Ukraine

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Introduction

During 2016 and 1Q of 2017, the pivotal reformation processes have continued across the Ukrainian banking sector, prompted first of all by the requirements of the International Monetary Fund (the "IMF"), reflected in the Memorandum of Economic and Financial Policies (the MEFP) between the IMF and Ukraine, which has undergone three revisions and updates since its conclusion in February 2015, the last being the restatement of 2 March 2017. Pressing internal challenges have also dictated the need for substantial reforms. The Parliament and the National Bank of Ukraine (the "NBU") have recently adopted a number of enactments addressing specific areas and, during this period, the NBU has been most busy with continuing thorough diagnostics of the banking sector along with resolution of the problematic banks. As of the end of 2016, the diagnostics of the 60 largest banks, representing 98% of industry assets, have been completed and respective recapitalisation plans adopted.

Drawing on the expert support of the IMF and the World Bank, the NBU has been identifying policy measures required to bring the Ukrainian banking regulation in compliance with the Basel Core Principles and EU directives, and some regulations aimed at achieving such conformity have been already adopted during 2016. Also, assessment of the current local regulatory and supervisory framework for governance practices against the 2015 Basel Guidelines for Corporate Governance for banks was completed by the NBU, which found its reflection in the new regulations pertaining to this area.

As prior to the nationalisation of the largest Ukrainian bank (Privatbank) state-owned banks represented 32% of industry assets, and following this nationalisation their share increased to 51%, the influence of the state-owned banks on the market is critical. In addressing this, the authorities have concentrated a great deal of effort on reforming this segment of the market, again in great part based on the guidance from the IMF and the World Bank.

During 2016 and 1Q 2017, 20 banks were rendered insolvent and four were liquidated voluntarily by their shareholders because of a failure to meet the advanced requirements.

A number of banks continued to decline, and out of 110 banks operating in the country as of May 2016, 92 are still operating in the industry as of April 2017.

In December 2016, the country saw one of the greatest landmark events in the industry's history, when the largest bank of the local marketplace, Privatbank, was nationalised by the state on the grounds that the bank did not demonstrate an ability to overcome its problems, which was revealed during the diagnostics process.

According to the information provided by the NBU to the IMF, most of the largest Ukrainian banks, representing 88% of industry assets, succeeded in meeting their recapitalisation requirements during 2016.

The risks of the banking sector in Ukraine are perceived to be high. In particular, according to the latest estimations of the NBU, credit risks, capital adequacy risks and legal risks remain at their highest levels, while liquidity, currency and profitability risks are viewed as improving areas. In particular, the legal risks of the banking industry stem from inefficient creditor protection and the law enforcement infrastructure. The court system is generally regarded as dysfunctional and regulations on enforcement of judgments and insolvency proved to be inconsistent with creditors' needs.

The banking sector in Ukraine is characterised by a large proportion of smaller banks in its overall composition, and at the end of 2016 the top 20 banks represented 89.4% of the industry's net assets. In 2016, as well as in 2015, the Ukrainian banking industry in general was still loss-making. but it is reasonably expected by experts that in 2017 the banks may become profit-making, as most legal provisioning for bad assets has been reflected in the books already.

Fifty-three per cent of the overall loan portfolio of Ukrainian banks represent non-performing loans, while non-performing loans in corporate lending represent approximately 40% of the overall corporate loans portfolio of the banks, according to the NBU's statistics.

Subsidiaries of foreign banks represent 35% of industry assets and 45% of the overall loan portfolios, as per NBU statistics.

Regulatory architecture: overview of banking regulators and key regulations

The National Bank of Ukraine is the state body that regulates and supervises banks in Ukraine. NBU holds most of the power to regulate banking activity, exercise registration and qualifications, issue licences, supervise on-site and off-site, control forex activities and anti-money laundering ("AML") rules, etc. and to penalise the banks for breaching regulations. Along with the NBU, the State Deposit Guarantee Fund (the "DGF") plays a substantial role in regulation and supervision of the banks. The competence of the DGF spreads over the aspects of banks' activity that relate to intake of retail deposits, responsibility towards retail depositors and, foremost, over the process of restructuring or liquidating insolvent banks, so far as this relates to repayment of the guaranteed amounts of deposits. Some aspects of banking activity are also regulated by other bodies, e.g. the Antimonopoly Committee, consumer protection authorities and the State Securities and Stock Market Commission, but none of these other bodies play any role in regulation and supervision of banks in the country that is comparable with that of the NBU. There is no supra-national body having authority to regulate Ukrainian banks.

The fundamental principles of banking regulation in Ukraine are represented by the Law "On banks and banking activity" (the "Banking Law"), which sets forth a core regulatory framework for banks. There are also several other laws that determine the regulatory landscape along with the Banking Law, such as the Law "On the National Bank of Ukraine", the Law that regulates the system of retail deposit guarantees (and the DGF's status) and of course the Civil and Commercial Codes.

NBU issues regulations on various aspects of banking activity, including some vital areas that are not specifically regulated by the abovementioned Laws. For example, NBU's decrees No 306 "On registration and licensing of banks", No 368 "On regulation of banking activity", No 129 "On statistics reporting", No 346 "On application of sanctions by the National Banks of Ukraine" and No 351 "On assessment of the credit risk in active operations of banks" and several others form the core of banking regulation in the country.

Banks in Ukraine can be established as public joint stock companies or cooperative banks only. There are certain types of specialised banks, determined by the NBU, and a category of "systemic banks", i.e. banks whose activity impacts the financial system of the country as a whole. Being a specialised or a systemic bank means that such a bank may be subjected to some specific regulations and requirements, such as compliance with more strict capital ratios, having special funds, risk control procedures, etc. For example, the NBU sets forth a requirement to maintain a "systemic" capital buffer.

There are some restrictions put on banks by the law, such as a prohibition to undertake any goods production and trade, insurance, to hold immovable property with a value that exceeds 25% of the bank's capital (excepting banking premises and collateral), to transact with related parties indirectly or on a non-arm's-length basis and to make direct investments above defined limits.

Recent regulatory themes and key regulatory developments in your jurisdiction

The diagnostics of the banking sector, started by the NBU in spring 2015, have been under way during all of 2016 and 2017 and is planned to be completed in autumn 2017. As result of this, the NBU has identified the state of affairs in banks with regard to quality of assets, estimation and provisioning of risks, efficiency of management, related party lending and several other key parameters. Additionally, an intensive process of enhancement of shareholders' transparency has been under way. The deadlines of these thorough diagnostics have been rescheduled more than once because of the scale and complexity of the problems revealed. In the course of the diagnostics, the NBU has introduced a number of radical resolutions resulting in rendering some banks insolvent, which raised some concerns in the banking community with regard to the integrity of the process.

During 2016 and 2017, the process of adopting Ukrainian banking supervision regulations to Basel principles and European standards has continued, which reflects the transition of the banking supervision from a "rule-based" to a "risk-based" process. According to the NBU report on changes in the regulatory environment in 2016, several developments deserve special attention.

The FX restrictions, introduced starting from 2014 to tackle the crisis, have been further relaxed. For example, cash withdrawal limits for individuals at banks were significantly raised, the rate for the mandatory surrender of FX proceeds by exporters was reduced, the maximum term for the export/import settlements was extended, and the requirement was lifted for import price examination confirming the fair cost of services from non-residents. The NBU also allowed the purchase of FX for the repatriation of dividends for 2014–15 by companies, and paperwork for FX control over export and import transactions was simplified. The procedure for receiving individual FX licences has been simplified and legal entities and private entrepreneurs now no longer need to submit documents of general access to the NBU. Individual licence-holders are now authorised to submit to the NBU electronic rather than hard copy reports on transactions on accounts opened outside of Ukraine. Also, procedures for registration of loan agreements with non-residents and conditions for external financing from foreign export credit agencies and IFIs were simplified.

A transition to new rules of credit risk assessment in line with NBU Regulation No 351 is perceived to be one of the key changes in the regulation. The new approach provides for risk assessment based on losses expected over the next 12 months and also eliminates a number of gaps in the previous regulation that allowed banks to avoid full recognition of the credit risks and to lend to the insolvent and captive companies, accumulating significant credit risks. As previously credit risk assessment was mainly based on the current state of debt servicing, starting from January 2017 the financial condition of borrowers will be the key criterion for expected loss assessment. Banks are now authorised to employ their judgment in credit risk assessment, which should prevent non-recognition of credit risk by banks based on formal requirements. Also, this new regulation will facilitate the timely preparation of banks for full implementation of a new financial reporting standard (IFRS 9 on financial instruments) starting from 2018.

One of the most significant innovations of banking regulation in 2016 was the adoption of the Law "On Financial Restructuring", which allows banks and borrowers to restructure their liabilities out of court in short terms and to negotiate new loan terms that will enable the company to recover fully. The law does not specify any specific parameters of restructuring, leaving these entirely to the discretion of lenders and borrowers. The NBU adopted a number of by-laws needed for efficient implementation of this Law. Specifically, a template of a framework agreement on financial restructuring was developed and approved. Banks, non-banking financial institutions, and the DGF may now be parties to agreements. According to the framework agreement, arbitration dispute settlement will be final and binding on the parties. Additionally, the procedure for imposition of sanctions on banks for a breach of the law was approved.

There have been several enactments by the Parliament and the Cabinet of Ministers in 2016, improving judgment enforcement procedures and registration of some movable assets, which aim to ensure more efficient foreclosures and protection of banks from fraud with collateral. Some judgments by the Supreme Court of Ukraine, made in 2016, also served for enhancement of the protection of creditor rights, especially related to mortgages.

The Law "On Consumer Lending" was adopted in November 2016 and is due to come into force in July 2017. It enhances the protection of retail borrowers' rights and sets forth the requirements for the provision of services by banks and financial institutions and intermediaries.

Changes in FX regulations have provided banks with more opportunities for managing FX liquidity. According to the recent enactments, banks can buy foreign debt securities with high ratings under a simplified procedure. Previously, financial institutions were only allowed to place unencumbered FX funds on correspondent accounts at non-resident banks as deposits or interbank loans. According to the new rules, Ukrainian banks will be able to buy sovereign debt instruments of the 'Big Seven' countries and IFIs. For this, securities must have a rating of AA-/Aa3 or higher assigned by at least two international rating agencies. This change is aimed at enabling banks to earn a higher interest on their own FX funds with lower risk.

Also, procedures of the unified national system of electronic remote identification of individuals and legal entities were approved, which provides banks with an additional tool for "know your customer" ("KYC") purposes.

During 2016, several state authorities, involved in fiscal and financial activity, have started to elaborate measures for tackling BEPS (base erosion and profit shifting), in accordance with the OECD standards. This process is supposed to impact a wide area of regulation, including banking regulation, as it is perceived that outflow of capital through tax evasions schemes from Ukraine regularly reaches several billion USD per year.

The requirement that the ownership structures of banks must allow full visibility of all entities and persons in it, with no nominee or analogous elements, and sources of capital must be confirmed and cleared from any tax liabilities and AML considerations, has become a well-established concept and in 2016 and 1Q 2017, several banks where taken out of the market because of their failure to comply with this requirement. However, there were complaints from the market about inconsistencies in the approach of the NBU to dealing with non-compliant banks, which gave ground even to start of several investigation procedures by the National Anti-Corruption Bureau and other law enforcement authorities.

The related party review, where the NBU has implemented advanced standards of related party identification, continued through 2016 and 2017 and allowed the discovery that some banks have been in gross violation of the related party lending limit for years. Banks, who appeared to be in violation of the limit, were committed to fulfilment of the related lending unwinding plans in order to be able to operate normally in future.

Recently, regulation of banking groups has received more attention from the NBU, and there have been also amendments introduced, aimed at improving consolidated supervision and controls of banking groups, as well as giving the NBU authority to identify and recognise existing banking groups at its grounded discretion. The NBU's regulation No 254 "On regulation of banking groups activity" and No 134 "On identification and recognition of banking groups" are the key enactments in this area.

In addition to crucial developments in the AML area, which took place in 2014 and 2015 (the restated Law on AML, new NBU decree No 417 setting forth AML control regulations for banks), the NBU introduced the Regulation "On analysis of financial operations and counterparties" of 15 August 2016 and amendments to regulations on AML inspections of 17 February and 30 March 2016. These new regulations brought AML control for banks to a higher level, corresponding to the level of the most advanced markets. In general, the AML sphere has recently been in the special focus of the regulators and on 11 February 2016 the Cabinet of Ministers and the NBU adopted a joint Decree, setting forth the framework of the AML activity for all state authority involved in this matter.

Corporate governance in banking institutions and banking groups is receiving more attention from the regulators, and the banking industry has seen the introduction of higher standards of governance during 2016, including top management fit and proper test procedures, stricter requirements for independency of directors, groups' consolidated management rules, etc.

Bank governance and internal controls

The fundamentals of governance in banks are defined by the Banking Law, which sets forth that a bank has to be governed by three management bodies: shareholders, in the form of regular meetings; a Supervisory Board or Council, as a permanent body, representing the shareholders between meetings; and a Management Board, as an executive body. There is a requirement that the Supervisory Board must consist of at least five members, and at least a quarter of them must be independent members. The NBU is empowered to intervene and call a Supervisory Board meeting at a bank, when there is a necessity to settle substantial matters. Also, the NBU can demand dismissal of a member of the Supervisory Board or suspend a member of the Management Board should he/she fail to perform his/her duties and this threatens the bank's standing.

The Management Board can consist of persons who meet qualification criteria set forth by the Banking Law and have good reputation. The reputation requirements are established by special regulation which defines criteria of compromised reputation and also applies to members of Supervisory Boards. The NBU can also demand dismissal of Management Board members in case they fail to perform their duties. Moreover, a person can take up the position of chairman of the Management Board, chief accountant, head of internal audit or chief AML officer of a bank only upon approval by the NBU. Managers of banks are required by law to act in the best interests of the bank and to avoid personal conflicts of interest.

Each bank must have a credit committee and a committee on assets and liabilities. Other committees a bank can establish depending on its governance model. Along with the committees, each bank is required to have independent risk management and audit functions, which are accountable to the bank's Supervisory Board.

At present, there are no specific rules on banks' remuneration policy. Each institution applies its own standards of remuneration. This state of regulation raises concerns, in particular with representatives of the IMF and the World Banks, and there is a process of developing special rules on remuneration of bank managers.

Banks may outsource functions except those which are defined as obligatory for each bank.

The Banking Law defines a list of circumstances within each governance area of which a bank is obliged to inform the NBU, such as replacement of the chairman of the Management Board, losses exceeding 15% of the capital, criminal charges against managers and some other major developments within a bank.

General requirements for banks' internal controls are set forth by the NBU in its Regulation No 867 "On the organization of internal control in banks", while internal audit rules are set forth in NBU Regulation No 311 "On the organization of internal audit in banks".

Bank capital requirements

According to the NBU 2016 report, over the year, banks where a capital gap had been discovered in the course of diagnostic studies were recapitalising in line with programmes approved by the NBU. Their factual authorised capital has increased by approximately a quarter in the course of 2016, largely as a result of subordinated debt conversion. The capital adequacy ratio began to rise. At present, capital is distributed unevenly across the industry – banks that need additional capital as well as banks with excessive capital operate on the market.

The Banking Law stipulates a minimum statutory capital requirement, which presently is UAH 500m or more (approximately $18.5m as of April 2017), for a new bank to be registered. At the same time, the statutory capital requirements for banks that had been operating on the market prior to July 2014 are less strict and they are obliged to raise their authorised statutory capital gradually; in particular: as of 11 July 2017, banks must provide for UAH 200m statutory capital; as of 11 July 2018 – UAH 300m; as of 11 July 2019 – 400m; as of 11 July 2020 – UAH 450m; and as of 11 July 2024 – UAH 500m. However, it should be noted that the statutory capital benchmarks have been recently amended several times and there is good reason to suppose that more amendments may be made in the future, reflecting economic and political conditions in the country. Contributions to the statutory capital may be done only in monetary form with some temporary exceptions set forth by anti-crisis regulations for existing banks. Along with the statutory capital there is a concept of regulatory capital, which is a risk-weighted capital and is calculated according to the methodology defined by the NBU.

According to the Banking Law, the National Bank of Ukraine is authorised to settle minimum regulatory capital requirements, regulatory capital adequacy parameters, tier 1 and tier 2 capital requirements, regulatory capital to assets and to liabilities ratios, and other ratios according to the NBU's regulations. At present, capital requirements and ratios are set forth by local Ukrainian regulations only.

Banks are supervised based on, along with the other criteria, economic ratios, each of which relates to specific bank activities and correlate to capital or its components. There are four groups of ratios, specifically: capital ratios; liquidity ratios; credit risk ratios; and investment ratios. Some of these ratios can also be defined as legal limits on operations.

Banks in Ukraine can distribute dividends once per year, provided that dividend distribution does not lead to breach of capital requirements.

Each bank in Ukraine has to maintain a Reserve Fund in an amount of not less than 25% of its regulatory capital.

The issue of banks' capital adequacy is closely related to the issue of asset quality and risk management. In December 2014, the Parliament adopted a law and the NBU issued special supporting decrees that initiated an overall analysis of banks, with the purpose of assessing banks' assets and determining the need for additional capital. It was expected that by the end of 2016, each of the banks who needed additional capital would have received a notice from the NBU stating the required capital increase and other restructurings that such a bank needs to perform. However this term has been extended over 2017 due to multiple complexities identified in the course of the diagnostics and scale of the problems identified. Also the press and the experts community wrote extensively about selective approach and protectionism exercised by the regulators in some cases along with the several investigation procedures commenced by the law enforcement agencies with regard to the same allegations.

Rules governing banks' relationships with their customers and other third parties

The most remarkable innovation in this area recently was the adoption in November 2016 of the Law "On Consumer Lending" which is due to come into force in July 2017. It enhances the protection of retail borrowers' rights and sets forth the requirements for the provision of services by banks, other financial institutions, and credit intermediaries. Amongst other requirements, the new law regulates more specifically activity of banks for computing variable loan interest rates, prohibits modification of this procedure without the borrowers' consent, as well as unilateral change of the interest rates for consumer loans.

In general, there is a layer of regulations governing relationships between consumers and service providers across the country, some of these rules being applicable to bank-client relationships as well. At the same time, there is a set of rules that specifically apply to banks and their customers. The principal rules belong to banking secrecy. The Banking Law contains a specific section addressing bank-client relationships and the banking secrecy requirements in particular. Banks are also prohibited from cross-selling unrequested products as a precondition to the sale of requested products to clients. The law also sets forth a list of information that banks are obliged to disclose to clients regarding banks' services as well as their governance and ownership matters.

Chapter 10 of the Banking Law regulates treatment of confidential information that banks obtain in the process of their activities. There is an open-ended list of data that forms banking secrecy rules that regulate actions of banks aimed at preservation of banking secrecy. Information that is gathered by state bodies, including the NBU, in the course of banking supervision, is privileged and protected under the banking secrecy rules. The law specifically regulates who, and in compliance with which procedures, is authorised to receive banking secrecy information without the consent of the owners.

Recent developments in banking regulation also address the issue of related party transactions. On March 2015, amendments were incorporated into the Banking Law, followed by the introduction of specific regulations by the NBU which set forth requirements and restrictions on related party transactions as well as liability for breaching these rules. In particular, the NBU received a right to identify related parties of a bank in the course of its supervision. Transactions between related parties on a non-arm's-length basis and indirect financing of related parties are prohibited and can be rendered null and void in court.

The abovementioned State Deposit Guarantee Fund is an institution whose primary role is the repayment of deposits to individuals who suffered losses from the insolvency of the banks they used. Currently, the deposit amount guaranteed to each individual depositor is UAH 200,000 (approximately $5,400 as of April 2017).

The EU-Ukraine Association Agreement stipulates that in four years Ukraine shall approximate its national legislation to the Directive 94/19/EC of 30 May 1994 on deposit guarantee schemes. To replace this act, the EU adopted a new Directive 2014/49/EC of 16 April 2014 that is effective now, whose provisions should serve as a benchmark for further transformation of the Ukrainian deposit guarantee system.

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Oleksandr Zavadetskyi was admitted to the Bar in 2001 and has gained substantial hands-on experience in Finance Regulation, Litigation and White-Collar Crime.

Oleksandr's representative experience in Banking and Corporate Finance includes high-profile deals such as IPOs and private placements in London, Frankfurt, Vienna and Kiev, domestic and cross-border M&A transactions, establishment of funds, advice to investment and asset managers across numerous jurisdictions, management of recovery and restructuring of international banks' NPL multi-billion portfolios, and investment projects in Ukraine, Russia, EU, Australia, Asia and Africa.

In 2015 and 2016, Oleksandr was engaged with the National Bank of Ukraine to fulfil several of the NBU's obligations under the MEFP between the IMF and Ukraine. There Oleksandr worked as Head of the Registration and Licensing and Related Parties Monitoring, simultaneously being the first ever Chairman of the NBU Qualification Commission and a member of the Banking Supervision Committee.

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