

# The Great Account for Foreign Banks



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**G**lobalization processes in the world economy have begun to be relevant for Ukraine too, and the Ukrainian banking system will be the first one to be affected by the presence of foreign banking capital within the process of integration into the world banking system.

As far back as in 1994, Ukraine ratified the Ukraine–EU Partnership & Cooperation Agreement of 1994, and so undertook to provide subsidiaries and branches of EU companies established on its territory with the “national regime”. Namely, the mode of operation which is not less favorable for Ukrainian companies and branches.

## Equal opportunities

Since then officials of finance institutions, politicians and scientists have faced the issue of the expediency and consequences of admitting branches of foreign banks into the Ukrainian finance market. This is because branches of foreign banks usually stay within the legal environment of the jurisdiction of their parent bank. Branches of foreign banks will not be legal entities on the territory of Ukraine and, therefore, the control and regulating influence of the National Bank of Ukraine over them will become weaker. Consequently, it breaches one of the basic principles of the functioning of the banking system – the creation of equal competitive conditions for all financial institutions operating on the market.

The named problem can be solved in part by adapting Ukrainian legislation to EU legislation. It will help to make Ukrainian legislation comply with the legislation of the European Union (*acquis communautaire*), including the requirements made by the EU of those states intending to join the EU. Harmonization of applicable Ukrainian and European laws and regulations in the banking law sector will enable Ukraine to move closer to European standards and to become successfully integrated into the global processes of international finances. In the event of effective adaptation of applicable legislation, Ukrainian banks and branches of foreign banks will “play” by the same rules on the territory of Ukraine.

## Time to act

The term determined for the performance of the first stage of adaptation program (adaptation of applicable Ukrainian legislation to EU legislation) will expire this year.

At this stage, the banking law is considered as one of the priority areas and, therefore, the Verkhovna Rada of Ukraine (Parliament) by its *Act of Ukraine of 16 November 2006, No.358-V* adopted some changes to the *On Banks and Banking Activities Act of Ukraine*. The said Act determined the procedure for establishing branches and representative offices of foreign banks on the territory of Ukraine, thereby stopping discussions regarding the expediency



of admitting branches of foreign banks onto the Ukrainian financial market.

According to the above Act, foreign banks will be able to open their branches and representative office in Ukraine after Ukraine has joined the World Trade Organization.

The Ukrainian Banking Association pointed out that it is necessary to delay the start of operation of branches of foreign banks for at least five years from the date Ukraine joins the World Trade Organization, or for six months after Ukraine has obtained the sovereign rating of not less than the "A" index in accordance with the classification of one of the world-wide known rating agencies.

It would give the Ukrainian banks the opportunity to adjust to new op-

eration and business conditions and to compete with the foreign banks on an equal basis.

### **We choose another way**

It is significant that Ukraine has obtained already the experience of protection of local financial institutions through the perfection of applicable legislation. For instance, on 7 July 2005 the Verkhovna Rada of Ukraine passed *Act, No.2774-IV*, according to which non-resident insurers may establish branches in Ukraine. Final provisions of the said Act state that it will come into effect five years after Ukraine has joined the World Trade Organization.

Such actions taken by Ukraine would correspond to norms and

standards of international law. The Annex on Financial Services to the WTO General Agreement on Trade in Services provides for the possibility for member states to take actions which are dictated by "foresight considerations" or quite necessary to secure the integrity and stability of the national financial system.

However, in the case with the admission of branches of foreign banks to the national market, Ukrainian legislators have chosen their own way.

The creation of equal conditions for Ukrainian banks and branches of foreign banks may be ensured by the fact that according to applicable Ukrainian legislation banking supervision and control in the jurisdiction in which a foreign bank is registered has

to comply with the Core Principles for Effective Banking Supervision adopted by the Basel Committee on Banking Supervision.

Thus, the operations of branches of foreign banks located in Ukraine will be permitted only in the event that the supervision of central banking authorities of such a branch's country of origin is adequate. Such an approach is correct, since the more differences that exist between the national banking supervision system and the international norms and rules, the more numerous the risks that accompany the operation of branches of foreign banks.

And, in particular, this is a reason why, for the purposes of registration of a branch of a foreign bank in Ukraine, it is essential to conclude an agreement on joint activity in the area of banking supervision and harmonization of its principles and conditions between the National Bank of Ukraine and the banking supervisor authority of the country where a foreign parent bank is registered.

Moreover, Ukraine determined that the activity of a foreign bank's branch has to meet the requirements of the *On Banks and Banking Activities Act of Ukraine* as well as other regulatory legal acts of the National Bank of Ukraine. The National Bank of Ukraine regulates the activity and establishes economic standards for branches of foreign banks pursuant to applicable Ukrainian legislation.

### Ukraine is not Russia

The opponents of admission of branches subsidiaries and representative offices of foreign banks to the Ukrainian market consider it important to ensure the protection of interests of national banking institutions at the legislative level and refer to the experience of the Russian Federation.

Thus, the Government and the Central Bank of the Russian Federation worked out a strategy for the banking sector's development for the period until 2008. The strategy determines that establishment of branches of for-

foreign banks in the Russian Federation is untimely and premature, reasoning it by the necessity to maintain equal competitive terms and conditions for all credit institutions which render banking services.

When deciding the same issue, Ukraine selected a more liberal path: it does not prohibit or limit the participation of foreign banks in the national

## Major foreign banks have a range of essential advantages in comparison with Ukrainian ones

economy, but adopts such applicable legislation which would allow the creation of equal competitive conditions both for Ukrainian banks and the branches of foreign banks.

### Wind of change or a hostile storm?

What changes can we expect as a result of branches of foreign banks and representative offices coming to the Ukrainian market?

Since the activities of representative offices of foreign banks are limited by applicable legislation and, consequently, such offices may not carry out banking and financial transactions on the territory of Ukraine, let's pay more attention to the activities of branches of foreign banks.

Certainly, these banks will encourage an increase in the efficiency of the Ukrainian banking sector. They will also cause an increase in the sums of direct foreign investment coming into the country, implementation of innovative technologies in the banking sector, expansion of business competition and,

as a result, a reduction in costs and the availability of cheaper credit resources.

Major foreign banks have a range of essential advantages in comparison with Ukrainian ones. Such advantages will automatically be extended to their branches in Ukraine.

The following are such advantages:

- ▶ High level of trust of the bank's potential customers;
- ▶ Better conditions for professional advices of the most reputable and honored consulting firms;
- ▶ Great opportunities to attract "long" monetary funds for cheaper and to diversify revenue sources;
- ▶ Lower risk of insolvency and bankruptcy due to external factors;
- ▶ Possibility to pay for work of more qualified personnel.

This means that branches of major foreign banks from jurisdictions with a developed economy are based upon the resources of their parent banks in comparison to which the capitalization level of the Ukrainian banking sector is not high. That is why branches of foreign banks can significantly affect the nature and development priorities of the Ukrainian economy, and may control the most developed and profitable areas of activities.

It is worth noting that in developed countries like Germany, the USA, Switzerland and Japan, the quota of foreign banks (including branches of foreign banks) is insignificant and does not exceed 10%.

At the same time, in the financial systems of Botswana, Bahrein, Jordan, and Luxembourg, local banks are almost absent. This results in foreign control over the local banking sector.

Currently Ukraine has to solve a tricky task: how to retain the balance of market presence between foreign banks and their branches and Ukrainian banks in order to use all the advantages proposed by foreign banks. And, and at the same time to retain the possibility of manage the banking sector of the economy for the benefit of Ukraine and not to lose its economic sovereignty.

## Look at your neighbors

In order to have a better understanding of the Ukrainian banking sector's development prospects after the admission of branches of foreign banks to the market, we need to refer to the experience of countries which were once at the same starting point as Ukraine.

Poland provided equal conditions to both Polish banks and foreign banks to enter the national banking service market in 1999. By the end of 2003, 45 of 57 commercial banks operating in Poland were actually controlled by foreign capital, which owned about 60% of the fixed capital of the entire banking sector.

After Poland joined the European Union, the admission of branches of foreign banks into the Polish banking services market was simplified. Today, such a process includes just notifying registration with the relevant Polish banking supervisory authorities.

It is also important to note that the average capital value per official of the world banking system is about USD 250,000, and the average asset value is USD 5.5 million. In order to reach such figures, Poland has to reduce the number of officials by more than tenfold or increase its funds and improve asset acquisition procedures.

Following the foregoing, Polish experts believe the survival chances of banks with purely Polish capital to be very low.

The activity of branches of foreign banks in the Czech Republic is permitted by the *Banking Act*. Regardless of the fact that the quota of foreign bank branches is almost 30%, they perform a small number of operations on the retail service market and do not create any affiliated systems. At the same time, just a few major banks dominate the Czech banking sector.

In Lithuania banks began to open their branches in 1997. Although the role of branches of foreign banks is growing continuously, no such branch owns assets whose value exceeds EUR 100 million.

## Pros and cons

Today, the activity of branches of foreign banks in countries with a transitional economy, which is also applied to Ukraine, is directed mainly at providing services in the most developed sectors of the economy and concentrated in individual market niches.

It should be noted that banks from economically developed countries establish branches in those countries where the investment rating is at the A, 2A or 3A level.

Ukraine's low credit rating causes a high risk of financing, foreign banks have to reserve their assets in the amount of 100%

Unfortunately, Ukraine currently does not have such a high investment rating and, therefore, leading banks from the US, Western Europe, Japan and other economically developed countries will not place their assets in Ukraine in abundance. As Ukraine's low credit rating causes a high risk of financing, foreign banks have to reserve their assets in the amount of 100%.

Therefore, it can be concluded that the arrival of branches of foreign banks in Ukraine will mostly benefit Ukrainian banking services customers.

The branches of foreign banks will be able to provide their customers with lower interest rates on loans and to provide an improved and extended range of banking services.

In general, Ukraine will also enjoy considerable benefits from the presence of branches of foreign banks. Such benefits will include an increase in Ukraine's investment rating, extension of amounts of foreign investment, a reduction in the influence of internal

factors (including political ones) on the stability of the banking system. The national banking system will come closer to the standards of jurisdictions with a developed market economy.

However, when selling more attractive banking services, the leading foreign banks may easily win those clients who pose a lower financial risk and, by so doing, may affect the competition environment for other banks, in the main Ukrainian banks with local capital.

It should also be considered that Ukraine's insufficiently high investment rating may result in a large-scale invasion of the national banking service market by foreign banks which have an investment rating close to the Ukrainian one. This will not cause a significant improvement in the quality of banking services, but just increase the level of competition for clients of Ukrainian banks and, consequently, the risk of using branches of such foreign banks just for exporting Ukrainian capital and "money laundering".

Before Ukraine does join the WTO, it still has some time to improve its legislation to protect the interests of both Ukrainian banks and Ukrainian clients of branches of foreign banks. During this period of time it is advisable to establish via legislation a procedure for liquidation of the branches of foreign banks in order to provide customers with the possibility to get back their cash deposits. It is also necessary to prevent a situation when, affected by external factors, foreign banks urgently terminate their activities in Ukraine. Such termination could prompt a huge outflow of capital from Ukraine. The amount of the guaranteed repayment of individual deposits should be increased up to the European standard, which is EUR 20,000. Otherwise, we may face a cross-flow of deposited funds from Ukrainian banks to branches of foreign banks.

If Ukraine has a competent and balanced policy, we will have the opportunity to enjoy all the advantages and benefits which result from the presence of branches of foreign banks on the national market and, at the same time, to avoid or minimize the risks of losing economic sovereignty. ■