USAID
FROM THE AMERICAN PEOPLE

Capital Markets Project

AN ASSESSMENT

OF UKRAINE`S PREPAREDNESS FOR A UNIFIED REGULATOR

Dr. Oonagh McDonald CBE

Kyiv
July 27, 2006

Table of Contents

EXECUTIVE SUMMARY 3
1. The Purpose of the Report....4
2. Outline of the Current Structure 4
2.1 Commercial Banks and the National Bank of Ukraine 4
2.2 The Securities and Stock Market State Commission (SSMSC).... 6
2.3 The State Commission for the Regulation of Financial Services Markets (FSR).... 9
3. International Standards for Regulatory Authorities 10
3.1 Operational Independence.... 11
3.2 Legal Immunity.... 14
3.3 The Powers of the Regulatory Authorities.... 15
3.4 Registration and Licensing.... 16
3.5 The Power to Make Legally Binding Regulations.... 18
3.6 Reporting Obligations, Information Gathering and Surveillance 19
3.7 Accountability of the Regulatory Authorities.... 19
3.8 Conduct of the Staff 21
3.9 Enforcement.... 21
3.10 Consumer/Investor Protection.... 23
3.11 Conclusion 23
4. The Reasons for Establishing a Single, Unified Regulator....23
Conclusion 29
5. The Enabling Law 29
5.1 Objectives of Financial Regulation.... 30
5.2 Independence 32
5.3 Registering, Deregistering, and General Prohibitions 33
5.4 Rulemaking Powers 35
5.5 Supervision 36
5.6 Enforcement.... 37
5.7 Information Sharing.... 38
5.8 Responsibilities of Regulators.... 38
5.9 Accountability.... 39
6. Establishing a Single Regulator 40
6.1 The Transition Management Task Force 40
6.2 The Handbook Development Task Force 42
7. Funding Issues 44
7.1 Funding by the Ministry of Finance 44
7.2 Mixture of Industry Funding and Public Funding.... 44
7.3 Industry Funding 44
8. Costs and Benefits of a Single Regulator for the Ukraine 46
9. Estimated Costs of Transitioning to a Unified Regulator....48
9.1 Employment Costs.... 48
9.2 Travel, Training and Recruitment.... 50
9.3 Office Space 51
9.4 Information Technology Costs 51
9.5 Conclusion 52
10. RECOMMENDATIONS....53

Attachment 1. Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority 54

EXECUTIVE SUMMARY

- The report provides an analysis of the current framework for the regulation of the financial services in Ukraine, and then sets out the process for the establishment of a single regulatory authority.
- An assessment is provided of the degree of conformity of the legal framework with international standards, which reveals that a thorough overhaul of the existing laws would be required, together with significant changes in the status and powers of the existing regulatory bodies.
- This provides both a justification and a reason for establishing a single regulator. A fresh start is required, not only because there should be an overhaul of the present system, but also because Ukraine can reap the benefits that others have experienced from a single regulatory authority.
- These benefits include a much improved ability to supervise financial conglomerates, an increasingly dominant trend in all financial markets, including Ukraine's, but also because it enables the regulator to become more effective and efficient in a variety of ways. Over the longer term, it will be possible to achieve economies of scale. In the near future, the new regulator should be able to attract and retain qualified staff and deploy them more efficiently.
- Establishing a single regulator has not only benefited developed markets, but also post Socialist markets, such as Latvia and Hungary. The IMF assessment of financial regulation in each of these countries has been highly favorable.
- The report outlines the steps, which should be taken in order to establish a single regulatory authority. These include drafting an Enabling Bill, with the aid of a Bill Committee, acting as a champion of the new legal framework that incorporates international standards to which the law should conform. Prior to the Bill becoming law, the three organizations to be merged should occupy the same building so that they can more easily work together before they become a single organization.
- At the same time, the work of the Transition Management Task Force and the Handbook Development Task Force will begin, so that when the single regulator is established the organizational structure, costs and budget and its strategic plans will be in place.
- The question of funding the new agency is addressed. It is proposed that a gradual move towards industry funding takes place.
- The report gives an indication of what the costs might look like; bearing in mind that relevant information was not always available. A summary of the qualitative benefits is given.

1. The Purpose of the Report

There are three main issues addressed in this report. The first step is to provide an analysis of the current regulatory framework in the Ukraine and the steps that are necessary to achieve regulatory consolidation. The new legal framework should meet international standards, so that the legislation establishing the regulation of banks, securities, insurance and the financial services market have been reviewed to identify areas where they should be revised. The report will also provide an indicative analysis of costs and benefits of introducing these regulatory changes. The report will also provide specific recommendations on funding and on any changes in the legal and regulatory framework that may be required.

2. Outline of the Current Structure

2.1 Commercial Banks and the National Bank of Ukraine

The major laws governing the banking sector in the Ukraine are the law of Ukraine, “On the National Bank of Ukraine” (May, 1999, Law No 679-XIV) and the “Law of Ukraine on banks and Banking Activity” (December, 2000, No 2121-III). The banking system consists of the Central Bank, the National Bank of Ukraine, NBU (which is regarded as independent of the government and profit-making) and commercial banks. The National Bank is allowed to issue regulations on all matters within its competence. However, that “competence” may be limited or overridden by the Civil or Administrative Codes. The commercial banks themselves are incorporated under various legal structures with most of them operating as “open joint stock” companies which allows for the unrestricted sale of shares or increases in authorized capital from time to time. The Central Bank categorizes banks into four tiers, depending on the size of their total assets. Tier 1 and Tier 2 banks are under the jurisdiction of the central office of the NBU and Tiers 3 and 4, the smaller banks, are the responsibility of the regional offices.

The NBU is in a unique position in that it is not dependent on the government for its funds, but derives its income from the issuance of stabilization credits to a number of banks for liquidity and solvency, for membership in the payments system, which it operates, and issues bank notes, as well as a system of fees for licensing, and for the submission of documents. It can direct its own budget within these approved limits, and any excess over estimated expenses for the financial year are returned to the State Budget. The NBU therefore is economically independent of the Government, and is also politically independent to a large extent.

The banking supervision department of the NBU currently supervises some 165 operating banks as at June 1, 2006 (with 21 banks under liquidation), which are licensed by the NBU to perform general banking activities. Of the 165 banks, 28 are operating with some foreign capital, and eleven banks are wholly foreign owned. The total share of foreign capital in the statutory capital of banks is 21.5%. [1] Banking sector assets are still concentrated in the ten top banks, which own more than half the banking assets in the sector followed by the top thirty banks, which account for 75% of the assets. The majority of the remaining banks, the “pocket” banks are small with over 125 of the banks in this group with assets of less than US$150m. The larger banks are also part of large financial/industrial conglomerates, which often also include insurance companies. The

[1] Source: National Bank of Ukraine, Main Indicators of Ukrainian bank activities.

process of consolidation has been slow with only one bank reorganized through a merger with another bank in 2004 and another reorganization allowed in 2005. Other changes, which are taking place, include the acquisition of Aval Bank (the second largest bank) by Raiffeisen Bank of Austria (the eighth largest bank in Ukraine by assets) in 2005. That bank is estimated to have 12% of total banking assets. In addition, UkrSibBank has been acquired by BNP Paribas and UkrSots by Banca Intesa, reflecting a continuing trend in the acquisition of Ukrainian banks by foreign banks. Mergers between the smaller banks are expected to strengthen their asset base in the face of increasing foreign competition.

The IMF Follow-up Report (2005) on the Financial Services Action Plan pointed out that although much progress had been made in the supervisory and structural process in the banking sector, more work needs to be carried out. The NBU has been able to increase provisioning ratios for un-hedged foreign currency loans, reduced the limits for foreign currency open positions, tightened the definitions of capital and non-performing loans, and reduced the limit for related party lending (assuming that related parties can be identified). A credit bureau has also been established which will facilitate risk assessment of the regulated entities, a joint initiative undertaken by 30 commercial banks, which currently control over 65% of the retail lending market, and two insurance companies. This also requires legislation but has been conducted on a voluntary basis with the disclosure of information by borrowers to a centralized credit bureau. But, the report added *"more generally, to strengthen banking supervision further, the NBU should move from the present procedural-driven approach to more risk-based supervision, and still seemed to regard its approach as over-bureaucratic, despite the progress which has been made."*

However, essential amendments to the Banking Law were rejected by Parliament. These were highly significant requirements regarding ownership, registration, and a requirement for internal
and external audits. The most important issue was the right of the NBU to require information about the ownership of the bank and other state agencies together with the right to monitor ownership on an ongoing basis. In addition, the draft banking law sought to provide the Central Bank with improved procedures regarding the liquidation of a bank, which at present is subject to challenge in the courts. The NBU also wanted to be able to safeguard banks against panic-driven runs on banks, which require amendments to the Civil Code, the NBU Act and the banking Act, but these were also rejected by the Parliament. Under the current rules (given that the amendments were rejected by the Parliament before the election), banks cannot enter into contracts that prohibit the early withdrawal of funds nor can the NBU legally impose a moratorium on early deposit withdrawals in a crisis. However, it now appears that the President and the Cabinet of Ministers are ready to move forward again on at least some of the key issues in improving banking regulation.

The Credit Bureau Law was adopted by Parliament in June 2005 and since then three major Ukrainian credit bureaus have been established. The International Bureau of Credit History (partly owned by TAS Finance Group), the Ukrainian Bureau of Credit History and the First All-Ukrainian Bureau of Credit History, created by the Association of Ukrainian Banks, are all waiting approval by the Ministry of Justice, which is also developing the regulations. The international company, Creditinfo Group, has taken a 5% stake in the First All-Ukrainian Bureau of Credit History. This will bring more international expertise into credit risk management in Ukraine. The introduction of credit bureaus will enable banks to offer personal and small business loans more efficiently and extend the mortgage market. It will assist the NBU in ensuring that banks manage credit risk more effectively and will lead to more responsible borrowing.

The NBU also sought to allow the deposit guarantee scheme to exercise enforcement actions against banks, as another level of protective regulation. Such moves should be carefully considered since they would require banks to report to another regulator, that is, the deposit guarantee scheme, when the aim is to make regulatory reporting more efficient for the industry as well as regulators. It would involve either two separate sets of regulators with two sets of enforcement powers and powers to act in a crisis or the supervision of the deposit guarantee regulator by the NBU. The former is the choice in the USA and Canada, but these are long-established entities, and perhaps would not be established now if either country began with a blank sheet.

2.2 The Securities and Stock Market State Commission (SSMSC)

The Commission was first established in 1995 by Presidential Decree, "On the Securities and Stock Market State Commission", which established the SSMSC as the regulatory authority for the securities market. The first stock market, the Ukrainian Stock Exchange, was set up in 1991, followed by the First Securities Trading System (PFTS) in 1996 and then the establishment of the securities depository owned and operated by market participants in 1997. The SSMSC reports to the President of Ukraine and is also accountable to Parliament. It collaborates with the President's Administration, the Cabinet of Ministers, ministries and other government agencies. It consists of a central office, and 26 regional offices, which together are responsible for regulating the securities market.

The Commission is responsible for the regulation and supervision of the Ukrainian stock market, which continued to grow rapidly in 2005 with total capitalization reaching US$29bn. The market has grown from one of the smallest in the region, representing 10% of GDP in 2003 to an estimated 35% of GDP last year. However, liquidity remains low with most security transactions taking place off-exchange or any trading system. This is due to the concentration of ownership of privatized companies in the hands of the six major financial groups or the State, leaving few shares available for trading. Indeed, although there are 262 listed companies, market capitalization of the ten largest companies represents about 57% of the market, resulting in a highly fragmented market, lacking price transparency and low liquidity.

This is the consequence, in Ukraine and elsewhere, of the mass privatization in the mid-1990s, which led the regulator to act more as an administrator of the market than a regulator, licensing stock exchanges to handle privatizations of local enterprises. This has resulted in Ukraine having 10 trade organizations, licensed by the SSMSC, eight of which are registered as stock exchanges and two are registered as trade information systems (electronic trading systems). Most of these are practically dormant, but one of the trade organizations is PFTS, an electronic trading system, which accounts for 86% of all trading volumes and the Ukrainian Stock Exchange accounts for the remaining 13%. The remaining exchanges engage in sporadic trading, which further adversely affects price and liquidity. A previous report notes that the general market view is that occasional trades conducted over these exchanges are carried out for the purpose of artificially inflating the price of a traded issue and leads to dramatic price changes over a one month period for no apparent reason.[2]

[2] USAID Capital Markets Project, *The Ukraine Stock Exchange Environment: Challenges and Recommendations*, Robert L. Smith, January 2006.

The main responsibilities of the SSMSC were first set out in the 1996 "Law on the State Regulation of the Securities Market" and include:

- defining and ensuring the implementation of a unified government policy concerning the development and functioning of the securities and derivatives market in Ukraine, as well as promoting the adaptation of the Ukrainian securities markets to international standards;
- regulation and oversight of the issuing and circulation of securities and their derivatives in Ukraine and to ensure compliance;
- protection of investors ` rights through the prevention and elimination of violations of the securities laws and regulations;
- promote the development of the securities markets; and
- propose improvements to the existing legislation.

The legal framework has been developed through Presidential Decrees and regulations since then with the most recent Law (No.3480-IV) "On Securities and the Stock Market" being enacted in February 2006. This marks a further step towards international standards in that it provides for disclosure of information by issuers, including "ad hoc" information by which is meant information on any events that may affect the issuer's financial and business position, thus causing a significant change in the value of securities. However, the law does not specify that "holders of securities should be treated in a fair and equitable manner." Nor does it require that the financial statements be independently verified and comply with well-defined and internationally acceptable standards. Enforcement measures should be in place, not only to ensure that such reports are filed in a timely fashion but that they fulfill proper accounting standards as well.

The new Law on Securities and the Stock Market, effective May 12, 2006 also seeks to ban insider dealing, a vital condition of a transparent and well-functioning market. However, the opportunity should have been taken to expand these provisions in light of both IOSCO principles and the EU Market Abuse Directive, which was adopted in 2004. Article 44 of the Law introduces a prohibition on insider dealing, and Article 45 (4) is intended to introduce some enforcement actions to be taken in the case of proven insider dealing, and is presumably intended to widen the categories of those who have insider knowledge for reasons other than labour or contractual reasons, presumably to include spouses, for example. However, such relationships should be spelt out and included in the Law and consideration should be given to the selection of apparently independent nominee shareholders.

The EU Directive on Market Abuse also requires issuers and their advisers to maintain lists of insiders, requiring both managers and directors to disclose details of their personal share dealings. Firms arranging transactions are also are obliged to report these transactions where there is a reasonable suspicion that market abuse may have taken place. These reporting requirements are not the only ones required under EU Directives. The Markets in Financial Instruments Directive is due to take effect by November 2007, which will apply to investment banks, portfolio managers, stockbrokers and broker/dealers, corporate finance firms, many futures and options firms and some commodities firms. Amongst many other requirements in this Directive is full post-trade reporting of any instrument admitted to trading on regulated markets, including OTC (over-the-counter) traded instruments, which are referenced to instruments traded on prescribed markets.

In addition, the new Law on Securities and the Stock Market should have introduced market manipulation, which covers three areas: transactions and orders to trade that give false or misleading signals or secure the price of a financial instrument at an artificial level; transactions or orders to trade that employ fictitious devices; and, then the dissemination of information likely to give false or misleading signals. The obligation to report suspicious transactions should also apply. [3]

Furthermore, given the large number of apparently inactive broker/dealers, the low level of turnover on dormant exchanges, the revocation of licenses should be considered. It is clear that a market with such low levels of activity cannot provide an income or scope for 794 securities traders, 370 independent registrars and 143 custodians. The 2006 Law provides for an increase in the capital requirements for dealers with higher capital requirements for brokers and underwriters, which has since been set out in detail by a resolution of the Cabinet of Ministers of Ukraine (June 2006, pursuant to Articles 4 and 8 of the Law of Ukraine, 448/96-VR). The licenses are issued for limited periods of time. For securities depository activities, stock exchanges and clearing and settlement activity, the license is issued for 10 years. For broker/dealers, underwriting, securities management activity, asset management, mortgage coverage activity, custodians and registrars, the term of the license is 5 years. But although there are now more effective barriers to entry, it is unclear whether these apply to firms already in existence or whether this level of capital should be retained as a minimum level and further capital required in relation to the risks. No arrangements are in place for what should happen when a license comes up for renewal.

The fees charged are set at different levels. For depositories, the fee is UAH 10,000; for stock exchanges, the license fee is UAH 5,500; for underwriting, securities management, asset management, mortgage coverage management and custodians, the fee is UAH 2000, and for broker/dealers and registrars, the fee is 1,700 UAH. It appears that the SSMSC believes that the new fees for issuing a license will discourage small non-operating market participants. These requirements are set out in Article 17, which also sets out in detail the permitted activities of each category. It is not enough, however, simply to raise the fees as a barrier to entry. It is a matter of on-going capital requirements as well and these should also be used as a means of revoking the license for inactive securities firms. The renewal of a license should not be an automatic procedure either.

It appears that the licenses of both market participants and stock exchanges may be revoked or suspended for “violations” of the regulations and the existing legislation, but as indicated later in the report, these seem to be largely for procedural reasons. These should involve an assessment of the capital of the company concerned in relation to the level of activity and the risks the company faces, prohibit new contracts or extending the coverage or length of time of existing contracts. Making possible the revocation of licenses as part of a review of a large number of broker/dealers already in existence would be a step forward for the SSMSC, bringing its approach into line with fact that the licensing conditions imposed by other regulators, such as the FSR, which allows the authority to revoke the license of a company that does not engage in the activity for which it has been granted the license.

[3] The NBU has difficulties in assessing market risk of a bank if the securities the bank deals in are not listed and traded on an exchange. However, if reporting requirements of off-exchange trading or OTC trading are required as indicated above, MOUs between SSMSC and the NBU should allow for information to be appropriately shared. Once again, a unified regulator may be in a better position to assess such risks.

Article 47 of the Law “On Securities and the Stock Market”, dated 2006, introduces the delegation of powers to Self –Regulatory Organizations, which includes “rules and standards of professional activities in the stock market that shall be mandatory for all members of the self-regulatory organization” (Article 48) and in Article 49, SROs are apparently able to conduct “inspections of the performance of the relevant type of professional activities” including “compliance with the requirements of the securities law, and rules and standards of professional conduct” and the “submission to it of a request, mandatory for review, on the termination or suspension of a license to perform a certain type of activity by a professional stock market participant.” As it stands, it looks as though the SSMCS is delegating significant powers without proper oversight, as a regulatory body, to an organization, which it does not itself supervise and which can exercise its powers without reference to the regulatory authority. Certainly, Articles 47-49 of the Law on Securities and Stock Markets does give the SSMSC the power to set out the terms on which self-regulatory organizations may exercise a wide range of powers.

There seems to be confusion between a professional association and a regulatory authority, an SRO, which it would be well to clarify before these Articles are implemented. It should be noted that where regulatory powers are delegated to an SRO, it should be supervised by the regulatory authority. The principles for securities regulation set out by IOSCO require that “oversight of the SRO should be ongoing. Moreover, once the SRO is operating, the regulator should assure itself that the exercise of this power is in the public interest, and results in fair and consistent enforcement of applicable securities laws, regulations and appropriate SRO rules”. (Principles for Self-Regulation, The Role of SROs, 7.3).[4]

The failure to bring securities regulation in Ukraine fully into line with international standards could mean that Ukrainian companies may find that it is in their interests to seek a listing on Western stock exchanges even though the listing requirements are more demanding. Hence, four Ukrainian start-up companies, including the Ukrproduct Group and XX1 Century, have listed on the Alternative Investment Market of the London Stock Exchange, which is designed for companies at an early stage of their development, allowing them to experience being a public company and all that that entails, as well as giving them access to capital for development.

2.3 The State Commission for the Regulation of Financial Services Markets (FSR)

The FSR was established by the Decree of the President of the Ukraine in December 2002 to regulate and supervise the activities of insurance companies, credit unions, pawn shops, trust companies, leasing companies, non-state pension funds and their administrators, and certain other financial entities under the auspices of the Law on Financial Services and State Regulation of Financial Services Markets, July 2001. The Commission currently supervises 398 insurance companies, of which 50 are life insurance companies (as of June 2006) 612 credit unions, 45 financial companies (as at December, 2004), and was also given the responsibility for the regulation and supervision of non-state pension funds.

The Law requires all NBFIs to register with the Commission, which also has the power to grant licenses to enable the providers of financial services to conduct financial services business in accordance with this Law and with the various relevant industry sector laws,

[4] Objectives and Principles of Securities Regulation, IOSCO, 2003, and also, IOSCO Public Document No 110, Model for Effective Self-Regulation, IOSCO SRO Consultative Committee, May 2000.

such as the Law on Insurance, the Law on Non-State Pension Funds, the Law on Credit Unions and so on. Licenses for credit unions are limited to between three and five years. No specific time limits are laid down for insurance companies and private pension fund administrators, provided that once they have received the license, they carry out the financial services operations for which they were licensed. If the company does not engage in such activities, then the license will be withdrawn. The period of time is one year for an insurance companies (FSR Licensing Requirements for Insurance Companies as of August 18, 2003), one year for pension fund administrators (FSR Licensing Requirements for PPF Administrators, January 12, 2004) and two years for asset management companies (Collective Investments Institutions Law). In addition, the FSR can limit the licensed activity of an insurance company (for example, to allow operations but to prohibit new contracts or extending the coverage or length of time of existing contracts).

The FSR was also given powers to register and to regulate the activities of all of these financial institutions, and to maintain the State Register of all of these financial institutions and other registers, such as the register of auditors, insurance and reinsurance brokers, and to supervise and inspect the activities of these financial institutions. In addition, the Commission has the power to set up enforcement procedures and to issue regulations, but such powers granted explicitly to the FSR (and to the NBU and SSSMC) should be excluded from the jurisdiction of the State Committee on Regulatory Policy and Entrepreneurship.

Pension reform in Ukraine has led to much of the supervisory responsibility being placed in the hands of the FSR, and its business plan has involved making the necessary organizational arrangements, such as establishing on-site pension inspection unit. Its strategic plans for the period from the present to 2008 include developing information systems for reporting by non-state pension funds, implementing effective prudential oversight in the sphere of non-state pension provision, and developing the regulatory and legal basis for Pillar II non-state pensions. Arrangements for sharing information with the SSMCS are also vital in order to ensure continuous oversight over non-state pension funds, their administrators, asset management companies and custodians. The SSMSC also has significant responsibilities for the supervision of non-state pension funds. Clearly future plans for the oversight of non-state pensions in terms of staff and support costs will have to be made as pension funds grow. The establishment of a unified regulator would deal with one of the problems, which the FSR has already identified.

3. International Standards for Regulatory Authorities

The Core Principles of each of the international standard-setting bodies, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), emphasize the necessity of regulatory independence, and describes the general characteristics of a regulatory authority that conforms to these principles. The system of financial regulation in Ukraine should be assessed in terms of its conformity with these principles.

The first set of principles relates to the operational independence of the regulator, and for IOSCO is as follows:

- The responsibilities of the regulator should be clear and objectively stated.
- The regulator should be operationally independent and accountable in the exercise of its functions and powers.

- The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
- The regulator should adopt clear and consistent regulatory processes.
- The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

The Basel Committee on Banking Supervision sets out its own Core Principle for Effective Banking Supervision, the first of which covers operational independence:

"An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework of banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with the laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place."

The Insurance Core Principles, set out by the International Association of Insurance Supervisors, also requires operational independence on the part of the supervisory authority, as follows:

- has adequate powers, legal protection and financial resources to exercise its functions and powers;
- is operationally independent and accountable in the exercise of its functions and powers;
- hires, trains and maintains sufficient staff with high professional standards; and
- treats confidential information appropriately.

These principles apply to all regulatory authorities and should be part of the existing legislation. Ukraine would need to amend existing laws to meet these conditions, but if Ukraine moves towards a unified regulator, each of these issues should be addressed in the enabling or framework bill, establishing the new regulator for the whole financial services industry. It is clear that the present major items of legislation are deficient in complying with these principles.

3.1 Operational Independence

The requirement for "operational independence" of the regulatory authority is given priority by all the international standard-setting bodies. Such independence is essential if the regulator is to be effective, and thus to play a proper part in ensuring that the financial services industry is to contribute to economic growth by maintaining financial stability. The regulator must have the capacity to develop regulatory policy, and to implement the policies and enforce them without inappropriate interference. The decisions of the regulator should be ones that are based on objective criteria and designed to meet the objectives of financial regulation as set out in the law.

Legal independence for the regulator depends on clarity regarding the terms under which regulators are appointed and dismissed; legal protections from interference; legal immunity for the staff of the regulatory authority, who carry out their work in good faith; and in the way in which potential conflicts between the regulator and the Government are resolved.

The first step is to conduct a full assessment of the regulatory independence and the powers of each of the two Commissions and the National Bank of Ukraine. These issues should certainly be addressed in the enabling bill law for a single regulator, but amendments to the existing laws should be made in advance of this effort.

In the case of the FSR, the following Articles should be amended to ensure that the Commission has the necessary operational independence:

- Article 24(2)(6) of the Law on Financial Services which allows the President to dismiss the Head of the Commission for “other reasons” is far too vague. It gives the President unlimited power to dismiss the Head at will and without any specific justification.
- Articles 25 and 26 of the Law on Financial Services allows the President to appoint Commission executives without consulting or involving the Head of the Commission. These appointments should be made on the recommendation of the Head. Furthermore, these executive appointments appear to relate to fixed positions in the authority, which gives the Chairman no flexibility in organizing the agency or using the skills of senior executives to their best advantage.
- The Presidential Decree of April 2002, establishing the Commission, delegates powers (such as licensing and sanctions) directly to specific departmental directors. The powers of the regulatory authority should be vested in the Chairman and the board, and these powers should then be exercised by those with executive responsibility for that area of the Commission’s activities and then only in line with the policies and rules of the Commission.

Other aspects of operational independence include the power to set licensing fees, impose fines and set a budget. In the case of the FSR, the Commission does charge licensing fees, but the fees are paid to the State’s Consolidated Revenue Fund and the budget for the Commission is approximately USD1.9m. The insurance companies’ total assets were USD4.1bil, credit unions’ total assets were USD 387.9m, pension fund assets reached USD 9.2m and those of financial companies reached USD 374.2m by the end of December 2005, so a flat levy of 1% would raise USD 48.7m and a much smaller levy of 0.1% would raise USD 4.9 m. If the aim was to have partial industry funding, then the levy could be reduced but would still provide considerable support for the regulatory. Any fines also have to be paid into the State Consolidated Fund but these could go towards the Budget. In two important areas, therefore, having freedom to set and manage a budget and in the appointment of the Chairman and senior managers, the FSR lacks operational independence.

In the case of the Securities and Stock Market State Commission, the terms of appointment are as follows:

- Law No. 448/96 BP, 30.10.1996, Article 6. This describes the Commission as a “state organ subordinated to the President of Ukraine and accountable to the Supreme Council of Ukraine.”
- A later amendment to the Law (No.2802-IV, September, 2005) states that the Commission shall be composed of the Chairman and six members of the Commission. They are to be “appointed and dismissed by the President of the Council, as agreed with the Parliament of Ukraine.” The term of office is seven years and the same person shall not be on the Commission for more than two consecutive terms. Members of the Commission may resign on grounds of ill health. They may also be dismissed if their citizenship has been withdrawn or if

they leave Ukraine, or if they commit an offense as set out in the Law on State Service. However, the latter is sufficiently imprecise to allow the President to dismiss the SSMSC Chairman or Commissioners, should he wish to do so, and for the decision to be ratified by the Verkhovna Rada.

The role of the chairman of the SSMSC and the six Commissioners is a full-time role, which initially involved the commissioners in executive roles. That has gradually changed over time as the day-to-day management of the Commission is in the hands of an executive director, leaving the Commissioners responsible for the development of strategy and policy. The Commission is expected to meet at least once a month and in fact meets much more frequently.

The SSMSC has the power to make regulations, which have to be registered with the Ministry of Justice. These regulations are binding on the local and regional offices of the Commission and also on the local state administrators as well as on securities market participants. The Commission was required to set up and establish regular meetings of a Consulting Expert Council, the membership of which has to be approved by the SSMSC, the function of which is to develop recommendations regarding securities market policy and assist in the development and drafting of legislation.

In the case of the National Bank of Ukraine, banking supervision is one of its functions as set out in Article 1 of the Law of Ukraine of the National Bank of Ukraine (No 679-XIV, 1999). It entails the creation of a system of regulations that regulate the activity of banks and define the general principles of banking activity, the procedures for performing bank oversight, and liability for violations of banking legislation. Banking oversight is defined as a system of controls and active regulatory measures, designed to ensure that the legislation of Ukraine and established standards are upheld by the banks, to ensure the stability of the banking system and to protect the interests of depositors and lenders. The NBU is also the lender of last resort.

The Council of the NBU consists of fourteen members, seven members are appointed by the President and seven by Verkhovna Rada. The Governor is a member of the Council by virtue of his position and is appointed by Verkhovna Rada on the recommendation of the President. Candidates for membership on the Council are considered by a special committee of Verkhovna Rada in open session and are then put before the Verkhovna Rada for ratification. Their appointment is for seven years and may be terminated through loss of citizenship or residence in Ukraine or if found guilty of a criminal offence. It is possible for the President or the Verkhovna Rada to dismiss the entire Council in a vote of “no confidence” if it fails to maintain monetary stability. The role of the Council is that of a supervisory board with the power to develop monetary and credit policy.

The Governor chairs the management board of the NBU, which is empowered to take decisions on all issues connected with the application of monetary and credit policy, including the conditions under which foreign capital may be accepted into the banking system. The first deputy governor and three deputy governors are ex officio members of the board. The Governor is ultimately responsible for the organizational structure of the NBU, the deployment and salaries of its staff, the procedures for granting bank licenses, and its legal and regulatory activities, amongst other duties.

The Governor of the NBU is appointed by the Verkhovna Rada on the recommendation of the President for a period of five years. He may be dismissed by the Verkhovna Rada on the recommendation of the President before his term of office has expired, if he commits a

criminal offence, provides a letter of resignation for personal or political reasons, ceases to be a citizen of Ukraine or leaves the country. He can be dismissed "upon the recommendation of the President within the scope of his constitutional powers", which may still undermine the independence of the Governor (Law of Ukraine on the National Bank of Ukraine, No 679-XIV, 1999 as amended, 2004, Article 18).

It is difficult to assess the legal independence of the National Bank in respect of its supervisory activities, but it does seem to have a greater degree of independence than other regulatory bodies. It does have its own sources of income, as outlined above, but even then, its spending must be "within the limits of the approved estimated budget" (Article 4, Law of Ukraine on the National Bank of Ukraine). If the National Bank does not spend the agreed estimated budget for the year, the surplus is returned to the State Budget, but it may be used to cover a deficit in the following year.

The regulatory powers are vested in the Council and the Board, where under Article 8, the former has a wide range of powers, including the power to develop the banking system and individual banking regulations. The Council does not, however, have the power to assess the qualities of the Governor, members of the Board of the Bank or to make a personal assessment of the activities of individual officers of the Bank, which limits their ability to act as a check on the powers of the Governor in relation to banking supervision. The Council's assessments are limited to the implementation of the fundamental principles of monetary and credit policy and other Bank policies. It has the right to make its criticisms known to the Verkhovna Rada, to the Governor and to the President.

3.2 Legal Immunity

In the case of the SSMCS, Article 15 of the 1996 Law deals with the answerability of the Commission. It states that officials of the Commission found guilty of non-fulfillment or improper fulfillment of duties shall be held answerable in keeping with procedures established by the laws of Ukraine. If it can be shown that damage was incurred in the securities market by unlawful acts of the Commission, then the losses will be indemnified by the State. In fact, no cases have ever been brought to the courts.

The law "On Financial Services and State Regulation of Financial Services Markets" seems to provide an indemnity for staff, but once again, there is no reference to "good faith" and "non-fulfillment" of their duties, which allows this provision to be widely interpreted. Further clarification is required. The need for a clear statement that staff should have immunity if they have acted in good faith is illustrated by the Chairman's statement that the Commission is engaged in approximately 10,000 court actions, some of which involve, for example, the decision not to grant a license. Provided that the conditions for issuing a license are clearly stated in regulation and that it has been rejected on entirely objective grounds--that it is obvious that various conditions have not been met by the applicant-- the case should never get to court. It is simply not possible for a regulatory authority to carry out its work, if it is challenged in the courts at every turn. The onus is, however, on every official of the regulatory authority to act strictly in accordance with the rules and to act, having taken care to establish the reasons for his actions, to record them and to explain them in correspondence with the person or persons concerned.

In the case of the FSR, Article 45(1) of the law "On Financial Services and State Regulation of Financial Services Markets" states that officials of the Authority, "shall be liable by law for the non-fulfillment or improper fulfillment of their official duties" and, in Article 45 (2) that the liability for financial damage caused by illegitimate actions of

Commission staff will be born by the State. There is no reference to actions being carried out in “good faith” and the reference to “non-fulfillment” of duties could open the door to endless legal challenges.

Neither the “Law on the Bank of Ukraine” nor the law of Ukraine “On Banks and Banking Activity” provide the supervisory staff of the bank with legal protection. Indeed, Article 99, which should not be part of any new legislation, specifically allows “banks or other persons under the National Bank of Ukraine authority” to have “the right, according to the procedure specified in law, to challenge in court the decisions or actions of the National Bank of Ukraine or its employees, provisional administrator or liquidator, as well as the actions or inaction of its provisional administration or liquidators.” The Law goes even further. Not only is it possible to challenge the National Bank’s decisions but the individual employee, administrator, liquidator or expert appointed to provide assistance to the liquidator or professional administrator is responsible for damage so caused provided the action or lack of action was intentional. The damage caused by a mistake of the professional administrator is compensated under the National Bank’s regulations and financial risk insurance contracts.

This makes proper regulation of the banks very difficult to say the least. NBU decisions to liquidate three banks is being challenged in court while the process of liquidation is under way and two more decisions to liquidate banks are being challenged before the process has begun. The NBU, of course, thoroughly prepares its defense and files the full set of documents with the Prosecutor’s Office. Despite NBU efforts to consult widely on proposed regulations and to hold round-table discussions and working groups, it still faces challenges in the courts to proposed changes in regulations. The challenges are often mounted by the Ukrainian Association of Banks rather than by individual banks. The depositors of some of the banks, which have recently been closed, with consequent losses for depositors, are also suing the NBU. (There is an Individual Depositors Guarantee Fund but that currently only pays 8000 UAH per account. The Fund has just proposed raising the maximum to UAH 15,000 and it will come into force as soon as the decision is registered with the Ministry of Justice). Given that the NBU is not allowed to identify and publicize the ultimate owners of the banks, the depositors suffer. If such information were available, then the owners would be obliged to make up the shortfall in a bank’s capital and would then have an interest in ensuring that the bank was properly managed.

However, the lack of legal immunity is entirely out of line with international principles of banking supervision. Basel Principle 1 requires legal protection for supervisors. The protection from personal and institutional liability for supervisory action taken in good faith in the course of performing supervisory duties is usually set out in the law.

3.3 The Powers of the Regulatory Authorities

The Core Principles of the above mentioned international standards set out the powers required by each regulatory authority in order to carry out effective supervision. In each case the principles set out the requirement that the regulatory authority should have sufficient powers. These are summarized in the Basel Core Principles as a “suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns” (Principle 1).

The International Association of Insurance Supervisors sets out the same Principle as the requirement that the regulatory authority have “adequate powers”`, defined as “being fully

empowered to meet its objectives in terms of its legal basis, independence and accountability, powers and financial resources, enabling it to effectively carry out its supervisory responsibilities.” The legislation should also give the regulatory authority the “power to issue and enforce rules by administrative means.” Where necessary, the regulatory authority should be able to take immediate action to achieve its objectives, in particular, to protect policyholders’ interests. IOSCO similarly requires that the “regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.”

The key powers are:

- registration and licensing, including withdrawal of a license.
- regulation and standards setting.
- reporting obligations and information gathering, including powers of investigation and surveillance.

3.4 Registration and Licensing

The Securities and Stock Market Commission has the authority to issue licenses allowing professional activities in the securities market and to control such activities. (Law on State Regulation of the Securities Market of Ukraine, No 448/96, BP, 1996 as amended and the Law on Securities and the Stock Market, No 3840-IV, 2006). Under Article 27 of the most recent Law, the SSMSC has the power to set licensing requirements, including the amount of statutory capital and the owners’ equity and the rules for assessing the latter for professional stock market participants.

The licensing conditions also include meeting the liquidity requirements and the possession of appropriate qualifications. A license is granted for a period of five years and the renewal of the license is at present a formal process, but should provide an opportunity for a thorough appraisal of the market intermediary and the possible revocation of the license, especially if the intermediary is more or less inactive. The SSMSC has the power to add further requirements in order to limit the risks involved in stock market activities. These should also include other standards indicated by IOSCO such as skills and past conduct, that is, the “fit and proper” requirements together with the power to refuse a license.

The SSMSC has recently increased the capital requirements for participants in the stock market but it is unclear whether or not these will also be applied to existing participants and under what circumstances a license can be revoked. The capital requirement should be maintained and should be regularly reported to the regulator, and should be related to the nature and amount of business undertaken by the intermediary. Market intermediaries should also be required to comply with standards for internal organization and operational conduct aimed at protecting the interests of clients, ensuring proper management of risk and that the management of the intermediary accepts primary responsibility for these matters.

The FSR has the power to register and license particular institutions subject to the Law on Financial Services and State Regulation of Financial Services Markets No 2664-III, 2001. Article 28 (2) and (3) of this Law gives the Commission the power to register and license particular institutions subject to the laws of Ukraine. Articles 34 to 38 of this Law, as amended by the Law of the Ukraine 3201-IV, December 2005, sets out the licensing conditions. The list is, however, rather limited and does not allow the regulator to develop

licensing conditions as the market and the regulator acquire more experience. The time for review of a licensing application is also rather limited-just thirty days. Other regulatory authorities allow far more time for the lengthy investigations involved if all the relevant information is to be taken into account.

In the case of insurance companies, the “clear, objective and public licensing criteria”, according to IAIS recommendations, is much more extensive, requiring the suitability of the board members, senior management, auditors, (actuaries, but the number in Ukraine is extremely limited) and the applicant’s significant owners to be suitable. It includes information about the applicant’s risk management systems, a three-year business plan and information about the products to be offered by the insurer.

The FSR is committed to improving the regulation of insurance services (implementing the IAIS standards), which will involve up-grading licensing conditions as well as other improvements in the regulations.[5] This is borne out by the review of reporting requirements, leading to a single reporting form to be completed both quarterly and annually by insurance companies. Work was in progress (but is currently suspended) on a draft law, which both raised the minimum capital requirement and introduced new requirements for liquidity and capital adequacy. The plan was to submit the new draft law to the Cabinet of Ministers. Similar considerations apply to the FSR’s other areas of responsibility, including the licensing of non-state pension funds, credit unions, financial leasing and factoring companies and trust companies.

The FSR also regulates the mandatory accumulation pension scheme, which is to operate like a private pension fund, in which asset managers will be subject to control and oversight of the SSMSC and custodians under the control of the NBU. The establishment of the non-state pension scheme has been developed with international standards in mind, and the determination that these standards should apply to the regulation of private pension funds. The relevant international principles are the OECD Guidelines for pension fund asset management, which were adopted by the OECD Council in January 2006. These guidelines do not refer to the overall structure of regulation but to specific guidelines on pension fund asset management, containing the prudent person standard, the investment policy of the fund, portfolio limits, and the requirement for a proper, transparent and disclosed basis for valuing pension assets.

In the case of the NBU, the Law of Ukraine on banks and banking activity (Law No 2121-III, 2000, which has been amended in every year since then) specifically grants the NBU the authority to license banks on a wide range of criteria, set out in Article 17. The conditions for the receipt of a license are at first sight, broadly in line with the principles set out by Basel. However, once again, as the NBU readily admits, it is the lack of information about the ultimate ownership structure, which denies the NBU conformity with these standards. The NBU is well aware of this issue and has sought to rectify this gap in the banking law.

The Core Principles state clearly that “supervisors must be able to check the ownership structure of banking organizations”, including the bank’s direct or indirect shareholders in order to review the controlling shareholders’ past banking and non-banking business ventures, their integrity and standing in the business community, as well as their financial strength. The supervisor should know the source of the initial capital to be invested. If the bank is part of a larger organization, the supervisor has to be sure that the other parts of

[5] Report on the Development and State Regulation of the Non-bank Financial Services Markets, 2005, p.7

the organization will not be a source of weakness for the bank and that the bank will not be used as a captive source of funds for the owners. In addition, the supervisor should be sure that there will be sufficient transparency to allow them to identify the individuals responsible for running the bank and that they have sufficient autonomy. It is also essential for the supervisor to know the identity of the ultimate owners in order to identify connected lending so that such lending does not take place on especially favourable terms and the supervisor should have the ability to place strict limits on such lending. If the ultimate owners cannot be identified, then this puts the whole bank at risk as well as the interests of other depositors. In such circumstances, the supervisor should have the power to make discretionary judgments about the existence of connections between the bank and other parties, especially where measures have been taken to conceal such connections. [6]

3.5 The Power to Make Legally Binding Regulations

The Securities and Stock Market State Commission has the power to develop and approve "legislative acts within its competence", which are binding on market participants, according to Article 6 of the Law on State Regulation of the Securities Markets. In the early years of its existence, the SSMSC was not required to register its regulations with the Ministry of Justice as is now the case. The role of the Ministry of Justice is to check whether the adoption of a particular government agency is in compliance with other laws or Codes. In addition, the SSMSC (as with other agencies) has to abide by the Law of Ukraine on the Principles of State Regulatory Policy in the Area of Economic Activity, dated September 2003. According to this Law, all central agencies with executive power are subject to the approval of the State Committee on Regulatory Policy and Entrepreneurship (Articles 1 and 12). The role of this body is to protect entrepreneurship, which, of course, conflicts with the objectives of financial regulation, which is to protect investors and consumers. Such requirement undermines the independence of this Commission and that of the State Commission for the Regulation of Financial Services Markets.

According to Article 28 (1) of the Law on Financial Services and State Regulation of Financial Services Markets No 2664-III, 2001, the powers of the FSR clearly include the power to *"develop and approve regulations binding upon central and local executive authorities, local self-administrative bodies, members of the financial services markets, their associations, and control the implementation thereof."* The range of supervisory activities is set out in Article 29 but there is no reference to corporate governance or to "fit and proper" considerations. The same process with regard to the registration of all such regulations with the Ministry of Justice and with the State Committee on Regulatory Policy and Entrepreneurship is followed.

The NBU also has the power to issue regulations in accordance with Articles 55 and 56 of the Law "On the National Bank of Ukraine." These are also subject to registration with the Ministry of Justice and 'take effect in accordance with the legislation of Ukraine."

The Principles of State Regulatory Policy require all agencies to consult widely on the draft regulations so that individuals, companies and associations can submit their responses to the proposals. The period of consultation has to be between one and three months, but

[6] It was announced on July 19, 2006, that the Cabinet and the NBU are to develop bills to identify the real owners of banks, improve bank audits, enforce creditors' rights and monitor creditors' accountability for outstanding loans. This is an important announcements, but the moves to identify real owners and to improve audit standards should apply to all financial institutions.

this is often limited to one month. The drafts then have to be submitted, as already indicated, to the State Committee on Regulatory Policy and Entrepreneurship.

3.6 Reporting Obligations, Information Gathering and Surveillance

Article 3 of the Law on the State Regulation of the Securities Markets, No. 448/96B, and subsequent amendments, appear to provide the SSMSC with the powers governing reporting, information gathering and surveillance. The Commission does conduct on-site investigations as well. However, the Law should be clarified so that the regulator clearly has comprehensive inspection, investigation and surveillance powers.

The laws and the system of regulation should ensure that the regulator has the power to require that all the necessary information should be provided and be able to carry out inspections of the companies it regulates whenever it considers that this is necessary to make sure that the company complies with regulations. It should not be necessary to suspect a lack of compliance in order to conduct an on-site visit. The regulator must have comprehensive powers to obtain data, information, documents, statements and records from those involved or those who may have relevant information.[7]

Articles 28 and 30 of the Law on Financial Services and State Regulation of the Financial Services Markets provides the FSR with sufficient powers to require appropriate reports and information from regulated institutions. Indeed, the Commission seems to be in danger of information overload and may need to consider the nature and extent of the information relevant to its regulatory objectives. However, it appears that monitoring, surveillance and the investigation of breaches may be curtailed by the underlying industry laws, an issue which will require careful examination in the development of detailed regulations, and amendments to the underlying industry laws where necessary.

Articles 68 and 71 of the Law on Banks and Banking Activity, N0 2121-III, 2000, and subsequent amendments, seem to provide NBU with all the necessary reporting obligations, information gathering, monitoring and surveillance required. The powers meet international standards.

3.7 Accountability of the Regulatory Authorities

The powers required by the regulatory authorities do in turn impose responsibilities on them. International standards require that the “supervisory authority conducts its functions in a transparent and accountable manner” (IAIS Principles), IOSCO spells out the duties and responsibilities of the regulator, the powers that the authority should have and the approach to accountability. The onus is on the regulator to adopt clear and consistent regulatory processes, which should be comprehensible to all concerned; transparent to the public; and the authority should be fair and equitable at all times. The regulatory authorities should have a public process of consultation on the drafts of new regulations and policies. This standard should be met by all the regulatory authorities and include a requirement for public disclosure of the regulator’s policies and its approach to regulation as well.

The original Basel Core Principles did not refer to accountability. However, Basel has set out a new set of Core Principles, which are currently out for consultation (ending on June

[7] Objectives and Principles of Securities Regulation, May, 2003, Principle 8.2 Inspection and Compliance Progammes.

23, 2006) and which are intended to replace the 1997 version. Principle 1 sets out the requirements for the regulatory authority as follows:

“An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the overall exercise of its duties.”

In Ukraine, apart from the requirement for public consultation on draft regulations, there are few explicit accountability requirements set out in the legislation for each regulatory authority. Article 14, N0 448-BP, 1996, Law on State Regulation of the Securities Market of Ukraine, states that individual officials may be held responsible for failing to fulfill their duties or improper fulfillment, and Article 6, states that the Commission is answerable to the Parliament. For the State Commission for the Regulation of the Financial Services Markets, there is a general provision in Article 24(6) of the Law, which states that the head of the Commission is individually accountable for its activities, there appear to be very few other accountability requirements.

Banking supervision under the NBU is in a somewhat different position in that it is accountable to the Supervisory Council for all its activities and is also accountable to the President and to the Parliament (Articles 8, 9 and 51, Law on the National Bank of the Ukraine, No 679, 1999 and amendments). The Governor of the NBU publishes an annual report that is personally presented to Parliament.

Once again, the accountability requirements should apply equally to all the regulatory authorities and should take the following form:

- The formal reporting requirements should be set out in legislation, and should include the publication of an annual report, together with a financial report, which conforms to International Financial Reporting Standards and which should be externally audited. The report should cover the activities of the regulator during the financial year.
- In connection with possible industry funding, the authority should also publish its strategy and business plan for the forthcoming year and its proposed budget.
- The reports should appear on a timely basis (that is, by the end of the first quarter of the following year) and should be available to the public and to the industry on the website of the regulatory authority and in paper form on request.
- The report should cover the authority’s financial management and budget framework and how expenditure has matched the covering of staff costs, travel, training, recruitment, accommodation and office services, IT costs, publications and any professional fees incurred. It should also contain IFRS independently audited financial accounts together with the auditor’s report to the Board. Details on the numbers of staff employed and in what capacity should be given as well as the turnover of staff in the financial year. In addition, the report should set out every aspect of the work of the authority during the course of the year, such as developments in the market and regulatory policy development together with the numbers of financial institutions regulated and the enforcement actions taken. It should also set out what practices in the industry have been a cause of concern during the year and what steps the authority has taken and plans to take in the future to ensure compliance. Such a report should be presented to the President

and to Parliament for questions. In the interests of keeping the public informed, the Chairman of the regulatory authority should release the report to the media and conduct a press conference.

3.8 Conduct of the Staff

It is important that the staff of the regulatory authority observe the highest professional standards, given their extensive powers and responsibilities. The IOSCO principles set these out in detail as:

- avoidance of conflicts of interests (including, where relevant, the conditions under which staff may trade in securities);
- appropriate use of information obtained in the course of the exercise of powers and the discharge of duty;
- proper observance of confidentiality and secrecy provisions and the protection of personal data; and
- observance of procedural fairness.

Some of these principles are already enshrined in the legislation; for example, officials of the NBU are prohibited from receiving loans from any other lending institutions except the NBU and are subject to confidentiality rules (Articles 65 & 66, Law on the National Bank of Ukraine). Similar provisions apply to the NBFIR (Article 31, Law on Financial Services and State Regulation of the Financial Services Markets). It may well be appropriate to enshrine these principles in a Code of Ethics, which should form part of the induction training of new recruits to the regulatory authority. The Code of Ethics should be developed in all three institutions and for the single authority on the basis of the principles set out above.

3.9 Enforcement

International standards indicate a wide range of enforcement powers, designed to enable the regulators to apply appropriate sanctions. The first step will often be to agree on a remedial programme with the senior management of the business, setting out a timetable, and if the company fails to take the necessary steps, sanctions will be applied. The sanctions should be clearly set out in the legislation. In the case of insurance companies, these may include placing restrictions on the company's business activities, preventing the insurer from writing new business or withholding approval for new activities or acquisitions. They should also include the power to have controlling owners, directors and managers replaced or to restrict their powers or even, in extreme circumstances, remove the management altogether and place it in administration or receivership in order to protect policyholders. Some of measures are contained in Article 40 of the Law on Financial Services and State Regulation of Financial Services Markets, but the power to take control of the insurer or to bar individuals from acting in senior management positions does not.

IOSCO sets out the enforcement powers in more general terms but recommends that these include the power to seek court orders or take other enforcement actions to ensure that the regulator can obtain all the data, information, documents, statements and records from those involved or take statements from them. Regulators should also be able to accept binding undertakings and to ensure that agreements are enforced, suspend trading, impose trading restrictions or requirements on individual market participants. Some of these powers are contained in Article 8 of the Law on State Regulation of the Securities Market of Ukraine (as amended in 2005).

The NBU has a wide range of enforcement powers. These take the form of requiring remedial action; restricting business activities; suspending dividend payments; imposing strict capital requirements on the bank; or calling a meeting of the supervisory board or the general meeting of shareholders to approve a rehabilitation or reorganization of the bank. Senior bank officials may be removed from their positions and in extreme case, the bank may be put into administration or the license be withdrawn.

All three regulators have the power to withdraw licenses if the regulated financial institution fails to comply with the laws and regulations. These are contained in Article 8 of the Law of Ukraine on State Regulation of the Securities Market of Ukraine, No 2804-IV, 2005, in Article 40 of the Law of Ukraine on Financial Services and State Regulation of Financial Service Markets and in Article 20 of the Law of Ukraine on Banks and Banking Activity, No 2121-III, 2000 as amended. The conditions for the removal of a license should be reviewed, given the large number of inactive brokers and dealers, stock exchanges and possibly insurance companies. One way of tackling this is to ensure that there are continuous solvency requirements and that monitoring and surveillance are sufficient to detect any shortfall. The reasons for seeking to maintain the license, while remaining inactive or only sporadically taking part in the licensed activities are, on the basis of discussions with regulatory staff, likely to be dubious to say the least. It is clearly a matter that requires strong regulatory action.

All three regulatory authorities have the power to impose fines, but are restricted by the Administrative Code as to the level of fines they may impose. Fines are based on a formula related to the tax-free personal allowance, i.e. that proportion of income which the individual is allowed to retain free of tax (the non-taxable minimum individual income). The fines are multiples of the tax-free personal allowance. Regulatory officials all regarded the level of fines on individuals and officials as inadequate (if not laughable). The range of fines is illustrated by a fine of US$ 34,000 for issuing unregistered securities imposed on a market participant at one extreme to a fine of US$ 68-170 for unlicensed operations with securities imposed on an individual or an official at the other.

One or two examples from other regulatory authorities may serve as an illustration: The FSA fined Lloyds TSB GPB 1.9m (USD 3.62m) for illegally selling precipice bonds (bonds for which a high level of income is guaranteed, although the investment is linked to the performance of a specific stock market index- the “income” is paid from the principal if the index falls, so the investor may lose all or part of his principal). FSA fined another company, Lincoln Assurance, GBP 480,000 (USD 914m) for illegally selling 10-year savings plans. The company also had to compensate many of its customers, which cost an additional GBP8.8m (USD 16.75m). In Hungary, fines range from Eur500 to Eur5000, depending on the nature of the offence. Instructions to compensate customers, who have suffered a loss, are both an effective and worthwhile approach. Fines at an appropriate level, especially when combined with a full public statement as to the reason for the fine, are an effective intermediate enforcement action. Many of the other enforcement actions (apart from restrictions on business activities) are regulatory actions of the last resort.

In Ukraine, the failure to obtain a license is also the subject of an enforcement action, but it is too easily regarded as an administrative matter, subject to the kind of fines mentioned above. However, all the legislation indicates that registration and a license are subject to certain conditions that the financial institution must meet (even if improvements could be made in the conditions required for registration and licensing). The possibility of enforcement action against those engaged in financial services activities without a license is contained in Article 34 of the Law on Financial Services and State Regulation of

Financial Services Markets and in the legislation covering the securities market, it is Article 11 of the Law of Ukraine on the Securities Market, 1996 (as amended) with a fine of up to US$ 17,000 with a reference to the police for prosecution. The Law of Ukraine on Banks and Banking Activity, Article 18, states that those carrying out banking activities without a license "shall bear criminal, civil or administrative responsibility in accordance with the laws of Ukraine." The point is that *all* the activities of financial institutions, such as inviting investments in collective investment schemes, should *only* be conducted by licensed financial institutions where the license is specifically for those activities. Failure to seek a license should be regarded as a criminal offence. The regulatory authority should seek out such companies and bring their activities to a halt, and at the same time should seek to educate consumers to check whether or not the company is licensed.

In all three areas, conducting financial services business is an administrative offence punishable by a fine of the kind mentioned above. If, however, the unlicensed activity produces an income of over US$3,300 it becomes a criminal offence punishable by a fine or imprisonment. It is clear that unlicensed activities of this kind are deliberately pursued and are not accidental omissions on the part of those conducting them.

3.10 Consumer/Investor Protection

The laws setting up the regulatory authorities for securities and for the financial services markets, do in fact, include references to investor and consumer protection. In the case of the FRS, the law does set out the customer's right to information on the operations of a financial institution in order to provide some protection. It also specifically states that one of the objectives of regulation is to "protect the interests of the users of financial services," Articles 12 and 19, of the Law on Financial Services and State Regulation of Financial Services. The Law on Banks and Banking Activity states clearly that the object and purpose of the law, *inter alia*, is to protect the legal interests of depositors and clients of the banks. However, the objectives of protecting investors and customers should be given a much higher priority in both the legislation and the activities of the regulators.

3.11 Conclusion

The review of the major existing laws governing financial regulation in Ukraine has been carried out to show that in many respects the laws do not meet international standards. Laws governing major areas of the financial sector would have to be overhauled and that applies, in particular, to those governing the status and powers of the regulatory authorities. A fresh start is required. This can be accomplished by a new enabling law, as set out below, which provides a law that fulfills the basic, internationally recognized, principles of financial regulation. A framework law of this nature allows for more detailed regulations, which should both reflect more detailed international standards and yet allow for flexibility as the market in Ukraine develops.

4. The Reasons for Establishing a Single, Unified Regulator

There are a number of factors that may make the choice of a single regulator more likely to occur, but these should not be regarded as a set of fixed criteria to which a country should conform. These factors include the fact that financial conglomerates make up a large proportion of the financial system; that the financial sector is of a suitable size for there to be a single regulator; a recent banking crisis has occurred, where banking supervision was the responsibility of the central bank; an independent central bank has control of its own

monetary policy; and a high level of economic development. [8] These are the primary reasons given for adopting the single regulator in a wide range of countries at various stages of development.

One of the main driving forces for the establishment of a single supervisor is the changing structure of the financial services industry or the existence of an industry dominated by financial conglomerates. In Australia, for example, the Wallis Report (which led to the establishment of the so-called `twin peaks` approach of the division between prudential regulation and conduct of business) concluded that "the financial system is a far cry from the system that existed when banking and insurance arrangements were put in place." The emergence of financial conglomerates had blurred the traditional lines drawn between banks, insurance companies, securities firms, fund managers and other intermediaries so that financial conglomerates held around 80% of the financial assets of Australia.

In the UK, as the Financial Services Authority (FSA) noted at the time "financial groups have been integrating their management and controls on a group-wide basis and supervision has developed partly as a response to this", as indeed the emergence of conglomerates was one of the reasons behind the introduction of a single regulator. It was also to the advantage of the industry when many financial institutions were reporting to several regulators, which existed prior to 1997. [9] The emergence of financial conglomerates is typical of the pattern of development in the former Soviet economies.

However, the problem of supervising financial conglomerates is much more complicated in Ukraine than in many other countries. There are only minimal restrictions on the ownership structure of a bank, which has led to a number of banks, including several of the largest, to be almost wholly owned by single individuals, family groups and multi-layered and closely held corporate conglomerates. Historically, such banks were formed for reasons of tax avoidance, often accomplished through the creation of a network of inter-linked corporate fronts which protected the ultimate beneficiaries from scrutiny by both tax and bank supervision authorities. This structure has allowed the creation of a number of so-called "pocket banks" whose main purpose has been to serve the needs of owners and has also led to bank failures. [10] The same conglomerates also own a large number of the small insurance companies. At present, supervisors have their hands tied as they are not able to publicly identify the ultimate owners, although both supervisors and auditors claim to know who they really are, but are unable to take matters further.

The role of the central bank also determines the nature of the relationship between the single regulator and the Central Bank, as well as the potential fragility of the banking system. In the case of the UK, following the establishment of the FSA, the Central Bank still continues to analyze the balance sheets of some institutions that are regarded as important for the financial stability of the financial system as a whole. The Central Bank also focuses on research and development of banking supervision to a much greater extent than the FSA does, although both participate in Basel Committee on Banking Supervision.

[8] Christian Hawkesby, The Institutional Structure of Financial Supervision: A Cost-Benefit Approach, 2000.
[9] Prior to the establishment of the FSA, the regulatory bodies consisted of the Securities & Investments Board, the Investment Management Regulatory Organisation, the Securities and Futures Authority, Building Societies Commission, Insurance Directorate of the Dept of Trade & Industry, Friendly Societies Commission, the Registrar of Friendly Societies and the Supervision & Surveillance Dept of the Bank of England.
[10] Ukraine Financial Sector Review, 2004, Financial Sector Analyses, Part II, Mel Brown, pp 36-37.

In the case of the National Bank of Ukraine, the bank has indicated that it wishes to withdraw from bank supervision and considers that this role should be undertaken by a separate agency. This is apparently because the NBU fears that blame for any banking crisis could undermine its authority as a central bank responsible for the management and development of monetary policy, where the credibility of the central bank is a key factor. This is not unusual as bank failures do happen and are often blamed on the central bank. However, as the NBU will continue to be responsible for, and will continue to monitor the payment and settlements system, where banks must settle transactions against each other by the end of the banking day, it will continue to have significant insight into the viability of the banks. If a bank does not settle immediately at the end of the day, then this might well indicate financial difficulties and if a bank uses the NBU`s standby facilities too often, then this could also indicate the possibility that the bank is about to become insolvent. What this indicates is that the sharing of information and the ability to act together decisively in handling a crisis is essential, so the single regulatory authority and the NBU will have to have appropriate arrangements in place.

However, to some extent the debate has moved on since the late 1990s. The focus then was on banking supervision and the role of the central bank with concerns being expressed that separating prudential supervision from the maintenance of the stability of the financial system could increase the risks and that the quality of banking supervision would decline. It does not appear that those risks have been realized, and, at the same time, the number and proportion of financial conglomerates has increased considerably. Indeed, the last twenty years have been characterized by an increasing integration of banking, securities and insurance markets as well as in their products and financial instruments and a corresponding increase in the number of fully integrated regulatory authorities. By the end of 2004, there were 30 such regulators in the world of which about half were in Europe.[11] In some cases, however, as in the case of Australia, prudential integration covers all types of financial institutions, market conduct and consumer protection are the responsibility of the Australian Securities and Investments Commission, in other words, the “twin peaks” approach.

The most important arguments for a unified regulatory approach to regulation and supervision are efficiency and effectiveness, with the former consideration applying to companies (especially financial conglomerates) as well as to the regulator. It should be possible to streamline reporting requirements, when the company only has to report to one regulator, and also to ensure that the regulated entities have to deal with a consistent approach to regulation. From the regulator’s point of view the advantage is access to all the information required and the ability to act promptly. With a single supervisor more explicit decisions can be made on the most efficient allocation of resources e.g. if the banking area or the insurance area is a problem then the decision to provide more supervisory attention can be made more easily.

It is difficult to achieve these advantages with more than one regulator, no matter what degree of co-operation and exchange of information there may be. Even with high degrees of cooperation, the information may be too late and again may be hindered by a bureaucratic approach. That could all too easily happen in Ukraine, when cooperation means establishing yet another Coordinating Council with formal membership and formal meetings.

[11] IMF Working Paper, Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision, M Cihak & R Podiera, WP/06/57. The Slovak Republic intends to integrate financial supervision in 2006.

Other advantages were set out in a study of the Scandinavian experience by Michael Taylor & Alex Fleming[12] in which the regulators there argued that "an integrated agency could achieve significant economies of scale." Centralizing regulatory functions and activities permits the development of joint administrative, IT and other support functions. It also facilitates the recruitment and retention of suitably qualified regulatory personnel, because an integrated organization can offer them better career opportunities than smaller specialized agencies. Finally, it permits the regulatory authority to deploy staff with scarce skills and experience, and also to allocate their staff where risks are greatest. Furthermore, the regulator has far greater flexibility in reorganization as and when the market changes.

The integrated approach has indeed improved the standing of financial regulation in each of these countries and in particular a higher status in the eyes of the national governments. The Scandinavian approach is also justified in terms of the best use of skills in a small transition or developing country, where small refers to the relative size of the financial sector not to the population as a whole. However, it should be noted that the cost savings are likely to be found in support staff and in IT but may not lead to a substantial reduction in supervisory staff.

Unified financial services regulators have been established in post-Socialist countries, including Latvia and Hungary. In Latvia the transition from three separate regulators to a single regulator took place in 2001. The new Financial and Capital Market Commission merged the operations undertaken by the Banking Supervision Department of the Bank of Latvia, the Insurance Supervision Inspectorate in the Ministry of Finance and the Securities Market Commission. The organizational structure of the Financial and Capital Market Commission has not adopted a "silo" approach. The lead departments of the Commission focus on functions such as the overall supervision and licensing of financial intermediaries and institutions, irrespective of the type of intermediary, institution or business activity being supervised.

The single regulator in Latvia is responsible for the supervision of 23 banks, 17 credit unions, 25 insurance companies, 22 brokers, 4 pension funds, 3 investment funds and 5 leasing companies, as at the end of 2000 (latest available) with approximately 90 staff members. The regulatory authority is funded by annual fees from the industry, but the Government sets the fees. The IMF assessment of Latvia`s system of financial regulation in 2002 concluded that banking supervision was largely in compliance with the Basel Core Principles and the regulation of insurance companies was in compliance with the minimum standards of regulation. [13]

In Hungary, the HSFA was established in 2000, by a merger of the previous sectoral supervisors (banking and capital markets, pension funds and insurance companies) with the responsibility for the legal framework at that time residing with the Ministry of Finance, under the oversight of the government and the powers of granting licenses limited to non-bank financial institutions. As of 2005 the HFSA has acquired more substantive powers, including powers to issue a range of regulations and recommendations to market participants, driven by the need to fulfill EU Directives. By 2005, the authority was supervising 30 commercial banks, 5 specialized banks, 178 savings and credit

[12] Integrated Financial Supervision, Lessons of the Scandinavian Experience, Finance & Development, Dec 1999, Vol 38, No 4.
[13] Republic of Latvia, Financial Stability Assessment Report, 02/67 March 2002.

cooperatives, 168 pension and health funds, 65 insurance companies, 148 investment funds, 17 investment companies and 208 financial enterprises. The total number of staff of the supervisory authority is approximately 529 in 2004 according to the latest data available in their Annual Report for 2004.

The HFSA has made considerable progress towards achieving its objective of following a risk-based supervision approach across all sectors, especially in the supervision of banks and securities companies. Again the IMF assessment of 2005[14] concluded that Hungary's framework compares well with the relevant international standards, especially the assessment of insurance supervision against IAIS Insurance Core Principles.

Finally, Poland has given much consideration to establishing a unified regulator, the Financial Supervision Office, led by a President with executive powers. However, according to recent press reports, the proposals have been recently redrafted to establish instead the Financial Supervisory Commission, a merger between the Insurance and Pensions Funds Supervisory Office and the Polish Securities and Exchange Commission, and both will be merged with the General Inspectorate of Banking Supervision in 2007, a year earlier than initially proposed. Some had expressed fears that the President of a unified authority would have too much power, and so a collegiate system was proposed instead. That fear could have been resolved by the appointment of a strong board and proper accountability and reporting arrangements. Instead, in the eyes of some, such as Pawel Pelc, Vice President of the Polish Securities and Exchange Commission, the collegial system will slow down the decision-making process, the level of responsibility for decisions will be lost and the opportunity for quarrelling between the commission will be greatly increased.[15]

In Kazakhstan, the financial sector has developed considerably over the past decade or more, so that by 2005 the country has 35 banks with total assets of $20 billion. The largest three banks are privately held with some foreign investment. Together they hold more than 60% of total assets and deposits in the banking system. A private pension system was set up in 1998, and 16 pension funds have been established, controlling assets of nearly $4 billion. The number of insurance companies has been reduced from 70 to 36 in 2005, with assets of $300 million. The banks in Kazakhstan are all part of financial conglomerates, which include non-financial companies, posing the same problems of supervision as in other post-socialist states. As the regulatory authorities have more effectively conducted consolidated supervision, the problems have slowly started to disappear.

The process of consolidation into a unified regulator took place over a period of two years so that by 2003 each of the separate functions were combined into one department to form the core structure of the future unified regulator, the FSA. It was also decided to combine the two approaches to the organizational structure so that the FSA has both sector and functional units and departments. The decision was also taken to separate the monetary policy and financial sector supervision, partly because the concentration of power in a single entity may be too great. The process of establishing a single financial regulatory authority with sufficient independence from the government, but with the assistance of the Central Bank was able to establish the appropriate autonomy. The help of the Central Bank was significant in another way in that recruitment by the FSA is through the Central Bank, which can offer more attractive remuneration than the rest of the civil service,

[14] Hungary: Financial System Stability Report, 02/112, June 2002 and update, 05/212, May 2005.
[15] Globalpensions, Polish government u-turn over the FSO presidency, 06/12/06

though that is now under threat. The process of establishing a single regulator in Kazakhstan also does indicate the problems in the process, which have to be taken into account; such as the risks involved in revising the laws and regulations and the disruption to the workload and staff, highlighting the need for careful planning and communications with staff at all levels. However, the successful transition to a unified regulator in Kazakhstan indicates that it is possible to achieve and although the market is different in size from that of Ukraine, it shares some of the same relevant characteristics.[16]

These examples show that the move towards a single regulator have taken place in the post-socialist companies as well as in developed countries and seem to have been successful when assessed by independent assessors. The rationale for a single regulator does not depend on the size of the market. The system has worked in markets of various sizes. One feature of all markets is the trend towards financial conglomerates, where the unified regulator does have a chance of a better view of the conformity of the conglomerates with financial regulation.

Not much empirical work has been carried out on whether or not integrated supervisory agencies have a higher and more even quality of supervision across all sectors of the industry. But where such an analysis has been carried out, the results are positive. One study, conducted by Martin Cihak and Richard Podpiera to whom reference has already been made, is based on the IMF assessments of regulatory authorities, which are publicly available and where the assessments have been made on a consistent and coherent points system. Their analysis suggests that integrated supervisory authorities tend to have a higher quality of not only banking supervision but also of securities and insurance supervision as measured by compliance with the relevant standards and may even be associated with other performance indicators, such as better non-performing loan ratios and interest rate margins. They do, however, caution against too much reliance on these conclusions, as causality is still an open question. But their research does suggest a real value.

The integration process is not an easy one and may bring its own risks. Care must be taken that a move to a single regulator will not just be seen as a fashionable, modernizing step so that legislation will be hastily prepared, or, on the other hand, that delays will occur so that the legislation will be delayed too long. Integration does require enabling legislation, which must be in line with international standards and without influence from vested interests.

It will also require that the process of change be well managed and that sufficient time is allowed for implementation of the process. It should be noted that in a mature market, such as the UK, the process of setting up a single regulator began in 1997 with the Chancellor's announcement and ended in November 2001 with the formal implementation of the Financial Services and Markets Act. The process should be managed in such a way that the advantages of integration can be obtained, which includes the following:

- efficient exchange of information, experience and knowledge within the organization;
- harmonization of the quality of regulation and supervision so that it results in better overall supervision but especially with regard to financial conglomerates; and
- cost savings resulting from the support activities.

[16] See 'Unification of financial sector regulators: *The Case of Kazakhstan,* Bryan D Stirewalt, BearingPoint, Central Banking Publications, 2005.

Conclusion

This brief survey shows that a single unified regulator can be established at various stages in the development of the financial services industry. Much work has been done to seek to improve the quality and effectiveness of regulation in Ukraine, but the analysis of the laws governing financial regulation shows that they fail to meet international standards in important respects and they do not provide the authorities with adequate powers and protection. Moving towards a single regulator in the way set out in the subsequent sections of this report provides a real opportunity to address these issues and to get financial regulation on a proper footing. The fresh start should provide the impetus necessary to carry out a demanding process so that the benefits of a single regulator can be obtained. Other aims can also be achieved in this way, such as the desired integration with the markets of the European Union.

The recommendation is that in the development of a single regulator in Ukraine, a number of steps should be taken, but these should all form part of a plan which has three concurrent strands: preparation of an enabling law, which would set out a structure for financial regulation. The remaining strands consist of creating a single organization and bringing together and reviewing regulations, so that the approach to the regulation is coherent and internally consistent.

5. The Enabling Law

The purpose of the Enabling Law is to provide a framework for the operation of the unified regulator and to ensure that it conforms to international standards and is intended to provide for the independence and the full range of powers for regulator. It will sometimes supercede the provisions in the existing laws covering the SSMCS, the FSR and the NBU. With regard to detailed regulations contained in some of the existing laws, these should be reviewed and may well be incorporated into the Handbook. In Ukraine, all the elected deputies, the Cabinet of Ministers and the President may submit a draft Law to Verkhovna Rada for its consideration. The draft law may be amended during its progress through Verkhovna Rada and must have a majority at each stage, that is, three separate readings of draft law (Enabling Law) before its passage through the Verkhovna Rada is completed. The process often takes three years to complete. However, in the case of the Enabling Law it is hoped that this would be put forward by the Cabinet of Ministers and the President, following the work of the drafting committee and that its proposals would be understood and accepted by members of the Verkhovna Rada prior to its introduction into the parliamentary process.

The proposal for an Enabling Law may well take time to become law, but it is vital that the final law gives the necessary independence and powers to the regulatory authority, and that these objectives are not lost in the process. There are risks in an Enabling Law being drafted in haste and failing to provide an enduring framework or providing one that again fails to meet international standards. Hence it is proposed that the drafting of the Enabling Law be handled by a special Committee dedicated to this task.

Representatives of the three regulatory bodies and staff of the Cabinet, the Ministry of Finance and the Ministry of Justice should be involved in drafting the enabling law together with international donors. Membership in the Enabling Law drafting committee should be consistent, committed and limited in numbers (not more than ten at the maximum) for the time it takes to draw up the draft legislation. The Committee should have the support staff

necessary for the project. The Committee chairman with the support of other members, but under his/her direction at all times, should, at the appropriate stage, be proactive in explaining the purpose of the Enabling law to the Cabinet of Ministers, to Peoples' Deputies in the Verkhovna Rada and to the media as the work on the draft law nears completion.

Since this is an Enabling Law, it need not be long or complicated but should give clear powers to delegate making regulations to the regulator. The existing regulatory authorities do have these powers in Ukraine, but have to refer the regulations to the Ministry of Justice and to the State Committee for Regulatory Policy and Entrepreneurship. The purpose of the latter's authority is to promote and protect entrepreneurship, which may well be in fundamental conflict with, for example, the duty of the regulatory authority to protect consumers and investors. Regulations should not have to be referred to this Committee. It is important that the potential conflict of interests are understood and, at the same time, that full transparency regarding proposed regulations and policy changes with the right of all interested parties, including the State Committee on Regulatory Policy and Entrepreneurship, to comment. Responses to regulatory changes in other jurisdictions do take that form, and it is essential for the regulatory authority to be able to demonstrate both the costs and the benefits of such reforms. The Enabling Law should have certain core elements more fully discussed below.

5.1 Objectives of Financial Regulation

The objectives of the regulatory authority are often not stated in the law, and where they are, the objectives are not easy to measure. In Ukraine, the laws do set out objectives, but these are often a list of objectives some of which are too specific to be included in a statement of objectives. For example, Article 2, of the Law on the State regulation of the Securities Markets of Ukraine, No 448/96-BP, as amended) list no less than ten objectives, not all of which should have the status of overarching objectives.

The Law on Banks and Banking Activity, No 2121-III, 2000, Article 1, is more specific with just one objective, namely, "*guaranteeing the stable development and activity of the banks in Ukraine, and creating with the same goal an appropriate competitive environment in the financial market, protecting the legal interests of depositors and clients of the banks, creating favourable conditions for the development of Ukraine's economy and support for the domestic commodity producers."*

The Law of Ukraine on Financial Services and State Regulation of the Financial Services Markets, (No 2664-III, 2001, as amended), Article 19, lists no less than nine objectives, not all of which are relevant to the specific objectives of financial regulation; for example, to "avert monopolies" or to "foster integration in the European and worldwide markets of financial services." These are both important objectives for the Government but not necessarily for the role of the regulatory authority. The regulatory authority has a *vital* role to play in the latter objective since Ukraine simply would not achieve integration into the European market for financial services if, as is certainly the case at present, the status and powers of the authority do not match European and international standards and its regulations do not conform to the EU directives establishing the single market in financial services. This should, however, be a matter of policy for the regulatory authority and for the Government, not an objective of the authority as such.

The necessity of a clear statement of objectives is set out in the principles of regulation to which reference has already been made. The Basel Core Principles refers to "clear

responsibilities and objectives", IOSCO has three essential objectives, these being, "the protection of investors, ensuring that markets are fair, efficient and transparent, and the reduction of systemic risk". IAIS sets out the need for the "principal objectives of insurance supervision" being "clearly defined."

A few examples demonstrate the kind of statement of objectives other regulatory authorities have adopted. The Japanese Financial Services Act refers to "establishing a stable and dynamic financial system" and "ensuring transparency and fairness in financial administration." In Finland, the objective of the FSA is "to promote financial stability and public confidence in the operation of the financial markets", and, as its own strategic objectives, the FSA aims at ensuring that "supervised entities" capacity to bear all their risk-taking activities is good and that the "corporate culture" is sound, that "publicized information and market practices promote sound market development" and "the regulatory regime is proactive and the FSA's supervision and enforcement meets the requirements of accountability". For the Hungarian FSA, it is "enhancing the transparency of markets" and "maintaining fair and regulated market competition through the permanent surveillance of the prudent operation of organizations and entities engaged in financial services."

The regulatory objectives of the UK's Financial Services Authority are set out in Part 1 clause 2 of the Financial Services and Markets Act, 2000. They are as follows:

- maintaining market confidence in the financial system;
- promoting public awareness, that is, understanding of the financial system;
- protection of consumers; and
- reduction of financial crime.

Since the UK objectives cover the whole financial services market, they are perhaps more comprehensive. The objectives do not provide a means of measuring the effectiveness of the work of the regulator. The activities of a regulatory authority are often concerned with *preventing* certain events from occurring, and, as such, do not give rise to measurable events. Nevertheless, the statement of objectives is one way of holding a regulatory authority accountable in that it helps to define the scope of the legitimate activities of the regulatory body. The objectives can also serve as a mission statement for the regulatory authority itself, which serves to remind it and its supervisory staff of the purpose of their work. "What am I doing this for? What do I expect to achieve by this action?" are often salutary questions for the authority as a whole or for individual members of staff to ask themselves. It helps focus regulatory activities and guides the use of resources.

The objectives can be further defined by setting out in more detail the relationship between the objectives and the functions of the authority. For example, the FSA has to "have regard to" seven further requirements, which are listed as follows:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorized persons;
- the principle that the burden placed on companies is proportionate to the benefits;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the UK;
- the need to minimize the adverse effects on competition which might arise from the impact of regulation; and

- the desirability of facilitating competition between those who are subject to regulation by the Authority.

This should serve as an example of the requirements to be met by the Authority in fulfilling its objectives. It should also be borne in mind that if the regulatory authority has objectives, which are expressed in terms of preventing various undesirable outcomes or events, then this can both help to focus regulatory activities and guide the use of resources. The more detailed description of these and the objectives themselves should be contained in the legislation, as this provides another way of ensuring that the regulatory authority is accountable.

5.2 Independence

International standards require the regulatory authority to be independent, and it is fair to say that achieving that aim in terms of structure and its relationship with central government does vary from one jurisdiction to another. This should be set against, on the one hand, the reluctance of governments to grant regulatory authorities independence from the political arm of government. The financial system may be seen as a means of redistributive policies, for example, in directed and connected lending, or may be able to generate rents from politically connected banks. Hence governments may wish to remain formally or informally involved in the regulation and supervision of the financial sector. The effect of this is, in one sense self-defeating, as it may inhibit the growth of the financial sector and the contribution to the economy which it would otherwise make.

One way of establishing the independence of the regulatory authority is for it to become a statutory body with its own governance board, which is also defined in law. It is then possible to delegate the structure of remuneration, budgeting, funding, staffing, and rulemaking to such a body, subject to a full range of accountability provisions. It may well be possible to consider creating a single regulator as such an agency, provided that the Constitution allows for a statutory authority to receive delegated regulatory powers and provided that such an unfamiliar approach is acceptable in Ukraine. It is a useful way to ensure independence, but it is not absolutely essential, provided that other criteria for independence are met. Other models do exist in the European Union and elsewhere, which could be adapted to Ukraine's needs, providing sufficient flexibility is available to allow for more flexibility over rates of pay and promotion.

Industry funding (the income from licensing fees, annual fees and fines) is another way of protecting the independence of the regulatory authority. It is not proposed that the single regulator should move to full industry funding in the immediate future but that partial industry funding should be proposed (as it appears that the insurance companies and credit unions are already prepared to pay in principle at least but there is no agreement on the amount as yet). This is in line with other countries, which allow for full or partial industry funding.

The Enabling Law should include provisions to raise funds from the financial services industry and their use in all regulatory activities. Current laws should be reviewed and the necessary amendments made to the relevant laws. Other studies suggest that the amendments would be relatively insignificant, but it appears that the following laws should be considered: The Ukrainian Budget Code, 2001 and the Law on Sources of Finance, 1999 together with the Labour Code of Ukraine; the Law on Labour Remuneration and the

Law on Public Service.[17] Industry funding does not in and of itself secure independence, but it is an important element, along with other elements.

The Enabling Law should therefore include a series of legal protections of the single regulator's independence:

- provisions for industry funding and the retention of fines;
- terms for the appointment and dismissal of members of the Commission, including the chairman. First of all, the statutory list of qualifications, knowledge and experience required for an individual to be appointed should be publicly set out. In many countries, the posts are advertised and the terms of appointment are set out in the advertisements;
- length of the appointment should also be set out as well as the terms and length of any reappointment. The period of appointments may vary, an example is the UK, where the appointment of the chairman and chief executive is for three years with the possibility of re-appointment for a further three years; and
- In order to avoid any possible conflict of interest, the person appointed should not have any current position in any one of the regulated financial institutions or should resign on appointment if he has such a position. The chairman should not have any interest in a financial institution, and if any member of his immediate family has such an interest that should be declared in the Register of Interests. This will also be a public document, available on the regulator's website and form part of its annual report.
- Some countries also require the appointment, if proposed by the President or responsible Minister, to be ratified by Parliament or a Parliamentary committee of some kind.
- The terms of dismissal should be clear and public, and generally include bankruptcy, criminal convictions, mental incapacity or gross dereliction of duty. If a decision is taken to dismiss an individual from office, the reasons for doing so should also be made public.
- The issue of legal indemnities for regulatory staff who carry out their duties in good faith should be addressed. This issue has already been discussed in some detail in this report. For example, the UK Financial Services Act states that "Neither the Authority nor any person who is, or is acting as, a member, officer, or member of staff of the Authority is to be liable in damages for anything done or omitted in the discharge, or purported discharge, of the Authority's function" (which also applies to an investigator or a person conducting an investigation on behalf of the investigator) unless the "act or omission is shown to have been in bad faith." A similar provision should be part of the Enabling bill.

5.3 Registering, Deregistering, and General Prohibitions

The existing regulatory authorities have the power to register and license financial institutions, which must at the very least cover the legal status of the applicant, the location of the head office, the nature of the links between the applicant and another company or persons, and ascertain whether those links are such as to prevent the authority's effective

[17] Ukraine: Review of Funding Options for the State Commission on the Regulation of Financial Services Markets of Ukraine. J Carmichael, 2004.

supervision of the applicant, and whether he has adequate resources to conduct the business.

The applicant must also satisfy the regulator that he is “fit and proper”, set out the nature of his connections, the nature of the proposed business and that his affairs are conducted soundly or prudently. The powers should also be expressed in such a way that further licensing conditions may be required as the financial services market in Ukraine develops or the regulatory authority may see, from experience, that the conditions should be amended or modified in some way. Regulatory authorities in Ukraine do have the power to license and register financial institutions or individuals but these may need to be redrawn. The time limit on the issuance of a license (often 30 days) may be too short in some cases to allow for a proper investigation. Six months may be more appropriate, bearing in mind that it is simpler to refuse a license than it is to grant a license and find that the company is in serious breach of regulations or is poorly or improperly managed to the detriment of consumers and investors, who may not be recompensed for their losses.

The authority should also have the power to revoke a license for a violation of the regulatory requirements, as is already the case. In some cases the license can be withdrawn for the failure to conduct financial services business for a period after its issuance. The period varies from one to two years after it has been granted, but this does not apply to securities traders. This should be harmonized and consideration should be given to withdrawing the license of any financial institution, at any time, for failure to conduct the business for which it was licensed, given that solvency requirements may no longer be met or that the failure to conduct business may well affect the savings and investments of the original policy holders or investors. Where licenses are granted for a period of time they should not be automatically renewed.

This prohibition should be stated in general terms, for example “No one may carry out a regulated financial activity unless authorized or registered with the regulator to do so.” This is a vital prohibition, since it provides one essential element of consumer protection. It should also apply to individuals or entities, which falsely claim to be registered, to carry out such activities.

This is currently regarded as an administrative offence, punishable by a fine. As already noted, it only becomes a criminal offence if the income received is more than US$3,300 which may be punishable by a prison sentence or a fine. The latter hardly acts as a deterrent and may well be impossible to detect, since the money may already have been diverted from investors’ accounts, but the former is an appropriate punishment, since it involves taking money from individuals or companies under false pretences. It is necessary to nip such schemes in the bud rather than waiting until the perpetrators have amassed significant income in all probability defrauding those who have put their savings into such schemes.

The Enabling Law should contain two elements: a person who contravenes the requirement to register is guilty of an offence and is subject to imprisonment. Since these are likely to involve some kind of pooled investment, the definition of such schemes must be wide and general enough to ensure that no such pooled investment project escapes the prohibition, as they often have done in the past under various regulatory authorities, such as ostrich farms (in the UK), timber (Sri Lanka) and ElitaCentre (Ukraine), a company apparently engaged in investment and construction projects.

Again, it might be useful to take the definition in the UK's Financial Services and Markets Act, 2000 as a starting point. Part XVII (clause 235) states that:

(1) A collective investment scheme means any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

(2) The arrangements must be such that the persons who are to participate do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

(3) The arrangements must have either or both of the following characteristics:

  (a) contributions of the participants and the profits or income out of which payments are to be made are pooled; and

  (b) property is managed as a whole by or on behalf of the operator of the scheme.

Ensuring that unlicensed companies do not undertake financial services business is an important tool in protecting the consumer. It does require vigilance on the part of the regulator, as it is often difficult to unearth the companies involved in such schemes. It also requires the regulator to enlist the aid of the consumer; first, by making sure that consumers understand that they must not place their money with an unlicensed financial services company, second the consumer should always check to see if the company's letterheads, business cards, business premises etc refer to the license given by the regulator, and third, the consumer should check the website (which apparently contain lists of regulated companies) or report the activities of an unlicensed operator to the regulator.

5.4 Rulemaking Powers

The Enabling Law should clearly state that the regulatory authority has the power to issue legally binding regulations and the power to vary and revoke them. The authority should have the power to issue statements of principle with respect to the conduct of boards, senior managers and others holding key positions in the company, which should be followed by codes of practice which enable the individual to determine whether or his conduct complies with the statement of principle. The authority should also require companies, directors, senior managers and boards to comply with the principles of corporate governance.

The Enabling Law should permit the authority to set the standards governing the ownership and control of financial institutions, which should include the "fit and proper" requirements and relevant knowledge, skills and experience. Other regulations should cover insider dealing and market abuse. The FSA has a detailed Code of Market Conduct, which covers a range of activities in the market, which are considered to be abusive. Other regulations and standards should cover capital adequacy, solvency and the measurement of capital, including excluded assets and liabilities. If the required capital for establishing a financial services company is expressed in monetary terms in primary legislation, then there is a risk that is will not be reviewed at frequent enough intervals to exclude companies that should not be licensed to conduct business. This will require a formula to be developed to apply appropriate barriers to entry.

On-going solvency requirements for all companies will have to be set out in regulations, taking the risks inherent in the business into account. The regulatory authority should apply solvency requirements in accordance with international standards for each sector; for example, Basel I and II and the forthcoming Solvency Directive of the European Union. Other regulations and standards should define valuation methods, where relevant for assets and liabilities, including the choice of discount rates. Regulations should cover the responsibilities of senior managers and the standards applicable to the management of risk by financial institutions.

Regulations should also cover the disclosure requirements for securities and retail investment products, including insurance policies and pension products. Companies should also be required to keep records of the complaints received and the procedures in place to handle complaints. Regulations should also cover the disclosure and listing requirements for the securities markets

Regulatory authorities typically require all the above broad regulatory powers, including prudential rules, reporting, and disclosure requirements, as well as organizational prescriptions and rules of conduct.

At present, regulatory authorities in Ukraine are required to submit their regulations to the Ministry of Justice, which checks whether the adoption of a draft regulation is within the power of the authority concerned and its compliance with other laws and Codes. This undermines the independence of the Commission and is not necessary given the requirement to consult. As indicated earlier the requirement to clear the regulations with the State Committee on Regulatory Policy and Entrepreneurship further undermines the regulator's independence as the latter exists to promote entrepreneurship and the former to protect consumers.

At present, the regulators are obliged to publish proposed regulations and put them out for consultation for a period of one to three months. Except for a very short and simple proposal, the period should be three months. That gives ample time for all interested parties to consider the implications of the proposal and to respond with their views, expressed in writing. The regulator should then respond, outlining the responses, including objections and criticisms, but without naming the sources, unless the individuals or companies wish to make their response public. The final version of the regulation should then be published, indicating where it has been amended, if it has, in the light of comments received. The regulator should also provide a reasoned justification for retaining the original proposals if these have been criticized, answering the points that have been made.

5.5 Supervision

The regulatory authority should have the power to require all financial institutions to provide whatever information it requires in whatever form it considers appropriate, including both regular reporting and specific reporting. This includes the right to inspect and copy documents.

The regulatory authority should also have the power to conduct on-site examinations, both announced or unannounced.

It should also have the power to require reports from `skilled persons` (typically accountants, lawyers, an actuary or a person with relevant experience, such as a banker)

about a licensed firm or individual. The regulator might wish to test an institution's compliance with prudential regulations or standards and may use experts to do so, even at the expense of the institution concerned.

The above powers may be exercised without having to show that there is any suspicion of wrongdoing; they are purely information gathering.

The regulatory authority should also have the power to conduct a special investigation when there are "circumstances suggesting" that certain criminal offences may have been committed such as insider dealing, market manipulation, misleading statements and unauthorized business, breaches of money laundering regulations and where an individual may not be fit and proper for the role he has in the company.

5.6 Enforcement

The regulator should have powers of enforcement:

- The power to issue directions to a financial institution requiring a specific action, such as removing a particular individual from a particular role in the company; to cease carrying out a particular action, such as investing in certain assets, limiting its lines of business, or changing the procedures of the company so that it complies with the relevant regulations. The regulator may also require the company to put matters right where customers have been disadvantaged by the failure of the company to comply with regulations.
- The regulator may be able to accept undertakings provided by the company that it will put in place procedures to ensure that the company will not commit the same breaches of regulations in the future. This undertaking should be both publishable and enforceable.
- The power to impose fines, which should be related to the severity of the offence or offences and to the failure of the company to comply with the regulations despite its commitment to do so. The current formula does not give the regulatory authorities the flexibility required. The imposition of the fine should be accompanied by a press release issued by the regulator, naming the company and explaining the reasons for the fine in full. This has the advantage both of informing the public and ensuring that the fine is not disproportionate to the offence. The regulator should be able to ensure that the fine is paid without resort to the courts.
- The power to freeze the assets of or under control of a financial institution where there is reason to suppose that the customers may be at risk.
- The power to remove authorization from an individual or a firm.
- The power to impose a statutory management, where the regulator considers that a financial institution may be insolvent, is behaving in a manner that puts clients' interests at risk or is in breach of financial sector laws. The manager can only be appointed with the permission of the regulator and must take directions from the regulator.
- The power to wind up a financial institution on application to the court.

5.7 Information Sharing

The Enabling Law should enable the regulatory authority to cooperate with and share information with other relevant supervisors, subject to confidentiality requirements, both in Ukraine and with similar authorities in other countries. This is becoming increasingly important for dealing with issues involving fraud, anti-money laundering and combating terrorist financing.

5.8 Responsibilities of Regulators

The Enabling Law should require the single regulator, the National Bank and the Ministry of Finance to set out in a public Memorandum of Understanding, the responsibilities of each body and the manner in which each entity should work together in the event of a crisis.

The Bill should also specify certain formal relationships, such as membership and attendance of the Deputy Governor of the NBU at board meetings of the single regulator and the membership and attendance of the chairman of the single regulator at board meetings of the NBU.

It should also establish a standing committee on financial stability, consisting of representatives of the Ministry of Finance, the NBU and the single regulator.

The Enabling Law should be based on the following principles:

- accountability;
- transparency;
- avoidance of duplication; and
- regular exchange of information.

The responsibilities of the NBU are as follows:

- ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the market to deal with fluctuations in liquidity; and
- overseeing the financial system infrastructure, in particular the payments system.

The responsibilities of the single regulator are set out in the Enabling Law as follows:

- authorization and prudential supervision of banks, investment firms, insurance companies, pension funds, brokers, and credit unions;
- supervision of financial markets, securities listings and clearing and settlement systems; and
- regulatory policy.

The responsibilities of the Ministry of Finance are the following:

- overall responsibility for the structure of financial regulation; and
- accounting to the Parliament for the management of serious problems in the financial system and any measures to resolve them.

In addition, the Ministry of Finance is responsible for Operational Crisis Management. The Ministry of Finance would undertake the following activities:

- establishes a framework for the coordination of management in the event of a crisis; and

- ensures that the government is fully informed and would liaise with other relevant bodies.

The NBU should monitor and facilitate the functioning of the markets and the payments system, providing liquidity where necessary. The Single Regulator would continue to monitor licensed firms and work with licensed firms to resolve any problems they may have in functioning normally.

The contents of this part of the Enabling Law and the proposed MOU take into account the fact that the single regulator may well be responsible for "maintaining confidence in the financial system," and that the National Bank of the Ukraine is responsible for the payments system, and that, as a consequence, both organizations are responsible for the stability of the financial system. Financial instability arises when the financial difficulties of one financial institution can be transferred to another, which is thought of as being highest among banks as deposit-takers. This applies especially to the payments system (where the NBU is in charge), since the failure of one bank to meet its obligations can have serious implications for the ability of other participants to meet their own obligations. Disruption to the payments system can in turn lead to a wider economic crisis. It is not the only source of contagion, since this can arise from the clearing and settlements system as well, but the NBU is in charge of the payment system, and both authorities are responsible for the stability of the financial system. It is therefore important to consider the manner in which they should work together in advance of a crisis. [18]

5.9 Accountability

This should be established through a combination of controls, which are such that no other single body controls the regulatory authority, yet there is an array of controls. Accountability allows the regulator to explain the nature and purpose of its activities to the public. Public reputation for competence, fairness in all its dealings and integrity can help the regulator to take decisive action in the face of opposition from vested interests. [19]

This part of the Enabling Bill should set out the following elements on accountability:

- submission of an annual report to the President and to the Parliament, including its regulatory policies, operations, and any issues related to achieving its statutory objectives; audited accounts, prepared in accordance with international accounting standards;
- appearances before Verkhovna Rada committees for questions on any aspect of the regulatory authority's work;
- publication of the budget and business plan for the forthcoming year;
- regular reports to the Ministry of Finance;
- consultation on new regulations and regulatory policy;
- regulatory impact analysis and cost-benefit assessments;

[18] The Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority in the UK is attached as Appendix 1 as an example of such an MOU, which can form the basis of further discussions of an appropriate MOU in Ukraine.

[19] The requirements set out here regarding the conduct and powers of a new regulatory agency should be seen in the context of growing empirical evidence of the value of regulatory governance as an essential element in economic development and macroeconomic growth. See e.g. Does Regulatory Governance Matter for Financial Stability? An Empirical Analysis, U.S Das, M.Quintyn & K. Chenard, IMF Working Paper, 04/80

- information on regulatory and supervisory practices on the website;
- oversight board with independent members appointed according to objective criteria for fixed terms;
- public information available on the website and through the media;
- mission statement on the website;
- information on regulatory or supervisory practices;
- annual reports;
- press releases and press conferences; and
- consumer information.

Concern has been expressed that the single regulator may be dominated by one powerful individual, who may not be committed to upholding the integrity of the Commission and the adherence to international standards. The accountability requirements set out above are designed to ensure that such a dominance does not take place, since the activities of the chairman of the single regulator will be limited by accountability and full transparency. Furthermore, the board of the regulatory authority has to approve all its actions, policies and expenditures and to ensure that it has all the information required for its task. Should the Board discover that the Chairman is in flagrant breach of the rules, it would be their responsibility to recommend his dismissal from office.

6. Establishing a Single Regulator

The process of establishing a single regulator by merging three existing regulators is a difficult and taxing undertaking, and even in developed economies, takes time. In the UK, it took some four years before it was completed, though a substantial part of the delay was due to the lengthy progress of the Enabling Bill through Parliament, rather than to organizational matters. The FSA is also a much larger authority, then employing about 2000 staff. It will be a period of intense change in which three organizations will become one, and in which other changes will have to be made simultaneously, such as improving the nature and quality of regulations and supervision, while not undermining the quality of current supervision and compromising the interests of the market.

The work should be managed by three separate Task Forces, one of which will be responsible for drafting the Enabling Law as set out above. The work of this Task Force, which is of necessity called the Enabling Law Drafting Committee. The other two Task Forces are the Handbook Development Task Force and the Transition Management Task Force. Since it appears that there are no legal barriers to bringing the three regulatory authorities together in one building prior to the enactment of the enabling legislation, it is recommended that this should be the one of the first steps. At this stage, there would be no change in the status or powers of the existing regulatory authorities, but the aim of working together in one place would be to facilitate communications between the staff of each organization and to enhance understanding of the differences in the approach to regulation and supervision, and the nature of the entities each supervise

6.1 The Transition Management Task Force

The task force will act as the Transition Management Task Force (TMTF) of the process with suitably qualified representatives from the three agencies, international experts, suitably qualified representatives from industry associations or from the private financial sector, including banking, insurance, securities, and preferably led by the chairman-to-be

of the single regulator. The references to “suitably qualified” in this context is intended to convey the need to have individuals with some experience in management and the management of organizational change, in particular. The chairman-to-be of the single authority should also have clear qualities of leadership. One of the international experts should have relevant managerial experience, balanced by another with regulatory experience.

The TMTF would be instructed to develop a strategy, dealing with the following items:

- Design of the new organizational structure, which must incorporate a team building programme to enable the three organizations to meld together into one organization in the longer term. Its plans should allow for the three current chairman (or the deputy governor in the case of the NBU) of the regulatory authorities to continue in their posts as the three managing directors of what could eventually be regarded as three departments of a single authority. The managing directors would be of equal status and continue to receive their current salaries.
- Development of a human resources policy, which would set out the requirements for appointments of individuals to the authority on the basis of merit and suitability for specific posts; be responsible for the training and development of individual members of the staff; analyze training needs and maintain training records for each member of the staff; measure performance according to relevant criteria; establish bonuses paid on the basis of performance assessments; promote members of staff on the basis of performance, skills and experience and not on length of service, for example, and the potential of existing director (s) should be explored to take charge of human resources with the appropriate training and development.[20] Redeployment of existing staff should be considered, but, apart from a possible reduction in the numbers of support staff, and given the under-staffing at two of the existing regulators, it is unlikely that there will be any reductions in the number of professional staff.
- Identification of possible risks, leading to under-performance of the single regulator and strategies for overcoming potential weaknesses.
- Establishing a single regulator would involve set-up costs, such as those indicated below, and the Task Force should provide a detailed account of the costs.
- Establish a system to allow the single regulator to set salaries outside the civil service scale and which bear some relationship to the salaries offered in the private sector to the staff in the regulatory authorities considered suitable for managerial posts in the private sector. The first step, however, will be to raise the salaries of the staff of the two regulatory authorities to the level of the NBU staff. The Task Force should provide a detailed analysis of the first step in terms of the salaries received by staff in the SSMCS and FSR to those with similar responsibilities in the NBU and the costs involved.
- Ensure that the appropriate strategic plan is in place to provide for IT compatibility as soon as possible.
- Complete its strategic plans within six months and present them to relevant government ministries, professional market participants and the existing staff. The

[20] It should be noted that the Centre for the Support of Civil Service Institutional Development was established in 2004, which, amongst other objectives undertakes the development of standards for personnel management, and standards for evaluating individuals. This was established after a Memorandum of Understanding was signed between the World Bank and the Government of Ukraine.

staff of the single regulator should not only have been consulted during the process but should also have had the opportunity to contribute. Members of the Task Force should explain and discuss the issues with the staff throughout the process.

During the development period and before the Enabling Bill becomes law, the three regulatory authorities shall continue to regulate and supervise the licensed entities for which they are responsible in terms of the existing laws and regulations. The aim should be to ensure that there is as little disruption to the market as possible and that supervision and enforcement continue at the appropriate level.

6.2 The Handbook Development Task Force

Meanwhile, the work of the Handbook Development Task Force should get under way. While this work is in progress, the existing regulations and their enforcement procedures would still apply. It may be necessary to introduce changes to the existing regulations from time to time in order to deal with a particular scam, which has emerged, but if so, care should be taken in drafting it to ensure that it would be in line with the future Handbook or to deal with specific issues, such as minimum capital requirements for entry to the market and whether and how appropriate capital levels should be maintained. Consultation with the Handbook Task Force would be required for the introduction of any new regulations in this period.

The Handbook Task Force would first require a review of existing regulations in order to bring these in line with the more detailed international standards set out by IOSCO, IAIS, OECD guidelines for pension fund asset management and Basel II. Each of these bodies have produced much more detailed guidance for the regulation of insurance, banking and the securities markets. Given Ukraine’s declared intention to seek membership in the European Union and to integrate its markets with the European markets before full membership, the review should also match the laws and regulations with the EU Directives constituting the “single market in financial services”, which also reflect international standards, an approach which has already been adopted with regard to the development of the Mandatory Accumulation System of Pension Insurance. It should also be designed to adopt a harmonized approach across the various sectors of the industry: for example, in general terms, conditions of entry to the market will be the same.

This work will involve representatives of the three existing regulators with the support of a small legal team and international experts. Its task will be similar to that undertaken by all member states of the European Union over recent years as financial services legislation has been reviewed and amended in order to apply the Directives, which are designed to create a single market in financial services. The relevant Directives are:

- Regarding credit institutions, the prudential supervision of electronic money institutions, and a supplementary directive regarding the supervision of credit institutions, insurance undertakings and investment funds in a financial conglomerate (2000 and 2002, together with the Capital Requirements Directive for Credit Institutions, 2005, which is in line with Basel II).

- Regarding capital markets, the relevant directives are the Prospectus Directive, 2003 and the Transparency Directive, 2004 and the Markets and Financial Instruments Directive, 2004. The EU Commission is also considering a possible directive on clearing and settlement.

- Regarding insurance, the relevant directives are the Insurance Mediation Directive, 2002, the Directive on Solvency Margins for Non-Life insurance, 2002 and work is under way on Solvency II, which will apply to life insurance.

- Other relevant directives and work being conducted by the European Commission concerns the improvement of company law and the completion of work in progress on corporate governance, and the Anti-Money Laundering and Financial Crime Directive, 2005.

Some of the Directives are quite general and the detail is to be found in the regulations or in Level 2 applications, which are published by the Commission. The Handbook Development Task Force would have to examine all the existing regulations and policy statements and draft new regulations that comply with the Directives. The proposed changes would go out for consultation but with an explanation of the relevant EU Directives and how they would apply to the conduct of financial services business in Ukraine.

The Handbook should take one year to eighteen months to complete. Its aim is to provide a clear and easily comprehensible set of rules for market participants, available on the website. Senior managers of any regulated institution would be expected to fully understand what the regulator expected of them and would also be expected to ensure that their staff is fully aware of the rules and regulations. Indeed, the staff, and especially line managers would be expected to have their own copies and to apply them to their activities and those of whom they supervise. The Handbook itself would be accompanied by a Supervisory handbook, issued by the regulator, which would explain what the regulator expects to find and to inspect when they conduct an arranged on-site visit. The supervisory handbook is designed to assist firms when they receive a monitoring visit. It reflects the relevant contents of the Handbook for a particular financial institution and explains how to prepare for the on-site visit.

The Handbook Task Force should also review, with the aim of reducing the amount of unnecessarily detailed reporting, the information which currently has to be supplied to the regulatory authority. One way of tackling the issue is to pose some basic questions, for example, about general and life insurance companies: What is the purpose of collecting this information? Does it help us to understand the nature of the business the company undertakes? Does it help us to see whether or not the company is in a position to pay out on claims or on the life insurance policies the company has issued? Can we judge from this information whether or not the company is solvent? The outcome of these decisions would again be the subject of consultation and then the required information from each category of company would also be part of the Handbook. The content of regulatory information does have to be changed from time to time and, in the case of insurance, assuming that international standards are applied to the new regulator, these requirements would be revised as the IFRS further develops standards for financial reports for insurance companies and the European Commission completes the Solvency II process.

It is suggested that plans for reorganization and the work of the Handbook development should take place concurrently. Both are important tasks and time-consuming, but the target is to establish a new and more effective regulator. When the legislation is passed and it comes into force, it should be seen as a new approach, one in which consumers, the industry, the government and the international community can have confidence. An

integrated regulator with appropriate independence, powers and a supervisory approach then would be in place. Achieving that will require hard work and determination.

7. Funding Issues

There are three main models of the funding of a regulatory authority:

7.1 Funding by the Ministry of Finance

This is the current practice in Ukraine and it apparently provides insufficient funding for the regulatory authorities to carry out their duties.

7.2 Mixture of Industry Funding and Public Funding

This may be a temporary phase as the GOU, industry and the regulatory authorities agree to gradually reduce funding the entire budget over a period of time. If Ukraine decides to adopt this approach, it is important to ensure that the government guarantees are firmly and transparently set out. This is to avoid the possibility that, whenever public finances are pressured, the government of the day would reduce the proportion of public expenditure and expect the regulatory authority to make up for the shortfall. The industry may not be ready for it or may be in the early stages of development and may not be able to support the costs of a properly functioning regulator. Furthermore, when the regulatory authority is either partially or fully funded by the industry, it may be the case that the collection and disbursement of funds has to be carried out by the government as state agencies or independent agencies may be unable to collect funds directly from the industry. It is important in such circumstances to have procedures in place so that the regulatory authority receives its financial support in a timely manner.

7.3 Industry Funding

The development of industry funding has been a significant trend over the past ten years or more especially in development Western economies, and is often part of the process of consolidating regulatory authorities, even in developing markets as is the case with Hungary and Latvia.

However, apart from the issue of independence from government, the main reasons are practical ones. The problem with public sector funding is two-fold. The Government will always have what they and the public will regard as higher priorities, such as education and health so that regulatory authorities would almost always be under-funded and unpredictable so that long-term planning would be difficult. Capital expenditure (on IT especially) would be especially vulnerable. Even where fees are charged for some of the regulator’s activities, such as licensing, these may still be requisitioned by the Government: for example, fees charged by the FSR for licensing have to be paid into the State’s Consolidated Revenue Fund.

Secondly, it allows the regulatory authorities to retain highly skilled staff by paying higher salaries. The salaries will never equal those offered by the private sector, but they will at least be sufficiently attractive to encourage staff to remain. It would be difficult in any country to offer civil service salaries, which properly compensated them for their functions, and which did not arouse hostility from the public and the media. The costs of high staff turnover and expensive training and time-consuming training of new recruits should be used to justify higher salaries than in other government departments.

This is not to say that industry funding is free from risks, since it may allow the industry to withhold funds or perhaps involve reliance on several large companies. However it is possible to avoid or at least mitigate such risks by the procedures that are adopted. Part of the funding may come from licensing or authorization fees, but the highest proportion will come from annual fees. This should involve the regulatory authorities setting out its business plan and budget for the forthcoming year, which has to be published, with the industry given the opportunity to comment, but not to reject. The formula for raising funds may be reviewed from time to time through the publication of consultative papers and may be reviewed and even altered as a result. Some regulatory authorities have a fully developed website, so the budget and business plan are easily accessible for information and comment. In other cases, the final decision on the budget may be taken by an independent body or the government, but in the case of the FSA, this is not so.

As has been indicated, the methods of raising industry funds vary considerably, but they are generally raised by some combination of a basic fee, bearing some relationship to the size of the institution; a licensing or authorization fee; fees for specific services; and fines and penalties for breaches of the law. The trend, however, is for greater reliance on annual fees, sometimes with a complex formula. In the case of the UK FSA, a complex formula is used to avoid the possibility that one sector of the industry cross-subsidizing another, a method which would not suit Ukraine.

Other countries adopt various methods and a simpler formula. In Latvia, the Commission is fully funded by the industry. These are annual fees specified by the Council of the Commission, but they are not allowed to exceed the amount specified by law. There are dangers in this, unless the law allows for a suitable annual increase in order to avoid the difficulty of amending the law to allow for appropriate increases. The Gibraltar Financial Services Commission charges an annual fee. The amount was originally set in law and was not increased in line with inflation until recently. The fees did not cover the cost of financial regulation, and the Government made an annual subsidy to meet the costs. The Commission is now in the process of becoming financially independent of the Government by gradually increasing the fees and reducing the subsidy. Over recent years the trend is towards partial or full industry funding, and besides the UK, other fully industry funded regulators include Canada, Australia, Sweden, Norway and Singapore, with Germany, Estonia, and Hungary either fully or partially funded by the industry.

Most regulators relying on industry funding estimate the basic annual levy on a measure of the institution size, generally using assets under management or market capitalization. Whatever method is chosen, it should be based on consultations with the industry and the annual charges should be set following the presentation of the budget and business plan. The move to being fully funded by fees from the industry may be a gradual process and one that takes into account developments in the size and profitability of the market. These are considerations that should apply to Ukraine.

In the case of Ukraine, it may also be necessary to review the laws, which may conflict with the possibility of funding from the industry. Such laws may include: the Ukrainian Budget Code; the Law on Sources of Finance; the Labour Code of Ukraine; and the Law on Labour

Remuneration.[21] If the decision of the Task Force on setting up a single regulator wishes at the same time to gradually move towards partial industry funding, then legal advice should be sought regarding the necessary amendments.

8. Costs and Benefits of a Single Regulator for the Ukraine

Over recent years, regulators in developed countries have sought to develop cost-benefit analyses of regulations imposed on the financial services industry and some regulatory authorities, such as the UK's Financial Services Authority, are under an obligation to undertake and publish such analyses. The FSA's requirement goes further than that since proposed regulations are considered in the light of the objectives of the FSA and the need for proportionality, the need to ensure competition between regulated firms and so on. [22] However, it is worth noting that even where a regulator has extensively used cost-benefit analyses in each ***specific*** regulation and guidance that it has issued since its inception, the approach is one in which "benefits may be assessed in qualitative terms". [23]

The benefits of a single regulator for the financial services industry have been discussed in Section 4 on the reasons for the introduction of a single regulator. Given that benefits in the approach to cost-benefit analyses in regulation are expressed in qualitative terms, this approach will be followed here. The benefits include improving the efficiency and the effectiveness of the regulator and the possibility of economies of scale and scope, at least in the longer term in Ukraine.

For all the countries that have adopted a single regulator, one of the main reasons has been the development of financial conglomerates and the acquisition of a company in one sector by another. A bank may acquire an insurance company or a broker/ dealer, and increasing number of cross-sector acquisitions is likely to take place. This is true of the market in Ukraine as elsewhere. As the market develops further, groups that include some combination of banking, insurance, securities and fund management will become more common. It is necessary then to have a single regulator, who can deal with cross-sector issues. The old style regulatory authorities, based on these divisions, will and do find it difficult to cope with the old-style sector divisions and probably find it difficult at present, although the difficulties may not be fully recognized. From this point of view, a single regulator is more efficient and more effective, since the problems such companies may have, can be recognized more easily. Cross-sector issues can be tackled more efficiently and effectively than when there is a multiplicity of regulators.

It is claimed that the single regulator is able to achieve economies in scale and scope. Economies in scale may be achieved from the move to a single set of support services, unified management, and the same procedures for setting standards, granting licenses, supervision and enforcement. These may take time to emerge as there are obviously set-up costs to be considered, as indicated below. The other advantages lie in the scope of regulation. It provides for a unified approach to legislation, including licensing, supervision and enforcement. The move to a single regulator will involve, as it has for other unified regulators, preparation of a single handbook of regulation and another for supervision and should also lead to the development of a single set of principles for business and a single

[21] Ukraine: Review of Funding Options for the State Commission on Regulation of Financial Services Markets, J. Carmichael, 2004.
[22] These are set out in detail in a speech by Clive Briault, Director, FSA, speech, July, 2003.
[23] I Alfon & P Andrews, Cost Benefit Analyses in Financial Regulation, Occasional Paper, Series 3, 1999.

statement of the responsibilities of senior managers and the duty to oversee systems and controls.

The particular advantage for Ukraine is that the decision to move to a single regulator in the way set out in this paper provides for a fresh start. The Enabling Law would establish a regulatory authority with the status, independence and power that it needs to reach international standards of regulation. That fresh start must include transparency concerning all its operations and the reasons for the introduction of new regulations.

Integrated supervision provides for consistent supervision across all the supervised financial institutions and consistent standards being applicable to all companies. Coordination and exchange of information more easily takes place in a single organization, provided the internal organizational structure does not allow a "silo" mentality to develop, that is, the creation or persistence of internal functional barriers, so that staff from one department never meet or communicate with staff from another. The unwillingness to share information or experience can actually undermine the effectiveness of the regulatory authority. This will be a challenge for the new regulator, as the evidence gathered during the preparation of this paper indicated that this does affect at least one of the existing regulatory authorities. A larger single regulatory authority may find it easier to attract and retain staff, but for that advantage to accrue it will be necessary to develop a human resources policy, which can break free from the bureaucratic and hierarchical approach, which is one of the reasons for the high turnover of staff in the existing agencies.

The fresh start is vital for Ukraine. Its failure to achieve international standards puts in jeopardy the agreement reached with the European Union to do so and indeed would prevent integration with the EU's capital markets.[24] If Ukraine does not raise the standards of financial regulation and ensure that all market participants act with integrity then it will simply lose out in terms of foreign investment and in terms of the development of its domestic market. There are already signs that Ukrainian companies are seeking to raise capital in developed markets: two at least have already turned to the London Stock Exchanges' Alternative Investment Market (AIM).

Other relevant studies demonstrate the economic value of good financial regulation, which it is hoped, Ukraine will achieve once the status, powers and regulations match international standards and the latter are properly and consistently applied. Reference has already been made to the existence of empirical evidence that the quality of regulatory governance, the practices adopted by financial services regulators and supervisors matter for financial system soundness.
The results of this research show that good regulatory governance does contribute to the soundness of the financial system and hence to economic growth. These benefits do not come from the establishment of a single regulator alone but from the way in which financial regulation is conducted.[25]

With regard to the costs of establishing a single regulator, it should be noted that this is not likely to lead to a reduction in supervisory staff, though it should lead to redeployment of existing staff. That will partly depend on the approach to supervision, when as time goes

[24] EU-Ukraine Action Plan, agreed in February, 2005, in which a series of structural reforms were designed to consolidate the functioning of the market economy, including the regulatory and supervisory framework for bank and non-bank financial institutions. (Part of the EU Neighbourhood Policy.)
[25] U A Das, M. Quityn & K. Chenard, *Does Regulatory Governance Matter for Financial System Analysis*, IMF Working Paper, May, 2004.

on, staff from the three agencies may work together in teams, especially when the financial conglomerates have been identified fully.

Nevertheless, for all the reasons set out in the paper, a decision to move to a single regulator would provide just the opportunity required to bring about a dramatic change in the quality and effectiveness of financial regulation in Ukraine. It would then match international standards, lead to a thriving financial services market and allow Ukraine to reap the benefits of good regulatory governance.

9. Estimated Costs of Transitioning to a Unified Regulator

It is particularly difficult to provide even an indicative estimate of the costs for a number of reasons, of which the most important concerns salary costs. For a regulatory authority, the costs fall into four major categories:

- **Employment Costs.**
- **Travel/Training/Recruitment.**
- **Accommodation & Office costs.**
- **IT costs.**

9.1 Employment Costs

With regard to employment costs, the largest element will be the cost of professional staff. There are difficulties in providing any accurate estimate of these costs since they are composed of the basic salary plus a wide range of allowances. The Law on Public Service governs the salary levels and employment conditions of the staff at the regulatory agencies. The guaranteed amount consists of a base salary rate, plus an increment based on rank (within the organization), tenure, and special skills such as languages and qualification. The guaranteed minimum amount is then multiplied by a regulating increment of up to 100%, which can be set by the head of the agency. In the case of the FSR, other allowances were identified, such as a vacation allowance and a social allowance on the grounds of the expenses of a child's education or medical treatment, or care of an elderly relative. Then the head of the department can award a special bonus for "professional risk" for special performance. It is dependent on the complex nature of the task and the performance of the individual staff member and is usually awarded to a small number of employees. The FSR has sought to develop appropriate and objective performance criteria (including self-assessments) to govern this award. The issue is that it is very difficult to compare salaries and costs for each of the organizations. This is significant when seeking to estimate the costs of the new authority.

The second issue is the maintenance of regional offices and the numbers of staff employed there. This appears to be an unnecessary burden and one that should be drastically reduced, if not abandoned altogether. It is difficult for the head offices to maintain a proper oversight of the regional offices and to train them to the appropriate standards.

The third issue is to examine the number of companies that the authorities have to supervise at present. A very rough guide to estimating the number of professional staff required is to look at the number of financial institutions the authority has to supervise and

develop an appropriate ratio of staff to institutions. This was the approach recommended by Carmichael Consulting[26] according to which the calculation would suggest:

- 1 staff member for every large insurance company, one staff member for every three medium sized insurance companies, one staff member for every five small insurance companies;
- One staff member for every two large credit unions, one member of staff for every four medium sized credit unions and one staff member for every eight small credit unions;
- One staff member for every five to ten institutions in other areas or even lower depending on the relative regulatory demands of the particular institutional groups.

Based on this approach, it is estimated that there would be an increase of between 10 and 30% from present levels. However, even if such a formula proved to be acceptable to the new authority, it should be born in mind that there will be (and should be) a significant reduction in the number of financial institutions to be supervised. A draft law on insurance companies is before the Cabinet of Ministers, which would both increase the minimum capital requirements for establishing an insurance company and would impose appropriate solvency levels. This should reduce the number of insurance companies through mergers and acquisitions and may well lead to restricting new business for others. In the securities industry, with its 794 securities firms, 370 independent registrars and 143 custodians, the formula would lead to a dramatic increase in staff. However, in a capital market characterized by such low liquidity, it is highly unlikely that all of these firms can make a living. Some attempt can be made to prevent more firms seeking licensing and this has been done by raising the capital requirements for entry, but this is insufficient. The securities firms should be subject to continuing capital requirements and more stringent requirements for obtaining a license and regulations governing their activities, which should give rise to a substantial reduction in the numbers.

It has been difficult to obtain detailed information concerning staff in the NBU's Banking Supervision Division. It is estimated that the total number of staff involved in banking supervision, including those employed in the regional offices is 1000 approximately. They are responsible for supervising 165 banks (with 21 banks having been declared insolvent). If the same formula were applied to banking supervision, it would drastically reduce the numbers employed to a total of 44 staff. That would be far too drastic but it is clear that the NBU currently has a staff-to-institution ratio that is about 30 times that of the FSR.

While the assets of the banks are much higher than those of the non-bank financial institutions, the proper supervision of insurance companies, for example, is as complex and demanding as that of the banks. The move to a single regulatory authority would allow for the redeployment of banking staff to other areas of supervision, while allowing for the possibility of considerable reduction in numbers of banking staff. The proportion employed in the head office is less than half (about 230) of the total number employed in banking supervision.

However, it appears that the NBU has established a working group to review the number of regional offices, presumably with an eye to reducing the number of staff employed in banking supervision, where supervision is focused on the bank branch rather than a head office of a bank located in one of the regions. Given the difficulties caused by the Law on

[26] Ukraine: Review of the Funding Options for State Commission on Regulation of Financial Services Markets of Ukraine, November 2004

Labour, the methods used for reducing banking supervisory staff will be not filling vacancies due to resignation or retirement. There is scope for reductions in the number of the staff in banking supervision and the possibility of redeploying staff from banking supervision to supervising other types of financial institutions. For this reason, it appears that the establishment of a single regulator will not require more professional staff and may be able to reduce support staff, excluding IT staff.

The real problem lies with the necessity of increasing the salaries of staff of the two Commissions to the level of the NBU banking supervisory staff. That is generally recognized as being necessary. As in many other countries, the central bank employees have a special employment status vis-à-vis other parts of the public sector. It is not therefore possible to transfer bank supervisory staff to a single regulator, which does not offer them similar benefits. The Legal Counsel to the World Bank comments "experience to date suggests that creating differences in terms and conditions of service amongst different components of the public sector is legally complicated and extraordinarily difficult." Hence the "preferred view amongst the commentators is that integrated regulators should be financed by way of an industry levy rather than through direct budgetary support."[27] The paper has already proposed that the single regulator should move towards at least partial industry funding in the first instance and full funding as soon as possible after the single regulator is fully established. As indicated earlier, that is the case in the post-socialist states that have moved to a single regulator.

What is difficult to determine without more detailed information is the cost of moving the staff to the salary levels of the NBU banking supervisory staff. The FSR was able to provide a breakdown of average salaries for staff at various levels in the central office of the Commission, but despite a formal request to the Deputy Governor for detailed information on salary levels, no detailed information has been forthcoming. Information about average salary levels is available on the website of the State Committee on Statistics, regarding average salaries for the NBU which for 2004 was USD835 per month for staff in the central office; for the FSR, the range is from USD 175 to USD 863 per month, depending, in part, on rank and responsibilities and for the Securities Commission, it is USD 173 per month in the Central Office. The averages cover all the staff, not just the professional staff, and these indicate that the banking supervisory staff earn about three to four times the amount earned by the staff of the other two agencies. It is this increase which could be the real cost for the single regulator and it is one for which suitable phasing will have to be found together with a partial move towards industry funding for this purpose. It could be balanced or even virtually eliminated (if ways can be found of achieving this difficult task) by substantial savings in the numbers of professional staff employed in banking supervision. For the reasons outlined above, it is not possible to provide a meaningful figure for the employment costs of the single regulator.

9.2 Travel, Training and Recruitment

The next item is travel, training and recruitment. The first and last items are permanent features of each of the regulatory authorities and need not be covered here. The two Commissions will require extensive training, and indeed technical assistance to implement risk based supervision. The banking supervision of the NBU has benefited from technical assistance but should also be included in the programme both for advanced training and new recruits in the banking supervision department should be included in the basic programme.

[27] *Establishing Legal Consistency for Integrated Regulation*, P. R. Kyle, World Bank, December, 2003.

9.3 Office Space

It is not expected that this item will add any extra costs to the budget for a single regulator. The Commissions currently occupy three offices and the NBU supervisory department currently occupies a large office block. This set of offices is considered to be suitable space that might be used in order to bring the three regulatory authorities together in one location at an early stage. The IT costs in the following section are an illustration of the costs of locating all the staff in a single office, involving the transfer of some 500 staff from the two Commissions to join the banking supervisory staff from the central office and possibly other staff from regional offices.

9.4 Information Technology Costs

It has only been possible to provide a guide to the costs of the IT provision for the staff of a single regulator, which is based on the assumption that 300 NBU staff remain in the current office for banking supervisory and the head office staff and that they are joined by approximately 500 staff from the two Commissions. It is assumed, therefore, that 500 new desktop computers would have to be provided and installed. The costs set out below are a very conservative estimate of what those costs would look like.

Estimated Information Technology Cost

HARDWARE		NETWORK		SOFTWARE	
ITEM	**COST**	**ITEM**	**COST**	**ITEM**	**COST**
Desktops 500 units x $1,300	$650,000.00	Local Area Network Cables Cost Drop Cable 500 connection x $50.00	$25,000.00	Licenses per Desktop 500 units x $250.00	$125,000.00
Printers 25 x $450.00	$11,250.00			Server Licenses	$35,000.00
Servers (1)- Database (1)- E-mail &Network Controller	$10,000.00	Routers and other Accessories	$15,000.00	Database Licenses	$20,000.00
TOTAL	**$671,250.00**		**$40,000.00**		**$180,000.00**

There are other costs incurred in meeting the needs of a regulatory authority, in particular the cost of the software applications, that is, the integrated regulatory applications, which are to enable the staff to read the financial and compliance reports sent to them by electronic means. These applications are vital to the work of a modern regulator.

The total cost set forth below are rough estimates of the cost of the IT requirements.

Estimates of Total Cost of Information Technology

TOTAL HARDWARE	$671,250.00
TOTAL NETWORK & ACCESSORIES	$40,000.00
SOFTWARE	$180,000.00
SUB-TOTAL	**$891,250.00**
PLUS MISC OVERHEARD 15%	$133,688.00
PLUS INTEGRATED REGULATORY APPLICATION	$550,000.00
SUB-TOTAL OF ESTIMATED COST	**$1,574,938.00**
DISCOUNT OF POSSBLE REUSED EQUIPEMENT (30%)	<$472,481.00>
TOTAL COST	**$1,102,457.00**

It should be clear that this is only an estimate, since neither the office nor the precise number of staff can be assessed accurately at this point in time. It is based on the assumption that all equipment from the FSR and the SSMCS would have to be replaced in order to provide a “worst case scenario.” It may be possible to re-use equipment and to integrate it with an existing system. That would still leave the costs of integration of the IT systems and then perhaps taking the opportunity to update the system.

9.5 Conclusion

Despite the difficulties of conducting a full cost-benefit analysis at this stage, it looks as though Ukraine could benefit from a single regulator. This is especially true given the structure of the financial services markets, given that financial conglomerates play such a significant, if not a dominant, role in the financial sector.

10. RECOMMENDATIONS

In summary, the recommendations are the following:

1. Ukraine should commit itself to the establishment of a single regulator.
2. As part of the process of moving towards international standards of regulation, Ukraine should invite the IMF to conduct an assessment of all three regulators.
3. Enabling Law Drafting Committee should be established to draft an Enabling Law, meeting international standards, which provides the legal framework for the powers and status of the new regulatory authority. Care should be taken so that vested interests in the Verkhovna Rada and in government do not prevent the development of appropriate legislation.
4. The three regulatory organizations should be moved into a single premises and the transfer should take place in such a way that the organizations are given every possible encouragement in terms of a new structure, and in every other way, to meld into one organization.
5. The Transition Management Task Force and the Handbook Development Task Force are established and provided with all the necessary support to carry out their work.
6. Consultation takes place with the industry, enabling them to have an input into the new Handbook, and discussions take place with the industry concerning the transition to industry funding.
7. The transition to full industry funding should be in place as soon as possible after the single regulator is established.
8. At all stages of the process, officials and relevant ministers are involved in the process.
9. Staff at all levels in the regulatory authority are kept informed and involved in the process as far as possible.
10. A target date some three years hence should be set for the full, independent single regulator to be established.

Attachment 1

Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority

1. This memorandum of understanding establishes a framework for co-operation between HM Treasury (the 'Treasury'), the Bank of England (the 'Bank') and the Financial Services Authority (the FSA) in the field of financial stability. It sets out the role of each authority, and explains how they work together towards the common objective of financial stability in the UK. The division of responsibilities is based on four guiding principles:

- clear **accountability**. Each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- **transparency**. Parliament, the markets and the public must know who is responsible for what;
- **avoidance of duplication**. Each authority must have a clearly defined role, to avoid second guessing, inefficiency and the unnecessary duplication of effort. This will help ensure proper accountability;
- regular **information exchange**. This helps each authority to discharge its responsibilities as efficiently and effectively as possible.

The Bank's responsibilities

2. The Bank contributes to the maintenance of the stability of the financial system as a whole – one of its two core purposes. This involves:

i. ensuring the stability of the monetary system as part of its monetary policyfunctions. It acts in the markets to deal with fluctuations in liquidity;

ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;

iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The FSA's responsibilities

3. The FSA's powers and responsibilities are set out in the Financial Services and Markets Act 2000. Within the scope of the Act, it is responsible for:

i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;

ii. the supervision of financial markets, securities listings and of clearing and settlement systems;

iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:

a) the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and

b) the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The Treasury's responsibilities

4. The Treasury is responsible for:

> i. the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;
>
> ii. informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations as set out in paragraphs 13 and 14; and
>
> iii. accounting for financial sector resilience to operational disruption within government.

5. The Treasury has no operational responsibility for the activities of the FSA and the Bank and shall not be involved in them. But there are a variety of circumstances where the FSA and the Bank will need to alert the Treasury about possible problems: for example, where a serious problem arises, which could cause wider financial or economic disruption; where there is, or could be, a need for a support operation; where diplomatic or foreign relations problems might arise; where a problem might suggest the need for a change in the law; or where a case is likely to lead to questions to Ministers in Parliament. This list is not exhaustive, and there will be other relevant situations. In each case it will be for the FSA and Bank to decide whether the Treasury needs to be alerted.

Information gathering

6. Through the exercise of its statutory responsibilities, the FSA gathers a wide range of information and data on the firms which it authorises and supervises. The Bank similarly collects information and data that it needs to discharge its responsibilities.

7. The FSA and the Bank work together to avoid separate collection of the same data, to minimise the burden on firms. Where both need access to the same information, they reach agreement as to who should collect it, and how it should be transmitted to the other.

Information exchange

8. Free exchange of information is essential if each authority is to meet its responsibilities satisfactorily. Information exchange is to take place on several levels. The Bank's Deputy Governor (financial stability) is a member of the FSA Board, and the FSA Chairman sits on the Court of the Bank. At all levels, there should be close and regular contact between the FSA and the Bank, who maintain a programme of secondments between the two institutions, to strengthen the links and foster a culture of co-operation.

9. The FSA and the Bank maintain information-sharing arrangements, to ensure that all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely. Each seeks to provide the other with relevant information as requested. The authority receiving this information ensures that it is used only for discharging its responsibilities, and that it is not transmitted to third parties except where permitted by law.

Standing Committee

10. The Standing Committee on Financial Stability is chaired by the Treasury and comprises representatives of the Treasury, the Bank and the FSA. It is the principal forum for agreeing policy and, where appropriate, coordinating or agreeing action between the three authorities. It is also an important channel for exchanging information on threats to UK financial stability.

11. Standing Committee meets on a monthly basis at deputies (official) level to discuss individual cases of significance and other developments relevant to financial stability. Meetings can be called at other times by any of the participating authorities if it considers there to be an issue which needs to be addressed urgently. Each authority is to have nominated representatives who can be contacted, and meet, at short notice.

12. A sub-group of Standing Committee co-ordinates the authorities' joint work on financial sector resilience to operational disruption and maintains and tests tripartite arrangements for effective crisis management in an operational disruption.

13. In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee meets at principals level, comprising the Chancellor of the Exchequer, the Governor of the Bank and the Chairman of the FSA (or senior alternates). The Bank and the FSA are each to assess, from the perspective of their distinct responsibilities and expertise, the seriousness of the crisis and its potential implications for the stability of the financial system as a whole. They will each provide their separate assessments to the Treasury, together with their views on the options available to the Chancellor. Standing Committee may then discuss the appropriate use of measures and ensure effective co-ordination of the response, while respecting the formal responsibilities of the three authorities (subject to paragraph 14).

Financial Crisis Management

14. In exceptional circumstances, there may be a need for an operation which goes beyond the Bank's published framework for operations in the money market. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a situation where such a support operation might become necessary, they would immediately inform the other authorities and invoke the co-ordination framework outlined in paragraph 16 below. Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor.

Thereafter they would keep the Treasury informed about the developing situation, as far as circumstances allowed.

15. In any such exceptional circumstances, the authorities' main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, they would seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.

16. The authorities maintain a framework for co-ordination in the management of a financial crisis. This includes arrangements that determine which authority would take the lead on particular problems arising and for ensuring orderly communication with market participants and overseas authorities. Each authority would:

- assess the situation and co-ordinate their response within the framework agreed with the other authorities. The form of the response would depend on the nature of the event and would be determined at the time; and

- where possible and desirable to facilitate a solution to a problem, and hence reduce risks to wider financial stability, encourage negotiations between third parties whose agreement might be beneficial for the reduction or resolution of the issue, in its area of responsibility.

Operational Crisis Management

17. The authorities also maintain a framework for co-ordination in the management of an operational crisis. In a major operational disruption, the respective roles of the authorities' are as follows:

i. The Treasury is to ensure that ministers are kept up-to-date on developments so as to be able to take key decisions without delay; and to ensure coherence between measures taken in the financial sector and the operation of public sector continuity arrangements. The Treasury would have specific responsibility for:

- liaising with other UK government departments and authorities, including law enforcement agencies; and

- maintaining contact and liaising with the UK Debt Management Office, particularly on the state of the gilts market.

ii. The Bank is to seek to ensure the orderly functioning of the UK's financial markets, including the maintenance of adequate liquidity. The Bank would have specific responsibility for:

- maintaining, through its market operations and as banker to the banking system, operational contacts with market participants so as to monitor and, as necessary, facilitate the functioning of UK markets; this may include the provision of liquidity assistance or other support operations agreed within the tripartite framework; and

- monitoring and, as necessary, facilitating the functioning of payment systems, alongside its operational role of providing settlement facilities for the Real Time Gross Settlement system.

iii. The FSA is to monitor the health of institutions that fall within its regulatory remit and ensure, as far as is appropriate in the circumstances, continuing compliance with regulatory standards. The FSA would have specific responsibility for:

- monitoring authorised firms and Recognised Bodies within the framework of the FSA's four statutory objectives where liaison would usually be via normal supervisory contacts; and

- working with authorised firms and Recognised Bodies to resolve any problems that may prevent them from operating normally, or from acting on either their own or their customers' behalf, in accordance with usual regulatory requirements.

Consultation on policy changes

18. Each authority will inform the other about any major policy changes. It will consult the other in advance on any policy changes which are likely to have a bearing on the responsibilities of the other.

Membership of committees

19. The FSA and the Bank cooperate fully in their relations with international regulatory groups and committees. They are both represented on the Basle Supervisors' Committee, the European Central Bank's Banking Supervisors' Sub-Committee and on other international committees. Where only one authority is represented, it will ensure that the other can contribute information and views in advance of any meeting; and will report fully to the other after the meeting. This promotes co-operation and minimises duplication.

20. The FSA and the Bank will keep the Treasury informed of developments in the international regulatory community which are relevant to its responsibilities.

21. The Bank chairs the following domestic market committees:

- Money Market Liaison Group

- Foreign Exchange Joint Standing Committee

- Securities Lending and Repo Committee

22. The FSA and the Bank will each use best endeavours to facilitate contacts by the other with overseas central banks and/or regulators, where necessary to discharge their respective responsibilities.

Provision of services

23. In some cases it is more efficient for a service to be provided by the FSA to the Bank, or vice versa, rather than for both authorities to meet their own needs separately. Where necessary, service agreements between the two authorities are maintained, setting out the nature of the service to be provided, together with agreed standards and other details.

Litigation

24. The Bank retains responsibility for any liability attributable to its acts or omissions in the discharge or purported discharge of its banking supervisory functions prior to the transfer of those functions to the FSA and shall have the sole conduct of any proceedings relating thereto. The two authorities will cooperate fully where either faces litigation.

Records

25. The FSA is responsible for the custody of all supervisory records. It ensures that, within the framework of the relevant legislation, the Bank has free and open access to these records.

Rt. Hon Gordon Brown MP
Chancellor of the Exchequer

Mervyn King
Governor of the Bank of England

Sir Callum McCarthy
Chairman, Financial Services Authority