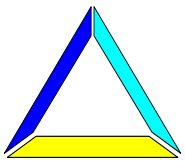
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Should Foreign Banks be Allowed to Open Branches in Ukraine?

Executive Summary

In contrast to most transition economies, Ukraine does not allow branches of foreign banks to operate in its domestic banking market. The NBU has recently submitted a draft law to parliament, which envisages allowing foreign branch entry. In this paper we *first* look at the fundamental question whether to allow or not to allow foreign branches to operate in Ukraine. *Afterwards* we comment on the widely debated draft law produced by the NBU.

Foreign branch entry will bring about substantial economic benefits to Ukraine. It will contribute to inflows of FDI, long-term capital and know-how. More benefits will stem from the facilitation of trade and WTO negotiations as from efficiency gains. Foreign bank entry can enhance the functioning and development of national banking and capital markets, with positive welfare implications for local banking customers and the economy as a whole. These benefits should however not come at the expense of financial stability. Proper regulation is of key importance to avoid the entrance of unreliable banks and protect the deposits of local customers.

The main provisions of the NBU draft law set an appropriate regulatory framework for foreign banks' branches. However, the provisions on solvency ratios (capital adequacy) are too tight and will discourage foreign banks to operate in Ukraine via a branch. Ideally, the draft law should be passed including softer restrictions on solvency. But also the adoption of the draft law in its current restrictive form would be a step in the right direction.

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1. Introduction

Most transition economies today allow branches of foreign banks to operate in their country. In Ukraine this is however not the case. The National Bank of Ukraine (NBU) has elaborated a draft law with amendments to the current banking legislation and submitted it to the parliament. It envisages allowing foreign banks branches to operate in Ukraine with some restrictions. A political debate is taking place whether this draft law should be enacted or not. Proponents of the NBU proposal emphasize the important economic benefits that foreign banks branches are likely to bring about to Ukraine, while opponents see them as a danger to financial stability and safety.

This paper has two goals. First, we study the fundamental question whether branches of foreign banks should be allowed to operate in Ukraine or not. Second, we will question if the NBU draft law sets an appropriate framework for foreign branch entry in Ukraine. For this purpose we characterise the different establishments of banks in foreign countries in Part 2. We then outline the main benefits and risks of opening the Ukrainian banking sector to foreign branches and refer to international experience and empirical evidence in Part 3. To put our appraisal of the NBU draft law (Part 5) on a firm footing, we will accentuate the main problems and tradeoffs of the regulation of foreign banks branches in Part 4.

2. What is a Branch of a Foreign Bank?
- Characterisation of Foreign Banks Establishments

Banks enter and conduct business in foreign countries through different types of establishments. They can be mainly grouped under three categories: representative offices, subsidiaries and branches. The foreign bank's choice between these options depends upon its general strategy, the type of activity it intends to undertake in the host country (i.e. the country of their foreign operation) and the respective legal and supervisory framework. In Ukraine foreign banks are only allowed to open representative offices and subsidiaries. In most emerging economies however, branches are an important and popular form of foreign bank participation – due to their specific features and advantages. The different types of establishments are commonly classified as shown below.

(i) Representative Offices

Representative offices are the most limited form of foreign banks involvement in a host country. Their main scope is to collect data and intelligence in the host country. They provide information on the market and general economic trends and sustain connections with actual and potential clients. In contrast to foreign subsidiaries and branches, representative offices are not authorized to carry out key banking functions such as deposit taking or lending and are often prohibited from engaging in any profit-making activities. In emerging economies, opening a representative office is usually the first step in entering the market.

(ii) Subsidiaries

Subsidiaries of foreign banks are legal entities separate from their parent bank. They are created under the law of the host country and are subject to local supervision and regulation. Although they are majority-owned by a foreign parent bank, subsidiaries are stand-alone entities with their own capital. As such they have separate accounts from those of the parent company and are financially independent. Subsidiaries can only borrow on the basis of their own capital. This can prove to be a major constraint to lending compared to branches.

Foreign subsidiaries are typically established where a banks objective is to compete directly with domestic banks in foreign markets. Subsidiaries of foreign banks typically adopt a local character and try to obtain access to the local business and retail market. Usually, subsidiaries operate at the same legal grounds as domestic banks, i.e. their operations are not restricted to any extent. They typically control wider foreign branch networks to enable them to participate in both retail and wholesale lending and deposit taking.

(iii) Branches

Branches are integral parts of the parent bank and act as a legal and functional extension of the foreign head office. They do not have separate legal personality and generally no separate accounts. Generally, the supervision of foreign banks branches lies first and foremost in the hands of their home country regulators and not of the host country authorities. This is logical as branches are mere extensions of their parent bank, which is subject to the laws and regulation at the headquarters. However, according to international practice, each country may impose its own rules on foreign branching.

From the point of view of a bank, the main advantages of opening a branch in comparison to a subsidiary are the patterns of lending. As a result of their legal incorporation, branches can be made able to borrow on the basis of their parent bank's full capital base and not only on the basis of the regulatory capital in the host country (as is the case with subsidiaries). This however has to be allowed by the host country regulatory authorities. Moreover, a branch generally costs less to establish than a subsidiary: In many host countries branches do not have to provide regulatory capital and their management structure can be much leaner than of an incorporated subsidiary. Branches can also attract clients through the parent's reputation and have direct access to the managerial and technical support of the parent bank. The advantages of a branch vis-à-vis a subsidiary depend heavily on the regulatory policy in the host country and shrink the more restrictions will be imposed on them. If branches face many regulatory requirements their difference to subsidiaries will actually disappear and foreign banks will thus have little incentive to enter via a branch (see Part 4).

The main activity of foreign branches is wholesale lending. Other main activities include trade financing, foreign exchange and money market trading or investment banking. When lending limits of branches are based upon the worldwide capital of the parent bank, they are less restricted to provide large loans to corporations and government agencies in a host country than foreign subsidiaries. Additionally they can then borrow and lend at advantageous rates as they have the same credit rating as their head office. Generally they perform more specialised functions than subsidiaries and are more closely linked to the operations of the parent bank. They mostly restrict themselves to relatively small market segments where they have a comparative advantage. Experience has shown that foreign branches are reluctant to build up extensive branch networks and engage in retail activity. Most foreign banks have only one branch, which they have placed in the host country's financial centre.

3. Benefits and Risks of Foreign Branch Entry for Ukraine

Allowing foreign branches is likely to have a number of advantages but also includes a number of risks. In most transition economies foreign branching has been the last step of liberalising the banking sector - in contrast to Asian or Latin American experience where branches have been the main vehicle of foreign bank entry. Opening the banking sector to foreign branches in Ukraine might have strong positive effects on the banking sector itself, on the volume of capital imports and FDI, on trade and WTO negotiations, as well as on capital

markets. Branch entry however will have to be properly regulated to minimize the potential risks such as the entry of non-reliable banks, or weakened stability and deposit safety. In the following we expose these main potential benefits and risks.

Benefits

(i) Increased Efficiency and Know-How Transfer in the Banking Sector

At present, foreign banks compete very little with Ukrainian banks. Thus, allowing foreign branches to operate in Ukraine will likely render local banking markets more competitive and diversified. Foreign branch entry is likely to foster the overall efficiency of the sector: The competition from experienced foreign banks will force domestic banks to improve their risk management, their services and their cost structure, as they would otherwise be left behind. Foreign bank entry also tends to reduce interest margins in the banking sector, which will benefit depositors and lenders alike.

In addition to increasing efficiency and competition, foreign institutions may bring important attributes that domestic financial institutions lack. Due to their experience, size and standing reputed banks are able to provide innovative and high-quality services and transfer essential know-how and technological skills. Foreign branches will complement the range of banking products offered by domestic banks especially for corporate customers and foreign investors. They introduce sophisticated management, accounting and risk evaluation techniques, which are likely to spill over to the host country. They also play a crucial role for the training of local employees, which will be able to learn about state-of-the art finance and banking practice.

(ii) Enhanced Access to International Capital through FDI and Loans

The establishment of foreign branches will favour foreign direct investments (FDI) in Ukraine. The presence of foreign banks branches can be a major determinant for FDI as they add credibility and improve the market environment for foreign companies. In effect, an industrial investor facing high degrees of risk and uncertainty will wish to work with a 'familiar' banking partner. Worldwide, foreign banks follow their customers by opening branches. The type of services provided in the context of FDI is not easily replicable by domestic banks: Foreign banks are able to offer the same type of products as in their home countries, provide information about the market and make use of the specific customer relationships that they have built up.

Additionally, foreign branches can become an important source of long-term finance on top of the capital brought in by subsidiaries. Especially corporate customers could benefit from additional capital that might be transferred by foreign branches to Ukraine. If the host country regulators do not impose respective restrictions, foreign branches are able to lend on the basis of their worldwide capital. Thus they are less restricted than subsidiaries to offer loans and can better engage in large operations. As foreign branches have the same credit rating as their parent bank they can also take advantage of lower cost of funds. Generally, empirical literature suggests a strong positive influence of foreign bank presence and the volume of credits to households and enterprises.

(iii) Facilitation of Trade and WTO Accession

Foreign banks bring with them networking links for foreign exchange and cross-boarder economic relations. The establishment of subsidiaries and branches is highly correlated with

ex- and imports to and from the foreign bank's home country. It will evidently have positive effects on the volume of trade if banks are able to offer their international clients trade financial services via the establishment of a branch.

According to the WTO liberalisation demands, foreign banks should be allowed to establish a local presence in all possible ways, including branches. A prohibition of branch entry contradicts a key demand of the GATS (General Agreement on Trade of Services) and will be a major obstacle during WTO accession negotiations. Several CIS, Eastern European and Baltic countries made deep market-opening commitments, as banking liberalisation (i.e. market opening) has been of crucial importance for WTO talks.

(iv) Development of Capital Markets

Foreign branches are likely to increase the number of financial products available to local customers. In OECD countries they focus mostly on areas where they have a real competitive advantage. They are often active in niche activities such as cross-boarder merger & acquisitions, derivative trading, bond issuing or initial public offerings (IPO's). Demand for such specialised services will increase in the future in Ukraine and foreign banks branches is certainly a good way to import them. Large and experienced foreign banks can also provide the skills needed to direct the investment activities of the business sector and improve the allocation of investment capital.

Risks

(i) Entry of non-reliable banks

Many opponents to foreign branch entry argue that it will open the doors to unreliable foreign banks with bad reputation, insufficient capitalization and low ratings. They fear that especially banks from countries with poor supervision might open branches in Ukraine putting at risk the deposits of local banking customers. They also assume that foreign branches are likely to conduct illegal operations such as illicit capital export and money laundering. These risks have to be taken seriously indeed, but can be successfully minimized by scrutinizing potential entrants and limiting branch entry to reputed top tier international banks. Ukraine's supervisory authorities can make sure that only banks from countries with adequate supervision are allowed to open their branches by signing respective agreements and by intensifying the collaboration with other country's supervision.

(ii) Stability

Often, the main concern of policymakers regarding foreign bank involvement is financial stability. Opponents to foreign bank entry fear that foreign branches – in times of crises – reduce credit more than domestically incorporated banks. This could then lead to rapid outflows of capital. Foreign branches are thought of being less "loyal" and more inclined to "cut and run" when their investments are not performing as expected.

While this seems plausible at first sight, several studies suggest that foreign bank presence does not in general increase but even reduce the likelihood of banking crises. A diversified credit portfolio backs global banks. As a result, they will be less affected by a crisis in the host country than their domestic competitors and can be a stable and counter cyclical source of credit. Studies found, that foreign banks introduce improved risk management practices and import highly valuable bank supervision from parent country regulators. In addition, the operation of a foreign branch presupposes extended knowledge of the domestic economy as of

its legal framework and requires significant investments in premises, infrastructure and training. Thus, setting up a branch in a foreign country is a strong commitment and will probably only be part of a bank's long-term strategy. In fact, experience shows that foreign branches are not usually closed during a financial crisis.

Benefits vs. Risks

Overall, greater openness to foreign financial institutions will benefit Ukraine. At present the Ukrainian banking sector remains underdeveloped and undercapitalized. Its contribution to the national economy is still inadequate. Research and international experience suggests that foreign branches can favour the expansion of credit and capital flows, transfer knowledge and increase competition and efficiency in the banking sector. Consequently, foreign branch entry should also be seen as a sensible instrument to pursue the common goal by central banks of reducing interest margins in the banking sector.[1]

Concerns have to be taken seriously, but the potential risks are controllable through prudential regulation and an appropriate legislative framework. In fact, many arguments against the permission of foreign branches are voiced by those that will be negatively affected by financial sector opening, whereas any benefits are likely to accrue across broader segments of the economy. As shown in Table 1, the existence of significant net benefits to the economy has persuaded policy makers in most transition countries to allow foreign branch entry.

Table 1: Is Foreign Branch Entry Permitted in Transition Economies?

Armenia	Yes	Kyrgyzstan	Yes
Azerbaijan	Yes	Latvia	Yes
Belarus	No	Lithuania	Yes
Bulgaria	Yes	Moldova	Yes
China	Yes	Poland	Yes
Croatia	Yes	Romania	Yes
Czech Republic	Yes	Russia	Yes
Estonia	Yes	Slovakia	Yes
Hungary	Yes	Slovenia	Yes
Kazakhstan	Yes	Ukraine	No

4. How Should Foreign Branches be Regulated?

Proper regulation is crucial to minimize the potential risks of foreign bank entry. Policy makers face a *trade off* between regulatory protection and the intensity of foreign branch entry. If foreign banks have to comply with numerous requirements and will face important restrictions, they will be seriously discouraged to open a branch. As a result the beneficial effects of foreign banks branch entry will not take place. On the other hand, too lax regulation will put at risk local banking customers and might jeopardize the wellbeing and safety of the financial sector. In the following we outline the most essential regulatory measures that should be applied to regulate foreign branches.

[1] The valid goal of reducing interest margins in Ukraine has not always been pursued with appropriate instruments in the recent past. See German Advisory Group, Policy Paper S 9.

First, the regulatory provisions have to make sure that only *sound banks* are allowed to open branches. This can be achieved by accepting only banks, which fulfill minimum requirements on own capital, balance assets or credit rating. A further pre-condition for entry should be the good quality of supervision in the home country. Merely banks from countries whose supervision comply with the "Basel Core Principles for Effective Banking Supervision" published by the Basel Committee on Banking Supervision should be allowed into the country. Thus, it is not enough to check the soundness of the foreign bank. Also the quality of its supervisor needs to be carefully assessed.

Second, it will be essential to properly supervise the *solvency and liquidity* of foreign branches. According to international rulings, supervision of solvency is primarily a matter for the home country authorities. This is reasonable, as the solvency of a branch is indistinguishable from that of the parent bank as a whole and it is the home country authorities that have legal access to the parent's books. Within the European Union for instance, branches do not have to fulfil any local solvency requirements. However, many host authorities have imposed additional requirements on foreign branches. Countries can demand foreign branches to provide endowment capital to guarantee a certain minimum investment level. Other – more protective – host regulators define such endowment capital (or the local regulatory capital) as the sole basis for the branches' lending activity. Additionally, the host state may require foreign branches to provide the same financial reports and statistical data as domestically incorporated banks. The latter requirements can result in serious obstacles for foreign branch activity. Contrary to solvency supervision the primary responsibility for supervising liquidity rests with the host authority, which is often best equipped to supervise liquidity as it relates to local practices, regulations, and the functioning of the domestic money markets.

Third, supervisory authorities have to care for adequate *protection of deposits* attracted by branches of foreign banks and regulate the liquidation of such foreign banks. A branch can only fail if the parent fails. As they form one single banking unit, the two institutions share joint liability for the failure of their assets. Due to their legal incorporation foreign branch deposits are generally covered by the deposit insurance scheme of the home country. However, twenty-five countries including the USA and Canada require all branches of foreign banks to participate in their domestic deposit protection schemes. In our view this is an acceptable regulatory option.

Generally, it is essential to establish an *efficient collaboration* between home and host country authorities and ensure continuous exchange of information. To encounter bank crises and insolvencies and to protect depositors, parent authorities should be informed immediately by the host authorities about any serious problems, which arise in a parent bank's foreign establishment and vice versa. They should interchange information on a regular basis about the entities ongoing risk and capital structure and - to reduce risk money laundering - on their individual transactions.

5. Comments to the NBU Draft Law

In the course of the last months the NBU has elaborated a draft law regarding the regulation of foreign bank's branch entry and supervision. With reference to Part 4, we will study if the provisions foreseen in this draft are appropriate and if they would set a satisfying framework for foreign branch entry to Ukraine.

Provision 1: The worldwide statutory capital of the foreign bank opening its branch cannot be less than EUR 100 m.

Comment: In our view this is a simple and transparent way to ensure that only serious banks entry the Ukrainian market.

Provision 2: Foreign branches must hold a minimum endowment capital of EUR 5 m.

Comment: This provision obliges foreign banks to make and to sustain a certain minimum investment level inland. The minimum endowment capital of EUR 5 m is in our view unlikely to deter foreign banks from opening branches in Ukraine.

Provision 3: Foreign branches are subject to the same regulations as domestic banks regarding *solvency* ratios (capital adequacy).

Comment: Lending limits of foreign branches will be calculated in relation to their domestic endowment capital. This means that branches will not be able to lend on the basis of their worldwide capital. This provision will eliminate one of the main advantages of foreign branches in comparison with subsidiaries: facilitated credit supply through the parent bank's worldwide capital and reputation. Branches – similarly to subsidiaries – would be restricted in their business and will not be able to take advantage of lower costs and higher flexibility. Thus foreign banks will likely invest in fewer projects or be discouraged to enter the country in the first place. We disapprove this provision.

Provision 4: Foreign branches are subject to the same regulations as domestic banks regarding *liquidity* ratios.

Comment: This provision is internationally recognised and in accordance to the supervisory standards of the Basel Committee.

Provision 5: Foreign branches must participate in the Ukrainian deposit insurance system.

Comment: This provision will not discourage the entry of sound banks and ensure additional protection for domestic banking customers putting their funds in the hands of foreign branches. Besides, we do not expect branches of foreign banks to raise considerable funds in the Ukrainian deposit market, as they lack large domestic branch networks and are rather to take advantage of easier and cheaper funding options in their home country.

Provision 6: Only banks from countries cooperating with the FATF (Financial Action Task Force on Money Laundering).

Comment: We fully agree.

Overall appraisal of the NBU draft law

On the whole, the provisions of the NBU draft law seem appropriate to set a good regulatory framework and to reduce the potential risks of foreign branch entry. The requirements on minimum statutory capital and endowment capital will help to hold off bad apples. However, we think that Provision 3 (see above) will set unnecessarily tight limits on foreign branch lending. The endowment capital should not serve as the sole basis for prudential limits. Instead the foreign banks total capital should be taken into account. This limitation would otherwise remove the main distinction and advantage of a foreign branch vis-à-vis a subsidiary and considerably reduce the attractiveness of opening a foreign branch in Ukraine.

Kyiv/Berlin, June 2004

R.G., D.S., Ch.T., Lector: F.P.