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I. Introduction

The election of Victor Yushchenko as President of Ukraine following the Orange Revolution of 2004 marks a turning point in the history of that country. Vowing to lead Ukraine out of its corrupt, immediate post-Soviet past and into a new and productive relationship with the West, President Yushchenko has made it clear that Ukraine's future is with Europe, the European Union (EU), and the North Atlantic Treaty Organisation.[1]

In September 2005, the U.S. Agency for International Development (USAID) closed its banking supervision project in Ukraine. The project had provided technical assistance to the National Bank of Ukraine (NBU) for more than ten years, beginning in 1995. While the desire to place ownership of the regulatory reform process entirely in the hands of the NBU is understandable, the timing of the closure is, in one sense, unfortunate; because it comes at the very time when a new administration, dedicated to market oriented reform, is just arriving on the scene and a maximum amount of international expertise would be particularly useful.[2] As a former Governor of the NBU, President Yushchenko clearly understands the critical importance of a strong financial sector to the economic health of any country. Efforts to bring the Ukrainian financial sector into closer harmony with interna-

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1. *See* World Economic Forum, Special Message by Victor A. Yushchenko (Jan. 28, 2005), http://www.weforum.org; World Economic Forum, Yushchenko argues Ukraine's case for EU entry (Jan. 28 2005), http://www.weforum.org.

2. The EU, through its Technical Assistance to the Commonwealth of Independent States and similar programs, and the World Bank, are expected to provide technical assistance to Ukraine in a number of key areas.

tional standards and practices—embodied in the standards of the EU, the Basel Committee on Banking Supervision (Basel Committee), and the World Trade Organization—are likely to assume increased importance.

This author had the privilege of serving as legal advisor to the NBU under the USAID project for eight years, from 1997 until its completion in 2005. This legal assistance included helping to draft an entirely new banking law (the Banking Law), which became effective on January 17, 2001.[3] The Banking Law replaced the 1991 Banking Law that had provided only a skeletal framework for banking supervision, and makes significant improvements in the structure for the supervision of commercial banks in Ukraine. The passage of the new banking law represents a small step on the road to Ukraine's eventual accession to full-fledged EU membership. The law includes many concepts that are compatible with EU practice and should greatly assist Ukraine in its quest to establish a modern system of financial sector supervision and regulation.

Yet the journey is far from complete. Much additional work is needed, especially in the areas of bank corporate governance; risk management; consolidated supervision of banking and financial groups; transparency of ownership and control of banks; prompt corrective action; and problem bank resolution. This article will summarize the key provisions of the 2001 banking law, indicate where the law fits in when evaluated against pertinent EU provisions and the international best practices of banking supervision, and will suggest some specific steps where further work is necessary.

II. The Framework for Reform

A. The Ukrainian Banking Sector

The Ukrainian financial system is small, but has been growing in the past five years, led by the banking sector. The financial sector is skewed towards banking, with the securities industry, pension funds, and insurance companies still in their formative stages.

As of 2004, Ukraine had 182 registered banks, with 160 of them operating.[4] Nineteen of these banks had foreign capital with seven being 100 percent foreign controlled.[5] The number of banks with foreign participation is expected to increase in the coming years as more trust and transparency becomes evident in the Ukrainian economy.[6]

The total assets of commercial banks has shown a remarkable growth rate in recent years, growing from less than 40 billion Ukrainian hrvnia (UAH) in 2001 ($8 billion) to 141 billion UAH ($28 billion) at year-end 2004.[7] While the total assets in the entire Ukrainian

3. The Law of Ukraine on Banks and Banking, amended by the Law of Ukraine, No. 2740-III (Sept. 20, 2001), *available at* http://www.microfinancegateway.org/content/article/detail/24788.

4. State Export-Import Bank of Ukraine; Banking System Review, at 2 (2005), http://www.eximb.com/download/en/reviews/bankreview/Banking_System_Review.pdf.

5. *Id.*

6. The statistical material in this section is largely from the NBU, the Ministry of Finance of Ukraine, the State Treasury of Ukraine, and the State Committee of Statistics of Ukraine and was compiled by the State Export-Import Bank of Ukraine *See* State Export-Import Bank of Ukraine, Banking Sector Review, Financial Review, and Main Macroeconomic Indicators, http://www.eximb.com/download/en/reviews; *see also* The Financial Sector Reform and Strengthening (FIRST) Initiative, http://www.firstinitiative.org. The FIRST Initiative is a multi-donor program that provides technical assistance grants for short- and medium-term projects in the areas of financial sector regulation, supervision, and development.

7. Banking System Review, *supra* note 4, at 5-6.

banking system are still less than the assets at many of the larger individual banks in more developed countries, this does represent a more than three-fold increase in as many years. Banking industry registered capital has also increased from $1 billion to $3.5 billion over this same time period.[8]

The top ten banks in Ukraine (in terms of size) control more than 50 percent of bank assets.[9] Ukrainian commercial banks have been increasingly successful in accessing international capital markets over the past several years, which speaks highly of the increasing trust and transparency in the banking sector.

Commercial banks have been successful in attracting deposits, particularly individual deposits, over the past several years. Total deposits UAH have increased steadily, to nearly 83 billion as of year-end 2004, up from 25.7 billion in 2001.[10] Deposit insurance is provided through an unlimited government guarantee on household deposits at one major bank, and a limited coverage guarantee on household deposits at other banks administered through the Fund for the Guarantee of Deposits of Natural Persons.

While the banking sector is relatively strong by regional standards, financial intermediation remains weak. Ukrainian banks are moving rapidly, from a miniscule starting point, into more small- and medium-sized business lending and more consumer credit. This presents opportunities for businesses and consumers, but also presents special challenges. Managing credit risk is more difficult with small- and medium-sized businesses because the borrowers are generally unknown, may not have a substantial credit history, and often lack financial sophistication that is generally expected of larger borrowers. This makes underwriting efforts much more difficult.

Additional challenges emanate from the risks associated with concentrations of foreign funding through loan syndications and Eurobonds. Primarily, the maturity of the obtained syndications and bonds is often less than the duration of the banks' loan portfolios. While the banking industry is inherently illiquid, concentrations of funding amplify this liquidity risk. Also, when funding comes to a bank in a large block, particularly through loan syndications, banks are under tremendous pressure to put this money to work in the form of loans as quickly as possible. This may push the banks to lower their credit standards in the short-term and make loans that they otherwise would not have made if the funding had come over time from steady deposit growth.

Outside of the loan portfolio, banks are beginning to turn to new investment products, other than Ukrainian government bonds, to increase interest income from the investment portfolio. The advent of new financial instruments in Ukraine will add desperately needed new, but as yet untested, investment products to the financial sector as a whole. New financial instruments, including more sophisticated hedging instruments, are not only critical to the banking system but also mandatory for growth in the nascent private pension sector.

The Ukrainian economy performed very well in the six years following the 1997-1998 global financial crisis, though it has shown disturbing signs in 2005. In 2003, real gross domestic product (GDP) increased by 9.4 percent, and by 12 percent in 2004.[11] Through

8. *Id.* at 5.

9. *Id.* at 5, 10.

10. *See* National Bank of Ukraine website, http://www.bank.gov.ua/ENGL/Statist/DEPOZITS/depoz_e.htm.

11. *See* International Monetary Fund, Ukraine—2004 IMF Article IV Consultation, http://www.imf.org/external/np/ms/2004/080304.htm#P14_673 [hereinafter 2004 Article IV Consultation].

2005, however, real GDP growth has decelerated, measuring 4 percent through the first half of the year.[12] The 2003-2004 growth can be attributed to favorable economic conditions for Ukrainian exporters and growth of investments in the country, coupled with steady rises in consumer demand, particularly in the construction sector. Inflation was relatively modest during the 2002-2004 period, but has been on a severe upward trend and is now approaching 15 percent.[13] The UAH has been stable throughout this period as well, except for the brief disruptions during the Orange Revolution in 2004. The average wage of Ukrainian workers has risen steadily, averaging nearly 26 percent higher at mid-2004 than a year earlier.[14] With the improvement in the economy over the past several years, and the generally positive changes in the government, Ukraine's sovereign debt ratings are slowly improving. This means that the government and the major banks are able to borrow for longer terms to maturity and cheaper costs. This should translate to lower borrowing costs for businesses in Ukraine and more stability to the banking system.

B. EU-Ukraine Relations

Ukraine was the first country in the Commonwealth of Independent States to sign a Partnership and Cooperation Agreement (PCA) with the EU in 1994 and to join the Council of Europe.[15] The PCA was not ratified by the EU states until 1998, when a number of other post-communist countries in central and eastern Europe had already moved far ahead with their associate membership with the EU.[16] On June 11, 1998, then-President Leonid Kuchma approved the Strategy of Integration of Ukraine to the European Union (Integration Strategy), stating that the "national interests of Ukraine require identification of Ukraine as an influential European country, full-fledged EU member."[17] Particular emphasis was placed on the fact that as a result of the EU's eastward enlargement, Ukraine would soon have a common border with the EU, which "'would create a principally new geopolitical situation' that required a 'clear and comprehensive definition of the foreign policy strategy concerning Ukraine's integration to the European political, economic and legal space.'"[18] The Integration Strategy defines the principal requirements of the integra-

12. *See* International Monetary Fund, Ukraine—2005 IMF Article IV Consultation, http://www.imf.org/external/np/ms/2005/080205.htm.

13. *Id.* The Consumer Price Index increased from a low of minus 0.6 percent in 2002 to 8 percent in 2004. 2004 Article IV Consultation, *supra* note 11.

14. *Id.*

15. Inna Pidluska, *Ukraine-EU Relations: Enlargement and Integration*, http://www.policy.hu/pidluska/EU-Ukraine.html (last visited Oct. 30, 2005); *see* European Union On-Line, Partnership and Cooperation Agreement Between the European Communities and Their Member States, and Ukraine, *available at* http://europa.eu.int/comm/external_relations/ceeca/pca/pca_ukraine.pdf (last visited Oct. 30, 2005) [hereinafter PCA]. In March 2004, Ukraine, the European Communities and their member states signed a Protocol to the Partnership and Co-operation Agreement to accommodate the accession of ten new member countries of the EU to the PCA and on adjustment to the PCA. The Protocol was ratified by the Verkhovna Rada on July 6, 2005. Discussions are currently underway to replace the PCA with an Association Agreement between Ukraine and the EU that would constitute an additional step toward full-fledged EU membership. A target date of 2003-2004 has been established for this goal. *See* Mission of Ukraine to European Communities, http://ukraine-eu.mfa.gov.ua.

16. Pidluska, *supra* note 15.

17. *Id.*

18. *Id.*

tion process as approximation of Ukrainian legislation to EU legislation, political consolidation and democracy, economic integration and the development of trade, and cooperation in the field of justice and home affairs, and sets out the main priorities for state executive bodies for the period up to 2007, when Ukraine hopes to meet the conditions for full EU membership. The main medium-term foreign policy priority was defined as acquiring the status of an associated member of the EU. Approximation of legislation is considered a "way to 'ensure development of the political, business, social, cultural activities of Ukraine's nationals, economic growth of the country within the EU framework as well as would facilitate gradual improvement of the well-being, making it closer to the level existing in the EU member-states.'"[19]

The aims of the PCA are:

- to provide an appropriate framework for the political dialogue between the Parties, allowing the development of close political relations;
- to promote trade and investment and harmonious economic relations between the Parties and so to foster their sustainable development;
- to provide a basis for mutually advantageous economic, social, financial, civil scientific technological and cultural cooperation;
- to support Ukrainian efforts to consolidate its democracy and to develop its economy and to complete the transition into a market economy.[20]

Under article 51 of the PCA, Ukraine has agreed to take measures to assure that its legislation will be brought step by step into accordance with the legislation of the EU.[21] Banking legislation is specifically mentioned in paragraph 2 of article 51.[22]

In addition, the mission of Ukraine to the EU has identified a number of priority areas to be worked on during the 2002-2011 period as necessary prerequisites for EU membership. The EU-Ukraine Cooperation Council in March 2002 defined seven priority areas for further co-operation within the framework of the PCA during 2002-2007.[23] The sixth meeting of the Cooperation Council, on March 18, 2003, identified harmonization of Ukrainian legislation with EU requirements as a key objective.[24]

Financial sector reform, and specifically banking reform, continues to be a high priority under the new administration. The European Neighbourhood Action Plan (Action Plan), adopted in 2004, specifically mentions banking reform and strengthening of the NBU as priority items.[25] In April 2005, the Cabinet of Ministers adopted a list of measures aimed at implementing the Action Plan in 2005.[26] In furtherance of this goal, Ukraine has announced its intentions to ensure:

19. *Id.*

20. PCA, *supra* note 15, at art. 1.

21. *Id.* at art. 51.

22. *Id.*

23. Mission of Ukraine, *supra* note 15.

24. *Id.*

25. International Enterprise Architecture Center, EU-Ukraine Action Plan, *available at* www.ieac.org.ua/pics/content/15/1109931048_ans.doc.

26. Cabinet of Ministers of Ukraine, Decision # 117-r, Measures to Implement Ukraine-EU Action Plan in 2005 (Apr. 22, 2005), http://www.ukraine-eu.mfa.gove.ua/data/upload/pulication/eu/en/2000/078_ap-measures_e.doc.

- preparation to introduce methods of banking oversight on the basis of risk appraisal principles, along with traditional oversight methods;
- creation of the methodology basis for introduction of banking oversight procedures [supervision] on the consolidated basis.[27]

C. International Monetary Fund Memorandum of Understanding

On March 11, 2004, Ukraine executed a Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding (MOU) with the International Monetary Fund (IMF).[28] The MOU notes that Ukraine's economic program is

> aimed at moving towards a well-functioning market economy with an effective social safety net, based on EU standards of the rule of law and public institutions. The program is intended to promote economic growth and employment, in order to raise the living standards of the population and help lay the foundations for membership in the WTO and eventually the European Union.[29]

With specific reference to banking sector reform, the MOU notes that the NBU will undertake to continue to improve banking supervision, intensify the enforcement of prudential regulations, and generally to move towards risk-based banking supervision.[30] The MOU contained various dates within 2004 for the submission of various amendments to the Verkhovna Rada (the Ukrainian Parliament), but this timetable was necessarily delayed by the events of the Orange Revolution in late 2004. Nevertheless, one of the goals of the Action Plan is for Ukraine to fully comply with the IMF recommendations regarding regulatory supervision of its banking sector by the end of 2005.[31]

D. Implementation Issues

The implementation task will be neither easy nor painless. First, as a general matter, financial sector reform in the former Soviet Republics is notoriously slow. Secondly, it is not at all clear precisely what is expected in terms of legislative harmonization. There is, strictly speaking, no single EU Banking Law, but rather a series of directives addressing specific legal issues to be implemented by the governments of the member states. In the banking sphere, the most important EU directives are the so-called Banking Directive[32] and the so-called Financial Conglomerates Directive.[33]

27. Action Plan Implementation Tool for 2005: Priorities and Concrete Actions to be Undertaken, http://www.iom.org.ua/docs/im33_1.doc.

28. *See* International Monetary Fund, Ukraine-Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding (Mar. 11, 2004), *available at* http://www.imf.org/external/NP/LOI/2004/ukr/01/index.htm.

29. *Id.* at ¶ 6.

30. *Id.* at ¶ 21.

31. Action Plan Implementation Tool, *supra* note 27.

32. Council Directive 2000/12/EC, Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 2000 O.J. (L 126), *amended* by Council Directive 2000/28/EC, 2000 O.J. (L 275) and Council Directive 2001/24/EC, 2001 O.J. (L 125) [hereinafter EU Banking Directive].

33. Council Directive 2002/87/EC, On the Supplementary Supervision of Credit Institutions, Insurance Undertakings, and Investment Firms in a Financial Conglomerate, 2003 O.J. (L 35/1) [hereinafter EU Financial Conglomerates Directive].

The principal purpose of the various directives is not to provide a comprehensive code for banking regulation and supervision, but rather to create certain minimum standards with the goal of promoting free trade and the establishment of banking organizations throughout the member states.[34] Specifically, this entails licensing and supervision of banks only in their respective home countries, with certain aspects of those items being harmonized throughout the EU, so that a bank licensed in one member state will be free to provide banking services throughout the EU under cooperation between the home and host country supervisors. The directives' standards have been implemented in very different ways in different EU member states, which are in fact at very different stages of development. Even prior to the admission of ten new members in 2004, the EU ran the gamut from Great Britain, France, and Germany on one end to Ireland, Portugal, and Greece on the other. Many former Soviet-bloc states from Eastern Europe have now become members. Even a cursory examination of the banking legislation of EU member states reveals wide disparities in the extent of incorporation of the directives' provisions and terminology. Nowhere have the directives' provisions been incorporated *in toto;* no EU member state has adopted a simple copy and paste approach, though some come closer than others in certain key areas. The member states have often varied the precise wording of the directives while retaining their substance (and, in many cases, have adopted stricter and more detailed requirements). The provisions of the directives are quite valuable, and on some topics perhaps even sufficient, but they are far from exhaustive. Some topics that are important for banking supervision are addressed only tangentially, or not at all, in the EU directives.

Thus, in implementing the PCA, Integration Strategy, Action Plan, and MOU, Ukraine should not confine itself to the contents of the EU directives. Rather, it will need to look further, and consult the internal banking legislation of other countries (both EU and non-EU, and even non-European) to fill in some of the gaps that the EU directives do not address. It will be important to examine the legislation of other countries with a somewhat critical eye, in order to determine which countries' laws provide the best models for implementing the spirit of the EU and Basel Committee principles. While a detailed assessment cannot practically be undertaken in this article, it is the author's view that within the EU, the banking laws of Germany, Austria, Estonia, and Latvia are particularly good supplements to the EU directives.

Germany and Austria offer good models because their banking laws follow many of the provisions of the EU directives quite closely, though both laws are probably more complex and more detailed than necessary for Ukraine at its present stage of development. Estonia and Latvia, former Soviet republics that were among the 2004 crop of new member states, both have banking laws that reflect many EU concepts. In particular, Estonia has taken many of the concepts in the directives and written them in a less complex and more user-friendly fashion that is suitable for a transition economy. Also, while they are not European laws, the banking legislation of Canada, Australia, and the United States contains much useful material that can effectively supplement the EU materials, and in some cases provide an alternative approach.

34. Treaty Establishing the European Economic Community, Mar. 25, 1957, O.J. (C 157) (providing for the freedom of commencing and carrying out of independent professions). Most of the banking-related directives have been adopted on the basis of provisions of this Treaty.

III. Highlights of Ukrainian Banking Legislation

A. Bank Corporate Governance

The Ukrainian Banking Law contains basic, and generally rudimentary, provisions on corporate governance in banks. In essence, the law does not emphasize clearly enough the role of the board of directors and the importance of risk management and internal controls.

Corporate governance in Ukraine, both in banks and in non-financially oriented institutions, is generally considered poor. Ukraine consistently ranks at or near the bottom in surveys undertaken by international organizations that emphasize corporate governance, transparency, and the transition to a market economy.[35] Part of the problem undoubtedly stems from the lack of a comprehensive Joint Stock Company Law. A draft law is currently being considered by the Verhkovna Rada, but this process has been ongoing for several years. For the time being, general corporate governance principles in Ukraine are found in the Economic Code[36] and the Law on Business Associations.[37] The banking sector is actually further developed than the general business sector, insofar as the Banking Law contains specific provisions regarding governance and management of banks. Unfortunately, in actual practice, banks suffer from many of the same difficulties as other types of business enterprises that do not have the benefit of modern corporate governance provisions.

In 2004, the International Finance Corporation completed a *Survey of Corporate Governance Practices in the Ukrainian Banking Sector*.[38] The survey summarizes certain key issues in bank corporate governance and recommends a number of ways in which they could be improved. The following points from the survey are noteworthy.

- In the banking sector, the relevant legislation is nearly compliant with all relevant EU directives. Still, many banks cited ineffective banking legislation as one of several key barriers to improvement in corporate governance.[39]
- While banks are generally aware of sound corporate governance principles, a number of banks have stated that recommendations of key international organizations such as the Basel Committee and the Organization for Economic Cooperation and Development (OECD) are incorporated into their internal procedures and documents mainly for compliance purposes. Banks have often reacted more to pressure from regulatory bodies such as the NBU rather than progressively acting on their own.[40]

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35. *See, e.g.*, Hsianmin Chen, Corporate Governance Sector Assessment Project: Report on the 2002 Assessment Results (European Bank for Reconstruction and Development May 2003), *available at* http://www.ebrd.com/country/sector/law/corpgov/assess/2003/report.pdf (giving Ukraine a very low compliance rating, primarily due to lack of a Joint Stock Company Law, as well as to weak enforcement of existing provisions); *see generally* Kostiantyn Shkurupiy, *The Corporate Governance Environment in Ukraine and its Impact on Corporate Performance and Finance*, *available at* http://www.oecd.org/dataoecd/6/0/1930649.pdf (last visited Oct. 30, 2005); N.S. Kuznetsova, *Corporate Governance in Ukraine*, *available at* http://www.oecd.org/dataoecd/6/13/1930958.pdf.

36. Economic Code of Ukraine N 5370 (Jan. 1, 2003), *available at* http://www.kac.com.ua/ukrtax/Economic%20Code.zip.

37. Ukraine Gateway, Law of Ukraine on Business Associations, http://www.ukraine-gateway.org.ua/gateway/gateway.nsf/webcontent/05010000.

38. International Finance Corporation, *A Survey of Corporate Governance Practices in the Ukrainian Banking Sector* (2004), *available at* http://www.ifc.org/ukraine/ucdp/materials_e.htm.

39. *Id.* at 19, 27.

40. *Id.* at 20.

- Legal requirements are one of the main drivers for improvements in corporate governance practices.[41]
- Most banks are in compliance with current legal and regulatory requirements with regard to governing bodies, but the internal organization of supervisory councils[42] barely meet international standards.[43] Moreover, there is a lack of clarity in the separation and formalization of duties and responsibilities, which in turn is the reason for other shortcomings in supervisory council practices in Ukrainian banks.[44] A more precise positioning of the supervisory council, both in legislation and in the perception of the business community, needs to be addressed in the further development of corporate governance practices in the banking sector.[45]

Under modern principles of corporate governance, the ultimate responsibility for the proper management of an enterprise, including a bank, rests with the board of directors.[46] While it is perfectly appropriate to assign the duty for performing the day-to-day functions to full-time senior managers and other employees, it is the obligation of the board to take adequate steps to make sure that the required tasks are carried out correctly through the adoption of adequate policies, procedures, and internal controls.[47] Where deficiencies are noted, it is the responsibility of the board to see that they are corrected.[48]

The Ukrainian Banking Law does not specifically state this principle. On the other hand, there are a number of provisions in the Banking Law that conflict with it. For example:

- *Authority of shareholders*. The general shareholders' meeting has the authority to define the basic trends in bank's activities and to approve reports on the implementation thereof.[49] In fact, the Banking Law currently characterizes the shareholders' meeting as a management body.[50] This is consistent with the general tendency in Ukraine to give an enormous amount of authority to shareholders, and secondarily, to the full-time senior management officials; the board of directors often functions primarily as a figurehead body, comprised largely of directors who do not direct.[51]
- *Executive Body*. The executive body acts in accordance with principles and procedures established by, among others, the general meeting of shareholders, and reports to the general meeting and the supervisory council.[52]

41. *Id.* at 11.

42. For consistency with Ukrainian terminology, this article will often use the words "supervisory council" interchangeably with "board of directors" or "supervisory board" to refer to the body of a bank that is elected by the shareholders to represent them and to oversee full-time senior management of the bank. In most countries, and in much of the international corporate governance literature, this body is referred to as the board of directors or the supervisory board. The Ukrainian Banking Law creates a certain amount of confusion by using the words "Board of Directors" to refer to the body that in many countries is called the management board, which is made up full-time senior executives appointed by the supervisory council.

43. *Survey of Corporate Governance*, *supra* note 38, at 12.

44. *Id.* at 42.

45. *Id.*

46. *See* Organisation for Economic Co-operation Development, OECD Principles of Corporate Governance 24 (2004), *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf.

47. *Id.*

48. *Id.*

49. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 38.

50. *Id.* at art. 37.

51. *Survey of Corporate Governance*, *supra* note 38, at 12.

52. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 40.

- *The Revision Commission.* The task of exercising control over financial and economic activities of the bank is assigned to the revision commission.[53]
- *Accounting and Reporting.* Each bank is required to adhere to certain accounting and reporting standards, but the Banking Law does not specifically state where the responsibility lies for ensuring the integrity of the reports (though article 41 suggests that this is the task of the revision commission).[54]
- *Legal compliance.* The Banking Law states in article 41 that the revision commission is responsible for controlling adherence by the bank to legal and regulatory requirements.[55] Article 45, on the other hand, assigns this responsibility to the internal audit unit.[56]

Each of these points raises substantial issues.

1. *Shareholder Authority*

The reference in the Banking Law to the general shareholders' meeting as a "management body" (articles 37 and 38) is not in keeping with modern corporate governance principles. As the OECD points out,

> [e]quity investors have certain property rights. For example, an equity share . . . can be bought, sold, or transferred. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participation in general shareholder meetings and by voting.
>
> As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board [of directors] and a management team that is selected, motivated and, when necessary, replaced by the board.[57]

To the extent that the shareholders disagree with the direction taken by the supervisory council, they have the ability to bring their disagreement to the attention of the council. In extreme cases, shareholders may express their desire that the enterprise take a different direction by replacing the members of the council who do not share the views of the majority of shareholders. But it is not accurate to describe the function of the general shareholders meeting as managing the enterprise. Accordingly, one of the revisions to the Banking Law should be to eliminate the references to the shareholders' meeting as a "management bod[y]."[58]

2. *Responsibilities of the Supervisory Council*

The OECD notes that the board's responsibilities should include the following.

53. *Id.* at art. 41; *see also* the discussion on the revision commission.
54. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 41.
55. *Id.* at art. 41(1).
56. *Id.* at art. 45(2).
57. Principles of Corporate Governance, *supra* note 46, at 32.
58. Law of Ukraine on Banks and Banking, *supra* note 463, at art. 37.

(1) Reviewing and guiding [the bank's business] strategy, major plans of action, risk [management] policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
(2) Monitoring the effectiveness of the company's governance practices and making changes as needed.
(3) Selecting, compensating, monitoring and, when necessary, replacing key [senior management] executives and overseeing succession planning.
(4) Aligning key [senior management] and board remuneration with the long-term interests and its shareholders.
(5) Ensuring a formal and transparent board nomination and election process.
(6) Monitoring and managing potential conflicts of interest of [senior] management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
(7) Ensuring the integrity of the [bank's] accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for [monitoring] risk . . . , financial . . . control, and compliance with the law . . . .
(8) Overseeing the process of disclosure and communications.[59]

This principle is applicable with special force in the banking sphere. The Basel Committee publications are replete with references to the responsibility of the board of directors (or supervisory council) for overall safe and sound bank management.[60]

The EU Banking Directive does not contain detailed information on the duties and responsibilities of the board of directors. Ukraine would, however, do well to follow the example of new EU entrant Estonia, whose Credit Institutions Act contains specific duties and responsibilities for the supervisory board. Under the Estonian law, the supervisory board is considered the directing body of the bank, and plans the activities of the bank, gives instructions to the management board for organization of the management of the bank, and supervises the activities of the management board.[61] The members of the supervisory board are required to ensure that the activities of the bank, the management board, and employees are in accordance with legislation and the provisions of internal rules and other rules established by the directing bodies of the bank.[62] The members of the supervisory board must comprehend the risks involved in the activities of the bank, and must

59. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 46, at 24-25.

60. *See, e.g.*, Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision 5, 17, 24-27 (Sept. 1997), *available at* http://www.bis.org/publ/bcbs30a.htm [hereinafter CORE PRINCIPLES]; BASEL COMMITTEE ON BANKING SUPERVISION, FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANISATIONS (Sept. 1998), *available at* http://www.bis.org/publ/bcbs40.htm [hereinafter FRAMEWORK]; BASEL COMMITTEE ON BANKING SUPERVISION, COMPLIANCE AND THE COMPLIANCE FUNCTION IN BANKS (Apr. 2005), *available at* http://www.bis.org/publ/bcbs113.htm; BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE IN BANKING ORGANISATIONS (Sept. 1999), *available at* http://www.bis.org/publ/bcbs56.htm [hereinafter ENHANCING CORPORATE GOVERNANCE]. In July 2005, the Basel Committee issued for comment a consultative paper proposing updates to the latter document. The consultative paper is available at the Committee's website, *http://www.bis.org/bcbs.*

61. Credit Institutions Act § 52 (1999) (Est.), *available at* http://www.eestipank.info/pub/en/dokumendid/dokumendid/oigusaktid/seadused/_124.htm.

62. *Id.*

ensure that the management board identifies, monitors, and controls those risks.[63] Specifically, the supervisory board is required to:

(1) approve the strategy and general principles of the activities of the [bank];
(2) approve the general principles of risk management [for] the [bank];
(3) approve the [bank's] organizational structure . . . ;
(4) approve the general principles of monitoring of the activities of the [bank];
(5) approve the statutes of the internal audit unit;
(6) elect and remove the chairman and members of the management board . . . ;
(7) appoint and remove from office the [head] of the internal audit unit . . . [and, on the proposal of the head of the internal audit unit, appoint and remove from office employees of the internal audit unit];
(8) approve the [bank's] budget and the investment plan . . . ;
(9) decide on the foundation or closure of branches in foreign states;
(10) approve the general principles of the activities and the competence of the credit committee;
(11) decide on the conclusion of [bank] transactions [that] are beyond the scope of the everyday . . . activities . . . ;
(12) decide on the conclusion of transactions with members of the management board, and appoint the representative of the [bank] in such transactions;
(13) file claims against members of the management board, and appoint the [bank's] representative [for pursuing] such claims;
(14) decide on other matters placed in the competence of the supervisory board by the articles of association.[64]

The Estonian law also leaves no room for doubt that the full-time senior management reports to, and is responsible to, the supervisory board. Thus, the management board is required to:

(1) develop a business plan for implementation of the strategy approved by the supervisory board;
(2) develop, pursuant to the general principles approved by the supervisory board, the principles of risk management of the [bank] and approve the conditions and limits for the grant of debenture loans;
(3) identify and assess regularly all risks involved in the activities of the [bank] and ensure the monitoring and control of the extent of such risks;
(4) develop the organisational structure of the [bank] on the basis of the principles provided for in the articles of association and approve the structure of the [bank];
(5) develop and implement systems for monitoring the activities of the [bank], ensure adherence to such systems, assess the sufficiency thereof regularly and improve them if necessary pursuant to the principles established by the supervisory board;
(6) ensure that all employees of the [bank] are aware of the provisions of legislation relating to their duties of employment and of the principles provided for in the documents approved by the directing bodies of the [bank];

63. *Id.*
64. *Id.*

(7) organize the effective functioning of the internal control system of the [bank] and ensure monitoring of the compliance of the activities of the [bank] and the managers and employees thereof with legislation and the documents approved by the directing bodies of the [bank] and with the principles of sound banking management;
(8) ensure the existence and functioning of systems to guarantee that information necessary for employees of the [bank] to perform their duties is communicated thereto in a timely manner;
(9) ensure the safety and regular monitoring of information technology systems used by the [bank] and systems used for the safekeeping of assets of clients;
(10) inform the supervisory board to the extent and pursuant to the procedure established thereby of all discovered violations of legislation or of internal rules or other rules established by the directing bodies of the [bank].[65]

The management board is also required to present an overview of the activities and economic situation of the bank to the supervisory board at least once every three months, and to immediately inform the members of the supervisory board of any deterioration in the economic situation of the bank, danger of such deterioration, or deviation from prudential ratios.[66]

3. *The Revision Commission*

Under the current Ukrainian Banking Law, there is no requirement for an audit committee. Instead, the law refers to a revision commission, that is elected by the general meeting of the shareholders and is responsible for controlling the financial and economic activity of the bank.[67] The concept of the revision commission, or a similar body with a different name, is relatively common in the former Soviet Union and eastern Europe, and appears to be a remnant of the socialist system.

This notion is incompatible with modern corporate governance primarily because it assigns to the revision commission a number of responsibilities that should properly be assigned to the supervisory council. Moreover, with both the supervisory council and the revision commission being elected by the general meeting of the shareholders, the issue of accountability is manifestly unclear. By mandating two bodies elected by the shareholders, with overlapping responsibilities, the law creates confusion and lack of accountability, as it is not clear what body is ultimately responsible for the safe and sound operation of the bank.

The Banking Law requires the supervisory council to "[s]et forth the procedure for [review and control] over financial and economic activity of the bank," while the revision commission exercises control over these financial and business activities.[68] This arrangement would be understandable if the commission were a committee of the council, acting on behalf of the council and reporting to it. Under the Banking Law, however, the commission

65. *Id.* § 55.
66. *Id.*
67. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 44. In the current draft of the Joint Stock Company Law, this body would be called the Inspection Commission. *See* Draft Law of Ukraine on Joint Stock Companies, Draft No. 3059-1, art. 71 (submitted by the Cabinet of Ministers to the Verkhovna Rada, Dec. 18, 2003) (on file with author).
68. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 39.

is appointed by, and reports to, the general meeting of the shareholders.[69] While the commission can submit proposals to the council on matters concerning the financial safety and stability of the bank and protection of interests of bank clients, the commission is ultimately responsible to the general meeting, not the council.[70] The law thus establishes two bodies that are responsible to the shareholders and are charged with responsibility for the financial and economic activity of the bank. It is thus not clear who—the supervisory council or the revision commission—is actually responsible for ensuring that the financial and economic activity of the bank is conducted in a sound and prudent manner.

The Banking Law requires the revision commission to perform the following tasks:

> (1) [c]ontrol adherence of the bank to the legislation of Ukraine . . . and of the [NBU regulations];
> (2) [review] reports of internal and external auditors, and prepare respective proposals for the . . . General Meeting of participants;
> (3) [s]ubmit proposals to the General Meeting of participants or the Supervisory Council of the bank on any issues [within] the competence of the [Revision] Commission, which concern financial [safety] and . . . stability and protection of the interests of [bank] clients.[71]

The revision commission reports on the results of audits and revisions to the general meeting of participants or the supervisory council of the bank, and prepares conclusions in respect of reports and bank balance sheets.[72] The general meeting cannot approve financial statements of the bank without a conclusion of the revision commission.[73] There is no provision in the Banking Law for review of the bank's financial statements by the supervisory council.

In modern corporate governance practice, controlling the financial and business activity of an enterprise (including a bank), ensuring appropriate risk management and internal controls, as well as ensuring compliance with applicable laws and regulations, are the tasks of the board of directors, not a separate body also elected by the shareholders. For example, principle VI of the OECD's Principles of Corporate Governance states that the board should, among other things:

- review and guide the company's strategy, major plans of action, risk policy, annual budgets, and business plans;
- ensure compliance with applicable law;
- ensure the integrity of the company's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular systems for monitoring risk, financial control, and compliance with law.[74]

This author is not aware of any market-oriented country outside of the former Soviet Union or eastern Europe that uses a revision commission such as described in the Ukrainian

69. *Id.* at art. 39(3).
70. *Id.* at art. 41.
71. *Id.*
72. *Id.*
73. *Id.*
74. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 46, at 24-25.

Banking Law.[75] On the other hand, in virtually every western, market-oriented country that this author has researched, audit committees are specialized committees of the board of directors and assist the council with its oversight functions. In some cases, audit committees are legally required. In other cases, audit committees are recommended in non-binding codes or best practice statements of corporate conduct, while in other cases, supervisory councils voluntarily establish audit committees simply because they believe that it is good business practice. But regardless of whether or not the establishment of an audit committee is a legal requirement, there is widespread consensus that such committees, as extensions of the supervisory council, are an essential component of good corporate governance.[76] Indeed, the audit committee is probably the most important committee in a bank. As the IFC Survey notes: "[a]n audit committee [of the supervisory council] overseeing the bank's internal and external auditors and addressing control weaknesses, non-compliance issues and other problems identified by the auditors in a timely fashion is considered to be an *absolute minimum* by international standard."[77]

There is, of course, a wealth of recommendatory material on audit committees available in corporate governance literature.[78] In this author's opinion, however, the best legislative provisions concerning the structure and functions of audit committees in banks are found in the Canadian Bank Act. The audit committee of a Canadian bank must consist of at least three directors, a majority of which cannot be persons affiliated with the bank.[79] None of the members of the audit committee may be officers or employees of the bank or a subsidiary of the bank.[80] The audit committee of a bank must:

(a) review the annual statement of the bank before the annual statement is approved by the directors;
(b) review such returns of the bank as the Superintendent [of Financial Institutions] may specify;
(c) require the management of the bank to implement and maintain appropriate internal control procedures;
(c.1) review, evaluate and approve those procedures;
(d) review such investments and transactions that could adversely affect the well-being of the bank as the auditor or auditors or any officer of the bank may bring to the attention of the committee;

75. In some countries, the audit committee does submit an annual statement to the shareholders, along with the company's annual report. For example, in the United States, audit committees of listed companies must provide a report as part of the company's annual proxy statement or information statement relating to the annual meeting. *See* 17 C.F.R. §229.306. But even in these countries, the audit committee is still a committee of the board (council), and its function is to assist the council, which after all, remains ultimately responsible for the sound and prudent operation of the company.

76. *See, e.g., European Commission Green Paper on the Role, the Position and the Liability of the Statutory Auditor Within the European Union*, at 26 (1996) ("[e]xperience . . . has shown that . . . audit committees . . . have proved their worth and developed into essential committees of the board of directors.").

77. *Survey of Corporate Governance, supra* note 38, at 37 (emphasis added).

78. *See, e.g.,* Enhancing Corporate Governance, *supra* note 60; BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, GUIDING PRINCIPLES FOR AUDIT COMMITTEE BEST PRACTICES (1999); REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 70-72 (2002).

79. Bank Act, S.C. ch. 46 § 194(1) (1991), *available at* http://laws.justice.gc.ca/en/b-1.01/2816.html.

80. *Id.* § 194(2).

(e) meet with the auditor or auditors to discuss the annual statement and the returns and transactions referred to in this subsection; and
(f) meet with the chief internal auditor of the bank, or the officer or employee of the bank acting in a similar capacity, and with management of the bank, to discuss the effectiveness of the internal control procedures established for the bank.[81]

The Canadian Bank Act also contains a virtually identical provision regarding audit committees in bank holding companies that greatly enhances the concept of consolidated supervision of banking groups.[82] Ukraine would do well to follow this example.

4. *Risk Management and Internal Controls*

In a very real sense, modern corporate governance is ultimately about risk management. Banks are in the business of taking risks, yet they utilize other people's money (mainly in the form of deposits) in their activities to a much greater degree than ordinary business enterprises. How banks manage their risk, and more specifically, managing risk in a way that protects depositors, is thus vitally important.

Currently, the Ukrainian Banking Law mentions risk management only in one place, article 44, and this pertains to the establishment of a standing committee on risk management, rather than to the concept of risk management and the components of a good risk management program. It does not mention where the responsibility is for approving the bank's risk management policies and ensuring their effective implementation. As noted above, this responsibility should clearly and explicitly be on the board of directors.

Similarly, while the Banking Law requires each bank to have an internal audit unit,[83] it does not explicitly mention internal controls in banks. Yet, a requirement for an adequate system of internal controls is one of the Basel Committee's Core Principles.[84] The Committee has also published detailed guidance on internal controls in banks.[85] While these principles are too voluminous to include here in their entirety, they can be summarized as follows:

> [b]ank[] 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.[86]

The EU also specifically mandates that all member state bank supervisors require banks to have adequate internal controls.[87] Similar legal requirements are found in the banking

81. *Id.* § 194(3).
82. *Id.* § 782.
83. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 45.
84. *See* Core Principles, *supra* note 60, at 29.
85. *See* Framework, *supra* note 60.
86. *Id.* at 4 (noting that the internal audit function should report directly to the board of directors or its audit committee and to senior management); Core Principles, *supra* note 60 (noting that the internal audit function should report to the audit committee). Originally, the internal audit unit reported to the management board. This was changed in 2003, so that the internal audit unit now reports to the supervisory board. Clearly this is a positive step, but more is needed.
87. EU Banking Directive, *supra* note 32, at art. 17.

laws of many individual EU and Basel Committee member countries.[88] Ukraine would do well to emulate these examples.

B. Consolidated Supervision

One of the hottest topics in modern financial sector supervision involves consolidated supervision of banking groups. Ukraine is no exception. In one sense, Ukraine is actually one of the more progressive of the former Soviet republics in this area, in that the Ukrainian Banking Law contains a number of provisions relating to such groups.[89] There are specific requirements relating to Bank Corporations, Bank Holding Groups, and Financial Holding Groups.[90] The law contains the concepts of essential participants, affiliated and related legal persons of banks, as well as reporting, inspection, and enforcement authority with regard to these persons. The Banking Law also states that the NBU carries out banking supervision on an individual and consolidated basis.[91]

Yet, the law is long on form and short on substance. It contains a number of provisions regarding the creation of various types of banking groups and the legal formalities of the component entities' relationships with each other, but is completely silent on the crucial issue of substantive, risk-based supervision of these groups. Moreover, there are a number of gaps that prevent the NBU from exercising full consolidated supervision to the extent necessary in the modern financial environment.

1. *The Importance of Consolidated Supervision*

All banks are subject to financial risks that emanate from activities that they directly undertake. Traditional banking risks include credit risk, liquidity risk, interest rate risk, and foreign exchange risk. But special risks, which are not as easily measured, also become applicable if the bank is part of a group of companies. Specific risks that apply in the banking group context include the following:

- *Contagion*—the risk that financial difficulties in an affiliated company of a bank might infect the bank itself. Normally this arises when the bank's depositors assume that financial problems of the affiliated company could mean that the financial stability of the bank is also in jeopardy. This perception can precipitate substantial rapid withdrawals of deposits, resulting in a liquidity deficiency, and, if the problem escalates, a major run on deposits, which can even spread to other banks.
- *Group Exposures to Particular Companies*—the possibility that individual lending limits could be circumvented through the use of bank subsidiaries, which themselves might

88. *See, e.g.*, Credit Institutions Act §§ 59; Bank Act, S.C. c. 46 § 193; Gesetz uber das Kreditwesen [Banking Act], Dec. 8, 1999, Federal Law Gazette I No. 54, at 2384, § 25a(1) (F.R.G.) (2002), *available at* http://www.bundesbank.de/bank/download/pdf/kwg_e.pdf; French Monetary and Financial Code, art. L511-41, *available at* http://www.legifrance.gouv.fr/html/codes_traduits/moneang.htm; Credit Institution Law § 112 (Lat.), *available at* http://www.fktk.lv/downloads/news_en/Credit_Institution_Law_argroz.doc; Federal Deposit Insurance Act, 12 U.S.C. § 1831m (2005).

89. For a more detailed discussion of the consolidated supervision provisions of the Ukrainian Banking Law, *see* Bryan D. Stirewalt & Gary A. Gegenheimer, *Consolidated Supervision of Banking Groups in the Former Soviet Republics: A Comparative Examination of the Emerging Trend in Emerging Markets*, 23 Ann. Rev. Banking & Fin. L. 533 (2004).

90. Law of Ukraine on Banks and Banking, *supra* note 3, at arts. 10-12.

91. *Id.* at art. 67.

not be subject to the same limitations as banks. This is also a concern in a wider banking group (e.g., a bank holding company and its non-bank subsidiaries) though it is usually not practical to apply the same kinds of bank lending limitations to such wider groups, especially if they contain a mix of financial and non-financial entities.

- *Transparency of Legal and Managerial Structures*—the possibility that controlling persons of banking groups may deliberately choose a complex structure in order to obscure the group's true ownership, control, or operations, and thereby avoid effective supervision.
- *Quality of Management*—the risk that management of a non-bank parent company might exercise its control in a manner detrimental to the bank or its depositors.
- *Moral Hazard*—the risk that related companies of a bank might take excessive risks in the belief that supervisory authorities will provide them with support to avoid a contagion effect on the related bank.[92]

Because of the dangers that these risks can pose to a bank, financial sector regulatory authorities must be aware of the structure of, and risks inherent in, any group of companies that includes a bank. Specifically, the regulator needs to be aware of the ownership structure, corporate governance standards, internal controls and risk management systems that the group uses to carry out its activities. The regulator also needs to review and assess the group's controls on intra-group transactions and have continuing knowledge of aggregated large risk exposures within the group. The regulator further needs to assess the adequacy of capital on a consolidated basis to prevent a single financial entity within the group from showing an adequate capital position by virtue of accounting gimmicks. In order to accomplish these tasks, the regulator must have two critical legal authorities: (1) the authority to obtain reliable information about all of the entities in the group and (2) the authority to take effective corrective actions, or cause other financial sector supervisors to do so, when activities or conditions of these affiliated persons may be detrimental to the financial stability of the bank(s) within the group. [93]

The Ukrainian Banking Law is only partially effective at giving the NBU the tools to perform effective consolidated supervision.

2. *Banking Groups*

The fundamental building block for implementing effective consolidated supervision is identification of all corporate groups that contain a bank. Defining the group requires clear definitions of affiliate (or similar terminology) and control. An affiliate should include any entity that controls a bank, any entity that a bank controls, and any entity that is controlled by the same person (legal or physical) that controls the bank. Control, in turn, should include not only share ownership or formal voting power above a certain benchmark, but also the ability in fact (not just the legal right) to exert a dominant influence over an entity.[94] By determining who ultimately controls a given bank, and also any other entities that are controlled by that person, the bank supervisor will be in a position to know whom to seek

92. Ronald MacDonald, Bank of England Handbooks in Central Banking No. 15: Consolidated Supervision of Banks 11-14 (Simon Gray ed.) (1998).

93. Core Principles, *supra* note 60, at 42, n9.

94. *See, e.g.*, EU Banking Directive, *supra* note 32, at art. 1, ¶ 8; EU Financial Conglomerates Directive, *supra* note 33, at art. 2, ¶ 13(b); Gesetz uber das Kreditwesen [Banking Act] § 1(8) (all defining control as either direct or indirect 50% ownership or the ability to exert a dominant influence over an entity); 12 U.S.C. § 1841(a)(2)(A) (§ 2 of the U.S. Bank Holding Company Act, referring to a controlling influence).

information from, and what persons to apply corrective measures to should this become necessary to protect the bank.

The Ukrainian Banking Law contains a satisfactory control definition, inasmuch as it emphasizes both formal ownership or voting rights above a certain benchmark (50 percent) and actual control irrespective of ownership or voting rights.[95] The problem is that the control definition does not satisfactorily connect to the banking group material. The group definitions are not written in terms of control, but rather of formal ownership.

The Ukrainian Banking Law recognizes three types of bank associations: a bank corporation, a bank holding group, and a financial holding group.[96] "A bank holding group is a bank association [consisting] exclusively of banks."[97] "A financial holding group is a group consisting predominantly or exclusively of institutions that render financial services, including at least one bank. The parent company must be a financial institution."[98] Parent entities of bank holding groups and financial holding groups are required "to submit consolidated, financial and statistical reports of the group . . . ."[99] The Banking Law also provides that bank holding groups are supervised on a consolidated basis,[100] but there is no comparable provision for financial holding groups.[101] The parent entity of a bank holding group or financial holding group must own at least 50 percent of the shares of each subsidiary bank or other group participant.[102] Thus, in order for the requirements of articles 11 or 12 to become applicable, there must be an actual, formal ownership relationship between the parent company and the subsidiary companies. Presumably, this must be direct ownership (i.e., not through other companies, since neither article 11 nor 12 mentions indirect ownership).

These provisions make the law extremely easy to evade: a company or controlling shareholder can design a creative ownership structure so that no one company directly owns 50 percent or more of a bank, thus avoiding the bank holding group or financial holding group designations while still, in substance, controlling the bank. Because the resulting group of companies is not considered a bank holding group or a financial holding group, it is not subject to NBU supervision, except to the extent that the above-mentioned brief reference in article 67 may be read as imposing such a requirement. Even this result is not satisfactory, however, since article 67 does not contain any indication of the substance of what consolidated supervision entails.

The problem is compounded by the fact that article 9 specifically stipulates that "[b]anks can participate in [other kinds of] industrial/financial groups . . . ," providing only that they comply with the requirements of the antimonopoly legislation of Ukraine.[103] Currently no provision, other than the almost passing reference in article 67, suggests that a group that does not fit the definition of one of the article 9 banking associations might be subject to

95. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 2.

96. *Id.* at art. 9.

97. *Id.* at art. 11.

98. *Id.* at art. 12. A noteworthy issue is that the basic definition of a financial holding group is internally inconsistent. The definition states that a financial holding group is a financial institution. This makes no sense, since a financial institution is, itself, a single legal entity.

99. *Id.* at arts. 11-12.

100. *Id.* at art. 11.

101. *See id.* at art. 12.

102. *Id.* at art. 12.

103. *Id.* at art. 9.

NBU oversight. Yet these other kinds of financial and industrial groups pose precisely the sorts of risks about which the NBU needs to be greatly concerned. Indeed, a number of such groups, many of which include banks, exist in Ukraine, and a number of them are unofficial. Many of these groups have their own "captive banks," which are banks owned by industrial groups and which function more like in-house treasuries for their groups than real banks.[104] In many cases, the controlling persons of such groups are hidden in a labyrinth of complex ownership and control structures, with many controllers or essential participants based in offshore zones where it is extremely difficult, or impossible, to obtain financial information about them.[105] Legal and supervisory tools are necessary to deal with the risks that such groups can pose to banks, yet the Ukrainian Banking Law does not address these groups at all. This is in sharp contrast to the situation in the EU where mixed activity holding companies are subject to many—albeit lighter—supervisory requirements in order to control the risks that may arise from banks' affiliations with non-financially oriented companies.[106]

As seen, article 11 states that supervision of bank holding groups is carried out on an individual and consolidated basis. However, because a bank holding group consists exclusively of banks, the NBU really has no authority over the group that it does not already have regarding each bank in the group. Article 12 (financial holding groups) does not contain an analogous provision. The closest parallel to this concept in article 12 is the requirement that the parent company of the financial holding group is obliged to submit consolidated, financial, and statistical reports of the group to the supervisory bodies, but the supervisory body is not specified.

In order to remedy this situation, Ukraine should amend its definition of a group to comport more closely with EU practice. For example, under the EU Financial Conglomerates Directive, a group of companies consists of a parent company, its subsidiaries, entities in which the parent company and subsidiaries hold participations (i.e., direct or indirect ownership of twenty percent or more of the capital or voting rights), and other entities that are linked to each other within the meaning of article 12(1) of the EU Consolidated Ac-

104. *See generally* Oxford Business Group, Encouraging Dynamics (Nov. 14, 2005), http://www.oxfordbusinessgroup.com/weekly01.asp?id=1666; Andriy Vorobyov, *How Do Companies in Eurasia Finance Their Trade/Investment Deals?* (2004), http://www.bisnis.doc.gov/BISNIS/fq2004/surveys/FinanceSurveyUkraine2004.htm (referring to "pocket banks" belonging to large financial-industrial groups).

105. While nominal ownership of most companies is publicly available, indirect and beneficial ownership is rarely disclosed. Ukraine ranks in category 3 out of 7 on the World Bank's Disclosure Index, which considers, inter alia, indirect ownership, beneficial ownership, and public availability of ownership and financial information. *See* The World Bank, Doing Business, Explore Economies, Ukraine, http://www.doingbusiness.org/ExploreEconomies/Default.aspx?exonomyid=194 (last visited Oct. 30, 2005). The IMF has also noted that it is necessary to amend the Banking Law regarding the divulging of information about the structure of the banks' property and their real owners. The Association of Ukrainian Banks has called for introduction of such requirements simultaneously to all market participants, or, at least, to all kinds of financial institutions, as excessive demands concerning transparency of the structure of ownership of only banks may "slow[] down capitalization of the banking system." *See* Ukrainian Monitor, Headlines and Comments, IMF Recommends Raising Transparency of Ukrainian Banks' Operations, www.foreignpolicy.org.ua/eng/headlines/globalization/imf/index.shtml?id=3458 (last visited Oct. 30, 2005); *see generally* The World Bank, Ukraine—Building Foundations for Sustainable Growth: A Country Economic Memorandum 17-28 (2004), *available at* www.worldbank.org/ua.

106. *See* EU Banking Directive, *supra* note 32, at art. 55, ¶¶ 1-2 (information and inspection requirements concerning mixed-activity holding companies), *and id.* art. 56, ¶ 8 (noting that EU member states must make provisions for the application of penalties to mixed activity holding companies).

counts Directive.[107] Estonia uses an analogous concept, the consolidation group, that consists of a parent company, its subsidiaries that are "credit institutions, financial institutions, or ancillary undertakings . . . ," as well as "credit institutions or financial institutions in which the credit institution included in the consolidation group holds at least 20 [percent] of the share capital or votes."[108]

In making these changes, Ukraine should avoid the temptation to simply apply definitions in other existing Ukrainian laws to the banking context. Many of them do not adequately reflect EU practice, and are not well-suited to the bank supervision process.

For example, some articles in the Ukrainian Banking Law use the words "parent" and "subsidiary," but these words are not defined.[109] The Ukrainian Economic Code does contain a subsidiary definition, but applying it in the bank supervisory area would be ill-advised. The Code provides a somewhat circular path to determining whether one enterprise is a subsidiary of another.

Article 63 of the Economic Code stipulates that an enterprise is deemed to be a subsidiary if it is dependent upon another enterprise as defined in article 126.[110] Article 126, in turn, provides that dependence can arise between associated enterprises. Associated enterprises are a "group of business entities associated with one another through relationships of economic and/or organizational dependence in the form of participation in the authorized fund and/or management. Dependence between associated enterprises may be ordinary and decisive."[111] Ordinary dependence exists if one enterprise "has an opportunity to block decisions of another (dependent) enterprise, which must be made according to the law and/or constituent documents of such enterprise by the qualified majority of votes."[112] Decisive dependence exists if there are control and subordination relationships due to dominant participation of the controlling body of one enterprise in the authorized fund and/or the general meeting or other management bodies of the other enterprise (subsidiary), in particular possession of a controlling block of shares.[113] The Economic Code does not define dominant participation, nor does it contain a numerical threshold for a controlling block of shares.[114] In international practice, control is typically—though not invariably—assumed to mean at least 50 percent share ownership.[115] Moreover, in EU practice, dominant influ-

107. EU Financial Conglomerates Directive, *supra* note 33, at art. 2, ¶¶ 11-12.

108. *See* Credit Institutions Act § 9. Note, however, that the Estonian consolidation group does not include non-financial entities, a major issue that must be addressed in Ukraine.

109. *See* Law of Ukraine on Banks and Banking, *supra* note 3, at arts. 11-12.

110. Economic Code of Ukraine, *supra* note 36, at art. 63.

111. *Id.* at art. 126, ¶ 1.

112. *Id.* at art. 126, ¶ 2.

113. *Id.* at art. 126, ¶ 3.

114. *Id.*

115. *See, e.g.*, EU Banking Directive, *supra* note 32, at art. 1(8); EU Financial Conglomerates Directive, *supra* note 33, at art. 2(13)(b) (both incorporating article 1 of Council Directive 83/349/EEC, based on the article 54(3)(g) of the Treaty on Consolidated Accounts, 1983 O.J. (L 193) [hereinafter Consolidated Accounts Directive], referring to majority ownership of shares or voting rights); Gesetz uber das Kreditwesen [Banking Act] § 1, ¶ 8 (referring to Handelsgesetzbuch (Commercial Code), § 290, defining parent-subsidiary relationship in terms of a majority of the voting power, see GERMAN COMMERCIAL CODE & CODE OF CIVIL PROCEDURE 85 (Charles E. Stewart trans., 2001; Credit Institutions Act §§ 7(4), 10(2) (referring to a majority of share capital or votes). *But see* 12 U.S.C. § 1841(a)(2)(A) (§ 2 of the U.S. Bank Holding Company Act, using a 25% threshold).

ence is generally considered to be the non-numerical equivalent of 50 percent ownership.[116] The Ukrainian Civil Code states that an economic partnership, which may include a limited liability partnership, additional liability partnership or a joint stock partnership, is considered to be dependent if the other principal economic partnership owns 20 or more percent of the charter capital of the limited liability partnership or additional liability partnership or 20 or more percent of ordinary shares of the joint stock partnership.[117] Query, however, whether 20 percent ownership can really be said to constitute a dominant participation in the statutory fund, especially if another shareholder owns a higher percentage of the shares and, in particular, a majority of the shares.

Relationships of decisive dependence may be determined on condition of consent from the relevant authorities of the Antimonopoly Committee of Ukraine.[118] Ordinary or decisive dependence must be specified in the information on the state registration of the dependent enterprise (subsidiary) and published in media pursuant to article 58 of the Economic Code.[119]

A business entity that holds a controlling block of shares of one or more subsidiaries is deemed to be a holding company.[120] Relationships of control and subordination are established between the holding company and its subsidiaries in compliance with the requirements of the Code and other laws.[121]

As is readily apparent, the above definitions exalt form over substance. The holding company and subsidiary definitions in the Economic Code are not suitable for bank supervision purposes because they focus on ownership of a controlling block of shares rather than actual control. As noted above, for bank supervisory purposes, actual control is much more relevant than formal share ownership. The EU definitions are better suited to this purpose because they emphasize actual control.

For example, the EU Banking Directive defines a subsidiary in part by cross reference to the EU's Consolidated Accounts Directive.[122] The latter does not contain an express subsidiary definition but incorporates the subsidiary terminology into the parent undertaking definition. According to the EU Consolidated Accounts Directive, a parent undertaking is one that:

> (A) [h]as a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or
> (B) [h]as the right to appoint or remove a majority of the members of the administrative, management, or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or

116. *See* EU Banking Directive, *supra* note 32, at art. 1, ¶ 12; Gesetz uber das Kreditwesen [Banking Act] § 1(6); Credit Institutions Act § 10(2) (all referring to a "dominant influence").

117. Civil Code of Ukraine art. 188 (Ukr.) (2004), *available at* http://www.kac.com.ua/ukrtax/CIVIL%20CODE.zip.

118. Economic Code of Ukraine, *supra* note 36, at art. 126, ¶ 3.

119. *Id.* at art. 126, ¶ 4.

120. *Id.* at art. 126, ¶ 5.

121. *Id.* at art. 126.

122. *See* EU Banking Directive, *supra* note 32, at art. 1, ¶ 13 (incorporating Consolidated Accounts Directive, *supra* note 115).

(C) [h]as the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract . . . or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions.[123]

Member states are not required to use the shareholding test in order to apply this definition, but the contract or articles of association test is a prerequisite for finding that one entity is a subsidiary of another.[124]

The EU Banking Directive also permits discretion in determining whether a given entity is a subsidiary of another. For purposes of supervision on a consolidated basis (and also for control of large exposures), a subsidiary means any undertaking over which, in the opinion of bank supervisors, a parent effectively exercises dominant influence.[125] The parent undertaking definition uses parallel language.[126] All subsidiaries of subsidiary undertakings are considered subsidiaries of the original parent.[127]

Ukraine would do well to follow EU practice more closely.

C. External Audits

The Ukrainian auditing profession is still in its infancy. The World Bank has noted that the auditing profession lacks credibility and professional competence, with the result that the public and Ukrainian and foreign institutional investors do not have confidence in statutory auditors' reports.[128]

Under the Ukrainian Banking Law, banks' financial statements must be audited annually by an auditor that has a certificate of the NBU to audit banking institutions.[129] The auditor's report must contain the following items:

(1) [b]ank balance sheet;
(2) [p]rofit and loss account [statement];
(3) [s]tatement of movement of capital;
(4) [s]chedule on assets and liabilities maturity;
(5) information on the adequacy of bank reserves and capital;
(6) information [on] the adequacy of the accounting, internal audit and bank's control mechanisms;
(7) [a] conclusion [as to] whether the submitted financial statements reflect the bank's real financial position.[130]

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123. Consolidated Accounts Directive, *supra* note 115, at art. 1(1).

124. *See id.* Note also that the Consolidated Accounts Directive does not address the matter of dominant influence by physical persons but only undertakings, which is quite understandable in view of the purpose of the directive.

125. EU Banking Directive, *supra* note 32, at art. 1, ¶ 13.

126. *Id.* at art. 1, ¶ 12.

127. *Id.* at art. 1, ¶ 13.

128. World Bank, Report on the Observance of Standards and Codes (Aug. 15, 2002), *available at* www.worldbank.org/ifa/rosc_ukraine.html [hereinafter *ROSC on Audits*].

129. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 69.

130. *Id.*

The World Bank has identified three areas of concern with respect to the legal provisions on bank audits:

- *Legal void.* The regulatory framework has achieved greater progress in relation to banks than in relation to non-bank financial institutions. The framework presents a legal void in this respect, and may provide banks and others with opportunities for regulatory arbitrage that have been destabilizing for the system as a whole.
- *Unclear accounting requirements.* NBU accounting rules fall short of International Accounting Standards in a number of areas. The legal provision stating that NBU rules are developed in accordance with IAS may mislead those who are not informed about NBU accounting rules and who may assume the financial statements that are based on NBU accounting rules present the financial position and results of operations of a bank in accordance with International Accounting Standards.
- *Unclear audit requirements.* The requirements as to the content of the audit do not provide a clear definition of audit requirements. Specifically, there is no reference to the audit framework and the scope of an audit is not specified. For example, the Banking Law and regulations do not state that an audit should be conducted in accordance with Ukrainian Standards on Auditing or another comprehensive auditing framework, and do not distinguish between audit and additional requests from the NBU to the external auditors to assist in specific supervisory tasks.[131]

In order for Ukraine to become fully EU-compliant in this area, a number of steps are necessary. The Basel Committee has published a particularly useful paper on the relationships between supervisory authorities and banks' external auditors.[132] The points in the paper have been incorporated into the banking legislation in many countries, as well as into the pertinent EU directives.[133] While the specific provisions vary somewhat between countries, a number of common themes are apparent:

- Auditors are required to inform the bank supervisor about violations or deficiencies that could impair the stability of banks;
- Auditors are not liable for breaches of confidentiality when they furnish such information to the bank supervisor;
- Often, audits are required not only for banks, but for other companies within a banking group. The auditor typically has the same reporting obligations regarding these companies as regards the bank itself.[134]

Ukraine would be well-advised to adopt similar provisions.

131. *ROSC on Audits*, *supra* note 128, at 5-6; *see also* Mehmet Ögütçü & Jaroslav Kinach, *Ukraine: A miracle in waiting?*, OECD OBSERVER, Aug. 2003, at 32.

132. BASEL COMMITTEE ON BANKING SUPERVISION, THE RELATIONSHIP BETWEEN BANKING SUPERVISORS AND BANKS' EXTERNAL AUDITORS (Jan. 2002), *available at* http://www.bis.org/publ/bcbs87.htm.

133. EU Banking Directive, *supra* note 32, at art. 31; Gesetz uber das Kreditwesen [Banking Act] § 25a(1); Credit Institutions Act §§ 52, 95; French Monetary and Financial Code, art. L613-9; Credit Institution Law § 88; 12 U.S.C. § 1831m; Law on Banks & Savings Banks, Nov. 8, 1934, art. 21, ¶¶ 3, 4 (Switz.), *available at* http://www.gbld.org/country_details.aspx?countryid=38;

134. EU Banking Directive, *supra* note 32, at art. 31; Gesetz uber das Kreditwesen [Banking Act] § 29(3); Credit Institutions Act § 95; French Monetary and Financial Code, art. L613-9; Credit Institution Law § 88; 12 U.S.C. § 1831m; Law on Banks & Savings Banks art. 21, ¶¶ 3-4.

D. ENFORCEMENT MEASURES

The enforcement provisions of the Ukrainian Banking Law are contained in article 73. If a bank or other person subject to NBU supervision violates the banking legislation of Ukraine, any regulations of the NBU, or carry out risky operations that threaten the interests of the bank's depositors or other creditors, the NBU has the right to use a number of enforcement measures, including:

(1) Send[ing] a written warning requiring the termination of such violations and adoption of measures to correct the situation; reduction of the bank's expenses; limitation of unwarranted high interest payments on the attracted funds; reduction or alienation of inefficient investments.
(2) Calling [a] general meeting of the stockholders, a meeting of the council of the bank or the Board of Directors of the bank to agree on the action plan for a bank's financial rehabilitation or a reorganisation plan.
(3) Signing a written agreement with the bank under which the bank or the bank-authorised person assumes an obligation to redress violations, improve the financial condition of the bank, etc.
(4) Issuing of instructions concerning the:
    (a) Suspension of the payment of dividends or the distribution of the capital in any other form;
    (b) Imposition of increased individual economic norms;
    (c) Increase in the loan loss provisions and allowances for other assets;
    (d) Limitation, termination or suspension of some high risk transactions performed by the bank;
    (e) Imposing a ban on the provision of bank credits;
    (f) Imposition of financial fines on:
        (i) bank directors in amount up to one hundred untaxed minimal personal incomes [of citizens];
        (ii) banks under the Regulations approved by the [NBU] Board, but not more than 1 percent of the registered statute fund;
    (g) Temporary[135] prohibition to the essential participation holder from the use of his/her voting rights, acquired shares (pays) in case he/she seriously or repeatedly violated requirements of [the Banking Law or NBU regulations];
    (h) [Temporary removal of a] bank's official from his/her office and [prohibition to hold any position] in case of serious or repeated violation of requirements of [the Banking Law or of NBU regulations];
    (i) Bank reorganization;
    (j) Appointment of a provisional administration of the bank.[136]

In the event of a violation of the Banking Law or NBU regulations that causes a significant loss of assets or income and brought about the insolvency of a bank, the NBU may revoke the bank's license and initiate bank liquidation procedures under this Law.[137]

135. In Ukrainian, this means until the violation is removed.
136. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 73.
137. *Id.*

A person discharged from office or temporarily stripped of voting rights in the bank pursuant to a National Bank decision can be restored to office or his voting right can be renewed only subject to prior permission of the NBU.[138]

At first glance, it would appear that the NBU has considerable corrective powers, but a close reading of article 73 reveals some troubling deficiencies.

First, and perhaps most serious, the list of mandatory measures that the NBU can impose in the event of violations is quite specific and mechanical. A broader provision, such as found in point one, entailing termination of such violations and application of measures to correct the situation, would be preferable. Virtually every Basel Committee country has provisions in their banking laws allowing the supervisor to impose mandatory measures, such as cease-and-desist orders that require correction of deficiencies to the supervisor's satisfaction.[139]

Second, the provisions on removing banks' officials and essential participants are much too weak to be effective. Subpoints (g) and (h) of section 4 permit the NBU to issue removal orders or to prohibit essential participants from exercising voting rights temporarily, which, in Ukrainian, means until the violation is removed. Although these persons may resume these activities only with the NBU's consent, article 73 appears to establish a presumption that such approval will be given once the violation has been corrected.[140] The problem is that some violations may be so colossally bad that the perpetrator should not be given the opportunity for a repeat performance.[141]

Third, the monetary penalty provisions are patently inadequate. The Law authorizes penalties against bank managers in the amount up to one hundred nontaxable minimal incomes of citizens.[142] This is in line with the Administrative Offenses Code of Ukraine, which stipulates that violations of banking legislation by managers of banks and other persons may be punished by a fine of fifty to one hundred non-taxable minimum salaries of citizens, approximately $150 to $300.[143] Clearly, this does come even remotely close to corresponding to the damage that can result from violations, nor does it serve as an effective

138. *Id.*

139. *See, e.g.*, 12 U.S.C. §1818(b) (authorizing the appropriate federal banking agencies to issue orders requiring banks to cease and desist from violation or unsafe or unsound practices, and to take affirmative action to correct the conditions resulting from such violations or practices); Gesetz uber das Kreditwesen [Banking Act] § 6 (authorizing the BAF to issue orders to banks that are appropriate and necessary to stop and prevent violations of regulatory provisions or to prevent or overcome undesirable developments at an institution which could impair the safety of the assets entrusted to it or could impair the proper conduct of its business); French Monetary and Financial Code, art. L613-16 (authorizing the *Commission Bancaire* to issue injunctions requiring a credit institution to take all necessary measures to restore or improve its financial situation, improve its management methods, or ensure that its organization matches its activities or development objectives); Law on Banks & Savings Banks art. 23 (authorizing the Banking Commission, in the event of violations of the law or of other irregularities, to "issue the necessary decisions to restore the rightful conditions and remove the abuses"); Bank Act, S.C. ch. 46 § 615 (authorizing the Superintendent of Financial Institutions to issue "directions of compliance," which may require the bank to cease or refrain from committing unsafe or unsound acts, and to perform such acts as in the opinion of the Superintendent are necessary to remedy the situation).

140. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 73.

141. 12 U.S.C. §1818(e) (removal and prohibition provisions under U.S. banking law, authorizing removal from the banking business of institution-affiliated parties if certain conditions are present). While in theory, a person who is subject to such an order can re-enter the banking business with the consent of the appropriate federal banking agency, in practice such consent is virtually never given.

142. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 73.

143. Administrative Code of Ukraine art. 166 (on file with author).

deterrent. On the contrary, it amounts to nothing more than a nuisance payment or a cost of doing business. Compared to the very substantial penalty provisions in many Basel Committee countries, the Ukrainian provisions seem virtually absent.[144]

Finally, there needs to be some effective mechanism for recovering damages from directors and officers who cause significant losses to their banks through intentional misconduct or gross negligence.

Article 43 of the Banking Law provides that bank managers, in carrying out their duties under the present Law, must act in the best interests of the bank and its clients and must place the bank's interests before their own.[145] Article 23 of the Law on Business Associations states that officials of a company are liable for any damage caused by them to the association as stipulated by the laws of Ukraine.[146] Finally, the Economic Code provides that officials of a business partnership are "held liable for the damage, caused by them to the partnership within the limits and in keeping with the procedure, established by the law and constituent documents of the partnership."[147]

The problem is that when a bank is operating under normal conditions (i.e., not under provisional administration or liquidation), lawsuits to recover monetary damages would have to be initiated by the bank's shareholders or supervisory council, as the NBU lacks specific authority to pursue such cases on its own. As a practical matter, however, it is often very difficult for shareholders to take the necessary steps to assess the damage caused by a bank's directors and officers and hold them accountable for their actions by suing to recover monetary damages. It is also extremely unlikely that a supervisory council or management board that has allowed the interests of shareholders and/or depositors to be harmed would be inclined to reverse its actions on receiving a complaint from the shareholders; bank boards are likely to be reluctant to bring a court action on behalf of the bank for economic harm done to the bank by other council or management board members.

As noted above, article 73 also allows the NBU, in the event of violations or other events that are harmful to a bank, to enter into a written agreement "with the bank under which the bank or the bank-authorised person assumes an obligation to redress violations, improve the financial condition of the bank, etc."[148] This is problematic because the legal enforceability of such an agreement would require the consent of the one who is to assume the obligation and the agreement must be with the bank. While the law refers to a third party assuming an obligation to take remedial action, it is not clear how this would work if the agreement is between the NBU and the bank.

Article 73 also allows the NBU to issue "a written warning requiring the termination of such violations" and to adopt "measures to correct the situation."[149] The problem here is

144. *Compare, e.g.*, 12 U.S.C. § 1818(h) (2005) (authorizing civil money penalties ranging from $1,000 to $1 million for each day a violation continues, depending on factors such as the willfulness of the violation, whether the violation was part of a pattern of misconduct, etc.) *with* Gesetz uber das Kreditwesen [Banking Act] § 56 (authorizing fines ranging up to 300,000 EURO) *and* Bank Act, S.C. c. 46 §§ 980-91 (authorizing fines of up to 500,000 Canadian dollars for individuals who violate the Bank Act, and up to 5 million Canadian dollars for entities).

145. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 43.

146. Law of Ukraine on Business Associations No. 3711-12 art. 23 (1997), *available at* http://www.ukraine-gateway.org.ua/gateway/gateway.nsf/webcontent/05010000.

147. Economic Code of Ukraine, *supra* note 36, at art. 89(4).

148. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 73(3).

149. *Id.* at art. 73.

that a warning is not an enforceable requirement; it merely indicates that more serious measures may be imposed if the situation is not corrected.

Under current Ukrainian legislation, it thus appears that the NBU lacks the authority to require restitution by members of a supervisory council or management board of an operating bank. Article 121 of the old Civil Procedural Code (which was still being used when this article was being prepared) allowed authorized state bodies to pursue actions in court to protect rights and liberties of other persons in cases stipulated by the law.[150] Article 45 of the new Civil Procedural Code, which became effective on September 1, 2005, contains a similar provision.[151] Because there is no specific provision in the Banking Law giving the NBU the authority to require restitution by members of a supervisory council or management board of an operating bank, it appears that these provisions of the Civil Procedural Code would not, by themselves, provide sufficient authority.

To remedy this situation, Ukraine should follow the example of the United States and give the NBU express authority to require restitution from directors and officers in egregious cases.[152] As the bank supervisor, the NBU is in a much better position than individual shareholders or depositors to quantify the amount of the harm to a bank and to move quickly to determine responsibility for the loss. Swift NBU action would be much more effective than requiring the shareholders or depositors to pursue individual cases in court. Article 67 of the Banking Law states that "[t]he main objective of bank[ing] supervision is to ensure [the] stability of the banking system and protect the interests of depositors and creditors of the banks in respect to the safekeeping of client funds on banking accounts."[153] Giving the NBU the explicit authority to require restitution or reimbursement for losses from council and management board members would thus be a logical extension of the shareholders' or depositors' ability to make claims for monetary harm.

E. Problem Bank Resolution

1. *Provisional Administration*

The Ukrainian Banking Law contains generally satisfactory provisions for winding up the affairs of severely troubled banks. The provisions on provisional administration are contained in chapter 15. The NBU "is obliged to appoint a provisional administration in the event of a considerable threat to a bank's solvency."[154] The NBU also has the authority to appoint a provisional administrator in the following cases:

> (1) systematic violations by the bank of legal requirements tipulated by the [NBU];
> (2) [d]ecreasing the bank's capital by 30 [percent] winthin the last 6 month[s] with simultaneous violation of at least one economic normative;

150. (Former) Civil Procedural Code of Ukraine, at art. 121 (on file with author).

151. Civil Procedural Code at art. 45 (Ukr.) (2004) (on file with author); *see* Forum, Honoring of Obligations and Commitments by Ukraine (Oct. 5, 2005), http://en.for-ua.com/analytics/2005/10/05/100735.html.

152. *See* 12 U.S.C. §1818(b)(6)(A) (authorizing the federal banking agencies to require institution-affiliated parties to make restitution in cases of unjust enrichment or reckless disregard for legal or regulatory requirements).

153. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 67; *see also* Law of Ukraine on the National Bank of Ukraine arts. 1, 55, *available at* www.bank.gov.ua/ENGL/B_legisl/index.htm.

154. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 75.

(3) [failure by the bank to honor for fifteen working days] at least 10 [percent] of its overdue liabilities;
(4) [t]he management of the bank is accused of the criminal actions;
(5) [concealing by the bank of] accounts, any assets, registers, reports, or documents;
(6) [unjustified refusal of the bank] to provide documents or information related to activities thereof to the authorised representatives of the [NBU];
(7) [existence of] a public conflict in the bank management;
(8) [filing of a petition by the bank for the] appointment of a provisional administration.[155]

These grounds are generally internationally compatible, but some of them raise significant issues.

Point (2) appears to be based on an analogous provision from the German Banking Law that allows the German Federal Federal Financial Supervisory Authority (BAFin) to revoke a bank's license if the discharge of the bank's "obligations to its creditors, and particularly the safety of the assets entrusted to it, is endangered, and the danger cannot be averted by taking other measures under [the Banking Act]."[156] The latter condition is established, inter alia, by:

- a loss amounting to one-half of [the bank's] liable capital calculated in accordance with section 10 [of the law], or
- a loss amounting to more than [10] percent of [the bank's] liable capital . . . in each of at least three successive financial years.[157]

Both the German and Ukrainian provisions are numerically based, but the Ukrainian provision is somewhat troublesome. Any bank that loses 30 percent of its regulatory capital in six months is in very serious trouble. This is true with or without a separate violation of an economic normative requirement. In this event, the NBU should be authorized to appoint a provisional administrator so that it can determine the cause of the problem and determine the most effective course of action. Whether or not there are simultaneous violations is not relevant.

The interaction of points (2) and (3) is also problematic. One of the components of the insolvency definition in article 2 is failure to pay creditors when obligations are due.[158] This is the case regardless of the volume of overdue liabilities or the length of time that this condition persists. If there is serious danger of this happening, paragraph 1 of article 75 not only permits, but actually requires, appointment of provisional administration.[159] Yet subpoint (3) of paragraph 2 requires that the actual (not just potential) failure to pay must last for at least fifteen working days before a provisional administrator can be appointed.[160] This is an inconsistency that needs to be remedied.

The approach of paragraph 1 is préferable. If a bank cannot, or does not, satisfy its obligations to even one creditor, fast action is necessary. Delaying the action will likely

155. *Id.*
156. Gesetz uber das Kreditwesen [Banking Act] § 35(2).
157. *Id.* § 35(2), ¶ 4.
158. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 75.
159. *Id.*
160. *Id.*

result in the problem getting worse, and will give unscrupulous owners and managers the opportunity to abscond with bank assets and evidence of wrongdoing.

Point (4) is a reasonable ground, but stronger authority would be desirable. If the NBU is aware of facts indicating a fundamental lack of trustworthiness on the part of the bank's owners or managers, it should have the ability to appoint a provisional administrator. The NBU should not have to wait until there is a formal determination by a court.[161]

The provisional administrator has the full and exclusive right to manage and control the bank, and to take any actions aimed at restoring the bank to satisfactory financial condition, or preparing the bank for sale or reorganization.[162]

This provision is sufficiently broad to enable the NBU to engage in a number of modern bank resolution techniques, such as purchase-and-assumption transactions, or mergers of troubled banks with healthier banks.

2. *Liquidation*

Under the Ukrainian Banking Law, a bank can be liquidated upon the initiative of the owners of the bank, or of the NBU (including based on an application from the creditors).[163] The NBU has the authority to revoke a bank's license under five specific circumstances:

(1) It is revealed that the documents, submitted for a receipt of the banking license, contain false information.
(2) The bank failed to [perform] operations during one year from the day the banking license was granted.
(3) [Any violation of the Ukrainian Banking Law or NBU regulations] which led to [a] significant [loss] of assets and insolvency of the bank.
(4) [On] the basis of a conclusion of the provisional administrator on the inability to bring the bank into legal conformity with [requirements of the Banking Law and NBU regulations].
(5) [The impracticality of] implementing the plan of the provisional administration as to the reorganization of the bank.[164]

License revocation is a legal ground to file a petition with the court for the liquidation of the bank.[165] Liquidation of a bank on the NBU's initiative is performed in line with the Banking Law and NBU regulations.[166]

Bank creditors who wish to initiate the bank liquidation process must send a registered letter to the NBU, with an application for the bank's liquidation, "if there are signs that it is insolvent."[167] The application must include documentary evidence that the bank has out-

161. *Compare* Gesetz uber das Kreditwesen [Banking Act] § 35(2), ¶ 3 (BAF in may revoke a license if it learns of facts that would warrant refusal of the license under article 33(1), which include, inter alia, a determination that an applicant, a manager, or a person with a qualified participating interest in the bank is not trustworthy) *with* Credit Institutions Act § 17, ¶ 1(4) (a license may be revoked if "a manager of the credit institution or a shareholder who has a qualifying holding does not meet the requirements provided for [in the Credit Institutions] Act and if the credit institution has failed to comply with the corresponding precept issued by the Financial Supervision Authority during the term specified in the precept").

162. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 80.

163. *Id.* at art. 87.

164. *Id.* at art. 20.

165. *Id.* at art. 88.

166. *Id.* at art. 87.

167. *Id.* at art. 88.

standing money obligations to them.[168] If the creditors do not obtain a response from the NBU within one month after filing the application, they may petition the court to recognize the bank as insolvent.[169] The court applies the legislation of Ukraine on restoring a debtor's solvency or recognizing the debtor as bankrupt (i.e., the Law on Bankruptcy and pertinent provisions of the Civil Code) to the extent that it does not contradict the provisions of the Banking Law.[170]

Article 88 creates a confusing pattern. The Ukrainian Bankruptcy Law provides that bankruptcy proceedings involving debtors that are banks are subject to the Banking Law.[171] Thus, it would appear that the Bankruptcy Law should not apply in cases involving bank liquidations or insolvency. Suggesting that portions of the Bankruptcy Law apply to bank liquidations, as article 88 of the Banking Law does, creates uncertainty and inconsistency. In fact, the Banking Law contains everything necessary to achieve the goal of bank resolution; introducing the Bankruptcy Law into the picture when it is not necessary merely clutters up the legal framework and may have the unintended effect of applying some procedures to banks that are not really suitable for their unique situation.

Interestingly, among the grounds for appointment of a liquidator are legal or regulatory violations resulting in substantial financial losses and ultimately, insolvency of a bank. Both article 20 and article 73 frame the requirement in the conjunctive rather than the disjunctive: the violations must have led to a significant loss of assets and insolvency.[172] This phrasing renders the significant loss component rather superfluous, since insolvency would necessarily entail a significant loss in any event. Rephrasing these grounds in the disjunctive (i.e., or) would give the NBU more flexibility to revoke a bank's license before it reached the point of insolvency, thus increasing the likelihood that assets would be available to satisfy depositors and other creditors. This would be fully consistent with international practice.[173]

168. *Id.*

169. *Id.*

170. *Id.*

171. Law of Ukraine on the Restoration of Solvency of the Debtor or Declaring it Bankrupt (June 30, 1999) (Ukr.) No. 784-XIV, art. 5,¶ 2.

172. *See* Law of Ukraine on Banks and Banking, *supra* note 3, at arts. 20, 73.

173. *Compare, e.g.*, Law on Banks & Savings Banks art. 23(5) (authorizing license revocation and forcible liquidation for gross violations of legal requirements) *with* 12 U.S.C. § 1821(c)(5) (section 11 of the U.S. Federal Deposit Insurance Act, authorizing appointment of a conservator or receiver for a bank on the basis of, among other things, an "unsafe or unsound condition to transact business," "violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to . . . seriously prejudice the interests of the institution's depositors or the deposit insurance fund") *and* Gesetz uber das Kreditwesen [Banking Act] §§ 35, 38 (authorizing license revocation and resultant liquidation if grounds exist that would warrant refusal of the license, or if "the safety of the assets entrusted" to a bank is "endangered") *and* Bank Act, S.C. c. 46 §§ 648-51 (authorizing the Superintendent of Financial Institutions to take control of a bank if, among other grounds, he determines that a practice or "state of affairs exists in respect of the bank that may be materially prejudicial to the interests of the bank's depositors or creditors or the owners of any assets under the bank's administration." The Superintendent may petition the court for a "winding-up order" with respect to any bank that is under his control) *and* Credit Institutions Act § 17(11) (authorizing license revocation if a bank's "activities . . . cause significant damage to the interests of depositors . . . .") *and* French Monetary and Financial Code, arts. L613-21 and 613-22 (a bank may be deleted from the list of authorized credit institutions, which may entail liquidation of the bank, if the bank "has breached a legislative or regulatory provision applicable to its business, or failed to respond to a recommendation or heed a warning, or has not complied with the special conditions imposed or the undertakings given in connection with an application for authorisation or an authorisation or a derogation provided for by [applicable] laws or regulations."). *See also* TOBIAS M.C. ASSER, LEGAL ASPECTS OF REGULATORY TREATMENT OF BANKS IN DISTRESS 124-26, 149-51, (2001).

It would be even more efficient to distinguish the violations component from the insolvency or financial loss component, so that truly serious violations could constitute grounds for license revocation irrespective of whether the insolvency or loss had actually materialized. While it is preferable, wherever possible, to achieve corrective action under the law's general enforcement provisions, the simple fact is that there are times when a bank's owners and managers will turn out to be so fundamentally incompetent or untrustworthy that leaving them in control of the bank clearly would not be appropriate, and intermediate measures such as cease-and-desist orders and management removals alone may not be adequate to cure the problem.[174] This can occur regardless of whether or not the bank is still solvent. In this situation, the NBU must have the authority to take control of the bank and to resolve its situation in a manner which, in its judgment, will be most likely to protect the bank's depositors. Of course, the legal standard should be relatively difficult to meet, and as a practical matter such authority should be used only rarely.

It is possible to get to the same point via a somewhat more complex route. As we have seen, the Banking Law allows the NBU to appoint a provisional administrator under a variety of serious circumstances that do not necessarily entail insolvency or a substantial loss of capital or assets.[175] The provisional administrator can then make a recommendation that the bank be liquidated, or resolved in some other satisfactory manner, in order to best protect the bank's depositors, and the NBU can make the decision it deems most appropriate.[176] As a practical matter, this accomplishes the same thing as allowing the NBU to directly appoint a liquidator under more flexible criteria. Still, there may be times when a bank's owners and managers are notoriously uncooperative, and going through the process of provisional administration would be an empty exercise. The preferable approach in those situations would be to allow the NBU to bypass the provisional administration stage and to proceed directly with the appointment of a receiver or liquidator.

Another issue concerns license revocation in the case of non-transparent bank ownership or control, which ties into the discussion above of consolidated supervision. A number of countries that have adopted comprehensive consolidated supervision principles permit license revocation if a bank is part of a group which impedes effective supervision or if the ownership structure in not transparent.[177] Ukraine should seriously consider following their lead.

174. A good example is where an entity with a banking license turns out to be, in fact, a money-laundering enterprise or pyramid scheme. Such an enterprise should be closed down immediately—whether or not it is insolvent is not relevant.

175. *See* discussion *infra* Part III(E)(1).

176. *Id.*

177. *See, e.g.*, EU Banking Directive, *supra* note 32, at art. 7, ¶ 3 (directing EU member states to refuse authorization if close links between a bank and other persons would prevent effective exercise of supervisory functions) and art. 14, ¶ 1(c) (authorizing withdrawal of authorization if the conditions under which it was granted are no longer satisfied); Gesetz uber das Kreditwesen [Banking Act] § 35(2) (incorporating § 33(3), allowing refusal of a banking license if the bank is associated with a corporate network which impairs effective supervision of the bank); Credit Institutions Act §§ 17(8)-(9) (authorizing license revocation if a bank belongs to a consolidation group the structure of which prevents the receipt of information necessary for supervision on a consolidated basis, or if a company which belongs to the same consolidation group as the credit institution operates on the basis of legislation of a foreign state, which prevents the exercise of sufficient supervision or . . . if close links between the credit institution and other persons prevent the exercise of sufficient supervision); Croatian Banking Law arts.21, 129(1), *available at* http://www.lexadin.nl/wlg (authorizing the National Bank

3. *Pursuing Lawsuits for Damages*

The Banking Law gives a provisional administrator or liquidator the authority to pursue claims on behalf of the bank. Thus, article 80(4) states that the provisional administrator may "bring actions to the court institutions on property rights."[178] Undoubtedly, illegal or grossly negligent actions or non-actions of a bank's supervisory council or management board members that have caused losses to the bank and a diminution in the value of shareholders' equity would fall into this category. Arguably, bank depositors who are not covered by deposit insurance and could not receive the full value of their deposits could also make similar claims.

Similarly, article 92 contains two provisions that could be used by liquidators to recover damages from council or management board members who had caused damage to the bank. The liquidator can "[p]erform functions of the bank['s] management bodies" or take actions to locate and recover "the bank's property held by third persons."[179]

In Ukraine, as in most post-Soviet countries, asset stripping is a huge problem in banks as well as in general business enterprises.[180] The above provisions therefore should be used vigorously when a bank is in provisional administration or liquidation. It is especially critical that all possible steps be taken to recover losses in the case of a bank that has insured deposits.

IV. Conclusion

Clearly, the NBU has come a long way since Ukraine gained independence in 1991, but much remains to be accomplished. President Yushchenko's election represents a golden opportunity to continue to advance banking sector reform. Ukraine must not let the opportunity slip away.

A common perception is that financial sector reform is extremely difficult in Ukraine because of cozy relationships between banks and members of the Verkhovna Rada, many of whom are the de facto, undisclosed beneficial owners of banks. This perception is undoubtedly true, yet this should not deter the NBU from seeking strong legal authority to perform its role of promoting a healthy banking sector and ensuring the safety of assets entrusted to banks, or from vigorously utilizing the legal authority that it does have in order to carry out its legislatively mandated functions. The NBU should forcefully advocate for strong supervisory authority, even if its position might not be politically popular. After all, the NBU is charged under the law with supervising an industry that is in the business of handling—and taking risks with—other people's money.

Some words of wisdom can be found in the following quotation from James Landis, former Chairman of the U.S. Securities and Exchange Commission, Dean of the Harvard

to revoke a bank's license if grounds exist to refuse permission for a person to have a qualifying holding in the bank; these grounds include, inter alia, that "operations of the bank could be endangered . . . " by the activities or operations of the qualified owner or a person connected thereto, or because "the supervision of the bank could be hindered or [made] substantially more difficult" by the manner of connections between the qualified owner or a person connected thereto.

178. Law of Ukraine on Banks and Banking, *supra* note 3, at art. 80(4).

179. *Id.* at art. 92.

180. *See generally* Vladimir Brovkin, *Moving Money, Making Money, and Parking Money Overseas: Front Companies in Offshore Jurisdictions*, 9 DEMOKRATIZATSIYA (Winter 2001), *available at* www.demokratizatiya.org.

Law School, and one of the chief architects of much of the early financial sector regulatory legislation in the United States:

> [t]he assumption of responsibility by an agency is always a gamble that may well make more enemies than friends. The easiest course is frequently that of inaction. A legalistic approach that reads a governing statute with the hope of finding limitations upon authority rather than grants of power with which to act decisively is thus common . . . . [T]here is an enormous difference between [a] legalistic form of approach that from the negative vantage of statutory limitation looks to see what it must do, and the approach that considers a problem from the standpoint of finding out what it can do.[181]

A final note of encouragement for the NBU can be found in the words of Frederick Douglass, who was born a slave in ninteenth century America, eventually gained his freedom, and devoted the rest of his life to ending slavery in the United States. During his later years, a young person asked Douglass what he could do to bring about positive change. Douglass' response was clear and simple: "Agitate. Agitate. Agitate."[182]

181. JAMES LANDIS, THE ADMINISTRATIVE PROCESS 75-76 (1938).

182. William S. Connery, The Life and Legacy of Frederick Douglass, http://www.rense.com/general34/lifeand.htm (last visited Oct. 30, 2005).