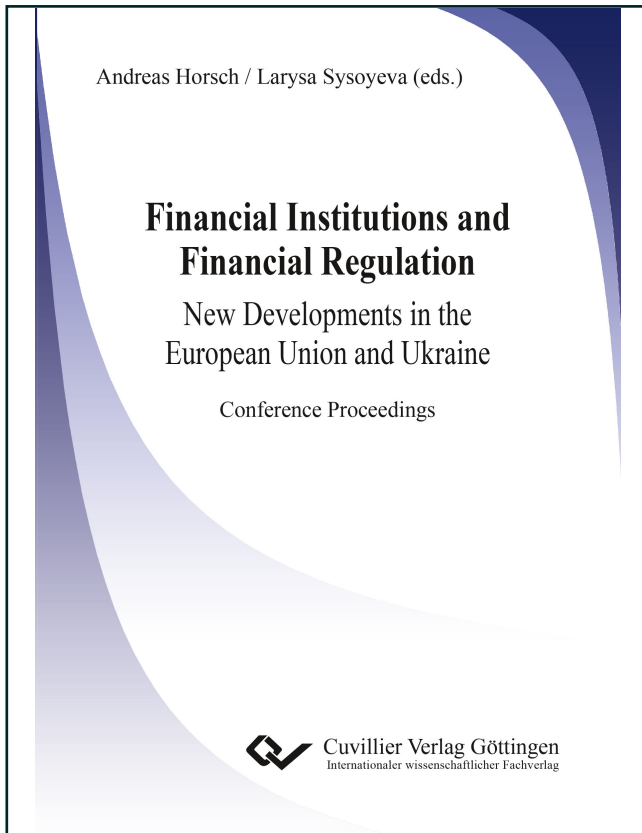




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**Financial Institutions and Financial Regulation – New
Developments in the European Union and Ukraine**
Conference Proceedings



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Editorial

On the Role of Banks and other Institutions of the Civil Society

Institutional change, however incremental, is ubiquitous. This general rule applies to financial systems in particular. While those of developed countries are still struggling with developments set in motion by the subprime and the financial crisis of 2007 – 2009, transition countries are pursuing reforms of their financial systems in order to support their national economy as well as their access to supranational institutions such as the European Union. By nature, these topics intrigue not only decision-makers in economic and political institutions, but also scientists.

Based hereupon, the former Ukrainian Academy of Banking of the National Bank of Ukraine hosted a conference on “International Competition in Banking: Theory in Practice”, in Sumy, Ukraine, in May 2014 (Ukrainian Academy of Banking of the National Bank of Ukraine 2014). At that time, just one of the papers was contributed by the Chair of Investment of Finance of Technische Universität Bergakademie Freiberg (Kleinow and Horsch 2014). However, it laid the foundation for a cooperation of the aforementioned scientific institutions that has thrived and prospered since then. Since then, several researchers of the Banking Academy – which was merged into Sumy State University throughout 2016 – have come to Freiberg as visiting researchers. The most important milestone of the collaboration, however, has been the successful joint application of Freiberg and Sumy for a grant of the German Academic Exchange Service (DAAD – Deutscher Akademischer Austauschdienst) within the DAAD’s program on Supporting Democracy in Ukraine (Ost-West Dialog: Unterstützung der Demokratie in der Ukraine, Förderlinie 2). The grant for the project on the role of banks and other institutions of the civil society (DAAD-Projektnr. 57243548) in particular made it possible to host two conferences. The first one took place in Freiberg, Germany, in April 2016, and was dedicated to “(Supra-)National institutions of financial regulation” (see the brief report of Sysoyeva and Horsch 2016). The second conference, covering “Institutional changes in the Ukrainian and EU banking systems” was held in Sumy, Ukraine, in October 2016. Both events lasted several days and included classic paper sessions as well as seminar-like sections, which were tailor-made for the students who participated in the conferences.

This compilation contains a selection of papers that have been presented at the aforementioned conferences or have been inspired by them. The project layout allowed for only a



basic review process, so that the articles are not perfect, but work in progress. Due to the nature of the DAAD-project, the majority of papers were contributed by members of the economic faculties of the universities of Freiberg and Sumy. However, the list of contributors also shows the involvement of further partners, both from science and practice, both national and international, whose participation was particularly welcome, as it added valuable insights.

We are grateful to the DAAD for supporting our cooperation and to everyone who contributed to the project in general and the conferences in particular, whether by presenting a paper, contributing to this compilation, or in another way. Special thanks go to Dr. Yaroslav Mozghovyi of Sumy and Dr. Jacob Kleinow of Freiberg, who started everything by exchanging ideas on systemically important financial institutions in early 2014. Moreover, we thank any member of the teams of the Chair of Finance, Banking and Insurance of Sumy State University and of the Chair of Investment and Finance of Technische Universität Bergakademie Freiberg for their commitment, friendliness, and hospitality, which made the events work and any guest feel absolutely welcome. Representing Sumy, our special thanks go to Professor Tetiana Vasilyeva and Professor Serhiy Leonov of Sumy State University, and the DAAD's regional representative, Carsten Grünwaldt.

In particular, we thank Mrs. Dipl.-Kffr. Sylvia Richter of the Chair of Investment and Finance of Technische Universität Bergakademie Freiberg, who became chief organizer and moving spirit of the project. With regard to her exceptional commitment and input, we dedicate this compilation to her and her – recently enlarged – family.

Freiberg / Greifswald / Sumy, January 2017,
Andreas Horsch and Larysa Sysoyeva

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Transparency of the Ownership and Corporate Structures of Banks in Ukraine

Sergii Bogma

Abstract

During the period of Ukraine's independence, improvements in the transparency of both ownership structures and corporate structures have been evident in the banking system. In this study, banking industry regulations and the current state of banking transparency in Ukraine are analyzed. The most significant changes occurred in the last 5 years, when regulatory requirements on information disclosure with respect to banks' activities and ownership were strengthened, and many banks were eliminated from the market.

Keywords: ownership structure of banks, regulatory requirements, banking system, corporate structure.

JEL Classification: E58, G21, G28.

Introduction

Transparent banking activity, ownership structure and corporate structure are the main pillars on which efficient, modern banking operations are based. Since the global financial crisis of 2007-2008, great emphasis has been placed on improving transparency in banking industries around the world. Meanwhile, the Ukrainian experience shows that the absence of transparent banking systems has worsened the financial crisis, and led to negative tendencies in the greater economy. This study provides analysis of changes in the transparency of bank ownership and corporate structures in Ukraine since the financial crisis, describing the current situation and chronicling regulations adopted by Ukrainian regulatory authorities in this period.

Literature review

In recent years, the number of studies devoted to the research of bank transparency issues has increased enormously. The topic of a transparent banking system is a burning issue today, and especially for developing / emerging countries like Ukraine. Thus, recent studies have tended to concentrate on the connection between bank transparency, the main banking characteristics and the characteristics of the market, such as market discipline, etc. Transparency is considered to be an important component of any monitoring process,



as it assists encouraging market discipline in a country's banking sector (Adeyemi 2011). Furthermore, the impacts of regulatory pressure and market discipline on capital adequacy ratios are investigated in several empirical studies, including Ashcraft (2001), Flannery and Rangan (2002), Barrios and Blanco (2003), and Nier and Baumann (2006).

Therefore, many papers are available that present their authors' investigations of bank ownership and its connection with e.g. macro indicators in different countries (Dages et al. 2000; Claessens and van Horen 2013; Cetorelli and Goldberg 2011); with bank behavior (Allen et al. 2011); with competition and efficiency (Detragiache and Gupta 2006; Hasan and Xie 2012); and with foreign shocks (Peek and Rosengren 2000), etc.

As for Ukrainian practice, many studies have been performed by rating and other agencies such as Standard & Poor's et al., USAID, UCRA et al. that investigate the transparency of Ukrainian banks from the mid-2000s onwards. Their research presents analysis of different spheres of Ukrainian banks' activity, disclosure of information about real owners and corporate structure in different sectors.

In addition, ongoing processes of legislative change can be observed in the sphere of banking transparency regulation and corporate structure for Ukrainian banks. After the world financial crisis of 2008 and, in particular, after the banking crisis in Ukraine, the National Bank of Ukraine (NBU) strengthened its requirements for banks with respect to information disclosure. The NBU stated that any... "bank with unknown shareholders is a 'black box'. It is impossible to do the job in an effective manner and build a stable banking system without having information about banks' ultimate beneficial owners". As a result, some banks were removed from the market by the NBU, while other banks fulfilled the requirements of the central bank of Ukraine either partially or in full.

Preface

Before proceeding directly to the analysis of Ukraine, best practice in the disclosure of information about real owners of entities in banking systems around the world should be considered. In its research, the Centre for Business Research at Cambridge University (1995-2005) provides the following results:

- Globally, developed countries are the leaders in the depth of information disclosure in banking – the level of transparency in their markets is close to the maximum, and has hardly changed in recent years;
- Developing countries are actively increasing transparency requirements, and are approaching the levels of developed countries;



- There is a convergence of rules of disclosure of information with respect to ownership structure;
- As a rule, the threshold requirement for an owner to be disclosed is the possession of not less than 5 percent of a bank's share capital;
- The minimum threshold tends to be at a level of 3 percent of share capital;
- Obligations to disclose information are closely connected with the protection of the rights of minority shareholders and ownership structure diversification.

Transparency of Bank Ownership in Ukraine and its Regulation

In 1991, when Ukraine became an independent country, its banking system embarked on a new course of development. Along with the necessity of building up an independent, efficient and sound banking system, there was a need to ensure transparent banking activities and ownership structures. Up to the mid-2000s, there were many attempts to increase the transparency of banking ownership structures and corporate structures. However, a large proportion of Ukrainian banks remained non-transparent.

It should be noted that the Ukrainian banking system developed under a model that implied that the main shareholders of Ukraine's banks were to be the owners of industrial enterprises. As a result, a huge amount of loans were provided by banks to their related parties. Of course, this regularly led to low-quality credit policies and, in the long run, to the worsening of the resilience of single banks, banking system soundness and even the bankruptcy of many banks during the recent crisis.

In the mid-2000s, Ukraine established a program of active cooperation with the IMF in the sphere of economic development. At this time, the Memorandum on Economic and Financial Cooperation was signed, and one of its conditions was the disclosure of information about the owners of domestic banks. In fulfilling these requirements, the National Bank of Ukraine and Ukraine's Cabinet of Ministries undertook the amendment of banking legislation, and obliged banks to disclose their ownership structures.

Subsequently, however, only foreign banks in Ukraine disclosed their ownership structure (due to Basel II regulations). Meanwhile, and starting from 2007, the NBU began to publish information quarterly about the major owners of domestic banks (those holding more than 10 percent of each banks' share capital). However, the banks did not disclose their end beneficiaries, and only named formal shareholders. At the same time, a new bill was introduced by the Ukrainian parliament in 2007 concerning amendments to legislation for the regulation of banking activity. It provided the requirements for the disclosure of real bank owners to fulfill Ukraine's obligations in joining the group of countries that



applied international standards of prudential banking regulation and cooperated with the Basel Committee on Banking Supervision. By 2011, however, these amendments had not been adopted. To secure receipt of the next tranche of loan payments from the IMF, the Ukrainian Parliament agreed to adopt new rules for the disclosure of information about real bank owners. The main changes in the new legislation were that:

- Each bank should disclose any person who is an indirect owner of the bank. Furthermore, such owners should provide all necessary information concerning their financial performance, status, availability of funds, etc.;
- A new form should be devised with which banks could provide more detailed information about their ownership structure and their ultimate owners;
- Each person (or group of persons) who directly or indirectly crosses the thresholds of holding 10, 25, 50 or 75 percent of a bank should inform the NBU within three weeks;
- All changes in a bank's ownership structure should be fully represented and be brought up to date.

Although the NBU had adopted the necessary requirements for banks, the process of ownership disclosure by banks themselves was not so effective. Although banks did try to disclose the identities of their owners, these were not always the end beneficiaries, and two thirds of banks in Ukraine remained non-transparent. In an attempt to force the disclosure process, the NBU took different actions to punish banks that did not fulfill their obligations. It was only at the end of 2014 that the NBU returned to the issue of non-transparent bank ownership in the banking system. In spring of 2015, new banking legislation was adopted, which aimed at increasing the level of transparency of bank ownership structures, and at increasing the responsibilities of related parties. In this case, the NBU used the new law to oblige banks to provide truthful information about end owners and their related parties.

Furthermore, the NBU defined the following types of non-transparent bank structures:

- “Football players” – A structure involving shareholders that own holdings of shares of less than 10 percent. The NBU considers this scheme a method of avoiding confirmation of the ownership of a significant stake;
- “Hugger-mugger” – A structure with tangled ownership relations, cross or cyclical ownership of bank shares or companies that own bank shares;
- “Trust” – Ownership structures that use trust declarations to avoid responsibility if the bank moves toward insolvency;



- “PoA is not okay” – Using the mechanism of warrants to either simplify confirmation procedures or to mask the real owner;
- “Cypriots” – Disclosure of ownership structure of individual non-residents (not always but most often from Cyprus), which in terms of the NBU are nominal holders of bank shares; and
- “Know nothing” – The situation that arises when a bank states with surprise that it doesn’t know who controls or owns it.

Furthermore, the NBU determined measures that will be taken with respect to non-transparent banks. These measures mostly refer to their possibility of non-transparent banks to engage in usual banking operations with clients and to obtain financial support from the central bank in case of financial problems. Thus, the measures are as following:

- Respective institutions will be classified as “problem banks”, which are considered to have problems with liquidity, capital, etc.;
- Restriction of financial support from the central bank – non-transparent banks cannot receive refinancing loans, or take part in tenders to support liquidity offered by the NBU;
- Restriction of some banking operations – banks cannot obtain a general license for foreign exchange transactions, meaning that they are unable to provide the full range of banking services for clients;
- Regulators will refuse to approve the new version of a bank’s charter (after new amendments to the registration and licensing procedures of banks in Ukraine);
- Increasing requirements for bank management. In this case managers of non-transparent banks will lose their reputation and in future their possibility to take positions in top management of other banks will be lower.

The measures taken did produce some results, and improved the transparency of ownership in the Ukrainian banking system. However, some banks were still violating the obligations with respect to the disclosure of information regarding ultimate beneficiaries. In response, the NBU took stronger measures, and eliminated such banks from the market. More detailed analysis of this will be provided in the next section.

Today, the NBU publishes complete information about the ownership of every bank currently operating in Ukraine. It also provides information about banks that have not completed the disclosure of their ultimate owners, and all of the work carried out with non-transparent banks.



The Current Situation in Ukraine

After the amendments to banking legislation in 2011, Ukraine's banks started to provide information about their ownership structures. However, not all of them disclosed their complete structures and identified all of the individuals that were ultimate beneficiaries of the banks' operations. Formally, the banks were fulfilling the obligations of the NBU, but the quality of the information provided was very low – resulting in the ownership structures of banks continuing to remain non-transparent throughout the banking system.

Taking this situation into account, new requirements were adopted for banks in 2015 that forced them to disclose their ultimate owners. At the end of 2015, the NBU published a list of 48 non-transparent banks, whose number had declined from some 67 banks in mid-2015. This list was not the last, having since been updated. It should be noted that these 48 banks made up only 7 percent of the market. Nevertheless, they increased risk for depositors and the Ukrainian banking system as a whole.

In February 2016, the NBU presented the new list of non-transparent banks, which contained 34 banks. At the same time, the regulator obliged these banks to disclose their ownership structure by April 1, 2016 – otherwise, they would face serious measures. Again, not all of the banks met the requirements – 7 made their ownership transparent, while a further 6 stated they would comply with the NBU directive, and were preparing necessary documents. Meanwhile, on the 9th of February, 2016, the first bank (PJSC – TK Credit) was assigned the status of an insolvent bank, as its ownership structure remained non-transparent.

Starting from the second quarter of 2016, the NBU began to punish non-transparent banks seriously by removing them from the market. The next banks after TK Credit were the PetrokommerzBank and Unison Bank, which had not met the obligations to provide information on their actual ownership. As a result, the former initiated liquidation procedures on April 21st, while on April 28th, the NBU embarked on a program of temporary administration for the latter. Along with removing so-called pocket banks and insolvent banks from the market due to issues with financial resources, huge liquidity gaps, violation of regulations and requirements, etc., the regulators continued to take measures regarding the violation of the disclosure of ownership structures. Consequently, on May 24th, 2016, a fourth bank – the Smart Bank – was removed from the market for refusing to disclose its true owners.

By June 2016, the head of the NBU announced that all banks with non-transparent ownership structures were to be removed from the market, and two more banks announced