ASSESSMENT OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The Republic of Armenia
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ASSESSMENT OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION FOR THE REPUBLIC OF ARMENIA

Executive Summary

An assessment of bank supervision in the Republic of Armenia using the Basel Core Principles was conducted in October 2005. The assessment team consisted of Mr. David Hawkins and Mr. Vern McKinley.

The banking system dominates Armenia's financial sector and represents its most developed part. In addition to the banking system, the Central Bank provides supervision to organizations. The Central Bank of Armenia (CBA) is now the only agency of the Armenia government with the authority to license and supervise banks in Armenia, withdraw licenses, and take corrective action when problems are noted.

The CBA has been engaged in an ambitious reform of the banking system, including bank supervision and has taken many positive steps to improve legislation and banking practices in this country. The supervision and methodology departments of the CBA have the resources necessary to implement supervision and are well-respected by commercial banks in the country. Armenia is, in our opinion, well ahead than many other transition countries, especially those of the Former Soviet Union, in implementing changes that will enhance bank supervision.

The CBA and Parliament are considered to be very responsive to recommendations made by both banks and other parties, such as the International Monetary Fund, the World Bank, the United States Agency for International Development and other parties on changes that are needed to be implemented to further enhance bank supervision. This year alone, the CBA has implemented new standards for internal controls at banks and has developed a concept paper on changes needed to improve corporate governance at banks that will serve as the basis for changes to law that are currently under review by Parliament and are expected to be passed this fall for enactment in January 2006. Anti Money Laundering measures have been enhanced with the implementation of Currency Reporting Transactions. Nonetheless, there are improvements that, if implemented, will help compliance with Basel Core Principles be even further improved. Many of the recommendations outlined in this report are expected to be implemented with the expected changes in laws.

Areas needing the most attention are:

- Legal protection for supervisors is needed, and costs associated with defending themselves against actions taken should be, by law, provided to them.
- Further changes are needed to improve Corporate Governance at banks, including, the need for public disclosure meeting standards recommended by the Basel Committee.
- The CBA needs to have full authority to take action, including fines and removal orders, against directors, shareholders (principal or other), beneficial owners and any other parties exhibiting significant influence over a bank. Civil money penalties (fines) should be at a level that will be a deterrent to unacceptable behavior and should be punitive.

- Laws should be improved so that related parties are fully defined, taking into account all possible cases, and allowing the CBA to use its discretion in determining what constitutes a related party.
- Banks should be required to implement risk management practices for all areas of risk, and Boards should be held legally liable for failure to implement these practices in full.
- All internal audit reports and reports outlining deficiencies/violations of anti money laundering legislation must be reported directly to the Board and not directly to management, in all instances.
- Both banks and external auditors should be required to immediately report any matter of material deficiency or that could be considered of supervisory interest to the CBA.
- The CBA should have the authority to prohibit an External Audit company from performing work at banks operating in Armenia.
- Conflicts of interest laws should be developed for bankers to use in all areas.
- It should be considered a violation of law to extend credit based on bribery, threat of harm, or similar circumstances.
- Boards should be required to establish stricter controls on lending to related parties (connected lending) and on large loans.
- Consolidated Supervision should be enhanced further by obtaining memorandae of understanding with supervisors from all countries that have banks operating in Armenia. Consolidation of financial statements of parties related to a bank should be reviewed for compliance with international standards.

Inputs, Methodology, and Findings

Introduction
The Basel Core Principle Assessment is being performed for the Republic of Armenia. The Central Bank of Armenia, as the sole regulator of financial institutions in Armenia, is the main institution and focus of the assessment. However, in order to implement effective supervision, we recognize that the CBA cannot operate in a vacuum without cooperation and coordination of many other entities, including Parliament, Ministry of Finance, the Court System, and other important institutions, and thus we are looking at the system that has the components for effective bank supervision. The assessment was performed under a technical assistance project funded by the United States Agency for International Development to identify deficiencies in banking supervision in Armenia. The assessment team included Mr. David Hawkins and Mr. Vern McKinley, with the Barents Group. Mr. Hawkins, a Senior Consultant, has over 20 years experience as a bank regulator, including tenure with the Office of the Comptroller of the Currency and with the Office of Thrift Supervision. He has over 10 years experience as an international consultant and was a long-term Resident Advisor for over 7 years in three different countries, all of which were part of the former Soviet Union. Mr. McKinley is a Senior Manager, an attorney, and has previous tenure with the Federal Deposit Insurance Corporation prior to his tenure at BearingPoint. He has over 20 years experience in banking and bank supervison.

The report is in two parts, the main body, which presents the conclusions and recommendations, and the Principle-by-Principle assessment.

Information Used
In performing this assessment various documents were reviewed and meetings were held with management and staff of CBA, including the Head of Bank Supervision, Head of Banking Methodology and Analysis, other BSD management and staff, and the Assistant to the Chairman of the CBA. Meetings were also held with two banks, the Bankers' Association and a credit organization. The documents reviewed for the purposes of this assessment are listed in the appendix to this report. All information required to perform the assessment was presented when requested and there were no known issues or problems that had an impact on the accuracy of the assessment.

Preconditions for Effective Banking Supervision
The Basel Committee recognizes that effective banking supervision requires a set of preconditions to be in place. While these preconditions are largely beyond the control of the supervisory authority, weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement effectively the Core Principles.

Macroeconomic Environment: The economic environment is considered excellent based on economic indicators. Armenia is among the fastest growing economies in the world. Annual GDP growth has been positive, and grew 10.1% in 2004. Only Azerbaijan, Tajikistan and Ukraine had higher levels of growth, and Armenia's growth was higher than all of the developed countries in the world. Inflation has been relatively low, and was 7% in 2004. Investments in the country were higher than expected and the budget deficit was lower.

With regard to the banking environment, interest rates and spreads remain high and public confidence and level of savings remain low. This is in spite of the introduction of a deposit

insurance program. Reportedly, over one-half of the money remains outside of the banking system.

Public Infrastructure: Although the Republic has made great strides in improving the public infrastructure since independence from the Soviet Union, there are still areas that need improvement. High levels of poverty are evident, with some estimates that greater than 50 percent of the population lives at the poverty level or below.

The credit culture is not fully functioning at an optimal level. The supply of credit is low and when available is characterized by high interest rates and the need for tangible collateral. According to our discussions, there may still be evidence of loans being provided in return for bribes. When collateral is available, the banks may be unwilling to lend as a result of their inability to successfully foreclose on collateral in the courts. There is no reliable appraisal function in the country for banks to use to obtain independent valuations of collateral. Although changes have been made to the Civil Code that, in theory, allow for the speedy foreclosure of certain properties, the debtor still has the right to proceed through the courts. In other instances also, the law favors debtors over creditors, especially with regard to the rights of persons living in properties that were provided as collateral. These problems are furthered by a lack of trained judiciary to deal with matters of pledge and at least anecdotally, judges still make some decisions based on bribery.

The laws also do not allow for banks to engage in non-bank activities. The law specifically states that banks may not be involved in, for example, insurance activities. Banks are thus, mainly reliant on the core banking activities to generate income.

Corporate governance, in the banks and in other companies, although improved, still requires improvements. The lack of basic corporate governance at companies, for example, will hinder a company from obtaining loans for projects that may actually be economically sound. In many cases, companies do not have the expertise to know how to approach a bank for a loan and what is needed to obtain one. Even if this were known, many companies would have difficulties knowing how to put together information in an acceptable format required to obtain credit.

Effective Market Discipline: Considerable efforts have been expended over the past two years in improving financial transparency and effective corporate governance. The CBA implemented, in January 2005, the MICR that provides information on what a bank's Board of Directors must do to protect its bank from undue risk in many areas. A "Concept Paper on Corporate Governance" has been introduced this year and laws are expected to be amended in the near future to clarify the duties of management and the Board with regards to corporate governance in banks. Although these are good steps, laws and regulations will need to be further amended if the banks in Armenia are to implement corporate governance to international standards. Transparency at banks, although improved, needs additional efforts if to be in line with international standards.

Supervisory Procedures: The CBA is responsible for the supervision of banks and other financial institutions. Supervisors must have ample procedures and policies to guide them in dealing with troubled banks. To this end, the CBA has been given broad powers, pursuant to the Law on the Central Bank and the Law on Banks and Banking, to implement effective supervision in Armenia. An Anti-Money Laundering Law was further strengthened with the introduction of a Law on Currency Regulation and Currency Control adopted in 2004. Laws

have also been upgraded on a periodic basis, as needed, which is considered positive. A considerable number of regulations have been adopted by the CBA to provide practical implementation of the powers provided in the laws. The CBA has the necessary legal framework, supervisory processes, and willingness to deal with problem banks. On-site, off-site and methodology functions are adequate to provide effective supervision of banks.

The CBA will be a "Unified Bank Regulator" in the near future, and will provide oversight to the stock exchange and insurance sector as well as the banks. An uncertainty is how well the transition at the CBA will proceed and whether there will be any interruption in the ability of the CBA to continue supervising banks at the same level of quality that currently exists with the addition of additional regulatory oversight functions. This should be reviewed on an ongoing basis and if deficiencies are noted, changes should be made immediately to ensure continued quality in bank supervision.

Public Safety Net: The CBA has the authority to be a "lender of last resort" pursuant to Article 5 of the LCBA. The "Natural Persons Deposit Guarantee Fund of the Republic of Armenia," was able to remunerate the guaranteed deposits of natural persons starting July 1, 2005. This helps to ensure the reliability and strengthening of the public confidence in the banking system. Compulsory contributions are made by all banks to help provide financial resources to the fund. In addition to this, the fund earns income from interest on invested assets, as well as other resources such as loans, borrowings, guarantees, grants, gifts and donations provided to the fund. Deposits are guaranteed up to 2 million drams (for dram deposits) and 1 million drams (for deposits in foreign currency).

Core Principles

The assessment of fulfillment of the Core Principles is not, and is not intended to be an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the Core Principles are seen as minimum standards.

The assessment of compliance with each Principle is made on a qualitative basis. A five-part assessment system is used: compliant; largely compliant; materially non-compliant; non-compliant; and not applicable. To achieve a "compliant" assessment with a Principle, all essential criteria generally must be met without any significant deficiencies. There may be instances where a country can demonstrate that the Principle has been achieved through different means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore one or more additional criteria and/or other measures may also be deemed necessary by the assessor to judge that compliance is achieved. A "largely compliant" assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that Principle. A "materially non-compliant assessment" is given when the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance, but substantive progress had been made. A "non-compliant" assessment is given when no substantive progress towards compliance has been achieved.

While laws and regulations are important aspects of effective supervision, they will be of limited value unless the supervisory function also has an adequate degree of independence, capacity, competence, and integrity; in effect, Core Principle 1 must be largely complied with

to have full compliance with the other principles. Furthermore, the CBA and other authorities must be willing to carry out the mandate to achieve compliance with core principles from both a legal and a practical standpoint. We have determined through our assessment that although there is not full compliance with CP 1(5) and (6), it did not affect our evaluation of the rest of the Core Principles in their entirety. In other words, the failure to fully comply with these preconditions was not considered to have a material effect on our evaluation of the other Core Principles.

Overall, the assessment with Basel Core Principles and the number of core principles within each category is as follows (Core Principle 1 subsections considered individually). Compliant – 6; Largely Compliant -14; Materially Non-Compliant – 6; Non-Compliant –4.

Assessment Summary

Below are the seven compliance levels indicating the core principles which fall under each level and whether efforts to achieve full compliance are currently underway. Recommendations for improving compliance with each core principle are provided.

1. **"Non-compliant, and efforts to achieve compliance not underway"**

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- **CP 1 (5) - Legal Protection for Supervisors.** Banking law should be amended to provide legal authority for supervisors and for expenses associated with defending the supervisors' actions taken while discharging their duties.

- **CP 11 – Policies and Procedures to Control Country Risk.** More formal procedures for country risk should be required. The Board of each bank should be required to implement controls to ensure that country risk taken is consistent with the bank's overall goals and strategies, and it must receive information on country exposure at its regular meetings. Each bank must have a comprehensive, written policy to address and control country risk, including transfer risk and sovereign risk. The formality of the process may vary, depending on the size and complexity of the operations of the bank.

- **CP 20 – Supervise Banking Group on Consolidated Basis.** The CBA should have the authority to evaluate all risks that non-banking activities conducted by a banking group may pose to the banking group. This includes reviewing the overall activities of a banking group, whether domestic or overseas.

  Prudential standards should be applied on consolidated basis, not just for a bank and subsidiaries. This especially applies to entities within the banking group that perform financial operations. The CBA should collect financial information on entities within a banking group on a periodic basis.

  The CBA, in order to carry out its supervisory duties for a banking group, must be able to share information with functional regulators of entities in the banking group, and receive information from them on the financial condition and adequacy of risk management controls of such entities.

  The CBA should be able to impose restrictions or limitations on the range of activities that the banking group may conduct and where they may be conducted. They should use this information to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.

2. **Non-compliant, and efforts to achieve compliance underway**

- **CP 14 – Bank Internal Controls.** It should be clear that the internal audit function report directly to the Board of Directors. This should be codified in banking laws. According to the CBA, this is currently being changed with amendments to the banking laws and is expected to take effect in January 2006.

The Board should take increased measures, through implementation of adequate policies and procedures, especially, but not exclusively related to, operational risk in banks. They should also take measures to fully understand the risks associated with their bank (as discussed in the previous Core Principle assessment).

The Board should be held accountable, by law, for the implementation of an environment that is conducive to establishing good internal controls at banks. Further, MIS should be checked to verify that accountability is ensured for the implementation of internal controls at all levels.

3. Materially non-compliant, and efforts to achieve compliance not underway

- **CP 13 – Risk Management Processes in Banks.** Many areas of risk are not covered by law or regulation. There is no requirement for identification, measurement, and control for Compliance Risk, Reputation Risk, Risk Management of Affiliated Companies, Country Risk, Price Risk, or Operations Risk. Some banks may have other risks that are not identified with any one area. The CBA agreed that there are deficiencies in this area but stated that they have no current plans to address them. The development and introduction of a comprehensive Risk Management Guideline that takes into account all areas of risk will bring the system into compliance. The CBA should make an assessment as to which laws should be changed to implement these guidelines at banks and to hold the banks and their Boards responsible for their implementation.

4. Materially non-compliant, and efforts to achieve compliance underway

- **CP 1 (6) – Information Sharing and Confidentiality.** MOUs need to be signed with all countries with a foreign presence. The CBA stated that, at present, an MOU has been presented to the Republic of Georgia for execution. The CBA has also approached the authorities in Great Britain to request an MOU. Agreements should also be reached with domestic agencies to share information.

- **CP 3 – Set Criteria for Licensing and Analysis.** Transparency of ownership must be a high priority. Beneficial ownership should be defined and all related parties and beneficial owners should also be required to disclose information to the CBA at licensing and after. According to the CBA, this problem will be corrected with the passage of new legislation this fall.

  There is also no provision in the law whereby the CBA may reject an applicant if the legal or managerial structure is too complex to foster effective supervision. The CBA stated that the new legislation will correct this concern.

- **CP 4 – Authority to Review/ Reject Ownership Changes.** There appears to be a possibility for ownership changes to be made at the parent company level without any notification required to be provided to the CBA. At a minimum, this could be clarified in law.

  In addition, approval for beneficial owners is currently not required; however, the CBA has stated that this will be corrected in the near future and will be effective in early 2005.

- **CP 7 – Independent Evaluation of Credit Risk in Banks**. The board of directors for each bank should be required, on at least an annual basis, to review and approve (with documentation in the minutes) the Loan and Investment Policies and any internal policies relating to these functions.

  Condition 4 of the MICR states that "the Board of the Bank, as well as the executive body, are responsible for working out and introducing rules of professional ethics and staff behavior." This should be codified in law. The CBA stated that this is one of the proposed changes to legislation that should be passed this fall.

  Laws should be changed to penalize any actions that lead to conflicts of interest in the lending/investment areas. For example, it should be a violation of law to lend to parties based on pressure, from inside or outside of the bank, bribery, or other actions that would cause a loan to be made when ordinarily it would not (such as through bribery). Conflicts of interest will be included in the new legislation, but may not be as comprehensive as included in this recommendation.

  In addition, banks should be required, either by law or regulation, to establish procedures whereby all large loans, and all loans to affiliates, either in their entirety or above a certain prescribed limit, should be reviewed by the full Board of Directors of the bank.

- **CP 10 – Related Party Lending.** The law does not allow for beneficial owners to be included as related, nor are there allowances for the CBA to further define this definition or make judgments as to who is related in all circumstances. More specifically, the CBA may not consider, pursuant to current law, two legal persons or two physical entities to be related. Laws need to be changed so that the definition is all encompassing with regard to related parties.

  The words "if possible," should be removed from Article 6 of the MICR so that all related persons are required to provide information on all financial interests to the bank on a periodic basis.

  Having no requirement for an interested party to refrain from preparing the loan or participating in the decision itself creates a possibility for undue exposure, and providing no clear definition of "preferential" could result in problems if ever legally tested by a bank. These concerns should be taken into consideration and changes to the law and regulations should be required.

5. Largely compliant, and efforts to achieve full compliance not underway

- **CP 5 – Criteria for Reviewing Acquisitions.** The country is largely in compliance with Principle 5, however, full compliance requires criteria to be established to judge individual proposals. The criteria used should also specifically state that the investment will not expose the bank to undue risk or may hinder the CBA's ability to effectively supervise the bank and its investments/subsidiaries. The CBA should consider the following:

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  - The CBA should know what entities the bank has investments in (especially sizable investments) and the risk posed to the bank by these investments, but that is not the same as "supervising" these entities. Supervision of these entities by the CBA should be authorized by law.

- **CP 6 – Capital Standards.** A Capital Restoration Plan should be required upon non-compliance with capital requirements.

  Consolidation of the bank with all of the affiliates in a banking group should be required. Capital adequacy should be calculated on both a consolidated and group basis for all financial entities.

  Branches should be required to operate pursuant to economic normatives or maintain a "capital equivalent." This is mitigated somewhat by the fact that there are currently no branches of foreign banks operating in Armenia. The informal policy of the bank, whereby branches of foreign banks would not be allowed to accept deposits from natural persons, should be codified in law or regulation.

- **CP 8 – Asset Quality Practices.** Banks should be required to value collateral on a periodic basis and maintain assets on the books at Net Realizable Value.

- **CP 9 – Lending Limits; Concentration Limitations.** The CBA stated that they do not have the full discretion to determine affiliates in the cases of whether two persons are affiliated or two legal parties are affiliated with each other. The law should be changed to allow for this.

  The CBA should consider obtaining information on sectoral and geographic exposures.

  Bank Boards should be required, by law, to approve all large loans at their bank.

- **CP 15 – Policies and Procedures – Money Laundering.** Customs should be required to report large currency movements across borders to the FIU. Fines are considered low and should be reconsidered.

The law should be amended to require not just an employee or department to be responsible for ensuring compliance with the AML law but for an executive officer of the bank to have responsibility.

Instances of non-compliance with the law should be reported directly to the Board and not to management of the bank. At a minimum, the information should be provided concurrently. This is considered to be a major deficiency in the law.

- **CP 17 – Regular Contract with Bank Management.** Banks should be required, pursuant to law, to report any material adverse changes to the BSD, including breach of legal and prudential requirements.

- **CP 18 – Offsite Analysis of Information.** By law, the CBA should be allowed to examine all related organizations and obtain financial information of them.

- **CP 19 – Validation of Supervisory Information.** The CBA should require, in addition to the audit report and management letter, a list of audit adjustments required as a result of the audit. Further, it would be beneficial to hold meetings with local audit firms on a periodic basis to discuss issues relevant to banking on an on-going basis. The scope of the audit to include, at a minimum, verification of the annual reports provided to the CBA for accuracy.

- **CP 21 – Accounting Policies and Principles.** The CBA should have the right to revoke the appointment of a bank's auditors. The CBA should hold roundtable meetings with external auditors on a periodic basis to discuss current and relevant issues. Auditors should also be required to report matters of materiality or supervisory significance to the CBA.

- **CP 22 – Measures to Achieve Corrective Action.** The CBA should have the legal authority to remove and prohibit board members, principal shareholders and other persons exhibiting "significant influence" and to fine them. Fines should be punitive and should act as a deterrent to unlawful behavior.

- **CP 23 – Consolidated Supervision over Local Banks with Foreign Presence.** Procedures should be developed for the CBA to use to supervise local banks with foreign presence, taking into account the level of supervision needed from Armenia in relation to the level of oversight provided by the host country.

- **CP 24 – Information Exchange with Other Supervisors.** The CBA should have supervisory control over all affiliates of local banks that may be established in other countries.

- **CP 25 – Local Operations of Foreign Banks.** The CBA currently has no authority to require branches of foreign banks to operate pursuant to most normatives, or to maintain a "capital equivalent" that would serve as the basis for these normatives.

6. Largely compliant, and efforts to achieve full compliance underway

- **CP 12 – Policies and Procedures to Control Market Risk.** Each bank should have a comprehensive, written policy to address and control market risk or at a minimum the components of the comprehensive policy in separate policies. The formality of the process may vary, depending on the size and complexity of the bank. The CBA has implemented the MICR that addresses some aspects of market risk and the CBA BSD will begin checking compliance with it this month.

7. Compliant

CP 1 (1) – Clear Responsibilities of Agency.
CP 1 (2) – Operational Independence and Resources
CP 1 (3) – Legal Framework – Bank Licensing
CP 1 (4) – Legal Framework - Legal Compliance
CP 2 – Regulated Use of Word "Bank"
CP 16 – Both On-Site and Off-Site Supervision Systems Used

In order of priority, recommendations to improving compliance with Basel Core Principles should be addressed as follows. Priority is based not only compliance with the Basel Core Principles but also on the level of risk to the banking industry given current level of market operations for activities. This priority could change depending on changes to the current banking climate and operations.

High Priority
CP 1 (5) - Legal Protection for Supervisors
CP 3 – Set Criteria for Licensing and Analysis
CP 4 – Authority to Review/ Reject Ownership Changes
CP 7 – Independent Evaluation of Credit Risk in Banks
CP 9 – Lending Limits; Concentration Limitations
CP 10 – Related Party Lending
CP 13 – Risk Management Processes in Banks
CP 14 – Bank Internal Controls
CP 15 – Policies and Procedures – Money Laundering
CP 20 – Supervise Banking Group on Consolidated Basis

Medium Priority
CP 1 (6) – Information Sharing and Confidentiality
CP 6 – Capital Standards
CP 11 – Policies and Procedures to Control Country Risk
CP 12 – Policies and Procedures to Control Market Risk
CP 18 – Offsite Analysis of Information
CP 19 – Validation of Supervisory Information
CP 22 – Measures to Achieve Corrective Action

Lower Priority
CP 5 – Criteria for Reviewing Acquisitions
CP 8 – Asset Quality Practices
CP 17 – Regular Contract with Bank Management
CP 21 – Accounting Policies and Principles
CP 23 – Consolidated Supervision over Local Banks with Foreign Presence

CP 24 – Information Exchange with Other Supervisors
CP 25 – Local Operations of Foreign Banks

Principle-by-Principle Assessment

This section contains an assessment of each core principle. Each assessment contains four parts: the principle, essential and additional criteria for assessing compliance, a description of the current status of activities related to the principle within the CBA, and an assessment indicating areas of non-compliance and recommended actions to improve compliance.

Abbreviations
CBA – Central Bank of Armenia
LCBA – Law on Central Bank of Armenia
LOBB – Law on Banks and Banking Activity
MICR – Minimum Internal Control Requirements for Banks (1/2005)
BCP – Basel Core Principles
EC – Essential criteria
AC – Additional criteria
AAS- Armenian Accounting Standards
IAS –International Accounting Standards
BSD – Bank Supervision Department of the CBA
FIU – Financial Investigations Unit of the CBA
ROA – Republic of Armenia
MOU- Memorandum of Understanding

Supervised Institutions
At year-end 2003, 20 banks were operating in Armenia with no increase in banks during 2004. Nine credit organizations were also operating under the supervision of the CBA, and due to the relatively low level of assets held in these institutions, were not included in our review. A total of 54 banks have been placed into bank bankruptcy since 1993.

The head offices of the banks and one-third of the bank branches are located in the city of Yerevan. Out of the 20 banks operating in Armenia, one is a cooperative bank, 2 are limited liability companies, 2 are open join-stock companies and the remaining 15 banks are closed joint stock companies. Participants of the 18 banks (not including open joint-stock companies) indicate that 28 out of 103 legal entities are non-residents. In seven banks, one shareholder owns more than 50% of the bank.

Total assets of Armenia banks were approximately 363 billion drams at the end of 2004. Total deposits were 227 billion drams during the same period. Total capital of the banks amounted to approximately 59 billion drams as of year-end 2004. Return on equity and return on assets are satisfactory at 18.5% and 3.3% as of the same period and has risen over levels of both 2002 and 2003.

As of year-end 2004, credit risk exposure as represented by risk classification of assets was:

Classification		Year-end 2004	Year-end 2003
Standard	A	97.9%	95.1%
Watch	B	1.1%	3.4%
Non-Standard	C	0.3%	0.7%
Doubtful	D	0.8%	0.8%

Non-performing assets (on-balance sheet) decreased from 6.3 billion drams in 2003 to 4.2 billion drams in 2004.

Principle 1: *An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

Note: Principle 1 is divided into six component parts. Four of the component parts are not repeated elsewhere in the Core Principles. However two parts (3 & 4) are developed in greater detail in one or more of the subsequent Principles. For these two, since the criteria will be developed further elsewhere, this section identifies only the most fundamental and crucial ones.

Principle 1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Essential criteria

1. Laws are in place for banking, and for the agency involved in banking supervision. The responsibilities and objectives are clearly defined.
2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.
3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.
4. The supervisor participates in deciding when and how to affect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

Additional criteria

1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.
2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

Description: Article 4 of the LCBA defines the basic objective of the CBA, which is to ensure the stability of prices. In addition, Article 5 of the same law lists functions to be used in carrying out these objectives, including, the licensing of banks, and to regulate and supervise their activities, and for other such functions, such as being the lender of last resort. Establishing monetary policy is another important function of the CBA as well as maintaining a payment system.

Article 20 of the LCBA states that the Central Bank Board grants banking and other licenses, revokes or considers as invalid those licenses, sets out the procedure for licensing banks and other persons in the manner defined by law. Article 20 also addresses the CBA's responsibility with regard to 1) recognizing banks as insolvent and initiating bankruptcy procedures, and making decisions regarding reorganization of banks, 2) adopting normatives and regulating the activities of banks and how to calculate normatives, 3) giving consent for acquisition of significant shares in banks, 4) setting procedures and frequency of examinations and audits, 5)

licensing auditors of banks and establishing internal control minimum standards, 6) set the size and frequency of deposit insurance premiums, 7) exercising authority to combat money laundering and funding of terrorism, and 8) defining the regulation for credit risk, as well as other well defined responsibilities.

Article 36 of the LCBA also states that the CBA establishes the main and other economic normatives for the activities of banks, the procedure for their computation, the procedures for provisioning for losses and the rules for capital computation. In addition, this Article states that the CBA licenses bank activities, supervises and audits banks and other financial institutions, defines formats for reports and statements submitted by them to the CBA and provides terms and deadlines for their submission. Article 36 further states that banking supervision is the "exclusive prerogative of the CBA."

Article 49 of the LCBA states that the CBA is responsible for regulating foreign exchange operations in Armenia.

The LBB also provides authority to the CBA for various responsibilities. Included are Articles 23-26 (Licensing of Banks), Article 27 (Registration of Banks and Branches of Foreign Banks), Article 28 (Registration of Branches and Representative Offices), Article 29 (Conditions on Obtaining License), Article 30 (Registration and Licensing Fee), Article 31 (Registration Log), Article 32 (Legal Consequences of the Withdrawal of Licenses), Article 33 (Registration of Amendments), Article 33.1 (Recognition of the Registration as Invalid), Article 34 (Operations of Banks), Article 35 (Investment Limitations), Article 36 (Dividend Payments), Article 37 (Repurchase of Bank Stock), Article 38 (Relationships with Customers/Conflicts of Interest), Article 39 (Affiliated Party Transactions), Article 41 (Restrictions on Banking Activities by the CBA). Disclosure of Information to the CBA is outlined in Article 43. Articles 44 to 54 of the LBB allow the CBA to establish normatives for capital, liquidity, large loans, loans to affiliates, obligatory reserve requirements at CBA, and FX management. Also allowed are special normatives for the purpose of stabilizing the banking system.

LBB Articles 55-59 outline that the CBA has the authority to require financial reporting on a periodic basis, accounting principles that must be adhered to according to the CBA, and the fact that the CBA has the "exclusive right to supervise banks."

The CBA may apply fines and other defined sanctions to banks and other financial organizations, pursuant to law. LBB Articles 60-66 allow for the CBA to deal with deficiencies at banks and/or problem banks, in that actions may be taken against both the banks and bank management for violations of law including unsafe and unsound practices. Sanctions include fines, deprivation of the bank manager's qualification certificate, recognition of a license as ineffective and warnings and directives may also be issued. Articles 72 –80 deal with liquidation of banks, including both self-liquidation and forced liquidation of banks.

The Law on Bankruptcy of Banks allows the CBA, through its temporary administrator and other processes, to require a merger or to restructure a problem bank.

The CBA has clear objectives and must report to Parliament on an annual basis so that its performance can be assessed. In addition, information on bank supervision is provided publicly on an annual basis. The report provides not only quantitative information on the banking system, but qualitative information on bank supervision as well, such as changes in law, types of violations noted at banks, and staff training.

The CBA has processes in place to ensure that information on the financial strength and performance of the banks is published on a regular basis. Proposed changes for additional information to be provided to the public will be implemented as provided in the Concept Paper on Corporate Governance in Banks and in the proposed amendments to law. The adequacy of the proposed changes will be discussed further in this report.

Assessment: The CBA is the sole regulator of banks in Armenia. Banking laws are in place and the responsibilities of the supervisor are well defined. The laws and regulations provide a sound basis for regulation of banks, and specific minimum prudential standards are established in implementing regulations and not in the laws.

The CBA has the direct authority to supervise Armenian banks and has established when and how to affect the orderly resolution of a problem bank situation. This includes supervisory actions for severely troubled banks and actions that may be taken prior to the situation arising needing severe action such as liquidation.

Banking laws have been updated on a periodic basis, and continue to be updated. An example of this are the proposed changes presented in the Concept Paper on Corporate Governance in Banks, which provides changes to be made to laws to improve governance for banks licensed in Armenia.

Compliance Level: Compliant.

Principle 1 (2): *Each such agency should possess operational independence and adequate Resources.*

Essential criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.
2. The supervisory agency and its staff have credibility based on their professionalism and integrity.
3. The supervisory agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:

- salary scales that allow it to attract and retain qualified staff;
- the ability to hire outside experts to deal with special situations;
- a training budget and program that provides regular training opportunities for staff;
- a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and
- a travel budget that allows appropriate on-site work.

Additional criteria

1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law .
2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.

Description: Article 1.5 of the LCBA states that the CBA is independent of other agencies in

Armenia in implementing its objectives. LCBA Articles 12, 13 and 14 address the issue of financing of the activities of the CBA, including supervision. Article 13(2) of the LCB states that the Central Bank is independent in planning its budget and its income is not subject to the approval of any state agency. Article 13(3) of the LCBA stipulates the expenses of the Central Bank to include costs for carrying out the objectives of the Central Bank. Article 14 of the LCB states that the plan of expenses and the maximum value of the capital investment must allow the Central Bank to fulfill its objectives of banking supervision in accordance with the international standards.

According to Article 14 of the LCBA, the Board of the CBA approves the annual expenses and submits to the Parliament for review/approval.

Salaries are set according to the law, based on similar positions in banks (Articles 26 and 14 of the LCBA).

There is no restriction on being able to hire outside experts, as needed, according to the laws, although it does not specifically allow for it.

According to our evaluation, and discussions with CBA staff, staff salaries and resources available, staff levels, and equipment provided is more than satisfactory.

Additional Criteria

The Chairman of the CBA is appointed for a period of 7 years according to Article 18 of the LCBA, and pursuant to Article 22 of the same law, may be removed for reasons specified, including incapacity. There is no provision in law whereby public disclosure would be required for the reasons the Chairman is dismissed.

Assessment: In general, the standards in this area have been met. BSD staff indicated that there is no evidence of government interference that would impede their ability to effectively supervise banks. Discussions with staff of the CBA lead to the determination that the staff is operating on a very professional level with integrity. The CBA has taken steps to ensure this in many ways, including, testing and certification of BSD staff and the requirement for staff to disclose financial interests on a periodic basis. Staff indicated that the level of resources available are more than adequate and that salary levels are adequate. The actual level of staffing is adequate and there is an equal dispersion of BSD staff across expertise levels. Training opportunities are provided on a regular basis to regulatory staff of the CBA.

Compliance with Basel standards could be improved if, where the CBA Chairman is removed from office, the reasons for it were required to be, by law, publicly disclosed.

Compliance Level: Compliant.

Principle 1 (3): *A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.*

Note: This component of Principle 1 is amplified considerably in the Principles dealing with Licensing and Structure (2 to 5), Prudential Regulation and Requirements (6 to 15), Methods of Ongoing Banking Supervision (16 - 20), and Information Requirements (21).

Essential criteria

1. The law identifies the authority responsible for granting and withdrawing banking licenses.

2. The law empowers the supervisor to set prudential rules administratively (without changing laws).
3. The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.

Description: The CBA has the sole authority to grant and withdraw banking licenses. Article 5 of the LCBA states the CBA may license banks. This is also discussed in Article 20(jf) of the same law whereby it states that the CBA "grants banking and other licenses, revokes or considers as invalid those licenses, sets out the procedure for licensing banks and other persons in the manner defined by the law."

Article 20 of the LCBA also addresses the CBA's responsibility with regard to 1) recognizing banks as insolvent and initiating bankruptcy procedures, and making decisions regarding reorganization of banks. Article 36 of the same law states that the CBA licenses banking activities, and may apply fines and other defined sanctions.

Articles 23 - 33.1 of the LBB further define licensing for banks and responsibilities. Article 65 provides the authority to withdraw a license and gives the conditions under which a license may be withdrawn. Regulation 1 of the CBA provides the specific procedures for licensing of banks.

The laws are explicit with regard to the CBA being able to set prudential rules and this is further assisted by establishing rules in regulations rather than laws. Normatives are established by the CBA by Articles 20 (ji) of the LCBA, and by Article 44 of the LBB. Regulation 2 provides specific requirements for economic normatives. The CBA also has the power to implement "temporary" normatives for up to 6 months in extraordinary circumstances pursuant to Article 54 of the LBB.

The CBA is allowed to get information from banks on a periodic basis, and has authority to determine what it wants, pursuant to Regulation 3. Article 55 of the LBB allows for the CBA to obtain information in the type, format, and terms and to provide procedures for reporting.

Assessment: Laws and regulations are considered adequate to provide the CBA with the necessary authority to grant and withdraw licenses of banks. Prudential rules are set in the regulations and not in laws, allowing the CBA to make changes, as authorized to them in the banking laws, without Parliamentary approval.

The CBA has the authority to obtain all information needed from the banks in the form and frequency needed.

Compliance Level: Compliant

Principle 1 (4): *A suitable legal framework for banking supervision is also necessary, including … powers to address compliance with laws as well as safety and soundness concerns.*

Note: This component of Principle 1 is amplified in Principle 22 which addresses Formal powers of Supervisors.

Essential criteria
1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.
2. The law permits the supervisor to apply qualitative judgment in forming this opinion.
3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.
4. When, in a supervisor's judgment, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to:

- take (and/or require a bank to take) prompt remedial action;
- impose a range of sanctions (including the revocation of the banking license).

Description: Article 5 of the LCBA grants authority to the CBA to regulate and supervise their activities.

Article 20 addresses the CBA's responsibility with regard to 1) recognizing banks as insolvent and initiating bankruptcy procedures, and making decisions regarding reorganization of banks, 2) adopting normatives and regulating the activities of banks and how to calculate normatives, 3) giving consent for acquisition of significant shares in banks, 4) setting procedures and frequency of examinations and audits, 5) licensing auditors of banks and establishing internal control minimum standards, 6) set the size and frequency of deposit insurance premiums, 7) defining the regulation for credit risk, as well as other well defined responsibilities.

In addition, Article 36 allows the CBA to regulate activities for the banks and states that the CBA is the "exclusive supervisor of the banks."

Article 60 of LBB, Part d) allows for judgment on the part of the CBA in determining whether a deficiency is serious enough to be considered to be a violation of law. It states that, it is a violation of law for, "the main economic normatives of the bank's performance are violated, or in the opinion of the CBA, the bank has undertaken such actions (activity) which may risk the interests of the depositors or the creditors of the banks." This is considered to be a broad principle for using judgment as to the "safety and soundness" of a bank.

When a bank is not complying with all laws or regulations, or is engaging in unsafe and unsound practices, the CBA has the authority to take action, including, remedial action, from warnings to revocation of bank licenses. All of the powers are included in the banking laws (e.g. Article 61 of the LBB), including revocation of the license. Other actions are included in the Law on Bank Bankruptcy, such as Temporary Administrator, and would include other actions available, such as merger of banks. Fines may also be assessed against banks and against certain individuals.
Assessment: A suitable legal framework is in place for the CBA to take action as needed against banks, and the CBA appears to use these powers as needed. Qualitative judgment is allowed, the CBA, by law, has access to bank records, and there is a range of sanctions available by law. A concern noted during the review results from the low level of fines allowed by law. The law specifically allows for fines only up to 1000 X the average minimal salary, which is 1000 drams. Such low levels do not act as a deterrent, nor are they considered punitive as they equal approximately $2,500. CBA bank supervision staff agreed that these levels are low; however, others stated that, since these are only one tool that may be used to correct problems noted at banks, they are sufficient.

Consideration should be given, when the LBB is amended, to amend Article 60 of the LBB, part d) to say "the main economic normatives of the bank's performance are violated, or in the opinion of the CBA, the bank has undertaken such actions (activity), **or has failed to take such actions,** which may risk the interests of the depositors or the creditors of the banks."
Compliance Level: Compliant, however could be improved through implementing noted recommendations.

Principle 1 (5): *A suitable legal framework for banking supervision is also necessary, including ... legal protection for supervisors***.**
Essential criteria
1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.
2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

Description: There is no legal protection for supervisors, nor protection against the costs arising as a result of supervisors defending themselves.
Assessment: Although the Civil Code reportedly protects public officers, the banking law should be revised to include this provision. Further, the CBA staff should also be protected, by law, against the costs of defending their actions while discharging duties.
Compliance Level: Non-compliant. The CBA, in its response to the FSAP review, requested technical assistance in assisting them in implementation of these amendments.

Principle 1 (6): *Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*
Essential criteria
1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.
2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.
3. The supervisor:
- may provide confidential information to another financial sector supervisor;
- is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party;
- is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.

4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

Description: There is no formalized agreement between the CBA and other agencies to share information on a regular basis. Cooperation was also not required, nor noted in the law, with regard to the Customs Agency and the FIU. This was particularly noted by the CBA as a need to help them combat money laundering.

Article 8 of the LCBA states that the CBA may represent the ROA out of the country, and may sign international agreements with central and other banks of other countries. Article 57(4) of

the LBB allows for it and for the use of MOUs to facilitate the sharing of information. Although MOUs have been signed with some countries (Iran, Lebanon, Kazakhstan, Russia and Ukraine) with foreign presence in Armenia, not all countries have MOUs (Georgia and England).

Although there is no requirement in law for the stipulation that information released to other parties be treated as confidential and used for supervisory purposes only, these conditions, according to the CBA, are included in the MOUs.

Article 28 of the LCBA also addresses EC 4. No information may be provided except in certain circumstances, such as at the written permission of the COB, if such secret is exclusively the right or authority of such person, 2) on carrying out their obligations or liabilities to the Court, as well as decisions adopted by other authorized bodies within their responsibilities, 3) to BSD or to external auditor, 4) for the purposes of defending the interests of the CBA management or employees.

Assessment: MOUs need to be signed with all countries with a foreign presence. The CBA has sent a draft to Georgia and this is seen as progress. A letter has also been sent to the authorities in the UK requesting to start negotiations on an MOU.

The CBA is currently taking action to deal with the Customs loophole in the AML law.
Compliance Level: Materially Non-Compliant.

Principle 2: *The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.*

Essential criteria

1. The term "bank" is clearly defined in law or regulations.
2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
3. The use of the word "bank" and any derivations such as "banking" in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.
4. The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.

Description: Article 4(1) of the LBB defines the term "bank," as a "legal entity, which on the basis of the license received in accordance with this law, may perform banking transactions."

Banking transactions include "taking deposits or offering to take deposits and allocating them on behalf and at the risk of the depositor, through loans, deposits and/or investments," pursuant to Article 4(2) of the LBB. Further according to this article, "it is prohibited to perform banking transactions without a banking license, granted by the CBA."

Article 6 of the LBB states that the use of the word "bank" may only be used in limited cases.

"Banking Deposit" is defined in Article 5 of the LBB. Article 34 of the same law states that banks may accept time and demand deposits. It states that banking transactions are only

allowed for entities with banking licenses, granted by the CBA.

Regulation of banking activities is included in Articles 34-43 or the LBB. More specifically, Article 34 (Financial Transactions) and Article 35 (Investments and Subscriptions) spell out what a bank may be active in.

Assessment: There were no instances of non-compliance with CP 2. No further improvements are recommended.
Compliance Level: Compliant.

Principle 3: *The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.*

Essential criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.
2. The criteria for issuing licenses are consistent with those applied in ongoing supervision.
3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.
4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.
5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.
6. A minimum initial capital amount is stipulated for all banks.
7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include:
(1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and
(2) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.
8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.
9. The operational structure is required to include, inter alia, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.
10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.
11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.
12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of "no objection") of the home country supervisor is obtained.
13. If the licensing, or supervisory, authority determines that the license was knowingly based on false information, the license can be revoked.

Additional criteria

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.
2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.
3. The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.

Description: According to Article 23 of the LBB, the CBA has the exclusive authority to issue a banking license. Procedures for licensing are in the same law, and documents to be submitted are general (Articles 25, 28 and 29 of the same law). However, the LBB states that the CBA may provide other conditions that need to be met prior to approval. Regulation 1 provides specific requirements that must be met prior to issuing a license.

Information required, as outlined in Regulation 1, includes, 1) authorized letter from organizers or from foreign bank, 2) draft by laws and founding bank docs, if a foreign bank, 3) operating plan, 4) authorized letter, and 5) documents on bank participants. The regulation also lists various other specific requirements and includes annexes for use in submitting information. Article 29, Part 3, allows the CBA to reject granting a license if the criteria are not fulfilled, or if inadequate. The law (Article 26 (2) of the LBB) allows for the CBA to suspend the licensing decision at any time prior to 30 days (pre-approval time) at its discretion, including the need for additional information. Also, if it is determined that false information was used to obtain a license, the CBA may withdraw the license (LBB Article 32). Regulation 1 of the CBA mentions specific requirements for licensing.

According to Article 29 of the LBB, banks must meet minimum total capital requirements (now $5MM pursuant to Regulation 1). They must also have sufficient space and level of equipment to operate properly, have set the organizational structure and operation systems of the banks, and maintain standards for the governors of the bank (or branch of foreign bank), to the requirements of the CBA. Also, after licensing, any changes in management must also be approved by the CBA pursuant to Regulation 1.

Although not mentioned specifically in the law, but provided for in Regulation 1, information on the legal and managerial structures of the banks themselves must be submitted, pursuant to Rule 1) d) and h). The CBA has the opportunity to review this information and express any concerns. There is no provision in the law that expressly provides authority to the CBA to reject an application if they determine that the legal and/or managerial structures of the bank will hinder effective supervision.

The CBA also obtains information on the major shareholders at licensing, including financial and biographical data. This information appears to only be legally required for ownership of the bank itself and not for any juridical person that may apply for ownership in a bank.

Source of initial capital must also be disclosed pursuant to Regulation 1, Rule 7(2.4). Although there is no requirement for the CBA to determine the transparency of the ownership structure, BSD said that they feel certain that the ownership structures are known to them.

All banks must have the initial total capital prescribed for banks according to Article 29 (1)(a).

Fit and proper requirements are outlined for all upper management except for department heads in Rule 5(2) of Regulation 1. Testing is provided for different levels of management. The proposed bank Chairman is specifically excluded from this definition; however, the CBA said that all board members are now called into the CBA, including the Chairman, to determine that sufficient expertise for operating a bank is there.

Persons with criminal records may not be managers (Article 5 of Regulation 1) and Article 22 of LBB. The CBA relies on the affirmation of directors and managers and to the extent

possible, criminal background checks to determine this. As stated previously, managers must also receive certification from the CBA and board members are tested by the CBA through discussions with proposed board members.

According to procedures established in Regulation 1, Rule 3, all licensees must submit an operating plan prior to being granted a license. Details of this are included in Rule 7 of the regulation. All policies must also be submitted to the CBA for review and no objection pursuant to Regulation 1.

Pro forma financial statements and projections for the proposed bank are required as a part of Reg 1, Rule 3) c) requires that the bank provide an operating plan which is listed in Annex 13. Financial information on both legal and juridical persons is required per Regulation 1.

Home country supervisor approval is obtained pursuant to Rule 11 of Regulation 1. Article 29(e) of the LBB requires home country supervisor approval.

In addition, Regulation 1 speaks of false information in Articles 10, 11, 16, 17, 18, 19 and 21 and the applicants sign a waiver that states the repercussions that may occur if providing false information.

Regarding the ability of the CBA to revoke a license based on submission of false information, this is included in Article 32 of the LBB (Legal Consequences of the withdrawal of license).

Additional Criteria

Although there is not a specific requirement legal requirement for the CBA to look at the applicant's ability to provide additional financial support as needed, CBA does look at the financial strength of the shareholders when reviewing whether to give a license or not.

There is no explicit requirement that at least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue. However, the CBA does call every director into the CBA prior to granting a license to hold discussions with them and to test their levels of expertise.

Progress against goals after licensing of a bank are assessed by BSD, through off-site and on-site monitoring. Any significant deviations would be met with call for action by the CBA.

Assessment: There are exceptions that need addressing.

It appears that the CBA only has the authority to look at the proposed ownership of the bank itself. In the case of a parent company, there appears to be no legal requirement that information on the ownership (shareholders/major shareholders) of the parent company be provided to the CBA for review. Beneficial owners should also, by law, require approval.

There is also no provision in the law whereby the CBA may reject an applicant if the legal or managerial structure is too complex to foster effective supervision (EC4).

Also, the 30-day deadline for decisions on licensing appears to be short. This does not appear to allow adequate time for the CBA to verify criminal backgrounds for proposed managers that are non-residents of Armenia.

Although the CBA checks to ensure that the bank will have effective corporate governance in place, the laws on corporate government and management of risk need to be improved.

The additional criteria, although not affecting the overall rating of this Core Principle, would also be recommended.

Compliance: Materially Non-Compliant. However, the CBA has stated, in discussions with the assessment team, that changes to the law will be made to address our concerns. Firstly, changes will require that all owners be identified, including those that are not direct shareholders of the bank or its affiliates. Secondly, the CBA will, by law have the opportunity to reject an applicant if the organizational structure of a banking "group" is too complex to foster effective supervision by the CBA. These recommendations will allow the system to be further in compliance with Core Principles.

Principle 4: *Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.*

Essential criteria
1. Law or regulation contains a clear definition of "significant" ownership.
2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.
3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

Additional criteria
1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.

Description: Article 9 of the LBB states that significant ownership is 10% or more of voting stocks, or less if there is an ability to make management decisions or exercise significant influence over decision making either directly or indirectly. Significant influence is also taken into consideration in this article. Article 9 states that:

> "participation in the statutory capital of the legal entity shall be considered significant if:
>
> a. The participant is in possession of over 10% of the voting rights enabling shares of the legal entity,
> b. The participant is in possession of less than 10% of the voting rights enabling shares of the legal entity or holds shares with no voting rights, while under criteria prescribed by the Central Bank and in the Central Bank's opinion by means of that participation through his business authority has the capacity to predetermine the decisions of the managing bodies of the legal entity or to significantly influence the decision-making or implementation of the decisions, or to predetermine the major directions, fields of operation of the legal entity, or
> c. For the purpose of this Law and other laws regulating banking activities the person shall be considered as having significant participation if he (she) has the capacity to

predetermine the decisions of the managing bodies of the legal entity, or to significantly influence the decision-making or implementation of the decisions, or to predetermine the major directions, fields of operation of the legal entity through the power of right of claim towards the bank."

Article 18 of the LBB provides restrictions on the acquisition of significant equity interests (or control) in the statutory funds of banks. They may do so only on the prior consent of the CBA. There are specific reasons for denying such an application. There is a caveat in Article 18-4 that restrictions are not relevant to owners where beneficial shares were bought over the stock market up to 20%. Persons in offshore zones may not acquire, at any level, without the consent of the CBA (Article 18-5). Article 18-6 has been added to also require approval from the CBA for ownership thresholds of 25% and 50%. Regulation 1 provides specific requirements for how to obtain approval and what must be submitted.

The information of the names and holdings of all significant shareholders is obtained at on-site examinations. The CBA does not require, for example and as stated in the assessment of CP 3, a list of shareholders for parent companies that own banks in Armenia. Although the parent company is not a "custodian," the CBA should have access to this information.

The concern with "Beneficial Ownership" also affects compliance with CP (4) as beneficial owners should also be required to obtain permission from the CBA prior to obtaining such rights.

Assessment: The CBA has made positive efforts to comply with this core principle. However, there appears to be a possibility for ownership changes to be made at the parent company level without any notification required to be provided to the CBA. This could, perhaps be made more clear in the law. In addition, approval for beneficial owners is currently not required; however, the CBA has stated that this will be corrected in the near future and will be effective in early 2005.
Compliance Level: Materially Non-Compliant

Principle 5: *Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

Essential criteria
1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval .
2. Laws or regulations provide criteria by which to judge individual proposals.
3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.

4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

Description: Article 35 of the LBB states that banks may not participate, without approval of the CBA, in 1) acquiring 4.99% and above in the statutory fund of an other entity, 2) acquisition of equity interest in the statutory fund of one entity, exceeding 15% of the bank's capital, 3) acquisition of equity interests in the statutory funds of all entities, exceeding in total 35% of the bank's total capital. There are cases where this may not be required, for example, for debts previously contracted.

There are no written procedures to use in evaluating proposals regarding investments. However, in practice the CBA uses judgment as to whether to allow an investment or not. Although not written, it appears that procedures used in practice are sufficient.

Assessment: The country is largely in compliance with Principle 5, however, full compliance requires criteria to be established to judge individual proposals. The criteria used should also specifically state that the investment will not expose the bank to undue risk or may hinder the CBA’s ability to effectively supervise the bank and its investments/subsidiaries. The CBA should consider the following:

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Compliance Level: Largely Compliant. Although half of the essential criteria are not present, it appears that, in practice, that the CBA does look closely at investment activities as provided by the law. The deficiency is that the criteria have not been well defined and put into a written form. Committing criteria to writing will cause the country to be Compliant with Core Principle 5. Other suggestions, although not affecting the compliance with this core principle, should be considered.

Principle 6: *Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.*

Essential criteria

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.
2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.
3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.

4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.
5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.

Additional criteria

1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.
2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.
3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.
4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basel Accord.
5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.
6. Laws or regulations stipulate a minimum absolute amount of capital for banks.

(Reference document: "International convergence of capital measurement and capital standards" - July 1988)

Description: Article 44 of the LBB allows the CBA to set normatives regarding minimum statutory fund and total capital, and to establish norms on adequacy of total capital. Changes were made to laws as needed to make sure that terms were consistent with Basel terminology and standards. Further, Articles 45-47 more explicitly provide the CBA's authorities with regard to capital adequacy. Regulation 2 states that there is a requirement of Tier 1 Capital/Risk Weighted Assets of 8% and Total Capital/Risk Weighted Assets of 12%.

The CBA has established, pursuant to Article 47 of the LBB and Regulation 2, the minimum amount of capital required taking into account credit risk, and to a lesser extent, market risk, and there are provisions whereby the CBA may increase the level of capital for individual banks as needed. Pursuant to Regulation 2, both on- and off-balance sheet items must be included.

Regulation 2 provides specific requirements for capital:
10.1 the minimum statutory capital and the total (equity) capital (hereinafter total capital)
10.2 the total capital adequacy standards
10.2.1 the ratio of total capital to risk weighted assets
10.2.2 the ratio of core capital to risk weights assets

According to Chapter 4, Part 12, all norms must be applied on a consolidated basis where the bank has a subsidiary. There is no mention of other affiliates, such as parent companies, subs of parent companies, and other affiliated companies and in fact, Regulation 2 specifically states consolidation as being the bank and its subsidiaries.

When a bank falls below the minimum capital ratio, the CBA has the authority to take action. This is provided, 1) in Article 60 (a) of the LBB, whereby it is considered a violation of law for which sanctions may be applied, 2) in Article 60(d), whereby the failure to maintain satisfactory economic normatives, 3) in the Law on Bankruptcy of Banks, whereby the CBA has the authority to take action in cases of bankruptcy and insolvency.

Capital ratios are required to be submitted on a periodic basis, at least monthly. Article 60 of the LBB provides as a violation of law normative when normatives are violated, including capital normatives.

Additional Criteria

All banks are required to follow the economic normatives. Branches of foreign banks are not required by law or regulation to do so. However, according to the CBA practice as related to us, branches of foreign banks are not allowed to accept deposits from natural persons, thus reducing the risk to the population. (Note: branches of foreign banks would be allowed to accept deposits of enterprises).

Sections 7 and 8 of the LBB specifically discuss what actions may be taken and failure to meet capital normatives is considered a violation of law whereby action may be taken. The Law on Bankruptcy of Banks also addresses capital failures as they relate to authority to declare a bank insolvent.

Banks are examined by BSD and capital adequacy is reviewed at these examinations. The bank's internal processes for assessing their overall capital adequacy vis a vis compliance with Regulation 2 normatives is reviewed.

The CBA has the authority to set higher individual minimum capital standards for banks pursuant to Article 44(4) of the LBB. This would allow them to take into account an environment in which a particular bank operates and to take into account above average risk and the capital needed to support it.

The CBA has made an attempt to require both consolidated and stand-alone information from banks. According to Regulation 2, Chapter 4, Part 12, all norms must be applied on a consolidated basis where the bank has a subsidiary. There is no mention of other affiliates, such as parent companies, subs of parent companies, and other affiliated companies. In fact, Regulation 3 only mentions consolidation from a bank downward.

Banks are/were required, pursuant to Regulation 2, to have the minimum total capital of a bank of the equivalent of $5,000,000 as of July 1, 2005.
Assessment: The country has taken very positive steps in complying with this Principle, including, defining capital requirements, establishment of capital normatives, including on-and off-balance sheet items, and has shown the ability to take action against banks that fail capital requirements. Nonetheless, there are some deficiencies in compliance with this normative. Although there are currently no branches of foreign banks operating in Armenia (all foreign banks have capitalized and have full banking licenses), branches should not be excluded from complying with normatives. The laws and regulations should be amended, as needed, so that this deficiency is removed. For branch operations in Armenia, the following suggestions are made:

- The foreign bank should be required to place a deposit in a designated amount with either the CBA or a commercial bank approved by the CBA, with access not allowed except with the approval of the CBA. This "capital equivalency deposit" would serve as the branch's "capital" and can be used for calculating lending limits, foreign exchange limits, liquidity limits, and other capital-based requirements.

- Most, if not all, of the prudential requirements that apply to banks should apply to foreign bank branches. The CBA should have the same enforcement authority with respect to foreign bank branches as it has with regard to licensed banks in Armenia.

Further, although the CBA has dealt with problem banks, including undercapitalized banks in the past, there is currently no requirement for the CBA to receive, as soon as a bank fails a capital requirement, a Capital Restoration Plan from the bank within a specified time period. This corrective action is used in practice and is considered to be a furtherance of best practices in bank supervision.

In addition, the consolidation of financial statements only downward is not consistent with current international best practices. Consolidated supervision necessitates application of some prudential requirements to the entire banking group. For example, virtually every country of which we are aware that practices consolidated supervision, applies a capital adequacy requirement to financially-oriented groups. Many countries also apply other prudential requirements to bank holding companies or banking groups as a whole, especially large exposure limitations. It is especially necessary to supervise capital adequacy, to ensure the financial well-being of the group, and also to ensure that bank capital is not artificially increased through accounting gimmicks, such as multiple gearing.

With regard to mixed activity groups (those that include both financial and non-financial entities within the group), it is neither practical nor desirable to impose formal numerically-oriented prudential requirements on the non-financial entities of such groups, or to the group as a whole, due to the very different business characteristics of the non-financial entities. Supervision of these kinds of groups therefore needs to stress transparency, group-wide corporate governance, risk management, internal controls, information requirements and enforcement measures.

Compliance Level: Largely Compliant. All essential criteria are met, however, there are certain improvements that could be made as mentioned above, such as the requirement for a Capital Restoration Plan upon non-compliance with capital requirements and consolidation of the bank with all of the affiliates in a banking group, not just from the bank to entities below it on the organizational structure. Further, branches are not required to operate pursuant to economic normatives or maintain a "capital equivalent." This is mitigated somewhat by the fact that there are currently no branches of foreign banks operating in Armenia. This is mitigated somewhat by the CBA's stated practice that they would not allow branches of foreign banks to accept deposits of natural persons.

Capital adequacy ratios are not required to be calculated on both a consolidated and group basis for all financial entities as provided in the recommendation above. The country should work towards full compliance with Core Principle 6.

Principle 7: *An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.*

Essential criteria
1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors.
2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including:

- a sound and well-documented credit granting and investment process;
- the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and
- ensuring adequate controls over credit risk.

3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.
4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.
5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

Additional criteria
1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.
2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.
3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.
(Reference document: "Principles for the Management of Credit Risk" – July 1999.)

Description: The MICR, effective January 2005, has been implemented. These standards require each Board to establish, pursuant to Condition 12, internal acts regulating the procedure of extension of loans (provision of loans, credit facilities, overdrafts, credit lines, credit cards, factoring and financial leasing operations) which are fairly comprehensive, including the target markets of the bank, preferred mix of the credit portfolio, lending authorities, loan concentration limits, diversification of loan portfolio, credit administration, loan loss provisioning, acceptable pledge, credit limits, standards for providing loans to related parties, possible exceptions to the loan policy, and other criteria.

In addition, the CBA has implemented guidelines for classification of assets for banks and has developed Credit Assessment Guidelines (CAG) to use in assessing assets at banks upon examination. These guidelines require banks to establish adequate credit granting and investment policies, practices and procedures.

Bank examiners of the CBA assess compliance with laws, rules, regulations and prudent lending at the on-site examinations and they also review asset quality on an off-site basis, and they will check compliance with the Internal Control Standards in the near future. The CBA has full access to lending and investment records at the banks.

Although there is no law requiring that transactions be made free of conflict and on an arms-

length basis, the CBA does, to the extent possible, verify this at examinations.

Additional Criteria

There is no requirement in law or regulation that the BOD must review loans or investments above a certain level or for other than mainstream credits or investments.

Management Information Systems are reviewed by the CBA at on-site examinations. Asset classification and provisioning would be reviewed for adequacy and MIS.

CBA staff indicated, and the Bank Examination Manual requires that the banks look at the total indebtedness of entities to which they extend credit. In practice, also, the CBA BSD staff stated that they classify all credits of a group of related parties, even at other banks, on a consistent basis.

Assessment: The CBA staff is considered to be well-versed on credit issues and has many tools available to it to assess the lending/investment function at banks. According to the Annual Report on Bank Supervision, Asset Classification violations and Credit Registry, taken together, comprise the majority of violations for the banks. This indicates a lack of control over the lending process at banks.

There are improvements that must be made if this principle is to be fully complied with. The board of directors for each bank should be required, on at least an annual basis, to review and approve (with documentation in the minutes) the Loan and Investment Policies and any internal policies relating to these functions.

Condition 4 of the MICR states that "the Board of the Bank, as well as the executive body, are responsible for working out and introducing rules of professional ethics and staff behavior." This is an important step. Changes to law would clarify and strengthen this.

However, laws should be changed to penalize any actions that lead to conflicts of interest in the lending/investment areas. For example, it should be a violation of law to lend to parties based on pressure, from inside or outside of the bank, bribery, or other actions that would cause a loan to be made when ordinarily it would not (such as through bribery).

In addition, banks should be required, either by law or regulation, to establish procedures whereby all large loans, and all loans to affiliates, either in their entirety or above a certain prescribed limit, should be reviewed by the full Board of Directors of the bank.

The CBA may also consider implementing clear directives on what constitutes a conflict of interest in the lending area, including, any inappropriate pressure from an insider of the bank to get a loan approved. It would also be good to include the requirement that directors may not vote or influence, directly or indirectly, the outcome of a vote, for an issue for which he has a beneficial interest in.

Compliance Level: Materially Non-Compliant. Some improvements were made in this area with the introduction of the MICR; however, this document is not comprehensive and does not have the force of law. Further improvements must be made to the laws to improve compliance. The CBA stated that amendments to the law that will be effective January 2005

will sufficiently address conflicts of interest and ethics requirements.

Principle 8: *Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.*

Essential criteria

1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.
2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.
3. The system for classification and provisioning includes off-balance-sheet exposures.
4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.
5. The supervisor determines that banks have appropriate procedures and organizational resources for the ongoing oversight of problem credits and for collecting past due loans.
6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.
7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.
8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.
9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.
10. The valuation of collateral is required to reflect the net realizable value.

Additional criteria

1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.
2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.

(Reference document: "Sound Practices for Loan Accounting and Disclosure" – July 1999.)

Description: Rules for the review and classification of assets are established through Classification of Assets Guideline (CAG) and a "Policy on Classification of Loans and Accounts Receivable, and Loan Loss Provisioning in Banks Operating in the Territory of the Republic of Armenia." Pursuant to Article 1.3, banks are responsible for classification of assets. Banks are also required to establish an internal policy on lending and classification of assets and provisioning. Both on- and off-balance sheet items may be classified. According to the Part 2.1 of the CBA Policy, definition of "Loans and Receivables" include "off-balance items involving credit risk for the bank."

The Policy specifically states, with regard to past due status,

Classification	Criteria (Past Due)	Minimum Provision
Standard		1 percent;
Watch	1-90 days	10-15 percent
Substandard	91-180 days	20-25 percent
Doubtful	181-270 days	50-70 percent

Loss	271 or more	100 percent or more

BSD reviews asset classification and provisioning policies of a bank at each examination and monitors the asset classifications and quality of assets on an off-site basis also. Information is reported on a monthly basis that allows them to review asset quality When problems or concerns are noted, the bank is contacted and corrective measures are required to be implemented. The examinations also conclude whether the banks have classified their assets on realistic payment assumptions and further, whether or not there are measures in place to make sure banks do not avoid classification by extending new loans. Capitalization of interest into principal is also looked at closely and does not result in a better classification. Examiners also review whether banks have the capacity to properly oversee problem credits and to collect on overdue loans. This is also included in the Bank Examination Manual.

The CBA has the authority to require a bank to strengthen its lending practices. This would be one of the authorities provided to the CBA in banking laws. Pursuant to Article 61 of the LBB, the CBA may require banks, through warnings and directives, to take action when problems are noted. This includes problem assets. Article 41 of the LBB also allows the CBA to restrict banking activities in order to limit the operations risk of a bank.

There are no real requirements for banks to assess the value of collateral or the strength of guarantees. However, the MICR specifically states, in Condition 12, Parts 33, that the banks establish procedures and policies on valuation of pledge. Banks do not typically, nor are they required, to value collateral on an NRV basis.

According to 2.6 of the Classification Policy, assets are considered non-performing if, for example, full or partial repayment of principal or interest is past due, interest payments have been capitalized, and payment terms have been adjusted or rolled-over into a new loan.

Additional Criteria

Loans are not only required to be classified based on number of days delinquent but may also be classified on subjectivity. As stated above, refinancing of loans does not lead to a better classification according to the Classification Policy.
Assessment: The CBA has the resources and the expertise to evaluate asset classification at banks, based on the current environment, and the Asset Classification Policy is considered satisfactory. The CAG is also a valuable tool in analyzing assets. CBA staff may use their subjective judgment and classify assets based on principles other than simply delinquency status.

From discussions with CBA staff and bankers, however, it appears that there are still many violations of law and credit and collateral deficiencies noted at banks. This is also evident in the Annual Report on Bank Supervision. Although this indicates that the CBA is performing at an acceptable level in identifying credit risks at banks, the banks themselves may not have systems in place that allow them to strengthen their own credit culture.

With regard to collateral valuation, it appears that banks are encouraged, but not required, to value collateral (pledge) on a periodic basis. This is also hindered by the lack of reliable valuation methods in Armenia. Net Realizable Value, not currently being used, should also be required when assessing collateral.

Improvement in the credit culture will become extremely important as the credit transactions that banks become involved in will only become more complex.

Compliance Level: Largely Compliant.

Principle 9: *Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.*

Essential criteria

1. A “closely related group” is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.
2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet.
3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.
4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.
5. The supervisor regularly obtains information that enables concentrations within a bank’s credit portfolio, including sectoral and geographic exposures, to be reviewed.

Additional criteria

1. Banks are required to adhere to the following definitions:

- 10 percent or more of a bank’s capital is defined as a large exposure;
- 25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.

Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.

(Reference document: “Measuring and controlling large credit exposures” – January 1991.)

Description: Article 8 of the LBB identifies a "linked person" for both natural and juridical persons, and is related, if,

a. A legal entity is in possession with voting rights of 20% and more of shares (shares, stocks, hereinafter – shares) of another entity, enabling voting rights, or by the power of participation or agreement signed between these entities is capable of predetermining the decisions of the other entity,
b. Participants in possession of more than 20% of shares enabling voting rights in one of the entities or participant (shareholder) or participants (shareholders) in possession of the rights to otherwise rightfully predetermine its decisions or their family members have the right to directly or indirectly manage (including but not limited to: selling and buying capacity, licensed management, agreement of joint activities, orders or any other transaction) more then 20% of shares enabling voting rights or in another rightful form have the capacity to predetermine the decisions of the other entity.
c. One third of persons in the managing body of a legal entity or other persons implementing similar functions or their family members are at the same in the managing body or implement similar functions in the other body.2.

Article 8 further states, in Part 2, "For the purpose of this Law and other laws regulating banking activities physical persons shall be considered related if they are members of the same family, or have common household, or jointly run business activities, or have been acting in accord aiming at common economic interests."

Further, in Part 3, "For the purpose of this Law and other laws regulating banking activities the legal entities and physical persons shall be considered related if the physical person or a member of his (her) family is a participant in possession of more than 20% of shares of the legal entity or has the capacity to otherwise predetermine the decisions of the legal entity, or serves as the Chairman of the Board, Deputy Chairman of the Board or a member of the Board, executive director or vice-director, Chairman of the Directorate or a member of the Department, Chief Accountant or Deputy Chief Accountant, Chairman of the Auditing Commission or a member of the Auditing Commission, or a member of other similar bodies, or an employee of a territorial or structural departments of that entity (including but not limited to departments, sections and desks, as well as units having in the opinion of the Central Bank direct link to the main activities of the legal entity, or operation under immediate supervision of its executive director, or having any influence on decision-making process in the managing bodies of the legal entities, when fulfilling the criteria prescribed by the Central Bank), and finally, in

Part 4. For the purpose of this Law and other laws regulating banking activities the following relatives shall be considered as members of immediate family: a father, a mother, a spouse, parents-in-law, a grandmother, a grandfather, a sister, a brother, children, brother's and sister's spouses and children.

According to CBA management, the CBA does not have the full authority, in all cases, to use judgment as to whether a party is related or not (case by case basis) nor are beneficial owners considered, by law, to be related.

Pursuant to Regulation 2, the maximum risk on a single borrower ($S3_1$) shall not exceed 20 % of the total capital. The maximum risk on major borrowers ($S3_2$) shall not exceed 500% of the total capital. On and off-balance sheet items are specifically included in the calculation pursuant to Regulation 2.

At the examination, the ability of management to monitor large loans is reviewed. The normatives are checked which include solo and consolidated basis.

Sectoral and geographic exposures are not required to be reviewed. However, if the CBA determines at an examination that there is undue risk to a bank as a result of large exposure to a sector or a geographic exposure, they can initiate corrective action.

Additional Criteria

The definition of a large exposure is provided in the Regulation on Financial Reporting (Regulation 3) and is considered 5% of capital.

The limitation is 20% according to $S3_1$ for the maximum exposure to one group.

Both of these are actually more conservative than suggested by Basel.

Assessment: Although the CBA does not have the authority to impose discretion, as warranted, as to who a closely related group is, the definition appears to be all encompassing however, does not take into account beneficial owners. Also, the CBA stated that they do not have the full discretion to determine affiliates in the cases of whether two persons are affiliated or two legal parties are affiliated with each other. Beneficial owners are also not considered for purposes of related parties.

The CBA has set acceptable limitations through normatives for large loans for individuals or groups of related parties. CBA examiners assess the adequacy of MIS at examinations and verifies that bank management monitors these limits on a solo and consolidated basis. They also look at exposures off-site.

Large exposures include both on- and off-balance sheet items pursuant to Regulation 3.

The CBA should consider obtaining information on sectoral and geographic exposures.

Bank Boards are not required, by law, to approve all large loans at their bank. Thus, the approval could be delegated downwards and could expose the bank to large amounts of risk perhaps with only approval "after the fact" to the board. The CBA should consider requiring by law, that the bank's board has the only approval authority for large exposures at their bank.
Compliance Level: Largely compliant. The CBA should take into account recommendations provided in this report to further compliance with this Core Principle. The question of beneficial ownership will be addressed in new legislation that is expected to be passed this fall and implemented in January 2006.

Principle 10: *In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.*

Essential criteria

1. A comprehensive definition of "connected or related parties" exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgments about the existence of connections between the bank and other parties.
2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding loans to non-related counter parties.
3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.
4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.
5. Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralization of such loans.

6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.
7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.

Additional criteria

1. The definition of “connected or related parties” established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.
2. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.

Description: Related parties are considered to be the bank's governors, persons with sufficient equity interests (defined in Article 39 of the LBB), persons linked with related parties, as defined above, and persons linked with the bank. Article 8 of the LBB identifies a "linked person" for both natural and juridical persons, and is provided in the evaluation of Core Principle 9.

There was no provision for the CBA to use discretion in determining whether a party is related or not on a case-by-case basis (for either two legal parties or two physical parties) nor are beneficial owners defined or included as “related.”

Article 39 of the LBB states that preferential transactions may not be provided to related parties and that they are null and void if noted. There is no requirement, as discussed above, for banks to establish internal rules on conflicts of interest nor are conflicts defined by law. There is also no real definition of “preferential.”

There is also no requirement, as discussed in the evaluation of Core Principle 7, for an interested party to refrain from preparing the loan or participating in the decision itself.

The maximum risk on one related party ($S4_1$) shall not exceed 5% of the total capital. The maximum risk on all related parties ($S4_2$) shall not exceed 20% of the total capital. These are in Regulation 2. The CBA has other authority to set more conservative limits through other means, such as directives or limiting operations of banks. Limitations are stricter than those for large loans.

According to the BSD, MIS are checked at the on-site examinations. Condition 6 of the Internal Controls Requirements requires that information on bank related persons be available to the bank which must at least include the name of the person, registered address, type of business activity, type of relationship, nature of relationship with the bank, all the loans received from the bank and other banks, *if possible*, and investments, pledge, other liabilities, deposits, loans provided to the bank. There is no requirement that these be updated on a periodic basis.

Further, information is provided to the CBA on a monthly basis regarding connected lending levels and normative compliance.

Assessment: The CBA has set acceptable limitations through normatives on maximum exposure from connected lending. The CBA monitors, on a monthly basis through reporting

and at the examinations the level of connected lending at banks. Nevertheless, there continues to be risk exposure to the banks regarding connected lending as follows.

The law does not allow for beneficial owners to be included as related, nor are there allowances for the CBA to further define this definition or make judgments as to who is related in all circumstances. More specifically, the CBA may not consider, pursuant to current law, two legal persons or two physical entities to be related.

The MICR, Condition 6, is a good start, but should not provide the phrase, "if possible," in the document because it allows the bank related persons to provide that it is "not possible" to provide the required information. Full disclosure of all financial interests, with the bank or with other parties should be required and should be required to be updated on a periodic basis. Only through this will there be transparency in a related interest of a director.

Having no requirement for an interested party to refrain from preparing the loan or participating in the decision itself creates a possibility for undue exposure, and providing no clear definition of "preferential" could result in problems if ever legally tested by a bank.

Compliance Level: Materially Non-Compliant. Conflicts of interest will be addressed in new legislation to be addressed this fall.

Principle 11: *Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.*

Essential criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/ end-counterpart basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.
2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.
3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to reasonable, risk-related, results. These include, inter alia:

- The supervisor decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.
- The supervisor sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures.
- The bank itself sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.

4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.

(Reference document: "Management of banks' international lending" – March 1982.)

Description: There are no requirements for the identification, measurement, or control of country risk in laws or regulations. The MICR does not specifically address all types of risk,

including country risk. Although there is a broad statement that the Board has responsibility for introducing internal controls, including, approving the "internal acts of the Bank" and reviewing acceptable risk limits on a regular basis, there could be more specific requirements laid out for all types of risk. Policies required are, at a minimum, Investment, Lending, ALM, Income Planning and Cost Estimate, Maintenance of Proper Capital and Internal Acts Regarding Staff Management. Country risk is not specified.

Assessment: There are no specific requirements for Country Risk. BSD staff stated that they do check levels of country risk at on-site examinations, and may restrict operations if undue risk were noted. The CBA may also check country risk from the reporting that is provided to the CBA but only on correspondent accounts in other countries. It does not appear that the CBA requires information on any other assets that may be held in other countries, such as securities, for example.

Any bank that lends money to borrowers outside its home country is subject to country risk. The fact that the majority of the lending is for domestic customers does not mitigate the need for monitoring Country Risk.

When banks lend outside their home countries, they face additional risks beyond those of the strength of the borrower. As such, the bank should gather information concerning the situation in each country it lends in and analyze the information to facilitate country risk management. A loan to a strong borrower in a weak country is as risky as a loan to a weak borrower in a strong country. The bank should use internal or external ratings to rate the countries in which it does business.

The Board of each bank should be required to implement controls to ensure that country risk taken is consistent with the bank's overall goals and strategies, and it must receive information on country exposure at its regular meetings.

Each bank must have a comprehensive, written policy to address and control country risk, including transfer risk and sovereign risk. The formality of the process may vary, depending on the size and complexity of the operations of the bank.

More formal requirements for Country Risk are needed.

Compliance Level: Non-Compliant

Principle 12: *Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and /or a specific capital charge on market risk exposures, if warranted.*

Essential criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.
2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.
3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.
4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.
5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.
6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.
7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

Additional criteria

1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information that they receive.
2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the banks' contingency plans for dealing with such conditions.
3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR.

(Reference document: "Amendment to the Capital Accord to incorporate market risks" –January 1996.)

Description: Market risk includes foreign exchange, IRR and price risk that lead to changes in market prices of assets held by banks. Regulation 2, Part 23 limits the foreign currency exposure to 25 percent of total capital and 5 percent for group II foreign currencies. Regulation 3 sets the weekly reporting requirement.

Banks are not required to set internal policies on components of market risk. Although the MICR, adopted January 2005, specifies that banks must stipulate the principles of limiting IRR, there is no requirement that bank boards specify acceptable limits of IRR, for example based on calculation of GAP or Duration.

No FX risk policy is called for and with regard to investments, the document does not specify any stress testing, however, does indicate that types of acceptable investments should be

determined.

The CBA has the authority to limit the activities of all banks, including FX activities. FX positions are, pursuant to Article 52 of the LBB, subject to the authority of the CBA. Limitations on FX are provided in Regulation 2. The CBA can limit the activities or may impose an Individual Minimum Capital Requirement as needed if problems are noted.

According to the MICR, banks are required to develop ALM/Liquidity (that includes an IRR component) and Investment policies. Compliance with MIS and adherence to policies is reviewed at exams.

Systems and controls for identifying, monitoring and controlling market risk are reviewed at exams. In addition, the CBA monitors these on a frequent basis, through financial reporting. For example, the CBA looks at not only normatives, but calculates IRR and duration analysis, and liquidity on a regular basis in the Methodology Department based on information provided to it by the banks.

Additional Criteria

Stress testing programs have been provided to the banks to assess market risk, but use is voluntary. As stated before, the CBA also looks at various components of market risk on a periodic basis. In addition, the Early Warning/UBPR systems allow the CBA to look at certain components of market risk, including foreign exchange and interest rate risks, and there are also tools available, such as VAR (value at risk) that are available for monitoring.

To the extent that the examiners review market risk, management is aware of the deficiencies and recommendations as conclusions and deficiencies are provided in reports. Procedures in the Examination Manual and off-site require the examiners to look at IRR and FX risk and to report on it to management when concerns are noted.

Banks only use the Duration and GAP analysis for IRR.

Assessment: Market Risk means the risk of loss to which the bank is exposed that is attributable to the possibility of adverse changes in the values of assets and liabilities owned by the bank or any of its subsidiaries, whether on- or off-balance sheet, as a result of changes in market rates or prices, from movements in interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices. There are three subcategories of risk that apply to market risk, including:

> Price Risk – means the risk of loss to which the bank is exposed that is attributable to the possibility of adverse changes in the values of financial instruments and other investments or assets owned by the bank or any of its subsidiaries, whether on- or off-balance sheet, as a result of changes in market prices. The risk arises from market-making, dealing, and position-taking in interest rate, foreign exchange, equity and commodities markets.
>
> Interest Rate Risk – means the risk of loss to which the bank is exposed that is attributable to the possibility that assets and liabilities, whether on- or off-balance sheet, of the bank or one or more of its subsidiaries, will be mismatched with regard to final maturity dates, repricing dates, or otherwise, as

a result of changes in market interest rates.

Foreign Exchange (Translation) Risk - means the risk of loss to which the bank is exposed that is attributable to the possibility of adverse changes in the values of financial instruments owned by the bank or any of its subsidiaries, whether on- or off-balance sheet, as a result of movement in the exchange rate of the currency of denomination.

Each bank should have a comprehensive, written policy to address and control market risk or at a minimum the components of the comprehensive policy in separate policies. The formality of the process may vary, depending on the size and complexity of the bank.

A comprehensive written policy to address and control ***price risk*** should be used at each bank. The policy should specify limits on the exposures that can be taken in specific instruments and by specific staff. The bank should conduct periodic analyses of the sensitivity of its positions with regard to a movement in prices of underlying products.

A comprehensive, written policy to address and control ***interest rate risk*** should be used at each bank. The policy should address which departments or staff will be responsible for implementing interest rate risk policies and procedures at the banks, as well as identifying the potential interest rate risk arising from new or existing products or activities. The bank should establish and maintain an interest rate risk measurement system. The system should be used to evaluate compliance with established risk tolerance as established by the Board. Risk measurement systems may range from relatively simple techniques, such as Gap analysis, to the more complex, such as stress testing that indicates the effects of potential risk on the bank's earnings or capital given certain interest rate environments. The Board can make a determination as to what is needed for its particular bank.

Under accepted risk management guidelines, the Board must receive reports on the bank's interest rate risk profile at least quarterly, but more frequently if the character and level of the bank's risk requires it. These reports should be sufficient in detail to allow for the evaluation of the amount of interest rate risk being taken, compliance with established risk limits, and whether management's strategies are appropriate given the Board's expressed level of risk tolerance.

Each bank should also develop and implement a comprehensive, written policy to address and control ***foreign exchange risk***. The policy should define limits on the acceptable level of risk arising from exposure to maintaining an imbalanced net open position in single currencies and all currencies in the aggregate as well as Stop/Loss provisions for setting maximum level of potential losses. The Board should also provide direction as to the desired structure of the bank with regard to foreign exchange holdings both on- and off-balance sheet.

Risk management in Armenia is not specifically required, by law or regulation, for all areas of market risk. Banks are not required to specifically develop policies on identifying, monitoring and controlling market risk, and many measures are voluntary.

Banks have been provided the opportunity to use stress modeling test software but have not been required to use it. Price risk policies are currently not required.

An IRR policy is required pursuant to the January 2005 MICR; however, does not call for a

basic component of such a policy as board-accepted limits for GAP or Duration levels at the bank. Failure to monitor IRR more closely is mitigated somewhat by the short-term nature of assets and liabilities but cannot be fully mitigated.

Foreign exchange policies are not required; however, FX risk is monitored closely by the CBA and presumably, by the banks themselves. The ability of the bank to assess FX risk is checked at examinations. Only with the implementation of policies will there be a movement from normative based management and supervision of FX to risk-based supervision.

In short, the CBA should require identification, measurement and control for IRR, FX and Price risks in banks.

During the assessment, further training in the area of Market Risk was requested by the CBA and would be beneficial for both banks and CBA staff.

Compliance: Largely Compliant, but only due to the low level of market risk in Armenia and the fact that there are normatives in place for FX monitoring. However, it is recommended that the CBA take the recommendations provided above to require more formal policies and procedures at banks in order to avoid harsher grading in the future.

Principle 13: *Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.*

Essential criteria

1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.

2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:

- Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.
- Interest rate risk: good management information systems and stress testing.
- Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.

3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.

4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration un-drawn commitments and other off-balance- sheet liabilities, as well as existing on-balance-sheet liabilities.

5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.
6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Additional criteria

1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.
2. The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.
3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformation.
4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign currency liquidity strategy is separately stress-tested and the results of such tests are a factor in determining the appropriateness of mismatches.

(Reference documents: "Principles for the management of interest rate risk" – September 1997 and "A framework for measuring and managing liquidity" – September 1992.)

Description: The requirement for banks to have risk management processes in place is not comprehensive for all types of risk. Although the new MICR were issued in January of this year, and are a good step forward, they do not specifically require Boards to look at all areas of risk in their bank and to initiate procedures to mitigate the levels of risk.

Liquidity was historically measured by normatives and they are still an integral part of the risk management strategy and of risk supervision. Liquidity for banks is governed by Regulation 2. According to this regulation, the minimum ratio of high liquid assets to total assets ($S2_1$) shall be 20%. The minimum ratio of high liquid assets to demand liabilities ($S2_2$) shall be 80%.

The CBA has implemented the MICR at banks that requires banks to develop a Liquidity/ALM Policy that is fairly comprehensive. The CBA is in the process of testing compliance of this policy through their on-site examination function. The minimum standards require the boards of each bank to approve internal acts regarding liquidity of the bank that include resources for meeting liquidity, secondary sources of liquidity, preferred and targeted structure of the balance sheet of the bank's assets and liabilities, restrictions on concentrations of funds for meeting liquidity, mechanisms for attracting funds, and other pertinent measures. It does not specifically require banks to set minimum/maximum levels of liquidity, nor does it assign responsibilities for implementing liquidity policy on a day-to-day basis.

IRR is also included in the MICR and is relatively comprehensive. The standards do not specify that banks must establish acceptable limits of IRR, how to measure IRR for their bank, who will ensure on a day to day basis that the limits are adhered to, etc.

Operational Risk is not specifically mentioned in the laws or in the MICR. Payments systems risk is included in the document and there is a requirement for "post-balance sheet operations." This includes processing of applications for credits lines, overdrafts credit cards, letters of credit and guarantees, etc. and safe deposit boxes, trust management.

Operational Risk is associated with human error, system failures and inadequate procedures

and controls. It is the risk of loss arising from the potential that inadequate information systems, technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses. Operational risk exists in all products and business activities. Operational risk results from such deficiencies as internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, business disruption and system failures, damage to physical assets, and finally execution, delivery and process management. As such, the board of each bank should be specifically required to initiate procedures to identify, measure and control operational risk of their bank.

The MICR states that {(Condition 3, Part 10 (e)} heads of subdivisions monitor the efficiency of implementation of responsibilities by their employees and Condition 4, Part 11c, requires that employees must be informed about the risks associated with the implementation of their duties at work and to advise them of their role with regard to the internal control system of the bank. The examiners will check compliance with this regulation in the nearest future.

Compliance with risk management processes is determined through both on-site and off-site processes. This is mainly limited to a determination of compliance with normatives and not necessarily on a qualitative basis.

Additional Criteria

The CBA has set capital requirements for the banks regarding capital; however, there are no requirements to hold additional capital against risks in addition to credit risk. However, pursuant to Article 44(4) the CB has the ability to set individual minimum capital requirements for banks as needed and if warranted for other types of risk identified.

With regard to risk management, there is currently no requirement and no requirement provided in the concept paper for Corporate Governance that banks disclose their risk management policies and procedures.

Regulation 3 (Financial Reporting) requires banks to provide information on FX and on liquidity. Although the banks have been provided with tools for stress testing of FX positions, the banks are not required to use them.

Assessment: Many areas of risk are not covered by law or regulation.

For example, there is no requirement for identification, measurement, and control for Compliance Risk, Reputation Risk, Risk Management of Affiliated Companies, Country Risk, Price Risk, or Operations Risk. Some banks may have other risks that are not identified with any one area.

The CBA has taken action to bring the system more into compliance with this Core Principle. This may be seen through the implementation of the MICR and in the Concept Paper on Corporate Governance, which has some items which, when implemented, will also improve compliance with Principle 13. However, there are still many deficiencies present that will only be alleviated with the development and introduction of a comprehensive Risk Management Guideline that takes into account all areas of risk. In many cases, laws will have to be further changed to hold banks responsible for the implementation of these guidelines.

Risk Management should be conducted at all levels of the bank. The Board must not only identify all types of risk inherent at their bank but must ascertain their bank's tolerance for risk, formulate strategy and policies for managing risk and establish adequate systems and controls to ensure that overall risk remains within acceptable levels and that the rewards compensate for the risk taken. One level lower in the organization, a business area or business line conducts day-to-day risk management. Within these groups, individuals perform risk management by following operational procedures, policies, internal controls and other guidelines established by management.

Until the law and regulations require banks to manage risk on a more formal basis and implements recommendations provided, compliance with this Core Principle will not be improved. Disclosure of risk management practices should also be publicly disclosed.

Foreign currency stress testing for liquidity purposes should also be required, and not simply encouraged.

Compliance Level: Materially Non-Compliant.

Principle 14: *Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.*

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.
2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organizational structure, accounting procedures, checks and balances and the safeguarding of assets and investments.

More specifically, these address:

- Organizational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
    - Accounting procedures: reconciliation of accounts, control lists, information for management.
- Checks and balances (or "four eyes principles"): segregation of duties, cross-checking, dual control of assets, double signatures.
- Safeguarding assets and investments: including physical control.

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.
5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practices and controls remain sufficient and appropriate for the bank's business.

The supervisor determines that the audit function:
- has unfettered access to all the bank's business lines and support departments;
- has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
- has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
- employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

6. The supervisor has access to the reports of the audit function.

Additional criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.
2. The supervisor requires the internal audit function to report to an Audit Committee.
3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.

(Reference document: "Framework for internal control systems in banking organizations" – September 1998)

Description: Article 21 of the LBB states what the Audit Committee is responsible for, including conformity with laws and regulations. The CBA could enforce this requirement through Article 60 (d) of the LBB, which allows the CBA the authority to take action if certain oversights are not provided. According to Article 21(4) of the LBB, audit reports are provided to executive body and not to board directly.

To date, none of the laws provide direct responsibility for banking officials for the maintenance of internal controls. The Concept Paper on Corporate Governance does not list identifying, measuring, and controlling risk and maintaining sufficient internal controls as duties of the board. The MICR identifies certain areas that need to be attended to by the Board, but is not all encompassing.

Internal control questionnaires are used at examinations, according to the Examination Manual. The sufficiency of the audit is determined at the examination. The supervisor has access to all information required, according to Article 55 and Article 58 of the LBB and there were no instances of noncompliance with this noted. Although key risks are not identified by

the bank itself (and are not required to be under the oversight of the Board by law) in a risk management policy, the examination staff identifies major risks and assesses the adequacy of the audit function on a periodic basis.

In the Concept Paper on Corporate Governance, Condition IV, Part 2(b), it states that the internal auditor will report to board ***and*** executive body. It does not say whether this is simultaneously or not. In another section of this same concept paper, Condition II, Part (6), it states that the BOD has the exclusive rights to evaluate the results of auditing and other reviews in the bank, and to control the measures for elimination of revealed defects. Conflicts are abundant with regard to this issue. In the AML law, deficiencies in compliance are reported to the management body and not to the Board.

Assessment: Although the MICR is a good start to the implementation of controls, there are still deficiencies that need to be addressed.

1) It should be clear that the internal audit function report directly to the Board of Directors. This should be codified in banking laws.
2) The Board should take increased measures, through implementation of adequate policies and procedures, especially, but not exclusively related to, operational risk in banks. They should also take measures to fully understand the risks associated with their bank (as discussed in the previous Core Principle assessment).
3) The Board should be held accountable, by law, for the implementation of an environment that is conducive to establishing good internal controls at banks. Further, MIS should be checked to verify that accountability is ensured for the implementation of internal controls at all levels.

Compliance Level: Non-Compliant. The CBA stated that the new legislation will require reporting directly to the Board.

Principle 15: *Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements***.**

Essential criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.
2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.
3. The supervisor determines that banks have formal procedures to recognize potentially suspicious transactions. These might include additional authorization for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.
4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.

5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.
6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.
7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.
8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.
9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.
10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.
11. The supervisor determines that banks have a policy statement on ethics and professional behavior that is clearly communicated to all staff.

Additional criteria

1. The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).
2. The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.
3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.
4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations.

(Reference document: "Prevention of criminal use of the banking system for the purpose of money-laundering" – December 1988.)

Description: Money laundering is criminalized under Article 190 of the Criminal Code.

In addition, pursuant to Article 4 of the newly implemented AML law, the reporting persons have to undertake measures in accordance with the procedure defined by law and other standard acts to identify and prevent suspicious transactions (deals) by their customers or third party. Under the procedure defined by the law and other standard acts, the reporting persons have to provide to the Authorized Body (CBA) information about laundering of illicit proceeds and terrorism financing stipulated by this law and other standard acts passed on the basis of it. There are also penalties for noncompliance with this law.

Noncompliance with the AML law can result in criminal action and fines. Fines are considered to be too small to be a deterrent to criminal activity such as money laundering. They provide only from 200X to 500X the minimal official salary of Armenia.

Article 13 of the AML law requires that banks have in place policies and procedures to ensure compliance with the law.

Articled 14 of the AML law states that the bank must appoint either a subdivision or an employee to verify compliance with AML requirements. Frequency is determined by the executive body and reporting of compliance is to executive body.

Article 5(5) of the AML law deals with liability of reporting to the FIU and states that persons providing information in good faith may not be held liable for providing such information.

According to our review of the AML law and the banking laws, the FIU does not currently have the *explicit* ability to enter banks and examine compliance with laws and regulations pertaining to AML. However, they can be appointed to accompany examiners on examinations by decree of the CBA Chairman and examiners will also check compliance at on-site examinations.

With regard to communicating among domestic and foreign agencies responsible for implementing AML in this and other countries, Article 11 of the AML law provides communication with domestic agencies and Article 12 of the AML law with international agencies.

Professional ethics and staff behavior are not specifically mentioned in the AML law, but are included in the MICR. It requires, pursuant to Condition 4, Part 11 (b) that the Board of Directors and the executive body of the bank are responsible for working out and introducing rules of professional ethics and staff behavior. Ethics will also be addressed in new legislation expected to be passed this fall and to be fully implemented in January 2006.

Compliance with the MICR will be checked by the CBA examination staff in the nearest future, according to the BSD.

Additional Criteria

In general, the law complies with the spirit of FATF, although not 100%. There continues to be some likelihood that money may be laundered physically through cross border journeys. Although not directly related to banks, this is a loophole that should be closed. The CBA has stated that they are currently communicating with Customs so that they communicate any suspicious activities with them; however, to date, Customs does not provide information to the FIU.

The CBA BSD has the legal obligation to report any concerns to the FIU.

Assessment: The law is a considered to be generally well written and mainly in compliance with the FATF "40 Recommendations."

The CBA staff and banks are still in somewhat of a transition period regarding full implementation of the AML law and Currency Transaction Reports are only now being required. Areas of concern that need addressing are:

- Customs is not required to report known or suspected cases to the FIU nor are they required to submit cross border currency movements. Although Basel deals with AML at banks, this is a deficiency worth mentioning but not taken into account for grading the level of compliance with this principle.

- Fines are considered to be extremely low and will not act as a deterrent or as a punitive measure.
- The law should be amended to require not just an employee or department to be responsible for ensuring compliance with the AML law but for an executive officer of the bank to have responsibility.
- Lastly, instances of non-compliance with the law should be reported directly to the Board and not to management of the bank. At a minimum, the information should be provided concurrently. This is considered to be a major deficiency in the law.

Compliance Level: Largely Compliant. Main deficiencies relate to the Board not receiving reports directly and the fact that an officer is not required to be appointed for oversight of compliance with the law. These need to be addressed to

Principle 16: *An effective banking supervisory system should consist of some form of both on-site and off-site supervision.*

(Note: this Principle should be considered in conjunction with Principles 17 through 20.)

Essential criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focusing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:

- provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;
- determine that information provided by banks is reliable;
- obtain additional information needed to assess the condition of the bank.

2. And (2) uses off-site work as a primary tool to:

- review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
- monitor trends and developments for the banking sector as a whole.

3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.
4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximize the synergy and avoid supervisory gaps.

Additional criteria

1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.
2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.
3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritized based on the results of that assessment.

4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.
5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.

Description: The CBA is allowed to examine banks as needed, and that includes checking for adequate corporate governance. However, as stated previously, the laws are not explicit with regard to corporate governance and the responsibilities of management and the Board. The CBA has the authority to obtain any information required, and the banks must submit it, according to Article 55 of the LBB. Audit reports must also be made available according to Article 58(3) and (4) including, presumably, workpapers. Prudential reports are submitted on at least a monthly basis and are reviewed and analyzed by the BSD/Methodology using the UBPR and other tools. BSD monitors trends and developments in the banking sector as a whole in practice. Verification of the information is performed by off-site and at examinations.

Prudential normative and compliance with them is provided on a monthly basis, if not more frequently. On-site and off-site are organizationally integrated, which allows for a more streamlined and accurate check for compliance. There is an appropriate mix of off-site and on-site.

It should be noted that on-site examinations are not always held at least once per annum, and could occur only once every three years. The CBA does have the authority, and implements it regularly, to perform targeted examinations based on the results of their risk-based supervision and UBPRs.

Additional Criteria

Every significant issue is reported to the Chairman of the CBA and every report is provided to him also. He makes a determination as to whether the full CBA Board needs to look at the issue and if the action proposed by the BSD is adequate. There is also an Internal Audit function of the CBA that checks compliance and reviews such as this assess adequacy of the function.

The CBA has access to both external and internal auditors to Articles 55 and 58 of the LBB.

The CBA has, within the past two years, initiated Risk-Based Supervision although they are still in transition. Also they are using CAMELS now instead of CAMEL. The BSD has stated that they have changed from a compliance driven examination focus to one of risk-based supervision. This is, however, somewhat dependent on the banks implementing better risk policies and procedures at their bank and the requirement for them to do so.

Additional training is needed in all areas of risk so that examiners can better understand risk management components and specific areas of risk. This will allow them to have better expertise in risk identification, control and how to measure and manage risk.

The CBA is required, according to Article 28 of the LCBA, to not disclose information that is

not publicly disclosed. The Law on Bank Secrecy is aimed mainly at the banks themselves and not the CBA. The CBA must disclose in certain cases, e.g. to courts, to BSD, to external auditors, etc. Article 57 of the LBB states that the CBA may disclose information to other regulatory agencies that have Armenian banks operating in their countries, if there is an international agreement allowing for such (Article 57-4). To date, not all MOUs are in place that should be.

The CBA examination staff checks the competence and independence of the internal audit function at the exam. The work is available at the exam and in other cases. The problem continues to be with the lack of independence of the audit function at the banks.

Assessment: The CBA staff is highly professional and knowledgeable with regard to bank supervision issues. They subscribe to a code of ethics and are required to provide information on their financial interests on a periodic basis. Knowledge testing is required at all levels of the BSD in order to move ahead to a higher level through an Examiner Certification program.

Further training, especially in the area of risk management, will help improve the CBA staff with regard to supervising banks at an international level. It will be extremely important in the future when banks and their boards are held more accountable for implementing better risk practices.

Compliance Level: Compliant. Further training is essential to the maintenance of compliance at this level.

Principle 17: *Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.*

Essential criteria

1. Based on the risk profile of individual banks, the supervisor has a program of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems, etc.
2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews, and regular meetings.
3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.
4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

Description: The supervisor meets with upper management and the Board at the end of every examination. On an as-needed basis, the CBA BSD staff meets with mid-level management

and other managers of the bank to discuss any concerns that arise. These meetings may be formal (in person) or by telephone for less critical problems. Documentation of phone calls is even maintained for the record.

Through the on-site, off-site processes, the CBA staff has a very good understanding of the activities of banks.

As far as notification of substantive changes in the financial condition, a breach of normative would be included in the financial reporting (Regulation 3, Financial Reporting). Significant changes in activities would not be required as long as they were still operating pursuant to the activities they are licensed for.

Any other substantive changes or material concerns of management are not required to be reported by law or regulation.

The quality of management is assessed as part of the on-site examination. Licensing looks at the quality of management as part of Regulation 1 and pursuant to laws pertaining to licensing.

Assessment: The CBA has regular contact with bank management at different levels in-between, during and after examinations. A recommendation is to require banks to report any material adverse change in the activities or financial condition of the bank to the CBA within a certain short period of time.

Compliance Level: Largely Compliant. Banks should be required, pursuant to the Core Principle, to report any material adverse changes to the BSD, including breach of legal and prudential requirements. As there are other material adverse changes that might not be reflected in normatives, steps should be taken to require this by law.

Principle 18: *Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.*

Essential criteria

1. The supervisor has the legal authority to require banking organizations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.
2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.
3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.
4. The information that is required to be submitted includes standardized prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on and off balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.
5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.
6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.
7. In order to make meaningful comparisons between banking organizations, the supervisor collects data from all banks and all other relevant entities within a banking organization on a comparable basis and related to the same dates (stock data) and periods (flow data).
8. The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

Description: The CBA has the authority to require banking organizations to submit information on their financial condition at regular intervals and more often as needed. They get information on a solo and consolidated basis. However, pursuant to Regulation 3, consolidation is only downward and not upward.

The CBA has the authority to require information to be submitted in the format (how often and according to its procedures) that it chooses (Article 55 of the LBB). The CBA has stated that the accounting shall be maintained in a manner approved by the CBA (Article 56). Armenian Accounting Standards are required which are 99% in compliance with IAS.

The CBA has the authority to take action against banks that do not supply information on a timely and accurate basis (Article 60(e) of the LBBA).

The forms submitted to the CBA must be signed or authorized by the Executive Board Member and the Chief Accountant.

Individuals may also be fined (Article 63 (5)) and the managers may be deprived of their Managers' Certification in cases, for example, when they have intentionally violated the law and other legal acts, have hindered the CBA, and other reasons. As stated previously, fines are relatively low.

Information required by the banks, not considering the consolidation issue, is considered adequate for the CBA to provide sufficient regulatory oversight to banks. Although the law states that the CBA may require banks to provide any information it asks for, theoretically a bank may refuse to provide information on, e.g. other subs of parent companies. In this case, the recourse for the CBA would be to restrict the activities of the bank itself.

On site and off-site functions are all under one BSD department. The results of the off-site are used to determine the scope of general exams and to perhaps initiate a limited scope exam.

Assessment: The CBA has the ability to request information as needed and the information requested is, in general, adequate to supervise banks and subsidiaries. The CBA should also, however, specifically be allowed to examine all related organizations and financial information of them. Without that at their disposal, the BSD is at a distinct disadvantage in assessing risk and properly supervising banks in Armenia.

Compliance Level: Largely compliant.

Principle 19: *Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.*

Essential criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.

2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.

3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.

4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.

5. The supervisor has a program for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.

Additional criteria

1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.
2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.

(Reference document: "The relationship between bank supervisors and external auditors" – July 1989.)

Description: The BSD has good resources in place to conduct a comprehensive examination, and they plan these based on risk. Although banks are not required to be examined at least annually, the CBA may commence targeted examinations on an as-needed basis as a result of concerns that might arise from the off-site process and use of the Early Warning System and the UBPR.

The CBA, in practice, is not required to be present and in general, does not attend, the exit meeting of auditors with the banks.

The MOF certifies auditors for all industries, including banks, and the CBA may not, according to law, directly oppose an auditor. However, BSD has stated that if they are not satisfied with the results of an audit, or suspect the work was not done satisfactorily, that they may require the bank, through other authorities (supervisory measures) provided, require a different firm to conduct an audit. At this time, all audits are being performed by foreign-based firms with offices in Armenia.

The CBA has the authority to engage an external auditor to perform specific work at banks and has done so in the past. Although there is no written requirement for the responsibilities of the CBA and the auditors in these circumstances, there have been no problems noted.

The CBA has the right to have full access to the bank records for the furtherance of supervisory work. According to Article 55, the CBA may determine what information is necessary to perform its duties. Article 57(3) states that the banks must cooperate with the CBA employees. When needed, the CBA has meetings/access to the board, management, and bank staff when required.

Again, although the CBA determines the validity of the returns at the examination, the examination may only occur every 3 years in certain circumstances. They may also check the accuracy of the returns, although not as easily, as a basis of off-site supervision. When returns are determined to be with material errors, the bank must submit amended returns to the CBA.

There is no requirement that the auditors examine returns (supervisory reports) provided to the CBA for accuracy.

Additional Criteria

There is no requirement to meet with banks on an annual basis at a minimum, although BSD

meets with bank management after examinations. However, since banks may not be examined annually, this requirement may not suffice.

According to BSD, the CBA does not regularly hold roundtable meetings with external audit firms to discuss current topics.

Assessment: The CBA has a system in place for planning and executing on-site examinations and although they may not perform a comprehensive examination at least annually, they do have the opportunity to perform targeted examinations as needed based on concerns noted through bank supervision. Auditors are required to submit not only annual reports to the CBA but management letters as well, that would outline any internal control deficiencies or other significant items of concern noted as a result of the audit. The CBA has the power to review any information that they deem necessary as a result of the audit, including workpapers and audit adjustments.

It would be beneficial for the CBA to require, in addition to the audit report and management letter, a list of audit adjustments required as a result of the audit. This would allow them to determine the level of expertise of the bank's accounting staff with regard to accounting standards. Further, it would be beneficial to hold meetings with local audit firms on a periodic basis to discuss issues relevant to banking on an on-going basis.

Also suggested would be for the scope of the audit to include, at a minimum, verification of the annual reports provided to the CBA for accuracy. As these are used by the CBA for supervisory purposes, it is important that these be checked for accuracy on at least an annual basis.

Compliance Level: Largely Compliant.

Principle 20: *An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis***.**

Essential criteria

1. The supervisor is aware of the overall structure of banking organizations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.
2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.
4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organization.
5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organization. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.
6. The supervisor collects consolidated financial information for each banking organization.
7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organization group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.

8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.

Additional criteria

1. For those countries that allow corporate ownership of banking companies:

- the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilizes the authority in practice to determine the safety and soundness of the bank;
- the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and
- the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.

(Reference documents: "Consolidated supervision of banks' international activities" – March 1979; "The supervision of cross-border banking" – October 1996.)

Description: As mentioned previously the CBA only has the authority to examine banks and any subsidiaries of the bank, i.e. may only look downward in the banking group (through Article 35(2) of the LBB, the CBA may "execute supervision" over the subsidiaries of the bank. There is no ability to examine either the 1) parent company or, 2) the affiliates of the parent company. Even if the supervisor were one hundred percent aware of the structure group, as they say, there is no ability to access risk for the banking group as a whole. In addition, beneficial owners are not included, by definition, as related parties and thus could not be subject to examination even if the CBA were to obtain the ability to examine them.

Pursuant to the examination manual, there are very general guidelines to follow with regard to "related organizations," but these organizations are mainly reviewed for the propriety of transactions with banks and not based on risk from the banking group as a whole.

From a practical standpoint, the BSD has stated that although they may not directly examine all affiliates within a banking group, they could, if need be, approach the bank itself and limit its operations, in a punitive manner, in order to indirectly impose some sanctions on an affiliate not subject to examination or supervision. Although this may work in some instances, it is not a satisfactory substitute to be able to examine and supervise all members of a banking group, at a minimum those that are financially-related companies.

Prudential standards are applied on a "consolidated basis" pursuant to Regulation 3. However, in this case consolidation means the bank downwards in the organization and not upwards.

Assessment: Our assessment indicates that there is only compliance with Essential Criteria 1, and the compliance with this is incomplete, in that the CBA may not be 100 percent sure of all related parties within a banking group, including beneficial owners.

The CBA should make a concerted effort to fully implement international best practices in Consolidated Supervision. Recommendations provided by the BearingPoint project in the past, if implemented, would provide improvement in this regard.

Compliance Level: Non-Compliant. The CBA has stated that some these deficiencies will be cleared up with the new legislation.

Principle 21: *Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.*

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.
2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.
4. The supervisor ensures that there are open communication lines with the external auditors.
5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.
6. The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.
7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.
8. The supervisor has the ability to treat as confidential certain types of sensitive information.
9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.
10. The supervisor has the right to revoke the appointment of a bank's auditors.
11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognized by the supervisor as having the necessary professional skills and independence to perform the work.

Additional criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.
2. The supervisor has guidelines covering the scope and conduct of audit programs that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.
3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.
4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.

Description: The CBA has the authority to take action against banks that do not supply information on a timely and accurate basis (Article 60(e) of the LBB). The forms must be signed or authorized by the Executive Board Member and the Chief Accountant. Individuals may also be fined (Article 63 (5)) and the managers may be deprived of their Managers' Certification in cases, for example, when they have intentionally violated the law and other legal acts, have hindered the CBA, and other reasons.

Banks are required, pursuant to Articles 58 and 59, to require an audit. According to CBA, audits may be unqualified, qualified, or negative. Strict requirements for the scope of the audit are required pursuant to local auditing standards.

According to the Bank Examinations Manual, the examination function is responsible for verification of reports that are submitted to the CBA. External audits are required on an annual basis, and must be published, according to Article 58 and 59, to be checked by the auditor and published within 4 months.

According to Article 58 (4), "upon the request of the CBA, the independent audit company shall be obliged to present to the CBA all the necessary documents regarding the audit of the bank irrespective whether they represent any commercial, bank or other secrets. In case of default of the obligations, specified under this paragraph, the auditing company shall carry a liability in the manner defined by the legislation of the RA."

Report instructions for the banks to use AAS are clearly established by Regulation 3 and bank accounting standards. AAS is considered, at least by local accountants, to be 99% in compliance with IAS.

The CBA is required, pursuant to the banking laws, on maintaining confidentiality and may not publicly disclose information.

Article 58 of the LBB requires every bank to be audited on an annual basis to assist in the compilation of financial reports, prepare and/or checks annual financial reports for accuracy, gives an opinion, checks the conformity of the formation and operation of the audit committee pursuant to legislation.

The CBA does not legally have the right to revoke the appointment of the auditor, which is appointed by the General Shareholders' Meeting. The MOF certifies external audit companies. There is no certification specifically for bank auditors to ensure that they have the skills necessary to audit a bank. Although the CBA does not rely solely on the external auditors, they still require auditors that are approved by the MOF. As discussed directly above, they do not certify bank auditors in Armenia.

Additional Criteria

As far as auditors being required to report to the CBA if material matters of significance are noted during the audit, it is not required, except for, pursuant to Article 4 of the Law on Bankruptcy, in case of insolvency. They are likewise not required to notify for any other item of significant supervisory interest.

Assessment: There are only minor deficiencies in the compliance with this principle. The

CBA does not have the right to revoke the appointment of a bank's auditors. CBA should consider establishing a separate certification program (separate from the Ministry of Finance), to ensure that all bank auditors have required minimum qualifications and knowledge. The CBA might also consider holding roundtable meetings with external auditors on a periodic basis to discuss current and relevant issues.

Auditors should also be required to report matters of materiality or supervisory significance to the CBA.

Compliance Level: Largely Compliant.

Principle 22: *Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.*

Essential criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking license.
2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.
3. The supervisor ensures that remedial actions are taken in a timely manner.
4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.

Additional criteria

1. Laws and/or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.
2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.

Description: Article 60 of the LBB provides definitions for Violations of Law that is quite extensive. It also has a provision (Part d) that allows the CBA to take action if, in its determination, the bank has undertaken such actions which may risk the interests of depositors or the creditors of the bank. Penalties and other remedial actions are in Article 61 of the same Law (Penalties for Violations of Laws), whereby the CBA may apply warnings and directives on the elimination of violations, fines, deprivation of the bank's manager's qualifications certificate, recognition of the license as ineffective. The application of these remedies does not release the banks or managers from other liability as established by laws. Each remedy may be introduced simultaneously to the bank and the bank management. Articles 62 (Warning and Instruction to Correct the Violation), 63 (Fines), 64 (Deprivation of the Bank Managers' of the Qualification Certificate) and 65 (Withdrawal of Bank License) give further direction.

According to Article 41 of the LBB, the CBA may impose restrictions on the bank's credit, deposit, financial operations, individual types of investments in order to limit the operations of the banks. Share repurchases are not allowed pursuant to Article 37 except in certain circumstances. Article 36 states that the CBA may restrict the payment of dividends, but only if it will cause insolvency. They also have the power to bar individuals from banking, i.e. through the deprivation of bank managers of the qualification certificate (Article 64 of the LBB) and through Regulation 1, whereby changes in management must be approved by the CBA. The CBA has the authority to apply penalties and sanctions to the banks and to managers, however, members of the BOD are not subject to fines. Further, the CBA may not remove and prohibit a principal shareholder from participating in the affairs of the bank. They may not also, under law, remove other related parties from participating in the affairs of the bank.

There are no known restrictions or prescribed timeframes that would prohibit the CBA from taking action in a timely manner.

Additional Criteria

There are no known restrictions or prescribed timeframes that would prohibit the CBA from taking action in a timely manner. In fact, the CBA practice is to provide internal deadlines for documents that flow through the review and approval process. This includes BSD matters as well.

There is no codification in the law that all remedial actions must be in writing, or that progress reports are required.

Assessment: The CBA has broad powers in its authority to use to adequately supervise banks and to take action against banks and individuals as needed. However, the inability to fine members of the Board is not realistic and needs to be changed. The CBA stated that this will be corrected prior to the end of the year with the implementation of amendments to the laws. However, even with the changes to law, principal shareholders and other persons exhibiting “significant influence” may not be fined.

Further, there are no expressed authorities for removal and prohibition for board members, principal shareholders and other persons exhibiting “significant influence” may not be fined.

Further, as discussed previously in this report, the level of fines that may be assessed are not sufficient to act as a deterrent or to be punitive. The CBA, in addition to the measures described by law, may also use the authority provided in the Law on Bankruptcy, including temporary administration and other measures.

Through discussions with BSD, it appears that the recordkeeping and flow of information with regard to problems noted at banks is sufficient. Not only does BSD maintain a record of phone conversations with banks regarding concerns noted, but, written communications are always sent to both the management and the Board.

Timeframes established internally by the CBA for the flow of information appear to be sufficient and do not necessarily delay the supervisory progress.

Areas needing improvement are in the level of fines that may be provided and in the need for the fines to be assessed against the board by law as needed.

Compliance Level: Largely Compliant.

Principle 23: *Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.*

Essential criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.
2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.
3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.
4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

Additional criteria

1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.
2. The supervisor ensures that management's local oversight of foreign operations is particularly close when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.
3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during these visits.
4. The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.

(Reference documents: "Principles for the supervision of banks' foreign establishments" – May 1983; "Minimum standards for the supervision of international banking groups and their cross-border establishments" – July 1992; "The supervision of cross-border banking" – October 1996.)

Description: There is only one local bank with overseas activities, with a bank subsidiary in Russia. Article 14 of the LBB allows for the opening of branches outside of the RA. Article 28 of the same law, part 3, states that when establishing branches and representations outside of the RA, consent of the CBA is needed, and registering documents must be submitted after registration in the foreign country. According to Part 6(h) of Article 28, if supervision in that country is not good, the CBA may reject the motion to establish a branch in the foreign country and for other reasons.

Part 6(d) of Article 28 states that the CBA may reject the motion if the professional know-how or the qualifications of the management of the bank's subsidiary do not meet the criteria defined by the CBA.

Members of the BSD staff indicated that it evaluates of the bank's local management oversight in the form of MIS, internal controls, and overall oversight of the foreign operations through BSD and asks questions and initiates corrective action as needed.

The CBA may require the closure of overseas branch or subsidiary operations (but not its affiliates) through Article 41 of the LBB which states, "for the purpose of restraining the risk factor of the banking activities, the Central Bank may provide for limitations on or special rules of procedure for the banks lending deposit, financial operations and certain types of investment".

Additional Criteria

There is no written policy for assessing whether an overseas office needs to be examined. As a rule, the CBA examines the one wholly-owned subsidiary in Moscow on a biannual basis. The legal basis is provided in the MOU that was required prior to establishing the branch.

Oversight is checked through both on-site and off-site activities through a review of reports provided to the CBA (solo and consolidated), examination of the bank, both here and overseas.

Although they do not perform a direct assessment of the overseas supervisor, they do get copies of reports on the subsidiaries and could, if not satisfied, perform an additional exam if needed.

Assessment: With only one organization operating outside of the country, there is relatively little need for the CBA to have formal procedures in place for determining when to examine a foreign subsidiary, what to examine, and, in general, how much oversight should be provided. However, this activity will, without a doubt, increase in the future and the present is the prime time to put procedures in place for BSD to use. Procedures should take into account the level of supervision needed from Armenia in relation to the level of oversight provided by the host country. Further, as discussed previously, there is no ability to examine or obtain information on all affiliates.
Compliance Level: Largely Compliant.

Principle 24: *A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.*

Essential criteria
1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.
2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.
3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.
Additional criteria
1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.
2. Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors.
(Reference documents: same as for Principle 23.)

Description: As discussed previously, there is only one overseas branch of a foreign bank. The CBA has an MOU with the Central Bank of Russia that allows them to exchange information with each other. The CBA states that the Russian authorities examine the Armenian bank subsidiary that is in Moscow and provides information to the CBA. Likewise the CBA shares information with the CBR.

Article 14 of the LBB allows for the opening of branches outside of the RA. Article 28 of the same law, part 3, states that when establishing branches and representations outside of the RA, consent of the CBA is needed, and registering documents must be submitted after registration in the foreign country. According to Part 6(h), is supervision in that country is not good, the CBA may reject the motion to establish a branch in the foreign country. Through discussions with the CBA, it is evident that the CBA would not allow for a branch or subsidiary to open in another country if there was not information sharing.

Assessment: Compliance with this Core Principle is satisfactory, with the exception of the CBA not having any supervisory control over all affiliates that may be established in other countries. Information exchange is good with the CBR, and the CBR allows the CBA examination staff to perform in-country examinations.
Compliance Level: Largely Compliant. The CBA does not have the ability to restrict operations of all affiliates, but their authority only relates to branches and subsidiaries.

Principle 25: *Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.*

Essential criteria
1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.
2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.
3. The host supervisor, before issuing a license, determines that approval (or no objection) from the home supervisor has been received.
4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.
5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.
6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.
Additional criteria
1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.
(Reference documents: same as for Principle 23.)
Description: Article 27 (4) of LBB states that a bank or foreign branch shall only be registered in the appropriate account opened in the CBA if the bank has the minimum statutory capital fund set by the CBA ($5 million).

With regard to whether the CBA supervises foreign banks and branches at the same level as other banks in Armenia, the answer is yes, but only due to the fact that all foreign banks have chosen to operate as separately licensed banks and not as branches. Pursuant to Regulation 2, as mentioned previously in this report, branches of foreign banks would only be required to operate pursuant to one normative, the deposit reserve requirement.

The CBA does not verify, for purposes of licensing, that the home country supervisor practices global consolidated supervision.

Article 29(1)(e) of the LBB states that the agreement of the home country supervisor must be obtained for branches or subsidiaries of foreign banks.

LBB, Art 57 provides that on the basis of an international agreement signed between the CBA and other supervisory authorities, the CBA may provide information obtained during on-site examinations even if it comprises banking or other types of secrecy. However, MOUs have not been signed with all countries. They have been signed with these countries: Lebanon, Iran, Kazakhstan, Russia and Ukraine, but not with Georgia and Great Britain.

Additional Criteria

The CBA may ask for information that it decides is necessary prior to granting a license for a branch or subsidiary to operate in Armenia.

Assessment: The CBA has the powers it needs to properly supervise subsidiaries of foreign banks that are operating in Armenia. These foreign-owned banks are supervised at the same level as the local banks. However, branches would not be. This is only mitigated by the fact that there are no branches of foreign banks currently operating in Armenia. Nonetheless, the

CBA currently has no authority to require branches of foreign banks to operate pursuant to most normatives, or to maintain a "capital equivalent" that would serve as the basis for these normatives.

The lack of MOUs with other countries prohibits the CBA with providing and obtaining information on a continuing basis regarding their role as the host country supervisor.
Compliance Level: Largely Compliant, but only due to the fact that there are currently no branches of foreign banks operating in Armenia. If Regulation 2 is not amended prior to the next Core Principle Assessment, a Materially Non-Compliant level is recommended.

APPENDIX A

DOCUMENTS REVIEWED DURING THE ASSESSMENT

Laws
- Law on Central Bank of Armenia
- Law on Banks and Banking
- Law on Bank Bankruptcy

Regulations
- Regulation 1 "Registration and Licensing of Banks and Foreign Bank Branches; Registration of Branches and Representations"
- Regulation 2 "Regulation of Banking; Prudential Standards for Banking"
- Regulation 3 "Bank Statements, Reporting and Release"
- Regulation 5 "Safeguarding Banks and Credit Institutions from Circulation of Criminally Obtained Funds; Preventing Funding for Terrorism"
- Regulation 8 "Currency Regulation and Exchange Control in Armenia"
- Regulation 13 "Technical Adequacy Requirements for Credit Organizations for Registration and Licensing; Record of Branches and Representations; Managers Qualification; Major Participation in Statutory Fund"
- Regulation 14 "Regulation of Credit Organizations Activity; Prudential Standards for Credit Organizations Activity"
- Regulation 20 "Mandatory Guarantee of Physical Entity Bank Deposits and Accounts"

Supervisory Manuals and Reports
- On-Site Examination Manual
- The Banking System of Armenia, 2004
- Annual Report of the Central Bank of Armenia, 2004
- "Surveyed Bank Indicators Assessment Method (CAMELS)"

Other Documents
- FSAP Report, IMF and World Bank
- Draft MOU with England
- Off-Site Analysis Report, Armenian Version (components explained by BSD)
- Concept Paper on Corporate Governance at Banks
- MICR
- 2003 and 2004 Core Principle Assessments, CBA and BearingPoint
- The Central Bank of Armenia, Development Vision
- The Central Bank of Armenia, FIU Strategy