"> <li>Contract obligation increased to full ceiling (\$3,591,207)</li> </ul>
#5	<ul style="list-style-type: none"> <li>Reporting of foreign taxes</li> </ul>
#6	<ul style="list-style-type: none"> <li>Extension of completion date to September 7, 2004</li> <li>Budget realignment</li> <li>Adjust scope of Task 1 (Risk-Based On-Site Inspections and Off-Site Monitoring), Task 2 (Bank Consolidation and Problem Bank Resolution) and Task 4 (Legal Reform)</li> </ul>
#7	<ul style="list-style-type: none"> <li>Extension of completion date to December 7, 2004</li> <li>Budget realignment</li> </ul>
#8	<ul style="list-style-type: none"> <li>Extension of completion date to January 7, 2005</li> <li>Budget realignment and increase in ceiling and obligation to \$3,620,194</li> <li>Adjustment to scope of Task 1 to include review of Basel Core Principles self-assessment.</li> </ul>

The sections that follow detail the objectives and benchmarks for the various project tasks (as amended) and describe the specific activities undertaken by the advisors to fulfill them.

## A. RISK-BASED ON-SITE INSPECTIONS AND OFF-SITE MONITORING (TASK 1)

Task 1 involved nine major component areas:

- Basel core principles assessments
- On-Site examinations
- Training
- Accreditation process
- Off-Site Supervision
- Uniform Bank Performance Report (UBPR)
- Risk Assessment Methodology
- Operational Risk Management
- Mortgage Lending

## 1. Basel Core Principles Assessments

*“Carry out an evaluation of the CBA’s compliance with the Basel Core Principles. This evaluation should assess the efficacy of the on-site/off-site supervision processes and tools, and extent of the integration of international standards into the supervisory processes of the CBA.” (60 day benchmark-August 10, 2002)*

*“Conduct an evaluation of the CBA’s compliance with the Basel Core Principles at the time of the completion of the first year of the Task Order.” (12 month benchmark-June 10, 2003)*

*“Review CBA staff’s Basel Core Principles Self-Assessment and provide summary analysis.” (Modification #8-complete by January 7, 2005)*

The original task order envisioned an initial comprehensive assessment of the CBA’s compliance with the Basel Core Principles (Core Principles) at the beginning of the project, followed by an update of the assessment roughly one year into the project to determine progress during the interim period. The initial comprehensive assessment of the existing framework was accomplished during early July through an analysis in relation to the Core Principles conducted on a principle-by-principle basis. The overall conclusion of the assessment ([Summary](#), [Table-detailed](#), [Table-summary](#)) was that the Armenian banking system was in compliance with the Principles in many significant areas, but enhancements were also needed in many areas. [Karen Wilson](#) undertook the first assessment. She was assisted by [Wayne Fralin](#) and [Vern McKinley](#).

The update was undertaken in June 2003. In an effort to begin a transfer of knowledge regarding the Core Principles to the CBA, the Bank Supervision Department was asked if they could undertake a self-assessment and they accepted. The overall conclusion of the report ([memo to chairman](#), [cover sheet](#), [executive summary](#), [summary by principle](#), [detailed summary](#)) was that there has been some improvement as reflected by the ratings of three of the main principles having improved. However, serious weaknesses remained in some of the key principles relating to credit.

The CBA undertook another self-assessment under the Core Principles in December 2004. [Jim Hightower](#) was brought to the project to review the self-assessment. The overall conclusion of the review ([memo to chairman](#), [cover sheet](#), [executive summary](#), [summary by principle](#)) was that there was overall improvement in compliance, but weaknesses still existed in the areas of consolidated global supervision, internal controls and risk management, credit policies and legal protection for supervisors.

## 2. On-site Examinations

*“Assist the BSD in at least two bank examinations, in total.” (180 day benchmark)  
(Modification #2-dropped)*

*“Continue to participate in on-site examinations (at least one during this period), and review and assist in planning and refining the report on examination procedures.” (12 month benchmark) (Modification #2)*

*“Demonstrate that actions recommended in the “Report of Examinations” following an inspection of a problem bank have been transmitted to senior CBA management and implemented at that bank.” (18 month benchmark) (Modification #1-change from “recalcitrant bank” to “problem bank and rewrite as follows: “Demonstrate that actions recommended by the CBA following inspection of a problem bank have been implemented at that bank.”)(Modification #6-benchmark deleted)*

*“Conduct actual on-site examinations of at least half of the assets of the banking system.” (24 month benchmark) (Modification #6-benchmark deleted).*

[Larry D. Boren](#) was the on-site resident advisor in Armenia for two years, encompassing the final year of Phase I of the program and the first year of Phase II. He undertook the bulk of the work under the on-site and related components addressed in paragraphs 2 through 4 detailed here under Task 1.

The original task order envisioned that during the first year of the program the advisors would participate in at least three examinations. Initially examinations were to begin in October 2002 with most of the work to be focused on on-the-job training in the use of the new examination manual. However, there were delays in completing the manual and it was not available for use until December, pushing the start date on the assistance with examinations into 2003. Additionally, given the front-loaded nature of the program and the other commitments and benchmarks involved, there was no way to block out sufficient time (four to five months) for the on-site advisor to participate in three examinations during the first year. As detailed above, contract modifications addressed needed adjustments to the task order.

Thus, during the first year, one examination was observed which was undertaken at Promethius Bank. As circumstances turned out, this was the only examination the advisor was involved in and as noted above the benchmarks regarding additional examinations were deleted from the task order. The advisor shadowed the team during the entire time of the examination, February 27, 2003 to April 3, 2003 and provided [observations](#) to the CBA on how the examination was staffed and conducted. He also responded to questions on examination procedures and internal controls and sat in on the examination closeout meeting with the CBA Board. Overall, the examination

scheduling was poor, as another examination was scheduled at the same time. Staffing was changed from what was originally planned due to other, reportedly more pressing assignments. Substitutions were not implemented seamlessly and the quality of the examination suffered as a result. The vast majority of the examination work was conducted by one examiner, a less than desirable situation. This person was also the examiner in charge.

Further on during his work at Prometheus, the advisor provided comments on the [report of examination](#). The report represents an improvement over previous reports reviewed. The information technology section of the report was excellent. However, there were still weaknesses in the report, including an overemphasis on display of statistics without sufficient accompanying discussion of their overall significance. Workpaper documentation is also in need of improvement.

The advisor also provided comments on the [examination manual](#) as part of his on-site analysis. These comments focused on the sections of the manual related to the report of examination, examination procedures, internal control questionnaires and workpaper documentation. As part of the review of the manual, the advisor also provided a recommended format for the [pre-planning](#) process. This analysis of the examination manual was a follow up to much of the work the advisor had done during the past year on developing the examination manual. The CBA determined that they would use the Federal Reserve's examination as a template to begin with and then the Methodology Department went through the manual and made changes with the advisor assisting on select issues. The translators, with oversight from the advisor, translated the manual sections that were added by the CBA so that a full English version of the manual is now available. The chapters for the manual are set forth in Table 2 below.

Table 2: On-site Examination Manual

<a href="#">Table of Contents</a> <a href="#">Chapter 1 Introduction</a> <a href="#">Chapter 2 Asset Quality</a> <a href="#">Chapter 3 Liabilities and Capital</a> <a href="#">Chapter 4 Income and Expense</a>	<a href="#">Chapter 5 Liquidity, Funds Management</a> <a href="#">Chapter 6 Other Areas</a> <a href="#">Chapter 7 Management</a> <a href="#">Chapter 8 Overall Assessment</a> <a href="#">Chapter 9 Report of Examination</a>
-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

One weakness noted during the examination, which the advisor focused particular attention on, was the need to update the [old version](#) of the loan line slip, the summary sheet for information on individual loans. The advisor provided [comments](#) and worked with the CBA to develop an [improved](#) loan line slip, which allowed more room for analysis and comment regarding the data contained therein, as well as space for financial information. Additionally, a draft set of examination workpapers was compiled as detailed in Table 3.



Table 3: Examination workpapers

<a href="#">Accounts receivable</a>	<a href="#">Insider loans</a>	<a href="#">Off balance sheet liabilities</a>
<a href="#">Affiliates</a>	<a href="#">Interbank purchases</a>	<a href="#">Other real estate owned</a>
<a href="#">Bank stock loans</a>	<a href="#">Interbank sold</a>	<a href="#">Other assets</a>
<a href="#">Borrowing lines</a>	<a href="#">Interested corporations</a>	<a href="#">Other liabilities</a>
<a href="#">Borrowings</a>	<a href="#">Investments</a>	<a href="#">Overdrafts</a>
<a href="#">Cash items</a>	<a href="#">Large deposits</a>	<a href="#">Overdue loans</a>
<a href="#">Commitments to make</a>	<a href="#">Letters of credit</a>	<a href="#">Pledged securities</a>
<a href="#">Commitments to purchase</a>	<a href="#">Litigation</a>	<a href="#">Prepaid Items</a>
<a href="#">Consultants, professionals</a>	<a href="#">Loan participations purchased</a>	<a href="#">Repossessed assets</a>
<a href="#">Credit suspense items</a>	<a href="#">Loan participations sold</a>	<a href="#">Safekeeping schedule</a>
<a href="#">Debit suspense items</a>	<a href="#">Major shareholders</a>	<a href="#">Supervisory board</a>
<a href="#">Followed loans</a>	<a href="#">Nonaccrual loans</a>	<a href="#">Supervisory council</a>
<a href="#">Government guarantees</a>	<a href="#">Off balance sheet assets</a>	<a href="#">Undisbursed loans</a>

To undertake the benchmark for tracking recommendations in a report of examination, a [request](#) for information was given to the CBA. However, the information request was denied and the benchmark was deleted from the task order.

Finally, closely related to the work on the examination process and the development of the manual, the advisor was asked to provide [comments](#) on a draft policy on corporate governance. In general, the content of the document was good and would dramatically improve the current corporate governance structure of commercial banks.

### 3. Training

*“Conduct and submit a written evaluation of priority training needs (at both the entry and advanced level) and a draft schedule for their delivery of the required training activities.” (Modification #1-60 day benchmark)*

*“Develop and organize on-site supervision skills training for BSD staff.” (120 day benchmark) (Modification #1-dropped due to redundancy)*

*“Continue both classroom and on-the-job on-site supervision training for BSD staff.” (12 month benchmark)(Modification #2)*

*“Organize U.S.-based training on bank examinations with a U.S. bank regulatory agency for at least five CBA employees.” (180 day benchmark)*

*“Complete and deliver a training class on examination techniques to BSD staff.” (18 month benchmark) (Modification #1-dropped due to redundancy)*

*“In addition to enhancing the quality and effectiveness of these examinations, develop a cadre of CBA bank examiners with on-site training in the use of examination procedures for the CAMEL components. This includes guidance for examination planning and coordination.” (24 months) (modification #1-eliminated due to redundancy)*

The original task order envisioned that the assessment of priority training needs would be completed at the beginning of the project and be followed by training sessions as determined therein. The [training assessment](#) (which also covered areas other than on-site examination) was completed in early August 2002. The assessment was completed after interviews were conducted with the training officer and numerous department heads and supervisors. These interviews addressed budget figures and criteria to be met before attendance at training sessions.

Initially the first training program was scheduled for December 2002 after the release of the examination manual. After much delay in allowing the first course to be scheduled, the initial training course was provided June 3<sup>rd</sup> through 6<sup>th</sup> 2003. The topic was internal controls with the following issues covered:

- Pre-planning procedures.
- Examination procedures.
- Internal control questionnaire.
- Workpapers.
- Report of examination format.

Approximately 28 supervisors attended the training session.

As for the required U.S.-based training, the State of Washington Division of Banks was chosen to provide training at on-site examinations. The [session](#) was conducted from January 25-February 8, 2003 with five participants and included the following activities:

- Initial meeting on January 27 with State of Washington Division of Banks officials and examiners to review the proposed approach.
- Observing and learning the pre-examination approach.
- Actual participation in two on-site examinations working with Division of Banks' examiners.
- Observing the conclusion of an examination.

Logistics of the training session were planned by [IMMA Limited](#).

During the second year of the project in late 2003, and in keeping with the recommendations in the training assessment, additional training was developed in the area of risk identification and management:

- interest rate risk [training](#), including classroom [exercises](#) and [supplementary memo](#);
- and derivatives [training](#), including classroom [exercises](#) and [outline](#).

#### 4. Accreditation Process

*“Develop a draft curriculum and course outlines for the examiner accreditation program for BSD examiners.” (Modification #1-90 day benchmark)*

*“Develop the course materials, certification criteria, and an appropriate training mechanism for the accreditation program.” (120 day benchmark)*

*“Discuss and finalize with the CBA the draft accreditation program.” (180 day benchmark)*

*“Provide evidence that the BSD has approved an accreditation program for bank supervisors, and that initial implementation has begun.” (12 month benchmark)*

*“Ensure that this accreditation program is institutionalized and implemented.” (24 month benchmark)*

Initial steps were taken at the beginning of Phase II to develop the accreditation program, including interviews to determine the structure of current hiring practices, job descriptions, the performance evaluation process and promotions. A review of the current test given to applicants seeking jobs at the CBA was also undertaken as well as a discussion of the interviewing process. Job levels for on-site examiners prior to any recommendations made by the advisor included:

- Specialist.
- Lead specialist.
- Senior specialist.

Based on this information, and drawing upon the BearingPoint’s library of previously-developed courses, the advisor developed a draft [curriculum](#) and course outlines for the accreditation program completed in early October 2002. Topics were subdivided into three levels at basic, intermediate and advanced courses. A summary of the courses proposed is contained in Table 4.

Table 4: Accreditation Courses

Level	Course
Basic Courses	<a href="#">Basic Bank Supervision</a> <a href="#">Basic Credit</a> <a href="#">Basic Foreign Exchange</a> <a href="#">Professional Conduct and Ethics</a> <a href="#">Internal Controls and Audit</a> <a href="#">Bank Accounting for Supervisors</a>

Intermediate Courses	<a href="#">Intermediate Credit</a> <a href="#">Funds Management and Liquidity</a> <a href="#">Communications</a> <a href="#">Information Technology</a> <a href="#">Writing Reports of Examination</a>
Advanced Courses	<a href="#">Advanced Bank Supervision-Risk Management</a> <a href="#">Supervising Troubled Banks</a> <a href="#">Train the Trainer</a> <a href="#">Managing the Examination</a>

Work continued on development of the course materials, certification criteria, and an appropriate training mechanism for the accreditation program throughout October 2002 and was completed in early November 2002. These materials that comprise the entire draft [accreditation process](#) included:

- Accreditation policy recommendations.
- Hiring recommendations.
- Job descriptions for the following positions:
  - Assistant supervisor I
  - Assistant supervisor II
  - Associate supervisor I
  - Associate supervisor II
  - Supervisor
- Course curriculum and course outlines.
- Description of testing and test examples.

The CBA spent a number of months reviewing the accreditation materials and completed their [comments](#) by February 2003. Most of the comments regarded minor changes in the scope of the recommendations. One potential problem area is the effort of the CBA to apply the same career ladder that is recommended for supervisors across-the-board at the CBA. This would not be desirable and may delay implementation of the career ladder for supervisors. Additionally, there was opposition to the requirement for current supervisors to go through the testing within one year. As of the end of the project, the accreditation process had been approved by the Board, but not fully implemented by human resources.

## 5. Off-Site Supervision

The initial task order for the project specifically excluded off-site activity due to the desire to avoid overlap with the ongoing work of the International Monetary Fund (IMF) resident advisor, who was tasked with focusing on off-site supervision. However, some early work required involvement to improve off-site processes in order to begin integration of the on-site and off-site functions, especially as it relates to the implementation of risk-based supervision. Additionally, a number of requests related to

off-site supervisory matters were received from the CBA. The initial work in the early part of the project on off-site supervision was accomplished by [Lilit Davoyan](#), the project senior financial analyst, including:

- [Revising the UBPR](#)-the advisor was involved in a working group with the Heads of the Methodology and Analysis Divisions. Technical assistance was provided in revising the structure and contents and correcting the existing errors. In particular, more meaningful analysis ratios were introduced, information on yields on different categories of assets and costs of liabilities were added, a section on interest rate risk was included and the formats for balance sheet and income statements were agreed upon. Assistance was also provided in defining certain ratios. The end product was a [revised UBPR](#).
- [Stress Testing](#)-the senior financial analyst worked with the CBA in developing a stress testing methodology that addressed credit, liquidity, foreign exchange and interest rate risk and assisted with conducting stress tests, developing stress scenarios and formulas that reflected the impact of different scenarios. Additionally, a detailed [analysis](#) of interest rate risk was developed as part of the review of these various types of risk.

After the IMF advisor departed from the CBA in December 2002 there remained a need to address a number of issues of focus in off-site supervision, but there was uncertainty as to whether these issues should be addressed and if they were to be addressed what specific tasks would be undertaken. To clarify the situation and provide benchmarks for the work, contract modification #6 in June 2004 explicitly addressed off-site supervision issues as detailed below. The bulk of the work on off-site supervision in the latter part of the project was accomplished by [Martin Guilfoyle](#) who was the supervision resident advisor in Armenia for the final year of Phase II of the program. The CBA has recently made progress in adopting risk-based supervision, but many issues remain with respect to its comprehensive implementation. The following activities are meant to enable the CBA to implement international best practices in bank supervision.

*“Determine current practice:*

- *Integration of UBPR into analysis procedure and routines*
- *Access sources and uses of external data (market and macroeconomic) in supervision*
- *Review examination reports and identification of key supervisory issues*
- *Assess effectiveness of follow-up of these issues in off-site analytical reports*
- *Define how key issues are communicated in CBA and analyze response” (Modification #6-completion by end of project)*

Agreement was reached that the best means to determine current practice would be to undertake a supervisory diagnostic of four banks. The advisor wrote extensive

memoranda on each of the four banks comprising a sampling of off-site surveillance by the CBA, summarizing his observations and suggesting areas for potential improvement: ([Observations on Bank A](#), [Observations on Bank B](#), [Observations on Bank C](#), [Comments on Bank C Examination Plan](#), [Observations on Bank D](#), [Comments on Bank D Examination Plan](#)). In August 2004 at the conclusion of the diagnostic, the advisor prepared a summary memo with specific recommendations to improve supervisory practices ([Conclusions and Recommendations on the four banks](#)), as well as a brief presentation for USAID ([Summary of Supervision of Four Banks](#)).

*“Assess high level components considered part of international best practice:*

- *Mission statement*
- *Strategic goals and plan*
- *Core supervisory philosophy*
- *Risk typology*
- *Risk assessment and evaluation criteria” (Modification #6-completion by end of project)*

The advisor prepared a series of memoranda on a variety of topics with regard to international best practice:

- [Supervisory best practices](#)
- [Evaluating the “S” or sensitivity to risk component from off-site](#)
- [Risk matrices](#)
- [Strategic planning frequently asked questions](#)
- [Strategic plans methodology](#)

Additionally, at the request of CBA counterparts, the advisor prepared comments on the current [CAMELS methodology](#).

*“Assist with development of an off-site surveillance manual*

- *Provide further comments to revised draft procedures*
- *Compare to comments made to first draft of procedures*
- *Review on-site examination process for suggested changes” (Modification #6-completion by end of project)*

The advisors were asked on two occasions ([comments on off-site manual](#); [comments on 2<sup>nd</sup> draft](#)) to provide comments on a proposed off-site surveillance manual being developed by the Methodology Department. The CBA is in the process of implementing the guidelines. This was borne out in part in our diagnostic of the four banks, discussed previously, which included a review of off-site monitoring reports. The observations and commentary prepared for the diagnostic will also be of value to the CBA as it seeks to improve its off-site monitoring of risk, and this in turn will help build capacity as less reliance is placed on on-site examinations.

*“Prepare and conduct training to complement the new procedures manual.*

- *Work one-on-one with supervisors.*
- *Critique written analytical reports*
- *Formal classroom training in bank analysis” (Modification #6-completion by end of project)*

The CBA did not want any formal classroom training. However, the advisors did have extensive one-on-one discussions with examiners as the review of each of the four banks in the diagnostic was completed (see observations on each bank discussed previously). This was supplemented with informal training in [uses of the UBPR](#) for on-site examiners done at the request of one of the unit heads in the Supervision Department.

*“Make recommendations for integration of off-site monitoring with other supervisory activities*

- *Off-site monitoring in supervisory cycle*
- *Coordination with on-site examinations*
- *Use of tools such as strategic plans to enhance resource allocation*
- *Suggest ways to incorporate activities of other CBA functions into supervision” (Modification #6-completion by end of project)*

Much of this benchmark was addressed in the material the advisors prepared describing a process for [strategic planning](#), as well as our [review](#) of the process used to allocate resources for supervisory activities in the various supervisory subunits. The advisor made further [recommendations](#) to better integrate supervisory activities at the conclusion of the diagnostic of the four banks.

## **6. Uniform Bank Performance Report (UBPR)**

The evolution of financial markets places tighter requirements on the range and scope of analytic tools used by supervisors. As CBA is continually adjusting to international standards, the supervisory inventory should improve as well. The UBPR has proved to be an efficient instrument to organize the financial data in an orderly, transparent and easy-to-analyze manner. The wide adoption of analysis using the UBPR is an important prerequisite for the development of risk-based supervision.

*“Review the final version of the UBPR*

- *“Assess the existing methodology from initial processing of information to compilation of pre-analysis format.*
- *Identify deficiencies in current methodology.*
- *Make recommendations for improvement.” (Modification #6-completion by end of project)*

The advisors worked closely with the CBA’s Methodology Department during the extension period, suggesting many areas for enhancing the UBPR. This was initially done in a memorandum prepared in November 2003 ([Comments on the New UBPR](#)). Our senior financial analyst was particularly involved in this effort, and followed-up on many of these recommendations, which are summarized in her March 2004 [memorandum](#), and again briefly in a [note](#) in July 2004.

*“Review of UBPR integration*

- *Review reports currently prepared by CBA on the basis of the UBPR.*
- *Make recommendations for their improvement.*
- *Provide assistance with the development of reports.*
- *Make recommendations for UBPR integration with MIS.” (Modification #6-completion by end of project)*

After the start of this phase of project work, we were informed by the Head of Methodology (David Sargsyan) that this area was not needed and could therefore be dropped. In any event, some of the recommendations we made in the documents noted above touched on integration, and we continue to believe this is an important element for the CBA.

*“Prepare materials and conduct training to improve financial analytical skills*

- *On the job.*
- *Case-based.*
- *Formal classroom.” (Modification #6-completion by end of project)*

One area where the advisors have made a special effort is to expand the use of the UBPR to the Supervision Department, where it could be of great use for examination planning and control. To this end, the advisors held an informal discussion session in March 2004 for examiners ([Use of the UBPR](#)), and further discussions were held individually in April and May. Based in part on our findings from the supervisory diagnostic of four banks (detailed in Item C below), we also prepared a brief [memorandum](#) to help supervisors better understand how external rating agencies use financial analysis to evaluate credit risk of banks and other debt issuers.



*“Preparation of quarterly reports on main trends in the banking system.” (Modification #6-completion by end of project)*

The senior financial analyst has prepared and distributed a quarterly analysis of the banking system since the beginning of Phase II:

- [1st](#) quarter of 2002;
- [2nd](#) quarter of 2002;
- [3rd](#) quarter of 2002;
- [4th](#) quarter of 2002;
- [1st](#) quarter of 2003;
- [2nd](#) quarter of 2003;
- [3rd](#) quarter of 2003;
- [4th](#) quarter of 2003;
- [1st](#) quarter of 2004;
- [2nd](#) quarter of 2004.

*“Development of measurement techniques/tools/models for risk assessment.” (Modification #6-completion by end of project)*

The project senior financial analyst left to attend graduate school in the U.S. shortly before the completion of the initial extension period. Although unable to finish the credit risk assessment model, she did prepare a summary of requirements and definitions under Basle II ([Credit Risk Modeling](#)). During the second extension period for Phase II, [Mayra Rodriguez](#), a specialist in risk assessment, undertook further analysis ([Part I](#), [Part II](#)) in the area of credit risk modeling which included assessing credit risk management of banks and CBA practices to monitor credit risk; developing credit risk model alternatives; and assessing the possibility of incorporating statistical models into credit risk management in Armenia.

## **7. Risk Assessment Methodology**

While the adoption of a risk-based approach has been central to the CBA supervision development in recent years, the risk component as a core to the approach has not been fully introduced into the banking industry. On the one hand, the CBA has been consistently advancing from theory to practice in the utilization of modern techniques in the field. On the other hand, the level of risk management sophistication throughout the banks is low. As modern best practice in risk-based supervision advocates increased reliance on sustainable risk management within financial institutions, the success of the adoption of banking risk-based supervision in Armenia depends on the incorporation of a risk management culture in the banks.

*“Assess CBA existing practices for risk-based bank supervision*

- *Evaluate existing CBA procedures from receipt of information from the banks to decision making in the risk-based supervision context.*
- *Assess risk related provisions in existing regulations and guidelines.”*  
*(Modification #6-completion by end of project)*

Much of our assessment of the CBA’s existing supervisory practices was undertaken in connection with the diagnostic of four banks, discussed more fully in the specific context of these banks. However, further to an initial [outline](#) we proposed in December 2003, we prepared several memoranda outlining international supervisory standards in those areas where we observed notable deficiencies in current practice: in overall supervision ([Supervisory Best Practices](#)); in strategic planning ([Strategic Planning FAQ](#), [Comments on Strategic Plans Methodology](#)), in resource allocation and budgeting ([Review of Charter & 2004 Workplans](#)); and in evaluation of the effectiveness of risk management from off-site ([Comment on Off-Site Manual](#), [Comments on 2nd Draft of Off-Site Manual](#)).

*“Assess existing internal risk management activities within the selected banks as a component of overall risk-based supervision process, based on information provided in the on-site examinations.*

- *Assess availability and adherence to risk management principles in internal policies, manuals and guidelines.*
- *Evaluate existing risk management procedures, organizational structures and communication interflows as well as overall risk awareness and culture.”*  
*(Modification #6-completion by end of project)*

The advisors in October 2003 had initially proposed a [risk matrix](#) as a way for the CBA to incorporate not only the level and trend of risk in its analysis, but also the effectiveness by which management identifies, monitors and controls a bank’s risks. Our project financial analyst [Aram Karapetyan](#), who did much of the work under this component, followed this up with specific [recommendations](#) in a memorandum which outlined a proposed risk typology. It is our understanding that management plans to incorporate many of these suggestions into the off-site surveillance manual currently being finalized.

*“Conduct overall comparison*

- *Risk typology and classification.*
- *Monitoring techniques, risk management processes.*
- *Reporting systems, risk-based decision making.”* *(Modification #6-completion by end of project)*

Following extensive discussions with supervisory staff, our financial analyst made [comments and suggestions](#) on the risk assessment in the off-site manual, and followed these up with [further comments](#) on information flows as it relates to risk-based supervision.

*“Conduct risk matrix analysis for the selected banks based on recent UBPR data*

- *Compilation of exemplary risk matrices based on the information from on-site reports and recent UBPR data for the selected banks.” (Modification #6-completion by end of project)*

The project financial analyst sought to apply this technique to one of the banks in the sample of four chosen by the CBA for our diagnostic review ([Risk Matrix Bank B](#), [Risk Matrix Bank B Attachments](#)). We were somewhat hampered in this regard by the lack of detail in the information provided, but we do believe that the essence of this technique was satisfactorily communicated. As a [follow up](#) to this analysis, further work was undertaken in refining the risk matrix model and incorporating the analysis into CBA’s analytical framework.

*“Develop recommendations on improvement in the risk related component of the bank supervision process*

- *Identify deficiencies in current practices and approaches at the CBA that relate to the risk component.*
- *Distinguish among the most appropriate areas of international best practice for adoption at the CBA.*
- *Suggest improvements that foster development of risk-based supervision in the banking industry.” (Modification #6-completion by end of project)*

We identified many deficiencies through our diagnostic of the four banks on which the advisor made specific comments. The most critical items are summarized in a [memorandum](#) we prepared at the conclusion of the diagnostic, and the slide presentation we have prepared for USAID ([Summary of Supervision of Four Banks](#)).

*“Develop recommendations on internal risk management procedures for the commercial banks*

- *Identify deficiencies in internal risk management practices at the selected banks.*
- *Distinguish among the most appropriate models of collaboration with the supervisory authority.*
- *Suggest improvements that foster development of risk-based supervision in the banking industry.” (Modification #6-completion by end of project)*

We made numerous suggestions for improvement of risk identification, particularly as part of the diagnostic of the four banks. Our financial analyst also prepared a memorandum on [information processing](#) in the supervision area.

*“Prepare materials and conduct training to develop risk-based decision making and advanced risk management skills*

- *Analytical reports.*
- *On the job training and conveyance of study results to supervisors.” (Modification #6-completion by end of project)*

Much of this training was done on an informal basis in the course of the diagnostic of the four banks, through discussion with individual supervisors. We have extensively documented this in the various memoranda prepared for each bank.

## **8. Operational Risk Management**

1. *“What is operational risk and how does it arise?*

- *Definition, problems and examples*
- *Measurement difficulties*
- *Linkages to other risk types (credit, reputation and legal, etc)*

2. *Why is operational risk important?*

- *Increasing awareness globally among bank managements*
- *Basle II requirements and capital implications*

3. *How is operational risk managed and controlled?*

- *Roles of Board and management*
- *Internal controls and audit*
- *Control self-assessment*
- *Risk mapping, indicators and metrics*
- *Mitigation tools and techniques*
- *The decision whether to self-insure*
- *Contingency (business continuity) plans*

4. *What role do supervisors play?*
    - *Operational risk framework*
    - *Independent evaluation of policies and procedures*
    - *Ensuring integrated management across groups*
    - *Public disclosures*
  5. *What is international best practice?*
    - *Basle guidance (Pillars I, II and III)*
    - *Calibrating operational risk under Basle II (the three approaches)*
    - *Internal controls framework (Treadway Commission)*
    - *Enterprise risk management (ERM)”*
- (Modification #6-completion by end of project)*

Based on an outline developed by the advisors in consultation with requirements communicated by the CBA ([Operational Risk Outline](#)), a short-term advisor, [John Ewald](#), developed a half-day [seminar](#) in operational risk, which he delivered in July 2004. The short-term advisor followed this training with a discussion of CBA concerns with the Head of the Methodology Department. He prepared a summary memorandum [exit report](#) as well as a matrix of [best practices](#) for use by CBA staff, particularly those in the Methodology area charged with implementing those parts of the new Basel Capital Accord that pertain to this area.

## 9. Mortgage Lending

1. *“Introduction to real estate lending*
  - *Definition and characteristics of real estate loans*
  - *Types of real estate loans (credit-based, project)*
2. *Risks related to real estate lending*
  - *Credit, interest rate, liquidity, transaction and compliance risk*
3. *Policy issues*
  - *Geographic diversity*
  - *Portfolio diversification guidelines / limits*
  - *Loan administration functions*
  - *Documentation, approval, and reporting requirements*
  - *Monitoring process – economic conditions*
  - *Underwriting standards*
  - *Valuation requirements and procedures*
4. *Construction loans*
  - *Types of construction loans*

- *Documentation requirements*
  - *Loan administration (disbursement, monitoring)*
  - *Repayment and releases*
  - *Interest reserves*
  - *Special concerns*
5. *Warning signs*
- *General portfolio*
  - *Individual loans*
6. *Real estate valuation*
- *What is “value”?*
    - ✓ *Demand, utility, scarcity and transferability*
    - ✓ *Other terms and concepts*
  - *Differences: cost, price, value*
  - *Types of value*
    - ✓ *Market value*
    - ✓ *Value in use*
    - ✓ *Going concern value*
    - ✓ *Assessed value*
  - *What influences value?*
  - *Valuation principles and factors (change, competition, conformity, etc)*
  - *Valuation process and practices*
    - ✓ *Valuation concepts and definitions*
    - ✓ *Steps in the valuation process*
    - ✓ *Parts of a valuation report*
    - ✓ *“Highest and best use” concept*
    - ✓ *Approaches to value (cost, direct sales, income)*
    - ✓ *Value reconciliation*
    - ✓ *Common problems and errors in valuation reports*
    - ✓ *Report review: who, what, when”*
- (Modification #6-completion by end of project)*

A short-term advisor, [James Crozier](#), arrived in June 2004 to develop a course on mortgage lending and real estate appraisal based on a needs [assessment](#) outline. Preliminary work included discussion with representatives of the National Association of Realtors and Appraisers, the Appraisal Development Center, and a local realtor. He completed his on-the-ground work through discussions with our local legal advisor, and our financial analyst and prepared a summary [memorandum](#) of the local real estate market. The [course](#) was delivered in modules to both CBA staff and commercial bankers over a one-week period in late July 2004. After the seminar and other discussions, he prepared summary [conclusions](#).

## B. BANK CONSOLIDATION AND PROBLEM BANK RESOLUTION (TASK 2)

### 1. Comprehensive Assessment

*“Complete a comprehensive assessment of the existing substantive and technical framework for early regulatory intervention, problem bank resolution, and bank liquidation (“Resolution and Liquidation Assessment” or “RLA”). This assessment should help develop a set of recommendations for shaping the process of problem bank identification and strengthen the legal framework for problem bank resolution.”  
(60 day benchmark)*

The comprehensive assessment for Task 2 was scheduled for early in the program. Unfortunately, due to health problems of the scheduled advisor, the beginning of the assessment was delayed. [Alain Abejdid](#), the project resolution and liquidation assessment advisor, began the [assessment](#) in August 2002. He first reviewed all the laws and relevant regulations regarding temporary administration and liquidation and the quarterly reports developed by the project senior financial analyst. Meetings were held with the acting director of supervision, the manager of the temporary administration department, all eight temporary administrators, the head of the problem bank unit, an attorney from the legal department and members of a mission from the World Bank working on this issue.

The on-site advisor worked on development of procedures for problem bank identification and enforcement actions. Initial discussions were held in July 2002 with the head of the problem bank unit. At that time, no formal policy dictated problem bank identification and when an institution should be transferred in or out of the unit. Draft copies of enforcement actions were also reviewed. Discussions continued with the problem bank unit and the on-site advisor composed a section addressing problem bank identification for the comprehensive assessment discussed immediately above. In February 2003, the CBA provided a draft policy on problem bank identification and the on-site advisor provided [comments](#). During that same month, the Board reviewed the policy, but did not adopt it. The policy was sent to the Legal Division for review and eventually approved by the Board in April 2003. The approved policy sets forth a much clearer and transparent process for problem bank identification than the previous ad hoc process.

## 2. Training

*“Complete at least one training class for on-site supervisors.” (120 day benchmark)*

*“Complete and deliver a training program on problem bank rehabilitation/ liquidation.” (180 day benchmark).*

*“Organize U.S.-based training on bank consolidation and problem bank resolution with a U.S. bank regulatory agency for at least five CBA employees.” (12 month benchmark)*

*“Complete and deliver a training program on problem bank resolution for the BSD staff.” (18 month benchmark)*

[Frank Francisco](#) of Parker, Whitfield & Co conducted the training sessions under this task. The [first course](#) covered the topic of interim administrations and was presented on November 2002 with a supplemental [training notebook](#) provided to the participants. The [second course](#) covered the topic of financial rehabilitation programs for banks and was presented on December 2002. The [third course](#) covered the topics of legal protection for interim administrators, concentration of assets in key sectors and resolution strategies and was presented in October 2003.

With regard to the U.S.-based training on bank consolidation, [a two-week session](#) was held in Dallas, Texas with the Federal Deposit Insurance Corporation. The first week of the course covered the identification and supervision of problem banks and the second week covered bank resolution and receiverships. The on-site resident advisor organized the training with assistance in logistics provided by [IMMA Limited](#).

## 3. Policies and Procedures

*“Develop a written draft plan for establishing standardized policies and procedures for rehabilitating, resolving, or liquidating problem and failed institutions.” (180 day benchmark)*

*“Policies and procedures on Interim Administration and Liquidation” (modification #3)(18 month benchmark)*

*“Demonstrate that the CBA has approved and formally institutionalized standardized policies and procedures for rehabilitating/resolving/liquidating problems and failed institutions.” (18 month benchmark)*



As a follow through to the Resolution and Liquidation Assessment, the resolution and liquidation assessment specialist also completed the [draft plan](#) for establishing policies and procedures for rehabilitating, resolving and liquidating problem and failed institutions. This draft plan set forth an outline for issues to be addressed in policies and procedures for interim administration.

As part of the changes in modification #3, discussed in more detail in the following section, an additional benchmark was added to draft the policies and procedures for interim administration and liquidation and advisor [Bill Dudley](#) was brought to the project to accomplish this. The following tables set forth an outline of the subject areas for each of the chapters.

Table 5: Policies and Procedures on Interim Administration

<a href="#">Cover Letter</a> <a href="#">Chapter 1</a> -Steps Leading to Interim Administration <a href="#">Chapter 2</a> -Discussion of Key Provisions of Law <a href="#">Chapter 3</a> -Supervision of the Interim Administration Program <a href="#">Chapter 4</a> -Intervention and Appointment of Interim Administration <a href="#">Chapter 5</a> -Day-to-Day Operations <a href="#">Chapter 6</a> -Sale of the Bank in Whole or In Part <a href="#">Chapter 6</a> -Attachments
------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Table 6: Policies and Procedures on Liquidation

<a href="#">Cover Page</a> <a href="#">Table of Contents</a> <a href="#">Introduction</a> <a href="#">Chapter 1</a> -Closing Coordinator <a href="#">Chapter 2</a> -Composition of the Closing Team <a href="#">Chapter 3</a> -Liquidator in Charge <a href="#">Chapter 4</a> -Facilities <a href="#">Chapter 5</a> -Assets <a href="#">Chapter 6</a> -Operations <a href="#">Chapter 7</a> -EDP <a href="#">Chapter 8</a> -Legal Advisor <a href="#">Chapter 9</a> -Bank Liquidation <a href="#">Chapter 10</a> -Day-to-day Liquidation <a href="#">Appendix Assets Related Attachments</a> <a href="#">Appendix Sample Information Package</a> <a href="#">Appendix Liquidator in Charge Information</a> <a href="#">Appendix Electronic Data Processing Forms</a> <a href="#">Appendix Facilities Forms</a>
-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

#### 4. Diagnostic and Cost Test

*“Diagnostic and cost test, including guidelines.” (modification #3) (12-month benchmark).*

During the latter months of 2001 and the early months of 2002, two of the largest banks in the Armenian banking system, Credit Yerevan and Ardshinbank, were placed into interim administration. Following missions throughout 2002, the International Monetary Fund (IMF) made it clear that these banks should be resolved in an expeditious fashion. As part of the Banking System Measures issued in July 2002 the IMF set forth the following benchmarks related to resolution of banks:

- Issue written guidelines for the conduct of temporary intervention of banks, limiting intervention to no longer than six months (December 2002).
- Implement guidelines for the resolution of problem banks, which include a “least cost” test (February 2003).
- Complete least-cost diagnostic analysis of the two largest banks in temporary intervention (April 2003).

These were later amended to have guidelines for performing least cost analysis to be completed by March 10, 2003, least cost diagnostic analyses for Ardshin Bank and Armcommunications Bank by end of May 2003 and the resolution of the banks and placement into liquidation to be completed by June, 2003. BearingPoint compiled a proposed plan of action to address these issues in September 2002. After further discussions amongst USAID, IMF, World Bank and Treasury Department, the required scope of work for a modification to the original task order was agreed to. The modification covered the following:

- Diagnostic and Cost Tests for Ardshin and Armcommunication Bank and guidelines for cost tests.
- Marketing and resolution of the two banks.
- Preparation of a liquidation balance sheet for the two banks, as well as Credit Yerevan.
- Policies and procedures on interim administration.

The modification to the contract was signed in February 2003 and four advisors ([Joel Shapiro](#), [Tina Mendelson](#), [Isabelle Daverne](#) and [Doug Carpenter](#)) began work later that month on the diagnostic and cost tests. By the time of the beginning of the work on the diagnostics and cost test, Ardshin had already been largely resolved through the sale of the majority of the assets in the bank. As a result, the diagnostic and cost test were undertaken only for Armcommunication Bank.

The first deliverable under the modification was a set of [guidelines](#) for a least cost test which was approved by the Board. These guidelines detailed the various steps necessary in conducting the least cost test:

- Perform a bank diagnostic

- Calculate the cost under a liquidation scenario
- Review other bank resolution options
- Determine the least cost option
- Obtain CBA approval of the chosen resolution strategy

Supplemental information provided included worksheets for [asset valuation](#) used in the bank diagnostic and a [hypothetical cost test](#). In addition, [training](#) was offered in late March detailing the process for undertaking a cost test.

The [diagnostic](#) for Armcommunication Bank concluded in April 2003. The overall conclusion of the diagnostic was that given the large concentration by Armcommunication Bank in Nairit-related assets and the questionable financial stability and bleak outlook for that entity that liquidation of the bank was the only realistic alternative. Supplemental information detailed the [valuation](#) of major assets at Armcommunication, [background](#) information on Nairit, [notes](#) on the bank's financial statements and details on the [least cost test](#).

As a follow up to the diagnostic and cost test, the senior policy resident advisor met with members of the interim administration team for Armcommunication. At this [meeting](#), the senior policy resident advisor provided clarification and responded to questions about the details of the diagnostic. Most of the focus of this meeting was on the Nairit-related assets and their valuation. The BearingPoint team, as represented by the senior policy resident advisor, stood by its conclusions regarding the valuation of the Nairit-related assets and the overall conclusion as of the time of conducting the diagnostic was that Armcommunication should be directly placed into liquidation given the financial position of the bank and the lack of details regarding potential investors expressing interest in the bank. As of the end of the project, the institution's status was still not fully resolved.

## 5. Marketing and Resolution

*“Marketing and Resolution (Credit Yerevan and Ardshin Bank).” (modification #3) (12-month benchmark) (modification #6-benchmark deleted).*

With regard to marketing and resolution of Credit Yerevan, the CBA determined that liquidation would be the appropriate avenue and thus marketing and resolution was not necessary. Ardshin Bank was sold by the CBA prior to the start up of the resolution add on discussed previously and marketing and resolution was also deemed unnecessary. Finally, the CBA wanted to sell Armcommunication based on the process of informally contacting potential international bidders that had already begun. They felt this process would be accomplished more quickly than having BearingPoint market and resolve the institution.

## 6. Liquidation Support

*“Preparation of liquidation balance sheet.” (modification #3) (12-month benchmark) (modification #6-benchmark deleted).*

With regard to the preparation of a liquidation balance sheet for the three banks, CBA determined that they did not need any assistance with the liquidation balance sheet given this is the responsibility of the liquidation administrator. However, they are responsible under law for overseeing the preparation of the liquidation balance sheet.

### C. SUPERVISION STRATEGY (TASK 3)

[Wayne Fralin](#) was the senior policy resident advisor in Armenia and the chief of party for the project for the final two years of Phase I and first year of Phase II of the program. [Jimmy Barton](#) was senior policy resident advisor and chief of party for the final year of Phase II.

#### 1. Comprehensive Assessment

*“Complete a comprehensive assessment of the BSD’s organizational framework, management system, strategy, policies, and procedures of the BSD.” (60 day benchmark)*

The comprehensive [assessment](#) for Task 3 was undertaken at the beginning of the program and primarily focused on the recent reorganization of the CBA Supervision Department—its details, how it fairs in comparison to the prior organizational structure and its weaknesses. The overall conclusion of the assessment was that the structure of the bank supervision department, including the recent changes to the organizational structure of the CBA, has displayed a marked improvement over the last several years. However, the function has not moved far enough on the issue of applying subjectivity and judgment to the supervision process. A full integration of work processes under the reorganized functions has not been achieved and will be necessary as progress is made toward implementing a risk-based supervision system. Additionally, the Board needs to delegate additional authority to the department level.

#### 2. Written Plans and Procedures

*“Complete a written plan, including recommendations for the BSD, on how to implement a risk-based supervision approach, as highlighted in the Supervisory Policy Manual. Assist in further refining the BSD’s policies and procedures.” (120 day*

*benchmark)*

*“Complete a written draft plan of an institutionalized process for integrating the work of the different BSD Units, along with recommendations for the Head of the BSD.” (120 day benchmark)*

*“Assist the CBA in adopting and institutionalizing the developed policies and procedures for risk based supervision.” (12 month benchmark)*

The two noted [plans](#) for implementation of a risk-based supervision approach and integrating the work of the different BSD units were combined into a single document. This document first provided background on the risk-based supervisory process, including how it differs from a proscriptive or prudential approach, its key principles, and how it impacts all the major component processes within a supervision function. This was followed by a detailed framework for the full implementation of a risk-based supervisory system, which includes risk-focused examinations and risk assessment exercises, review of the audit function, evaluation of the risk management process and evaluation and communication of results. Then the report addressed the planning that would be necessary on the part of the CBA and commercial banks, as well as the necessary changes in legislation, supervision procedures and reports. Finally, it contained a plan for an integrated system for risk-based supervision, including a detailed implementation schedule.

The policies were adopted and institutionalized through the following means:

- Adoption of the on-site manual that moved to risk-focused examination procedures.
- Development of guidelines on earnings, liquidity and market risk distributed to banks as guidelines for their risk management systems.
- Newly developed internal reports adapted to the risk-based approach.
- Uniform bank performance report that was revised accordingly for the new reports.
- Revisions to CAMELS assessment to increase subjectivity of ratings.
- Adoption of revised corporate governance procedures placing emphasis on management’s responsibility to manage the risks of the bank.

### 3. Training

*“Develop and deliver to the BSD staff a training program on risk based supervision.” (180 day benchmark)*

*“Assist in organizing training on supervision in Central and Eastern Europe (CEE) with a CEE bank regulatory agency for at least five CBA employees.” (12 month benchmark)*

The risk-based supervision [training program](#) set forth the various elements required of a program, the breakdown of the training among in-country classroom, out-of-country and on-the-job components for staff from the CBA, as well as seminars that will be needed for commercial bankers operating in Armenia.

As for the required CEE-based training, the Bank of Slovenia, the central bank in Slovenia was chosen to provide training at on-site examinations. The [session](#) was conducted from September 22 through September 28, 2003 with five participants and addressed the following issues:

- Overview of banking supervision in Slovenia.
- Consolidated supervision.
- Licensing.
- Offsite supervision and analysis.
- Supervisory orders.
- Bank accounting.
- Supervision of information technology.

Logistics of the training session were planned by [Jim Giannetto](#).

#### 4. Other Requests or Issues

Beyond the subject matter areas addressed under the individual benchmarks, the senior policy advisors regularly advised the CBA on a number of issues that were not directly addressed as part of the benchmarks.

##### a. Deposit Insurance

One of the most important of these issues was the phase in of a deposit insurance system. The amendments to the Law on the CBA passed in late 2001 dictated a phase in of deposit insurance, with banks beginning to pay into the system in July 2003 and the deposit insurance fund (DIF) beginning to take responsibility for paying depositors in failed institutions in July 2005. As the policy matters came under analysis by the CBA methodology department, the senior policy advisor provided [comments](#) for the Chairman of the CBA on the scope of the guarantee, level of premium payments, target size for the fund, fund management and the level of insured deposits. On a separate occasion, the Head of the Methodology and Analysis Department requested that the senior policy advisor [review](#) a draft of the [policy document](#) developed by the Methodology Department.

##### b. CAMELS

The senior policy advisor also commented on [standards](#) to be considered in setting more subjective criteria for CAMELS ratings as opposed to following some type of formulation based on static criteria. Related to the issues involved with the CAMELS ratings, separate guidelines were compiled for the individual CAMELS components of [liquidity](#), [earnings](#) and [sensitivity to risk](#).

### c. Consolidated Supervision

The senior policy advisor in response to a request from the Head of Methodology and Analysis also provided background information on [consolidated supervision](#), including the rationale for its implementation and its use under international practice, especially as it is defined under releases of the Basel Committee. This information was used for the CBA's initial consideration of whether a unified supervisor should be phased in to oversee the Armenian financial system. As the CBA focused more on the issue of implementing a unified supervisor, which is one method for implementing consolidated supervision, the [senior policy advisor](#) and [senior advisor](#) both provided comments based on international practice and applicability to the Armenian financial system.

### d. Other Issues

In addition to addressing these issues, the senior policy resident advisor on a number of occasions provided comments on a range of current strategy issues that the CBA was grappling with. On [one](#) occasion these issues included holding company structures, remote bank branches and cross-border banking issues; while on [another](#) they included sales and mergers of banks, open bank assistance and normatives for non-bank credit institutions; a [response](#) to questions on activities of cooperative banks; and a [memo](#) on supervisory best practices. Finally, [comments](#) were provided on a CBA draft resolution "On Approving the Minimum Criteria for Internal Controls in Banks."

## D. LEGAL REFORM (TASK 4)

### 1. Comprehensive Assessment

*"Complete a comprehensive assessment (a "Legal Framework Assessment" or "LFA") of the existing substantive and technical framework of the legal environment, taking into consideration pending or enacted laws and amendments to current banking laws." (Modification #2-completion by December 14, 2002)*

The initial task order envisioned a comprehensive assessment of the legal system followed by assistance with pending legislation and regulations, as well as training. The task order, as amended, set forth required assistance in three major areas:

- Legislation, including draft amendments to key banking laws.
- Regulations, including draft revisions to key CBA regulations.
- Training, including a seminar on requested legal issues of importance.

The [comprehensive assessment](#) was accomplished by the project legal advisors, [Vern McKinley](#) and [Monica Harutyunyan](#), early in the project and included a detailed summary of the current activities in each of the major areas, including legislation and

regulations in need of amendment. Major issues highlighted in the assessment of the legal framework included:

- Resolving the status of shareholders of non-viable commercial banks and credit institutions.
- Selling of commercial banks and CIs, in whole or in part, out of interim administration.
- Working with the courts and pressing for deference to the central bank in decision-making regarding troubled institutions.
- Providing loans or assistance to troubled banks.
- Defining the parameters of affiliated or linked persons.
- Transitioning to a system of deposit insurance over the next three years, including placing the deposit insurance fund (DIF) on a sound financial footing.
- Developing a regulatory framework for credit institutions.

The primary counterpart in the Legal Department, Varoujan Avedikian, provided [comments](#) in response to the assessment and these issues were discussed individually or were responded to in writing.

## 2. Regulations and Laws

*“Provide further assistance to the CBA’s Legal Department in updating and amending the CBA’s regulations and major banking laws so as to bring them into line with international practice.” (120 day benchmark)*

*“Provide evidence that at least an important subset of regulations have been altered to conform with both amendments to Armenian banking laws and international practice.” (12 month benchmark)*

*“Provide evidence that at least an important subset of laws pertinent to banking supervision has been amended to conform to international practice.” (12 month benchmark)*

*“Ensure that all core banking regulations are in accordance with amended banking laws and international practice.” (24 month benchmark)*

*“Provide evidence that at least an important subset of laws pertinent to banking supervision has been amended to conform to international practice.” (24 month benchmark)*

The bulk of the legal advisory work for the project involved ongoing assistance and comments on draft regulations and legislation all in an effort to move toward consistency with international practice. A number of these exercises involved follow through from legislative work under Phase I of the USAID program, while others were



initiatives independent of those legislative changes. The work undertaken by the CBA Legal Department during the course of the project was wide-ranging as to subject matter, involving major issues such as bank and credit institution bankruptcy and resolutions, deposit insurance, consolidated and unified supervision, anti-money laundering and mortgages. As of the end of the task order, a number of legislative efforts the advisors provided assistance on during Phase II to bring the financial system more in line with international practice were still progressing through the legislative process as detailed in the sections below.

#### a. Bank Consolidation and Problem Bank Resolution

As detailed in the discussion under Task 2, work continues on the development of an infrastructure to identify, resolve and liquidate problem banks. As a result, work also continues on modifications to the legal infrastructure. Initial focus at the beginning of the project was on the process of mergers of banks and asset sales and [comments](#) as well as training (see Section 3 of this task for training activities) were provided on this issue. On a closely related issue, the advisors provided a [response](#) to questions regarding how a limited review of CBA actions can be undertaken by the courts on matters such as extinguishing the rights of shareholders.

As a follow up to the passage of the amendments to the bank bankruptcy law in late 2001, the CBA promulgated Regulation 7 on which the advisors commented on an [initial draft](#) and a [revised draft](#). Additionally, comments were provided on a resolution for [changes of bank activity](#) for institutions transitioning to a credit institutions charter and recommendations were provided regarding how to equitably address [tax funds](#) placed at failing banks. [Amendments](#) to the bankruptcy law were also considered, many of which were consistent with those developed by the advisors, and additional [comments](#) were conveyed by the advisors.

As of the end of the task order, amendments to the Bankruptcy Law and the Code of Civil Procedure have been passed. Many of the current changes are consistent with the recommendations of the advisors:

- Reduced the current duration of the temporary administration from its current length of three years, with an option to extend for another three years to one year, with an option to extend for an additional year.
- Increased threshold of the deposit amount to be paid out on a priority basis.
- Increased involvement by the CBA in the liquidation process.
- Amended the Code of Civil Procedure to include a new provision on the procedure of appealing the decisions of the CBA and temporary administrator, i.e. limited review. In particular, the decisions may be appealed within a short period of time (seven days) and may be invalidated by the court only in the case of violation of the law.
- Granted the Deposit Insurance Fund a claim of the same priority as depositor compensated in liquidation.

## b. Deposit Insurance

As noted under Task 3, the Methodology Department of the CBA developed a general strategy or regulatory principles (“Principles”) to dictate a policy and financial framework for the deposit insurance fund. In keeping with those Principles, the Legal Department developed a [draft deposit insurance regulation](#) to be promulgated under authority granted to the CBA under the CBA Law, as well as proposed [draft amendments](#) to the law. The legal advisors provided [comments](#) on the deposit insurance regulation and amendments to the CBA Law that largely focused on questions regarding the financial stability of the fund, such as the initial capitalization of the fund and ongoing sources of revenue to build and maintain the fund. A great deal of reliance on building the financial stability of the DIF was placed on diverting profits from the CBA. This is not considered a good practice as it is not a very transparent means of building the DIF and it also diverts what are public funds (CBA profits) to benefit private commercial banks who will benefit from the DIF. The advisors continued to advise the CBA regarding various issues regarding the DIF throughout the course of the project. Near the project’s end, the CBA had proposed a new deposit insurance law and the advisors provided comments on that law. The law was approved and signed in late 2004. Negotiations were also in progress with the German Development Bank, KfW Entwicklungsbank, regarding a 3 million Euro capitalization of the DIF that was linked to the approval of the new law.

## c. Consolidated and Unified Supervision

In late 2003, the CBA began consideration of issues of unified supervision as a means to implement a comprehensive system of consolidated supervision. After the methodology department drafted up a policy analysis of the issue, the Legal Department developed a draft [unified supervision law](#). The legal advisors, with assistance from short-term legal advisor [Gary Gegenheimer](#), a specialist in this area of financial law, reviewed the draft law and provided an [analysis of unified supervision](#) in the context of the draft law. A primary issue raised by the advisors is the level of involvement by the CBA in controlling the new unified supervisor.

Additionally, the CBA was given a broader analysis on the topic of [consolidated supervision](#). As compared to unified supervision, consolidated supervision involves issues of allowing financial sector regulators to understand the ownership structure, actual control, overall organizational structure, corporate governance and risk management systems, and all material risks within any corporate group that includes financial service firms, and particularly one or more banks. Beyond providing this policy analysis, the advisors also provided [proposed amendments](#) to the Law on Banks to improve the current system of consolidated supervision.

As of the end of the project, the proposed changes to implement a system of unified supervision were still under consideration within the CBA. It is likely that further work will be undertaken in 2005 on this issue.

#### d. Anti-Money Laundering

The legal infrastructure in place to combat money laundering as of the beginning of the project phase included a brief article in the Law on Banks (Article 40) and Regulation 5, which was promulgated pursuant to the article. However, this overall framework was considered inadequate as reviewed under the Basel Core Principles Assessment<sup>2</sup> and a number of commercial banks indicated that their correspondent banking relationships were being placed in jeopardy because of this weakness in the system for combating money laundering. In response to these questions, the CBA developed a [draft money laundering law](#), and [criminal code provisions](#) to address money laundering. The legal advisors provided [initial comments](#) on the draft law and the criminal code provisions, which included a draft memorandum of understanding that the CBA should enter into with counterpart agencies in appropriate countries and also provided a second set of [comments](#) on a later draft, which reflected some of the major recommendations made previously. As of project end, the draft law had been submitted to the National Assembly, but it was not approved by the end of the 2004 session.

#### e. Mortgage Market

The CBA's Methodology Department engaged in a detailed study of the mortgage market. A [concept paper](#) was developed as the culmination of this research and a key conclusion of the paper was that the Armenian system would need a number of adjustments to its infrastructure and legislative framework in order to fully develop the mortgage market. As a follow on to the concept paper, the Legal Department drafted a number of [proposed amendments](#) that included changes to law that would create a mortgage loan agreement and a mortgage certificate. Additionally, amendments were proposed to the CBA Law that would create a secondary mortgage company that would buy loans underwritten in the primary market. The legal advisors provided [comments](#) on the mortgage law drafts. As of the end of the project, the amendments had not been approved or circulated beyond the CBA and the Ministry of Finance, which was also involved in analyzing this issue.

#### f. Other Issues

Other more short-term analyses undertaken by the legal advisors included the following:

- [payment systems law](#): discussed the relevant sections of the Core Principles for Systemically Important Payment Systems with the Head of the Legal Department. BearingPoint offered to bring a specialist in legal issues regarding payment systems, but the assistance was declined by the CBA. As of the end of the project, the Government had approved the draft law, but it had not yet been approved by the National Assembly.
- [comment](#) on a requirement that legal entities (small businesses) exchange their currency exclusively through commercial banks.

---

<sup>2</sup> Principle 15 judged as non compliant.

- [memo](#) detailing how attorneys should be involved with legal issues regarding banking supervision.
- [comments](#) on draft amendments to the Law on the Central Bank, Law on Banks and Banking and Law on Bank Secrecy.
- [annotated comments](#) on CBA’s corporate governance policy report; and a [report](#) on corporate governance, including detailed attachments on legislative language on [audit committees](#) and [suggested changes](#) to the current Law on Banks.
- [comments](#) on the draft [Cadastre Law](#). As of the end of the project, a new law had been passed on moveable collateral.

### 3. Training

*“Develop training classes dedicated to strengthening the Legal Department.” (120 day benchmark)*

*“Provide a minimum of one additional training activity for the Legal Department following the LFA.” (180 day benchmark)*

*“Complete at least one either third country or U.S. training class for two persons from the Legal Department.” (12 month benchmark) (Modification #6-Replace the third country or the U.S.-based training with series of in-country training on consolidated supervision).*

As detailed in the Regulation and Laws section, an area of particular focus during the early part of Phase II was the issue of [merger and sale of institutions](#). A training session was developed on [mergers and asset sales](#) with particular focus on the legal issues that arise.

The availability of the Legal Department to participate in third country or U.S.-based training on topics related to consolidated supervision, their topic of choice, was severely limited. Of the three senior counterparts in the Legal Department that the BearingPoint legal advisors have had the most frequent contact with, only one, the Head of the Legal Department, was still working at the CBA as of late 2003. As a result of time limitations, the head of the legal department requested that advisors who have worked on the issue of consolidated supervision in Kazakhstan, a developing market in similar circumstances that has already developed a legal and regulatory framework in this subject matter area, be brought to the CBA to conduct seminars ([overview](#), [illustrative examples](#), [international perspective](#)). Gary Gegenheimer, who previously advised the CBA on unified supervision, and [Bryan Stirewalt](#) were brought to the

project to conduct seminars on consolidated supervision. These seminars were also conducted for USAID management given the importance of this issue to the entire financial system.

## E. ACCOUNTING PROCEDURES STRENGTHENING (TASK 5)

The initial task order envisioned a comprehensive assessment of the existing accounting framework and a detailed implementation plan, to be followed by assistance to the CBA in bringing accounting practices in line with international standards, including through training.

### 1. Comprehensive Assessment

*“Complete a comprehensive assessment of the existing substantive and technical framework for bank accounting (“Accounting Framework Assessment” or “AFA”), with special attention given to IAS compliance and to developing policies and procedures in compliance with Armenian banking laws and international practice.” (Modification #2-completion by December 14, 2002)*

During the initial months of the task order in 2002, [Maureen Berry](#) undertook the comprehensive assessment of the existing framework. The assessment involved meeting with appropriate staff from the CBA and knowledgeable third parties, reviewing relevant documents, including policies, procedures and the chart of accounts and reviewing a sampling of audited financial statements for eight banks, with visits to five of the banks. The conclusion of the [assessment](#) was that the overall accounting framework largely complies with international standards of accounting and reporting. However, a number of weaknesses were evident throughout the course of the review with regard to the implementation of the framework. These included changes needed to various policies and procedures, legislation and regulations and the chart of accounts and its instructions. Recommendations regarding necessary training were detailed in an appendix to the report.

At a later point in the course of Phase II during early 2004, [Jeanne Wehlau](#) undertook a follow up to the comprehensive assessment. She summarized some general [findings](#) and her [overall](#) work. The remaining work from her follow up visit is addressed under the sections described under Task 5 below, as appropriate.

## 2. Written Draft Plan to Bring to International Practice

*“Complete a written draft plan, including recommendations for the Accounting Department, concerning how accounting policies and procedures shall be brought into compliance with international practice.” (120 day benchmark)*

*“Provide assistance in upgrading the Chart of Accounts.” (120 day benchmark)*

The next step after the comprehensive assessment was for the accounting advisor to draft a [plan](#) detailing recommendations for amending the chart of accounts and its instruction, and changing accounting policies and procedures. This plan was provided in great detail with regard to the appropriate changes needed to the chart of accounts (Appendix 1) and the various implementation instructions (Appendix 2).

At a later point in the project, [follow-up](#) analysis was undertaken on the chart of accounts with a particularly detailed analysis provided for [leasing](#). The [status](#) of each of the changes to the chart of accounts was summarized as of the second review.

## 3. Training

*“Develop training classes on IAS and Chart of Accounts for the CBA Accounting Department.” (120 day benchmark)*

*“Complete at least one additional training activity on IAS and Chart of Accounts for the CBA Accounting Department staff.” (180 day benchmark)*

Based on the comprehensive assessment and follow up discussions regarding priority training topics, a series of training sessions was scheduled for the summer 2003 by [Laszlo Urmenyhazi](#) as follows:

- [IAS 12 Income tax.](#)
- [IAS 17 Leasing.](#)
- [IAS 39 Financial instruments.](#)

In addition, a special request was made to organize training on [IAS 37 Provisions, contingent liabilities and contingent assets](#) and the accounting advisor accommodated the request by assembling a training session on this issue.

## 4. Accounting Policies and Regulations

“Assist in drafting the CBA accounting policies and regulations necessary for adoption and implementation of IAS by commercial banks.” (180 day benchmark)

As follow through to the initial assessment and follow up assessment and in response to requests from the CBA, the accounting advisors provided more detailed analysis in the following subject matter areas:

- [IAS 39](#) and changes in [IAS 32 and 39](#).
- [Repos Accounting](#)
- [contingent liabilities](#)
- [loan losses and repossessed collateral](#) and [follow-up](#) analysis.
- [loan commitments and guarantees](#)

The advisor also provided an analysis of various [policy issues](#), including the use of general reserves, netting and accounting for derivatives and calculation of a forward rate, comments; and on [another](#) occasion on reserve provisioning, recovery from collateral for a guarantee and reserves for standard loans (including in [table](#) form); and [comments](#) on existing accounting policies.

### F. TARGETED ASSISTANCE (TASK 6)

#### 1. Non-bank Intermediation

“Assist the CBA in drafting the legislation, policies, and procedures for non-bank intermediation.” (60 day benchmark)

“Provide assistance to the CBA in developing the regulatory framework for non-bank financial institutions (such as credit unions and savings houses).” (120 day benchmark)

As discussed under the strategy section, the senior policy advisor and legal advisor provided comments on the regulations that were issued on non-bank credit institutions. Additionally, during the early part of Phase II, the senior policy advisor and legal advisor met with the technical officer for USAID, John Carracciolo, on a regular basis on issues related to non-bank intermediation, primarily to assist with the development of the Microenterprise Development (MEDI) Task Order. When the MEDI project was initiated, the senior policy advisor and legal advisor met on a number of occasions with staff from the project providing input from the perspective of the CBA. Additionally, the local legal advisor joined the MEDI project as a legal advisor. As of the end of the project,

consideration was being given to a separate law for microenterprise institutions, but amendments to the current non-bank credit institutions law are more likely.

## 2. Public Outreach Program

*“Assist the relevant department in the CBA in developing human resources policy and designing a public outreach program for the commercial banks and the CBA.” (60 day benchmark)*

*“Provide assistance in developing the public outreach campaign for the CBA and commercial banks.” (120 day benchmark)*

*“Ensure that the BSD has approved a policy that delineates communication procedures with commercial banks and the public, and provide evidence that this has occurred.” (24 months)*

During the early months of Phase II, [Anthony Warmington](#), a specialist in press relations in the financial sector, provided the required assistance and developed a [public outreach program](#) for the use of the CBA. The recommended program was approved by the CBA Board in 2002.

## IV. RECOMMENDATIONS FOR FOLLOW-UP WORK

### A. CONSOLIDATED SUPERVISION

The issues regarding consolidated supervision are well grounded in international practice. “An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis” is one of the “25 Core Principles for effective Banking Supervision.” Further, without consolidated supervision, a banking supervisor is unable to comply with many of the remaining Core Principles. It is also important to note that consolidated supervision is obligatory for all banks incorporated in the eighteen member countries of the European Economic Area and must be carried out with specific minimum standards.

Effective consolidated supervision means the financial sector regulators must be aware of the ownership structure, the overall organizational structure, the corporate governance and risk management systems and all material risks within a financial services conglomerate. While the CBA has begun to understand the legal and supervisory issues central to consolidated supervision, the work yet to be undertaken far exceeds that which is completed. Future follow up work in this area will consist of considerable in-depth legal analysis combined with the development of legislative standards comparable to international best practice. In addition supervisors will need to be trained and supervisory policy rewritten to meet the challenge of consolidated supervision.



## B. RISK-BASED SUPERVISION

In prior project phases, we have proposed the adoption of risk-based supervision and obtained the conceptual buy-in of CBA management; assisted with procedure for identifying and dealing with problem banks; and developed an on-site examination manual. Our efforts in the current project phase have focused on assisting the CBA with implementing many of the concepts of risk-based supervision, particularly in the area of off-site monitoring. Our diagnostic of off-site supervision revealed a number of deficiencies, and indicates that much remains to be done to achieve full implementation of risk-based supervision in this area.

In this regard, we have identified the following more specific areas where further technical assistance would be required:

- Training in financial analysis and risk identification.
- Rollout of the Uniform Bank Performance Report (UBPR) by the Supervision Department and training on its use.
- Improving the quality of business writing and communication skills.
- Assistance with policy development in key areas.
- Advising on systemic risk issues and communicating more effectively with the local banking industry.

In light of the above detailed comments on risk-based supervision and our experience studying and analyzing on-site and off-site supervision, it is obvious that additional effort needs to be put into a full rewrite and revision of the on-site examination manual. During phase II of the task order, we laid out a plan to implement risk-based supervision, the implementation of which has been inconsistently applied. In developing the detailed roadmap for follow on work, specific reassessment of the handbook and the supervisory procedures and philosophy should be a focal point for substantive work.

The effective and successful implementation of risk-based supervision urges for wider use of more advanced and efficient analytical tools by supervisors. Over the past years based on the experiences of many countries, the UBPR has proved to be an important instrument in organizing the financial data in an orderly, transparent and easy-to-analyze manner. Its adoption by CBA will allow the following:

- Provide a common set of analytical ratios and other indicators available to everyone involved in the supervisory process.
- Establish an important tool for supervisors to use in preparing analytical reports envisioned in the proposed off-site surveillance manual.
- Encourage a more effective use of scarce staff resources through enhancing examination planning and control.
- Make supervision less “personal” and based more on objective standards and judgment which is reasoned and well supported.

- Increase efficiency through elimination of duplicate reporting of raw prudential return data such as financial statements.
- Enhance the level of disclosure to the extent the UBPR is made available to the public.

In order to take full advantage of this useful tool it is recommended that:

- Assist CBA with the development of a UBPR Handbook that will provide guidance on the significance and use of analytical ratios and other information included in the UBPR.
- Formal classroom or on-the-job training on financial analysis and use of the UBPR is provided to supervisors.
- Assistance provided with an effective integration of the UBPR within the supervisory cycle and CBA Management Information Systems.

### C. ACCOUNTING ADVISORY

During 2004 an Accounting Advisor spent 5-6 weeks focused on the accounting needs of the supervisory policy area of the CBA. She conducted a review of financial policies (swaps, FX derivatives, etc, follow-up on prior work done by advisors, implementation of 12/03 revisions to IFRS and changes in the chart of accounts.

The work done for CBA management was appreciated as important and additional questions surfaced which should be addressed. Future work should encompass a review of the Chart of Accounts combined with implementation instructions, preparation of a policy on leasing, and seminars covering international financial reporting standards, policy writing and internal auditing for supervisors and bankers.

### D. TRAINING

During Phase II, the consultants performed numerous training courses covering such topics as problem banks, derivatives, interest rate risk, consolidated supervision and in the latter stages operating risk and mortgage lending. While the future contracts should encompass micro training as before, the more important focus should be on both risk-based supervision for supervisors and bankers as well as focus on accreditation for supervisors.

In the latter case a fully developed program of accreditation including micro and macro training was recommended to the CBA management and Board. The Board reportedly approved the program, but human resources never implemented the recommendation. In order to assure effective implementation of a best practices supervisory process, it is imperative that the accreditation process be implemented.

## E. LEGAL ADVISORY

The legal advisors participating in both Phase I and Phase II have made major contributions to the legal and regulatory landscape at the CBA and in Armenia. Regulations promulgated under newly developed or amended laws will continue to focus the legal department of CBA and highlight how important external advisors will be to assisting with international best practices in legal and regulatory development.

Of particular note in the future legal landscape of Armenia and the CBA are such issues as regulatory implementation and refinement dealing with anti-money laundering, consolidated supervision, resolution and liquidation of banks and corporate governance. The experience and knowledge furnished by legal advisors in these complex areas will help to limit the development of material risks to the regulatory system.

## F. CORPORATE GOVERNANCE

Corporate governance refers to oversight mechanisms, including the process, structures and information used for directing and overseeing the management of an enterprise. It encompasses the means by which members of the board of directors and senior management are held accountable for their actions and for the establishment and implementation of oversight functions and procedures.

Effective corporate governance is vital to any business enterprise. But it is probably nowhere more essential than in the case of banks, which form a critical component of any country's economy. Banks, after all, are not ordinary business enterprises: they are depository institutions, they provide financing for a wide range of commercial and consumer needs, and they provide access to payment systems. The importance of banks to national economies is underscored by their access to government "safety nets" such as deposit insurance and the lender of last resort function of central banks.

The development of the foundation philosophy and the proposed legislative change in the area of Corporate Governance have been closely followed and aided by the legal advisory staff as part of Phase II. Throughout 2005 the CBA will continue to need the kind of sophisticated best practice advice and assistance which is only available through outside participation.