

# “Perspectives of liberalization of access for foreign capital to banking sector of Ukraine”

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## **PERSPECTIVES OF LIBERALIZATION OF ACCESS FOR FOREIGN CAPITAL TO BANKING SECTOR OF UKRAINE**

Fedir Shpyh

### **Abstract**

Financial globalization and the growing competition on the market of banking services have led to massive expansion of foreign banking capital to new markets, first of all, the markets of post-Soviet countries.

Considering that Ukraine is seeking liberalization of access to its financial market, particularly in regard to allowing foreign banks to open their branches as a prerequisite to the country's future joining to the World Trade Organization, the experience of other countries with transitional economies and with a high concentration of foreign capital will be very useful for Ukraine to study and analyze, especially in the field of legal regulations for the access and activities of foreign banks.

### **Introduction**

Recently much is spoken about the expediency of allowing foreign banks to open their branches in Ukraine. The desire of the country's leaders to integrate into Europe, steps aimed at attracting foreign investments into Ukraine and making simpler the procedures regulating the movement of goods and capitals are a positive aspect, but such activities must be well thought out and gradual, especially in the banking sphere. As a blood circulatory system of the country's economy, the banking system should be protected from being taken over by foreign capital.

The changes going on in the development of the banking industry are caused, to a considerable degree, by structural transformations in the world economy, in particular, by large-scale processes of economic globalization and internationalization of economic activities. Financial globalization and the growing competition on the market of banking services have led to massive expansion of foreign banking capital to new markets, first of all, the markets of post-Soviet countries.

The penetration of foreign capital has been especially pronounced in the banking systems of central and eastern European countries in the second half of the 90ies and, as expected, this expansion will continue and intensify. For example, only in the Czech Republic the share of banking assets controlled by foreign capital increased from 4 per cent to 95 per cent in the period from 1993 to 2000. In 1993 the share of foreign banks in Hungary was 22 per cent. In 2000 they had already 71 per cent of total banking assets or even 78 per cent considering the volumes of inter-governmental crediting. In the same year branches of foreign banks had 63 per cent of all deposits.

Considering that Ukraine is seeking liberalization of access to its financial market, particularly in regard to allowing foreign banks to open their branches as a prerequisite to the country's future joining to the World Trade Organization, the experience of other countries with transitional economies and with a high concentration of foreign capital will be very useful for Ukraine to study and analyze, especially in the field of legal regulations for the access and activities of foreign banks.

**The goal** of this article is the analysis of experience of countries in eastern and central Europe in the area of liberalization of access for foreign capital to their banking sector. In particular, it analyses the experience of Poland and the problems which arise from attracting foreign capital to the banking sector of Ukraine. Studying the experience of other countries in the area of liberalization of access for foreign capital to their banking systems it is necessary to examine the legislation of eastern and central European countries that regulates foreign investments in the banking sphere.

First of all, we will see how to receive the permission to open a banking branch and obtain a license to carry out banking activities in these countries.

To receive the permission a foreign bank must follow these rules:

- ◆ The money given by parent banks to their branches should come from transparent sources. Moreover, foreign banks provide information about the size of capital given to their branches (Poland, Slovakia, and Czech Republic).
- ◆ Foreign banks should be reliable and financially stable taking into account the scale of activities of branches of foreign banks.
- ◆ Branches should be properly technically equipped for carrying out their activities and have an efficient system of management and control, including the system of risk management.
- ◆ Branches should have a plan of their activities based on real economic calculations (Estonia, Poland, Slovakia, Russia, Czech Republic, Slovenia – plans for three years).
- ◆ Relations of foreign banks with other banks and financial institutions should be transparent.
- ◆ Bank employees wishing to hold leading positions at branches should possess appropriate qualifications and experience (Bulgaria, Estonia, Poland, Slovakia, Czech Republic).

According to the banking legislation in Central and Eastern European countries, branches of foreign banks have the right to carry out the following operations on their territory:

- ◆ Deposit and credit activities.
- ◆ Financial leasing.
- ◆ Factoring operations (Slovenia).
- ◆ Money transfers.
- ◆ Issue of non-cash modes of payments (debit and credit cards, traveller's cheques, banknotes, etc).
- ◆ Granting of guarantees, issue of L/C, endorsement of L/C.
- ◆ Participation in transactions with instruments of money and stock markets on behalf of customers and on banks' own behalf.
- ◆ Issue of securities and provision of similar services.
- ◆ Collecting, analysis and delivery of information about the credit solvency of legal persons (Slovenia).
- ◆ Consulting services (consultations about investment activities, structure of capital, development strategies, services relating to mergers and acquisitions of companies, etc).
- ◆ Management services (securities portfolio management, etc).
- ◆ Depository services.
- ◆ Other activities relating to the above-mentioned operations.

The activity of branches of foreign banks is controlled and overseen both by the country of registration of parent banks and by the supervision authority of countries where branches are located to the extent stipulated by legislation. For example, the National Bank of the Czech Republic controls the state of liquidity of branches of foreign banks. If risks arising from the activities of branches on the financial market of the host country can occur, the National Bank of the Czech Republic has the right to require from foreign branches to provide it with the same information it receives from local commercial banks.

The participation of foreign banks in the national banking systems began to spread in the mid 90ies. Prior to that foreign economic liberalization was limited to international trade. But after

the agreements regarding the liberalization of financial services were reached with the World Trade Organization, most countries removed barriers for the activities of foreign banks. At first, foreign banks preferred to work only in international financial centers of the developed countries. But in the process of privatization of the banking sector foreign banks penetrated into developing countries. Foreign banks occupied the leading positions on the markets of Eastern Europe and Latin America. The expansion of foreign banks on the local markets was less pronounced in Asia and Africa.

In the beginning of 90ies the banking sector of Latin America was totally closed for foreigners. Banking systems consisted of numerous local banks. But after a number of financial crises in the middle of 90ies foreign banks were allowed to enter the internal markets in order to recapitalize their banking sector. Local financial systems needed consolidation and denationalization. The biggest acquisitions were made by foreign banks in 1995. Usually, foreign banks sought to purchase the controlling blocks of shares of local banks with developed retail network.

In the second half of 90ies the structure of ownership in the banking sector changed considerably (Figure 1). State and national capitals gave way to foreign capital. Considerable expansion of foreign banks was made in Chili, Columbia, Mexico and Peru. In countries with historical domination of state banks, such as Brazil, the intervention of foreign banks took place because of privatization. In Argentina and Venezuela foreign banks entered local markets owing to privatization and buying of shares from big private shareholders.

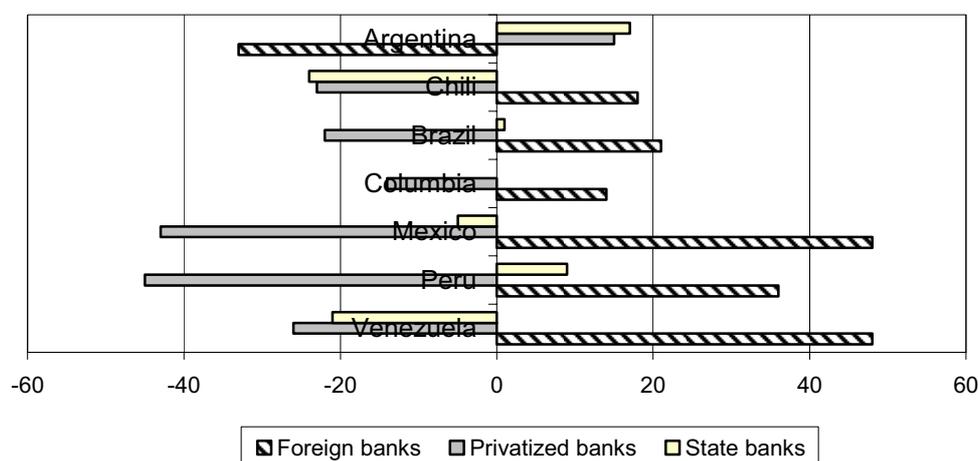


Fig. 1. Changes in the ownership structure of bank assets in the countries of Latin America (1995-2000)

Compared with other markets, foreign banks play insignificant role in the economies of South-East Asia. Due to political motives local authorities restrict the access of foreign banks to the markets of retail banking operations. International financial centers like Hong Kong and Singapore intentionally created hothouse conditions for local banks with an effort to make them strong competitors for foreign giant banks. In most Asian countries restrictions are still in place regarding the number of foreign banks and their branches. After the financial crisis in South-East Asia in 1997-1998 banking markets of many countries of the region were liberalized (except Malaysia). The conquering of Central and Eastern Europe by foreign banks is a good example of successful expansion.

Our neighbors, particularly Poland and Russia, have a long experience of working with foreign banks. In Russia in 2004 there were 129 banks and 1 non-bank credit organization with participation of nonresidents in their registered capitals. Beginning from 1999 the number of foreign credit organizations was reduced by 11 (8 per cent). Of all foreign banks 107 banks (87 per cent) are organized in the form of joint stock companies: 48 organizations (37 per cent) as closed joint stock companies and 23 organizations (18 per cent) as open joint stock companies. According

to the forecasts of Russian experts, in the near future the number of foreign banks in Russia will keep growing, probably reaching 150 in five year period.

The majority of credit organizations (63 per cent) carry out their activities on the basis of a general license. Almost one third of them have licenses to carry out transactions in roubles and foreign currency, 2 per cent have licenses to carry out transactions in roubles only. Almost all foreign banks (92 per cent) may receive deposits of physical persons.

If we look at foreign banks in Russia from regional aspect, most of them are concentrated in Moscow with 88 credit organizations registered there or 68 per cent of their total number. St.-Petersburg holds the second place (8 banks) with Tumen region following with 4 banks. 94 per cent of the capital of foreign banks is concentrated in Moscow. In 2004 the combined registered capital of all foreign credit organizations was 373,784 billion roubles. In Russia there were 14 branches of banks where the participation of foreign capital was 100 per cent. In the second quarter of 2004 the number of such branches was reduced by one because of the closure of the KMB Bank in Moscow.

During the financial crisis in 1998 foreign banks sustained heavy losses which resulted into reduction of their own resources. In 1999 the recapitalization of branches of foreign banks explained a sudden growth in participation of non-residents in the registered capital of the banking sector from 6,35 per cent in January to 12,58 per cent in July 1999. Later, the share of non-residents in the aggregate registered capital gradually stabilized to pre-crisis level of 5-6 per cent.

Table 1

## Participation of non-residents in the registered capital of banks in Russia

Share, per cent	Number of banks	Share in the general number of foreign banks, per cent	Investments of non-residents in the capital of banks, billion roubles	Share in the general amount of foreign investments
100	33	25,4	13,99	71,0
from 50 to 100	10	7,7	3,36	17,0
from 20 to 50	13	10,1	0,94	4,8
till 20	56	43,1	18,28	4,9

The majority of foreign investors into the banking sector are from western countries. According to the size of investments there are the following leaders:

- 1) Germany (MMB, Kommerzbank, Deutsche Bank, Dresdner Bank, Westdeutsche Landesbank);
- 2) Netherlands (ABN AMPO Bank, ING Bank, Financebank);
- 3) USA (Citybank, J.P. Morgan, Delta Credit);
- 4) France (Societe Generale, Calion Rusbank, BNP PARIBA, NATEXIS);
- 5) Austria (Raiffeisen Bank);
- 6) Turkey (Garanti Bank, Yapi Kredi Bank, Deniz Bank, Ziraat Bank).

The leading role of the German capital in the Russian banking system (nearly quarter of all foreign investments) shows that Germany is the leading foreign trade partner of Russia. The participation of CIS countries in the Russian banking system is rather limited. CIS countries are represented by several banks: National Bank of Uzbekistan, International Bank of Azerbaijan and Anelik Bank (Armenia). Insignificant participation of CIS countries is explained by the weakness of their banks, low level of their capitalization and the size of assets.

Studying the penetration of foreign capital into the banking systems of other countries it is important to examine the experience of Poland. According to its economic parameters Poland is close to Ukraine. Both countries have good economic relations. Besides, Polish banking system

has long been working with branches of foreign banks. So, we can study both positive and negative aspects of foreign branches in historical perspective.

Let's see what happened in the Polish banking system when the expansion of foreign capital began:

- ◆ Dynamic development of foreign banks in Poland, which begin to force Polish banks from the most lucrative fields of operations. By June 1996 the share of their capital in the aggregate capital of Polish banks reached 27,62 per cent.
- ◆ In 1998 the banking system was adjusted to the demands of the European Union, when the market of financial services was fully opened.

In 1995 total assets of banks with foreign capital increased by 80 per cent, while for Polish banks – only by 35,6 per cent. The characteristic feature of foreign banks is a higher share of credits in the structure of assets as compared with Polish banks. But the share of securities at foreign banks is 21,1 per cent, while at Polish banks it is 32,2 per cent. These data show that foreign banks have no problems in attracting customers. Foreign banks have considerable internal funds in the structure of their liabilities – 16,5 per cent (while Polish banks have only 8,4 per cent). The dynamics of gross internal funds at foreign banks was 230 per cent, with 127,7 per cent at Polish banks. The cost of gross internal funds at foreign banks is 965,9 million zloty, with 10954,8 million zloty at Polish banks.

The profitability of foreign banks was much higher than that of Polish banks. Gross profitability was 27 per cent, net profitability – 15,9 per cent. For Polish banks these figures were 19 and 11,1 per cent respectively.

In 1995 banks with foreign capital invested 490 million zloty into foreign banks and received 246,4 million zloty from these banks. This proves that foreign banks wish to invest their resources safely by moving their capital from Poland abroad rather than increasing the funding for the needs of the Polish economy.

The absence of exact data regarding the branches of foreign banks in Poland makes it impossible to fully analyze the phenomenon of internal internationalization of the Polish banking system. We have the data only about the number of foreign banks operation in Poland as well as their share in the assets of the Polish banking system in general (Table 2).

Table 2

## Foreign capital in the Polish banking system

Internationalization of the Polish banking system from 1994 till September 2003	Banks with domination of foreign capital	Share of assets of banks with domination of foreign capital in general assets (per cent)
1994	11	3,2
1995	18	4,2
1996	25	13
1997	29	15,3
1998	31	16,6
1999	39	47,2
2000	47	69,6
2001	48	69,2
2002	45	67,4
2003 IX	45	67

Table 2 shows that the peak of foreign capital expansion took place in 1999-2000. In that period 16 banks with domination of foreign capital were established. The general share of organizations with domination of foreign capital in the assets of the Polish banking system grew by more

than 50 per cent. In the following years the process of internationalization slowed down considerably. In spring 2003 foreign capital controlled 45 out of 57 commercial banks. The share of assets that they accumulated in the assets of the banking system reached 67 per cent. It should be noted that this level is very high. Among European countries only Luxemburg has a higher (almost 100 per cent) share of assets belonging to branches of foreign banks in the assets of the national banking system.

Investments of multinational banks into the Polish banking system took different forms. In 1990-1992 it was mainly the establishment of joint-stock companies with domination of foreign investors while few branches of foreign banks were opened in this period. In 1993-1994 the process of establishment of banks with foreign capital and its penetration into banks was deliberately slowed in order to preserve the competitiveness of Polish institutions. However, in 1995-1998 foreign investors took the initiative into their own hands by establishing 10 new banks and penetrating into several banks which needed replenishment of their capital. Since 1999, according to the commitments assumed by Poland in entering OECD, formal restrictions regarding the possibilities of establishing branches by foreign banks were abolished. That resulted in the above-mentioned processes of internationalization.

The process of penetration of foreign capital into the Polish banking system is made easier because of considerable possibilities for foreign banks to carry out their activities. In competing with Polish banks they can use:

- ◆ small capital of Polish banks;
- ◆ “niches” which exist due to weak offensive character of Polish banks;
- ◆ lower costs, more modern products, better knowledge of the world economy by foreign banks.

Foreign banks consider Poland to be “a sleeping banking system”, not ready for competition (A. Anderson).

All Ukrainian banks have a total capital in the amount of one billion 430 million dollars. In essence, this is the capital of two Polish banks. Ten Polish banks amount to one German bank. Three German banks amount to one American bank. The repetition of the Polish experience in Ukraine is more than likely, it is a certainty.

On the other hand, Ukrainian banks can be transformed into branches of foreign banks. This could result in the outflow of profits to parent banks, reduction in earnings from taxes (transfer of the most lucrative operations abroad), suspension of credits to the branches of economy which might pose a threat to shareholders of parent banks.

These are really serious problems. The question arises if certain restrictions for some foreign banks in the national banking system should be introduced (as in Spain and Switzerland) or non-interference is a better option. All restrictions could be only transitory and have sense when, at the same time, a considerable transformation of the banking system takes place.

However, in assessments of the presence of foreign banks in Ukrainian banking system little is said about the positive aspects of this phenomenon, paying all attention to Ukrainian banks losing the competition. They are considered to be too weak to compete with modern foreign banks. This approach does not only help make concrete decisions, but convinces foreign banks that Ukraine has the so called “sleeping banking system”, which is absolutely inadequate for competition with foreign banks. It is necessary, first of all, to change the conscience in Ukraine so that national banks believed that they could compete with foreign banks if they began to think strategically and formed long-term strategies of their development. These strategies should include solutions of those problems, which stand behind the weaknesses of our banks, as well as ways that lead to strengthening of their competitiveness. Such strategies would bring our banking system closer to the banking systems of the EU states. The realization of differences should not paralyze us, but push into action. Only then Ukrainian banks could openly compete with the growing number of foreign banks on our market. The stimulation of competition of Ukrainian banking system is very

important, because without such competition Ukrainian banks would have no chances against banks of other countries.

The choice of a certain strategy for national banks is very important if we really wish to rebuild our banking system. Only the movement in the right direction would allow us to transform our banking system and solve many of its other problems. For Ukraine, in order to become a member of the European Union, it is vital to use such strategy for its national banks that will unite the strategies of inheritance, transformation and competition. Only the decisions based on these three strategies will be conducive to the establishment of a properly functioning banking system. Ukrainian banks should remember that the experience of EU states can not provide them with a ready-made solution, because a banking system of every country should be adapted not only to European requirements, but also to the needs of the economy where it functions. Thus, changes in the banking sector should be carried out considering the changes in the whole economy, especially if it is in the process of transformation. Taking into account norms and regulations of both the European Union and of our country, it is necessary to define our attitude towards foreign banks operating on the Ukrainian market and to raise the competitiveness of Ukrainian banks. Without the help of foreign investors it would be impossible to overcome the biggest drawback of our banking system – the shortage of capitals. In other words, there is no sense to close our banking system to foreign capital. It is important to create such conditions which would help Ukrainian banks survive the increased competition on financial markets.

The law about the National Bank of Poland and the banking law do not contain any norms restricting the expansion of foreign capital in the banking sector. The Polish banking system is gradually pushed to the periphery (local economic niches) of the credit market. This is the consequence of the following factors:

- ◆ Very rapid growth of the share of foreign capital in the banking system. As of 31 January 1999 it was 70,1 per cent of total banking capital;
- ◆ The National Bank of Poland provided licenses to more than twenty foreign banks, in many cases for a small payment of several million US dollars;
- ◆ Constant speeding-up of the process of privatization, although Polish investors do not possess sufficient resources.

Foreign banks win the competition for the most profitable customers, exporters and foreign companies. At the same time many qualified Polish bank employees go to work to these banks as they are offered bigger salaries.

Further development of foreign banks in Poland will proceed in the following way:

- ◆ Expansion and development of the banking system;
- ◆ Further privatization of the existing Polish banks;
- ◆ Concentrating banks' activities on serving customers characterized as legal institutions.

The goal of foreign banks in Poland is to increase their assets and expand their activities to new territories, mostly neighboring countries. It is also worth considering that in several years foreign capital will conquer the Polish banking system unless the authorities begin to counteract.

The development strategy of the Polish banking system is based on the following preconditions:

- ◆ Polish banking sector should strengthen its positions by improving its efficiency.
- ◆ All state banks will be privatized with an exception of BGK, which must fulfill the functions of a state agent.
- ◆ During privatization the important factors will be prices and obligations, which guarantee the development of banks. Macroeconomic and political criteria will not be considered.
- ◆ Globalization of financial markets justifies giving up the Polish banking system.

- ◆ A strategic investor is required for proper privatization. This means, first of all, foreign investors.
- ◆ The notion of “national interests” is nonexistent in the European Union. There are no means to protect it.

It is important to dispel the myths which define the development strategy of the Polish banking system. First of all, Polish banks have made a great step forward in the field of technologies. In ten years they have managed to accomplish what foreign banks achieved in several decades. The next five years could be even the chances in this branch. Secondly, there is not much development in technologies and automatization at Polish banks (such as WBK) which have been taken over by foreign capital. Thirdly, the acquisition of Polish banks by foreign capital is not only the change of ownership of capital, but also the change of bank’s policies. From now on these Polish banks begin to work in the interests of parent banks abroad. In the fourth place, the dependence of subsidiary banks from parent banks is the same as the dependence of branches of foreign banks from their parent foreign banks. In the fifth place, privatization of banks will not be carried out in the nearest two years. (State banks operate in all countries of the European Union).

Arguments in favor of the positive role of foreign capital as a participant of privatization process in Poland cause serious doubts. Some experts give the following arguments: owners’ control, bigger capital, better knowledge, budget revenues.

According to many economists, owners’ control is a notion borrowed from the past era. Today, bank’s management proceeds from the prices of bank’s shares on the stock-market and profits (more than 50 per cent) from the results of the current year and the following years.

In Western countries research results confirmed the fact that with the growth of the market character in bank’s strategy more attention is given to the increase in the value of shares for shareholders and to the growing influence of the share market on the efficiency of banks and general assessment of results.

The increase of capital is not considered as the prime objective. More important is the growth in bank’s profitability. The increase in capital is inevitable for banks that strive to become global players. But regional banks that specialize in certain branches or services are not so dependant on capital as big banks.

The advantage from banks’ mergers is not self-evident. The experience of the global banking system shows that banks’ profitability is much more important than their size (“growth from the growth itself”) that earlier was believed to be a priority.

Under these conditions the argument about the necessity to radically limit the number of banks in Ukraine is not very appropriate, because in the future the need in specialized financial institutions, which operate on the local market and make it elastic and close to customers, will remain. In contrast to Ukrainian banks, the level of knowledge and skills at Polish banks is high enough. The further progress depends on quick implementation of this knowledge. At the same time we should remember that the revolution in the area of information sciences and telecommunication is a reason why the knowledge and expertise of Western banks begin to lose their edge.

And there remains the last argument. It is important to sell banks quickly, because banks sustain losses. This means to sell banks to foreign investors as only foreign investors possess the necessary resources.

In the new situation the following aspects are doubtful:

- ◆ previous instruments of central banks (capital and liquidity of foreign banks will depend on parent banks) as well as the sphere of banking control;
- ◆ opportunity to find creditors to finance the restructuring of our economy in accordance with the needs of our country;
- ◆ ability to counteract the investment of capital accumulated by foreign banks in Ukraine into other economic territories.

There are a lot of questions such as the following: would Ukraine reap any benefits from privatization with the help of foreign capital, would the competition contribute to the whole banking system, and would the sale of prospering banks lead to further growth of their capitals, number of branches and range of services.

Speaking in terms of prospects for the development of Ukraine's banking system foreigners will express considerable interest towards our country and its banking sector if the present rates of economic growth are preserved in spite of all legal and other barriers. As soon as several foreign "players" come to our market a new wave of mergers and acquisitions of our banks will begin. Their number will be greatly reduced. Some foreign experts closely watching Ukraine's financial sector believe that banks with the capital less than 50 million US dollars do not have any chances on the market. Ukrainian banks can dream about foreign investors only after 5-10 years of stable functioning, when they begin to occupy a considerable segment of the market in their regions and have positive results of working in other fields.

The sovereignty and economic stability of a country can be under threat in a situation, when some vital financial decisions will be made in foreign centers. National banks build a barrier that prevents the outflow of financial resources in case of turmoil in the international banking sector. Foreign capital can be evacuated from a country within 24 hours. Then only national banks remain.

This argument is represented by M. Stanchuk (Vice-president of Westdeutsche Landesbank). "I do not know of a case when, for example, the majority of local savings banks belonged to foreign capital. I think that it is a problem to preserve the national character of certain banking sectors during unfavorable economic conditions in our part of Europe. An economic crisis in one country can cause domino reaction for other states of the region. For example, the reduction in refinancing limits of Polish subsidiaries of foreign companies or the impact of global positions of parent companies on credit policies of Polish enterprises (bad credits and high reserves in South-East Asia can effect the rise of credit criteria on other markets (even in Eastern Europe, where the impact of events in Asia is very limited). The limited liquidity of the Polish national money market and the traditional Polish thrift can result in deterioration of liquidity of financial institutions connected to foreign financial groups and limit their expansion".

Banks, which are set up on foreign markets, aim to help import the goods from countries of their parent banks to their countries. Thus, they will not finance national competitive industries.

The banking system of Ukraine is fully open to foreign capital. The legislation allows to establish banks with 100 per cent of foreign capital, but with the necessary condition – these are to be subsidiary banks operating in the legal field of Ukraine.

Table 4

## The ratio of foreign and national capital in the banking system of Ukraine

Parameters	2000	2001	2002	2003	2004
Number of banks (end of the year)	195	189	182	179	182
Including banks registered during the year	1	3	5	5	7
Number of banks with the license of the National Bank of Ukraine that allows them to carry out banking operations (end of the year) and banks that provide reports (from the total number)	154	153	157	157	160
Banks according to their organizational and legal form:					
- joint-stock companies:	137	136	136	133	132
Open	99	95	94	94	92
including those owned by the state	2	2	2	2	2
Closed	38	41	42	39	40
- limited liability companies	17	17	20	24	28
- cooperative	-	-	1	-	-

Table 4 (continuous)

Parameters	2000	2001	2002	2003	2004
Banks with foreign capital:					
- number of banks	31	21	20	19	19
including banks with 100 per cent of foreign capital	7	6	7	7	7
- authorized capital, million Hryvnas	725	946	1046	1152	1630
including banks with 100 per cent of foreign capital, million Hryvnas	225	265	365	414	689
number of banks, which have a license of the National Bank of Ukraine to carry out currency transactions (end of the year)	149	149	153	156	158
other financial institutions with the license to carry out banking operations	1	1	1	1	1
authorized capital of subsidiary banks, million Hryvnas	3666	4576	6003	8116	11605
number of banks entered into the state register	9	9	12	8	4

As we see from Table 3, as of 1 January 2005, there were 19 banks with foreign capital, including 7 banks with 100 per cent of foreign capital registered in Ukraine. Within 2000-2004 the number of banks with foreign capital was reduced from 31 to 19. Regarding the banks, which fully belong to foreign investors, their number remained the same. The total amount of foreign investments into the banking sphere of Ukraine has grown two times. This explains the growth in the capital of banks controlled by foreigners and the increase of their share in the authorized capital of banks.

Considering Ukraine's request to enter the World Trade Organization, the latter has put forward a number of requirements that include the permission for foreign banks to set up their branches in Ukraine. This is a logical step on the part of the WTO, because with Ukraine's entry into this organization, the country will be flooded with big transnational corporations, which have their own banks. Ukrainian banks would not be able to ensure the activity of such corporations.

To satisfy this demand, the National Bank of Ukraine submitted a bill number 7274 to the Supreme Council of Ukraine. The bill offers changes to the Law of Ukraine "On banks and banking activity" in its part regarding the rights of foreign banks to open their branches in Ukraine.

If the bill is approved, branches of foreign banks will appear in the financial and economic field of Ukraine in the near future. These banks will not be independent legal persons, but branches of parent banks located abroad, their activity regulated by foreign legislation. In our opinion, this would disrupt the financial system, which was created during the years of Ukraine's independence and which insured economic security of the state's development. The bill number 7274 was accepted in its first reading, but in the second reading it was rejected by parliamentarians, who indicated that Ukraine was not ready for this step yet.

The main criticism regarding the bill:

#### ***I. Threat to economic sovereignty of the country.***

The bill, which gives foreign banks the right to open their branches in Ukraine, does not stipulate any restrictions concerning the presence of foreign capital in the national banking system.

In accordance with its functions, the banking system, through redistribution of financial functions, determines the development of the country's economy in general. This function is especially important in connection with a low level of development of the financial market's other segments. Thus, the preservation of the national banking system becomes the issue of the country's national security.

The experience of many countries with "transitional economies", in which an emphasis was laid on foreign investments, shows that the banking systems of these countries totally consist of big international banks (South America and Central and Eastern Europe). Under these condi-

tions banks with foreign capital begin to influence the character and economic priorities of these countries' economic development, control the most efficient spheres of activities.

These banks have specific strategic priorities that practically never coincide with national interests. Moreover, the decisions regarding the granting of credits can be made in favor of international customers or shareholders of parent banks, which in many cases means that national competitive companies would be left without funding. This results in the disruption of national economic interests, hampering the development of national businesses, first of all, small and medium businesses. The consequences include the growth of unemployment and other social problems as witnessed in Poland and other countries of Eastern Europe. To save Ukraine's economic independence it would be expedient to introduce the systems of state regulation of foreign capital.

### ***II. Unequal conditions for competition with Ukrainian banks.***

Foreign investments into the banking system are important from the viewpoint of inflow of additional financial resources, new banking technologies, support of competition between banks, etc.

At the same time, all this is justified when there is an already established banking system with its own resource base. But the monetary level in Ukraine (near 30 per cent of GDP) is considerably lower than in countries with developed economies where this figure approaches the size of GDP or even exceeds it. The size of the GDP itself is much lower. If the future activity of foreign branches in Ukraine is regulated according to the size of capital of their parent banks, this would put foreign banking institutions in a more favorable position as Ukrainian banks would not be able to compete with them. The assets and capital of all banking system of Ukraine are smaller than assets and capital of a middle European bank. Under these conditions the principle of "equal opportunities in competition" would not be realized.

### ***III. Outflow of capital from Ukraine.***

Branches, as structural divisions of foreign banks, are not involved in the formation of capital. This means that profits received by these branches from their activities in Ukraine will be fully transferred to foreign banks. Profits of Ukrainian banks (including those with foreign capital) stay mostly in Ukraine and are used for banks' capitalization.

***IV. Increase in risks for customers*** – residents of Ukraine – in connection with unregulated procedures of accreditation and financing of foreign banks' branches. The proposed bill gives foreign banks the right to establish their branches in Ukraine. At the same time it does not define the key mechanisms for the functioning of foreign banks' branches, in particular, opening of branches, supervision and regulation of their activity, application of liquidation procedures in case of need.

#### ***1. Capital***

The legislation determines the requirements regarding the size of authorized capital for banks registered in Ukraine. The bill introduces a special category of registered capital for branches of foreign banks, the status of which is not fully determined. It does not stipulate the order of use and return of the registered capital in case of branch's liquidation. According to the specifics of non-cash transactions, one way or another, the funds will remain on the account in one of foreign banks, which would make the control of the National Bank of Ukraine over these funds more difficult. Besides, the bill does not explain for whom this account will be opened: for foreign (parent) bank or its branch. It would be practically impossible to trace these funds on the account of the parent bank. In this situation the risks for creditors of branches of foreign banks (their customers and depositors) increase tremendously.

#### ***2. Procedures for the opening, regulation and liquidation of branches.***

The law "On banks and banking activity" regulates the main issues for the opening, receiving of licenses, operation and liquidation procedures for banks, which are legal persons.

Regarding the branches of foreign banks, the bill stipulates that the order of accreditation, concession of banking licenses, peculiarities of banking transactions, issues of regulation and con-

trol, procedures for liquidation of branches of foreign banks are determined by this law and legal acts of the National Bank of Ukraine.

In fact, neither this law nor the bill 7274 determine the procedures for the granting of banking licenses, regulation of activity and liquidation of branches of foreign banks. The issues of control over realization of the necessary norms for separate branches are not regulated. According to the existing procedures, the majority of norms (adequacy of capital, credit risks, investment activity, etc) are calculated relative to the regulative capital of banks as legal persons. Issues, which relate to the procedures to be used in case when branches of foreign banks violate the banking legislation or conduct activities fraught with risks, are also not regulated. According to the Ukrainian legislation, in such cases, sanctions are applied to parent banks. If the activity of a parent bank is regulated by foreign legislation while its branch must operate in Ukraine and comply with Ukrainian laws, the law should determine possible sanctions of the National Bank of Ukraine and ways they can be applied to branches of foreign banks. The law also does not provide mechanisms for the monitoring of parent banks' financial state by the National Bank of Ukraine. In our opinion, this monitoring should be realized by way of providing the National Bank of Ukraine with regular information about the activity of foreign banks by the supervision authorities in countries of parent banks. Especially important are the procedures of branches' liquidation. We think that this issue should be legally regulated. Customers of branches of foreign banks in Ukraine must realize how the procedure of liquidation will be carried out: based on the decision of parent banks, the National Bank of Ukraine or the demand of creditors. Who will be in charge of liquidation procedures? Though the bill has suggested that foreign banks should provide written obligations attesting that they would fulfill all their commitments resulting from activities in Ukraine, neither the form of such obligations nor the mechanism of their realization in regard to the legislation of foreign countries remain unclear.

#### ***V. Uncertain mechanisms for realization of certain provisions of the bill***

Uncertain remain the mechanisms for realization of some other provisions. For example, it is unclear who (which authority) would confirm if banking supervision regulations in the country of a foreign bank correspond to the main principles of the Basel Committee on banking supervision. It is also unclear how the right of Ukrainian banks to open their branches in other countries would be realized.

It should be emphasized that the bill 7274 in its present reading would be a step in handing our banking system into foreign hands, as all changes to the law "On banks and banking activity" are limited to the definition of a foreign bank, its branches and to some requirements to countries where parent banks are registered.

As an alternative, the bill could include the norms relating to:

- ◆ Limitation of the size of foreign capital (including the registered capital of branches of foreign banks) in the banking system of Ukraine to 25 per cent of its total amount.
- ◆ Enactment of the article 24 (about branches of foreign banks) within 6 months of Ukraine receiving the sovereign "A" rating.

The last proposal does not contradict the norms of the international law. On the contrary, from the point of view of international law it is absolutely lawful as Paragraph 2 of the General Agreement on trade in services of the WTO in regard to financial services stipulates some measures, "which are dictated by considerations of prudence" and which are necessary in order to "ensure the integrity and stability of financial system". The proposed measures are from this category. The alternative behavior of Ukraine would allow to stop the pressure of the USA, the European Union and others, because Ukrainian legislation would contain the right for foreign banks to establish their branches in Ukraine.

The best solution for solving this problem would be the passing of new laws and changing some existing ones. Our observations show the complexity of the problem of foreign capital's access to the banking sphere of Ukraine. The changes should affect not only the law "On banks and

banking activity”, but also other laws, such as the law “On the National Bank of Ukraine”, “On taxation of enterprises”, etc.

The haste in making such changes and insufficient coordination of bills could lead to the disappearance of Ukrainian banking system. Only banks will remain in Ukraine.

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