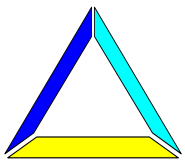
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S13

NBU profit: Who should get how much?

Summary

The current legislation in Ukraine does not contain a clear-cut rule for the NBU profit distribution. This causes uncertainty about the shares distributed to the NBU or the government and gives rise to costly negotiations. As a consequence, it possibly generates conflicts between these state authorities, which tend to weaken monetary stability in Ukraine by increasing long-term inflationary expectations and losing confidence in the hryvnia.

To avoid such problems, we argue for revising the current legislation concerning the NBU profit distribution. Specifically, we propose to establish a clear-cut rule for the NBU profit distribution that specifies the recipients of the NBU profit and shares received by each recipient. In our opinion, the NBU profit should be divided equally between the government and the NBU.

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1. Introduction

Central banks usually make profit, which they either keep within the bank or transfer to the government.[1] Typically, central banks prefer keeping a large share of profit, in order to increase their own capital, which has the function of a cushion for potential losses in the future. The government on the other hand is usually interested in getting as much money as possible from the central bank, in order to finance its expenditures. To prevent this potential conflict between the central bank and the government from erupting and from causing significant costs to the economy, a clear-cut system of the central bank profit distribution must be established.

This paper deals with the distribution of the central bank profit in Ukraine. In section 2 we describe the legal framework for the NBU profit distribution and analyze it in section 3. Section 4 is devoted to the discussion of the optimal size of the NBU own capital. In section 5 we present several recommendations to improve the current system. The implementation of these recommendations would not only improve the relationship between state institutions, but also strengthen the credibility of the national currency and the financial system in Ukraine.

2. Legal framework for the NBU profit distribution

The laws on the NBU and the state budget regulate the issues of the NBU profit distribution and its own capital formation. The law on the NBU specifies that the NBU profit is used in two ways. First - to be transferred to the government (Article 5 of "Law on the National Bank of Ukraine"):

" *…In case of the excess of the estimate revenues over the estimate expenses approved for the current budget year, the National Bank shall include the positive difference covering the budget deficit in the State Budget of Ukraine for the year following the reporting year…"*

Second, the NBU profit is the source of its own capital formation (Article 3 of "Law on the National Bank of Ukraine"):

"…Statutory capital shall amount to UAH 10 m. It may be altered by a decision of the Council of the National Bank. The sources of authorized capital of the National Bank shall be the revenues of its estimate and the State Budget of Ukraine, if necessary."

The law on state budget specifies the exact amount, which the NBU transfers to the state each year. For example, Article 5 of the "Law on State Budget of Ukraine 2002" states:

[1] Saying that the NBU profit is transferred to the government, we assume that this money is included into the central budget.

"I*n 2002 the NBU shall transfer to the state budget not less than UAH 200 m of its net revenues…"*

The mechanism of the NBU-government relations concerning the NBU profit is the following: Till April 1st of each year, the NBU presents the forecast of its revenues and expenditures for a current year to the government and the parliament (according to Article 33 of the "Budget Code of Ukraine"). Then, while preparing the state budget of the next year, the government specifies the amount, which the NBU has to transfer to the government in the next year as a positive difference between the NBU revenues and expenditures.

3. Analysis of the current system

The law on the NBU specifies the recipients of the NBU profit (the government and the NBU), but says nothing about proportions in which profit is transferred to them. It can be deduced from Article 5 that the total forecasted NBU profit should be transferred to the government, while Article 3 states that the NBU shall replenish its own capital from profit. Since the government and the NBU have different plans for the NBU profit usage, such vagueness in the legislation may give rise to informal negotiations between the NBU and the government, determining the exact scheme of the NBU profit distribution. For example, the first draft of the state budget 2002 required **UAH 500 m** from the NBU to be transferred to the revenue side of the state budget, while the final draft stated that the NBU should transfer not less than **UAH 200 m**. This divergence points out that bargaining processes between the NBU and the government have had a place. In addition, the first draft of the law on the state budget 2003 contains the provision that **UAH 700 m** should be transferred by the NBU to the revenue side of the state budget 2003. However, the NBU has forecasted **zero profit** for 2002. Thus, it again gives rise to the battle over the amount of the NBU profit transferred to the government.

In our opinion, such negotiations involve the possibility of conflict between the NBU and the government over the NBU profit distribution, thus worsening the relations between these institutions. Besides, if state authorities manage to gain more bargaining power, their influence on the NBU profit distribution may jeopardize the NBU independence in issues of formulation and implementation of the monetary policy. Furthermore, unclear distribution schemes are the reason for intransparent budget planning of the government if the exact amount of profit transferred depends on unclear negotiations. Therefore, we conclude that in order to avoid such debates it is advisable to have a law that explicitly regulates the distribution of the NBU profit.

4. Assessment of an appropriate level of the NBU own capital

While it is obvious to use the central bank profit in order to finance the budget deficit, it is less clear to see if and by how much this profit should be used to increase the NBU own capital.

The own capital of the central bank comprises statutory, reserve and special funds, and serves like a cushion against a sudden drop in the value of assets. If the value of central bank's assets depreciates significantly, and the size of the own capital is insufficient to cover the losses, the balance sheet of the central bank may deteriorate to a point where the central bank loses the control over the monetary policy and becomes unable to maintain price stability.

The probability of a sudden drop in the value of assets depends on the structure of assets. For example, if risky assets constitute a major part of assets, such probability is relatively high. Thus, the main factor that determines the amount of the own capital of the central bank is the structure of its assets. In order to argue for increasing the amount of the NBU own capital we present the structure of the NBU assets and then compare it with that in other countries.

Table 1. NBU Assets as of June 1, 2002

Assets items	**Amount (UAH m)**	**% of total assets**
Funds and deposits in foreign exchange	16289	32.5
Holdings in SDR	749	1.5
Monetary gold	854	1.6
Claims to IMF	9437	18.8
Government securities (mainly POVDPs)	9361	18.7
Credits granted to the government	10518	21.0
Credits granted to commercial banks and other creditors	399	0.8
Other assets	2558	5.1
TOTAL ASSETS	**50166**	**100**

Source: NBU

The major part of the NBU assets is funds and deposits denominated in foreign currency, followed by credits to the government, claims to IMF and state securities. The main source of risk in the NBU assets is credits to the government and government securities, which altogether constitute about 40% of total assets.[2]

As of June 1, 2002, the NBU own capital amounted to UAH 2203 m that constitutes 4.4% of total assets. Despite the fact that a lot of developed countries have lower ratios of own capital to total assets: in Canada, for example, the central bank own capital constitutes only 1.75% of total assets; we argue that the NBU should increase this ratio, because the structure of assets in Ukraine is much different from that of Canada.

[2] Taking into account current fiscal problems of the government and Ukraine's fiscal history, these liabilities have to be considered as being rather risky.

Own treasury securities, which are virtually risk-less, constitute 81% of assets in Canada, and only 19% of assets are exposed to some risk, while in Ukraine this share is approximately 40% (see above).

Besides, comparing Ukraine and other countries with a similar economic environment, we see that, for example, Latvia and Lithuania have similar capital/asset ratios: 6.3% and 8.9% respectively. However, their share of claims to the government and state securities in total assets is much lower than in Ukraine: 7% and 0.1% respectively. The same holds true for other countries such as Bulgaria, where these risky assets constitute about 60% of total assets, but capital/assets ratio is also higher: 11.1%.

Besides, the monetary base in Ukraine has constantly risen in the last few years, so that the NBU balance sheet has also expanded.[3] Therefore, if the amount of own capital remains fixed, its share in total assets will decrease further. Taking into account that in the last ten years the NBU has constantly made profit, which amounts to 1.5-2% of total assets, specification of a certain share of annual profit to be transferred to own capital will ensure that the NBU own capital will have a stable source for replenishment.

5. Recommendations on the NBU profit distribution

The discussion above shows that the current legislation in Ukraine defining the NBU profit distribution framework has a number of drawbacks. To overcome them, we make several recommendations on how the legislation concerning this issue should look like.

Recommendation 1. New provision of the law on the NBU should contain an explicit rule that defines the exact procedure of the NBU profit distribution.

This clear-cut rule should contain the scheme, which specifies the recipients of the NBU profit and the share of profit, which is transferred to each recipient. This will prevent the negotiations between the NBU and the government concerning the NBU profit distribution.

Recommendation 2. The amount of the NBU profit transferred to the government should be calculated on the basis of the actual, but not forecasted NBU profit.

From the government's point of view this implies that the NBU profit should be incorporated into the budget as a deficit financing item ("below the line"), and not as an item

[3] By the end of 2000 the NBU total assets were UAH 42705 m, by the end of 2001: UAH 49499 m and now they are UAH 50166 m. Thus, we observe a stable growth of the amount of the NBU assets and can assume that such growth will continue in future.

for financing budget expenditures ("above the line"). Furthermore, the government should put the conservative number for the NBU profit to be transferred to the budget.

Recommendation 3. A half (50%) of the NBU profit of the current year should be transferred to the reserve fund of the NBU in order to cover financial risks, arising from the NBU activity. The other half (50%) of the profit should be transferred to the government.

The equal distribution of the annual NBU profit between the government and the reserve fund is the most appropriate scheme. This will allow, on the one hand, to increase the revenues, used to finance central budget deficit; and, on the other hand, to create a stable source of own capital replenishment for the NBU. Besides, this rule is in line with requirements of the European Union concerning profit distribution of the central bank, which is of particular importance, since Ukraine has announced its intention to join the EU.

Taking into account that currently the size of the capital of the Deposit Insurance Fund is very low, we argue that the NBU profit should be temporarily used to increase the capital of this Fund. So, the NBU profit may have three recipients instead of two, each getting a certain share of profit (we propose that the government and the NBU reserve fund should obtain equal and large shares: 40% or 45% each; and the Deposit Insurance Fund should get 20% or 10%). Such scheme should be used until the capital of the Fund reaches certain sufficient level. Then fifty-fifty rule for the NBU profit distribution should be established. [4]

6. Conclusion

The current NBU regulation states that profits of the National Bank should be transferred to the government or used to replenish own capital of the NBU. However, the legislation lacks a precise rule for the NBU profit distribution. This vagueness in legislation may lead to the costly debates between the NBU and the government.

Thus, we argue for the changes in the current legislation and propose to create a clear-cut legal rule, which states that the government and the NBU should get each 50% of the NBU annual profit.

In our opinion this provision would improve the current legislation in three aspects:

1. It is the clear scheme of profit distribution that specifies all recipients of the NBU profit and defines exact proportions in which the profit is distributed.

[4] For more details on this issue see policy paper S15 "Deposit Insurance System: Time for Improvement".

2. The own capital of the NBU will increase. The NBU is very likely to continue making profit in the coming years. Thus, allocating a certain share of profit to the reserve fund (own capital) should increase its size.
3. The government will not count with a predetermined amount of money from the NBU, so a major source of conflict between the NBU and the government will be eliminated.
Thus, establishing such a clear-cut rule will help to avoid discussions between the NBU and the government, save resources and strengthen the independence of the NBU, thereby increasing confidence in the hryvnia. Moreover, temporary transfer of the certain share of the NBU profit to the Deposit Insurance Fund will allow to increase the size of the capital of this Fund, thus providing stable functioning of Ukrainian banking system.

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