Foreign Bank Branching in Ukraine: Comparative Analysis of Certain Aspects of
Regulatory Regimes in Ukraine and Canada

by

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ABSTRACT

After Ukraine’s accession to the World Trade Organization in 2008, foreign banks were permitted to open their branches directly in this country. This development brought the opportunity for additional capital inflow to Ukrainian economy. However, foreign banks tend to operate in Ukraine through locally incorporated subsidiaries rather than branches.

This thesis analyzes the Ukrainian regulatory framework for foreign bank branching and compares to the analogous Canadian regimen. I find that, although the minimum entry requirements for establishing a foreign bank branch are more relaxed in Ukraine as compared to Canada, the Ukrainian legal framework that is not conducive to operating via branches. The regulatory limits for a branch’s loan activities are based on a branch’s capital deposited in Ukraine rather than on the parent bank’s capital. Branches effectively have no inherent advantages over subsidiaries in this jurisdiction, whereas the disadvantages, such as unlimited liability, are preserved.
# TABLE OF CONTENTS

I. Introduction .......................................................................................................................... 1
   a. General Background......................................................................................................... 1
   b. Research Problem and Hypothesis ................................................................................. 7
      *Focus of the thesis* ......................................................................................................... 8
   c. Research Problem Urgency ............................................................................................. 9
   d. Research Methodology .................................................................................................. 13
      *Why compare Ukraine and Canada?* ........................................................................... 13
   e. Structure of the Thesis .................................................................................................. 16
II. Historical Perspective ......................................................................................................... 18
   a. Banking System in Ukraine .......................................................................................... 18
   b. Foreign Banking Presence in Ukraine before Accession to the WTO ...................... 22
      i. Foreign Banking Capital Share ................................................................................. 22
      ii. Forms of Foreign Banks Presence ........................................................................... 24
III. Accession of Ukraine to the WTO Club: Commitments under the General Agreement on Trade in Services (GATS) in the Banking Sector ................................................. 28
IV. Main Changes for Foreign Bank Presence after Ukraine’s Accession to the WTO ... 34
   a. Branch as New Form of Doing Banking Business ...................................................... 34
   b. Advantages and Disadvantages of Foreign Bank Branching in Ukraine .................. 37
   c. Requirements and Procedure for Establishing a Foreign Bank Branch .................... 43
V. Canadian Legal Regime for Foreign Banks ................................................................... 52
   a. Forms of Foreign Banking in Canada ......................................................................... 52
   b. Requirements and Procedure for Establishing a Foreign Bank Branch .................... 57
VI. Comparative Analysis of Canadian and Ukrainian Regulatory Regimes for Foreign Bank Branching .................................................................................................................. 63
VII. Final Conclusion .............................................................................................................. 72
Bibliography .......................................................................................................................... 80
I. Introduction

a. General Background

Following Ukraine’s accession to the World Trade Organization (WTO) in 2008, globalization processes in the world economy became relevant to Ukraine. The banking system was one of the sectors of the economy to be affected from the integration of Ukraine into the world system of free trade. The last decade has highlighted a spirited movement of Western banking capital into Ukrainian and other Eastern European developing markets. This expansion of foreign banks to the East was primarily motivated by a desire to acquire access to promising emerging markets and to benefit from so-called “carry trades”, i.e., borrowing at low interest rates in mature markets to re-lend at higher interest rates in developing but riskier markets.¹

The entry of foreign banks often evokes debates on whether this process is beneficial for the host country or, on the contrary, makes an economy more vulnerable to economic uncertainties.² On one hand, foreign banks supply additional capital that developing countries greatly need to maintain a growing pace. On the other hand, foreign banks may provoke or make a host country more exposed to a financial crisis by contributing to a credit “bubble” or credit boom.³ Moreover, foreign banks may bring a cross-border contagion to the financial sector of the host county economy such as continued financial turbulence caused by external financing conditions.⁴

This double-edged effect of potential foreign bank entry is an important dynamic to be aware of for policymakers in developing countries in order to make competent and efficient decisions. Ukraine is an example of such a developing country since its banking sector has become increasingly attractive for foreign credit granting institutions over the past decade. For example, Raiffeisen Bank International – a large Vienna-based international bank holding – has been present in Ukraine through its subsidiary JSBC Raiffeisenbank Ukraine since 1998. Also, the attraction of the Ukrainian banking market to investors is confirmed by “[t]he amount of agreements on sale of banks’ control shareholding to foreign investors”. More importantly, the overall presence of foreign banking capital in Ukraine has grown significantly from 9.6 per cent in 2005 to 40.4 per cent as of April 2011.

Before accession to the WTO, the most common way for foreign banks to enter the Ukrainian banking market was the acquisition of a local registered bank that had all the relevant licenses and permits. There were also two other alternative avenues available to foreign banks: to establish a de novo subsidiary for providing a full range of banking services or to set up a representative office that would generally be aimed at serving specific narrow purposes such as representing and protecting interests of the bank without performing actual banking operations.

In contrast to these approaches, one of the most popular forms of establishing a banking business in markets of developed foreign countries is by operating through branches. Generally, a branch as a form of business presence has its inherent features.

5 For a detailed discussion about difference between subsidiary and branch see Part IV (a) below.
6 National Bank of Ukraine, Annual Report 2007 at 2 (original in Ukrainian, translation is mine).
More specifically, branch can be characterized as an integral part of a foreign bank. It has no separate legal personality, does not commonly maintain separate accounts, and operates as a legal and functional extension of its foreign head office. The choice of a particular mode of entry (i.e., by subsidiary, either through acquisition of a local bank or by establishing a new entity, branch or representative office) depends upon the general goal of entry (e.g., establishing of a profit-oriented business or a mere representation of interests of the parent bank and its clients in the host country), types of activities to be undertaken in a host country, and the respective supervisory and legal frameworks.

Prior to WTO membership, foreign bank activities in Ukraine were traditionally heavily regulated to protect local banks from foreign competition. In contrast, in most transition type economies that emerged after the collapse of the Union of Soviet Socialist Republics, branch was an important and popular form of foreign bank entry – due to the specific features and advantages that this branch entity offers.9

In 2008 Ukraine became the 152nd member of the WTO. Within the “accession package” Ukraine joined all the constituting treaties of the WTO, including the General Agreement on Trade in Services (GATS)10, the first multilateral trade agreement to promote the liberalization of services in countries around the world.11 Negotiated by the member-state governments, the GATS sets the framework within which service-providing firms and individuals can operate on the markets of the member-states.12

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9 Important characteristics of a branch as a form of legal presence are discussed in Part IV (a).
Among various other service sectors, the GATS covers the financial service sector, including banking and insurance.\textsuperscript{13}

Article XVI of the GATS provides that with respect to market access, each member-state shall accord services and service suppliers of any other member-state treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.\textsuperscript{14} This fundamental rule of modern international trade is called the “National Treatment Principle”. The GATS sets out the measures which a member-state should not maintain nor adopt against services and services suppliers from other member states. Among such unacceptable measures are restrictions and specific requirements regarding types of legal entity or joint venture through which a service supplier may supply a service.\textsuperscript{15} Commitments taken by the GATS member-states, including Ukraine, contain significant developments to allow the commercial presence of foreign financial service suppliers by eliminating or relaxing limitations on foreign ownership of local financial institutions. These limitations include those in juridical form of commercial presence (that is, branches, subsidiaries, agencies, representative offices, etc.) and limitations on the expansion of existing operations.\textsuperscript{16}

The initial official legislative plan of Ukraine submitted to the WTO in August, 1999 did not envisage any possibility for direct branching in Ukraine for foreign banks.\textsuperscript{17} However, in the course of membership negotiations Ukraine changed its position. Decision to allow foreign bank branching in Ukraine “[w]as primary motivated by

\textsuperscript{13} Annex on Financial Services to the GATS, supra note 10.
\textsuperscript{14} Schedule is a document that provides concrete commitments undertaken by a member-state under the GATS and time limits for meeting such commitments.
\textsuperscript{15} Sub. (e) Section 2 of Article XVI of the GATS, supra note 10.
\textsuperscript{17} Orliuk O.P., “Issues of Admission of Foreign Bank Branches in Ukraine: Legal Aspects” (2004) 3 Naukowy Visnyk Chernivetskogo Univesytetu: Pravo

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political rather than economical considerations (otherwise Ukraine had no chances to be accepted to the WTO). In the context of the WTO accession process the amendments to the Law of Ukraine “On Banks and Banking Activity” (Law on Banks) were introduced in 2006 and came into force on May 16, 2008, on the day Ukraine’s official accession to the WTO. The amended Law on Banks provides that foreign banks are allowed to open branches within the territory of Ukraine and sets out the requirements and procedure for setting up a branch.

According to international practice of liberalization of trade in services, each country may impose its own rules on forms of business presence, including foreign branching. Ukraine’s Law on Banks clearly defines the local entry requirements that foreign banks must meet before applying for accreditation of their branches in Ukraine. Moreover, the Law on Banks envisages the circumstances under which the National Bank of Ukraine – the state regulator in banking sector – can turn down an application by a foreign bank to operate in Ukraine through a branch. Despite the fact that more than two years has already passed since foreign banks were allowed to directly enter the Ukrainian financial services market, the situation has not dramatically changed as no foreign branch has been set up in the country to date.

This thesis paper tries to reveal the shortcomings of Ukrainian regulatory regime for foreign bank branches based on comparison with analogous Canadian rules. The main argument of this paper is that the requirements for foreign banks to establish and operate a branch in Ukraine, as mandated in the Ukrainian legislation, make this form of presence

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20 Article 24 of the Law on Bank, supra note 8.
21 The Law on Banks uses the term “accreditation” with respect to the procedure of registration of a foreign bank branch by the National Bank of Ukraine.
impractical. The regulatory limits for a branch’s loan activities are based on the assigned capital of the branch deposited in Ukraine rather than on the parent bank’s capital. Branches effectively have no inherent advantages over subsidiaries in this jurisdiction, whereas the disadvantages, such as unlimited liability, are preserved. This is the principal regulatory issue that impedes foreign bank branching in Ukraine.

The situation in Canada with regards to the admission of foreign banks’ branches is the opposite to Ukrainian though. Canada is one of the founders of the WTO and a member since January 1, 1995, as well as a party to the GATS. In order to address the commitments taken under the GATS, in February, 1999 the government of Canada introduced respective legislation (i.e., Bill C-67) which, after certain amendments, was passed by Parliament and received Royal Assent to come into force on June 17, 1999. On June 28, 1999, Bill C-67, *An Act to amend the Bank Act, the Winding-up and Restructuring Act and other Acts relating to financial institutions and to make consequential amendments to other Acts*, came into effect. This legislation allowed foreign banks to establish specialized, commercially focused branches in Canada. Previously, foreign banks operating in Canada were required to establish separate subsidiaries. As a result of this amendment, as of April, 2011 there were 23 full-service and seven lending foreign bank branches operating in Canada servicing a considerable share of the country’s banking services market.22

The detailed requirements for foreign banks to establish and operate a branch in Canada are determined in Part XII.1 of the *Bank Act*.23 This act makes a distinction between a lending branch and a full-service branch.24 The *Guide to Foreign Bank Branching* issued by the Office of the Superintendent of Financial Institutions Canada –

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23 *Bank Act*, S.C. 1991, c.46 (hereinafter the *Bank Act*).
24 Section 524(1) of the *Bank Act*, supra note 23.
the primary regulator of federal financial institutions and pension plans in Canada – provides for criteria, specific information requirements, procedures to be followed in making an application, and rules for the commencement of business by a foreign bank branch in Canada.\textsuperscript{25}

\textbf{b. Research Problem and Hypothesis}

The possibility of entry into the financial services market with bank branches appears to be one of the most progressive developments in the Ukrainian banking legislation after the accession of Ukraine to the WTO. The amendments to the Ukrainian \textit{Law on Banks} that allowed foreign bank branching came into legal force on May, 16, 2008. However, the formal procedure to be followed in the process of submitting an application by a foreign bank, specific information that must be submitted in support of an application when establishing a branch had not been determined by the National Bank of Ukraine until August 2009. Accordingly, during the period between May, 2008 and August 2009, even those foreign banks which wanted to establish a branch in Ukraine could not do so because of a lack of formalized regulations. However, although the National Bank of Ukraine finally managed to approve the accreditation procedure for foreign bank branches in Ukraine in August, 2009,\textsuperscript{26} as previously mentioned, not a single foreign bank branch has been, as yet, accredited in Ukraine.

Notwithstanding the fact that Ukraine has fulfilled its commitments under GATS, and while the legal avenue for setting up a branch has been clearly defined by the Ukrainian Parliament and the banking regulator, foreign banks are not in a hurry to start


operating in Ukraine by initiating a branch office as part of their organizational structure.
So, the question is: what deters foreign banks from successfully penetrating the Ukrainian banking market by a branch expansion to establish their presence?

Focus of the thesis

The focus of this thesis is to analyze the procedural aspects of accreditation of foreign banks’ branches in Ukraine and compare them to analogous rules in Canada. It should be noted that there is a complex of factors that influence a bank’s decision as to choice of organizational form for entering a foreign markets. The most relevant are the host country’s regulatory regime for foreign banks’ activities, taxation system, level of competition on the market, desired degree of penetration into the market, target banking clientele (corporate or individual customers), capacity of the host country’s banking market, economic and political risks peculiar to the country, as well as the country’s level of economic development. These and other variables are widely analysed and discussed in the economic literature.27 The regulatory regime represents a particular interest for me as a law student. The host-country’s regulatory environment appears to be one of the main considerations that impact a foreign bank’s choice of organizational form.28 It is impossible to discuss all of the above factors within the limits of this thesis. Therefore, I will concentrate my attention on legal and regulatory aspects of foreign bank branching only. The main question of my research is whether the requirements and regulations

established by the Ukrainian legislation are too onerous and cumbersome, or otherwise distracting for foreign banks, therefore making other legal forms for operating banking business, such as subsidiaries or representative offices, more preferable. The answer to this question is yes - the Ukrainian regulator has failed to meet the challenge of prudent regulation of foreign bank branching by creating a legal framework that is not conducive to operating via branches. Branches effectively have no peculiar advantages over subsidiaries in this jurisdiction, whereas the disadvantages, such as unlimited liability, are preserved.

**c. Research Problem Urgency**

Notwithstanding the growth of foreign capital share, the Ukrainian banking market remains substantially undercapitalized because the local banks have low capital reserves and limited possibilities to borrow. This is one of the main issues concerning today’s ongoing banking system in Ukraine. Increased foreign investments in the banking sector are vital, from the perspective of supplying additional financial resources, and would substantially contribute to the economic growth of the country as a whole.

Moreover, there is weak inter-bank competition observed in Ukraine despite a large number of registered banks, 194 as of January 1, 2011. Commercial banks mainly serve their own small market niches. As a result, this lack of competition causes negative consequences such as high loan interest rates, poor quality of service, outright lack of services, and underfunded technological innovation. Therefore, a more active entry of

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29 The requirements and regulations for foreign bank branching as provided by the Ukrainian legislation are discussed in Part IV (c) below.
30 See supra p. 2.
33 Orliuk O.P. supra note 17 at 12.
foreign banking capital into the financial market of Ukraine through branch form of business presence would promote the progress of the banking system and contribute immensely to its credibility and success. Moreover, the available empirical economic evidentiary literature suggests that foreign bank entry affects the behaviour of the domestic banking system through increased competition and improved efficiency, bringing positive welfare effects.\textsuperscript{34}

From another point of view, businesses in countries with underdeveloped equity markets and shareholder protection rely heavily on bank credits to fund investment.\textsuperscript{35} As corporate debt and equity markets are still in the infancy stages of development in Ukraine, banks prefer competing with each other over credit terms (e.g., loan periods, different commission fees) rather than on interest rates. For example, according to the official release issued by the National Bank of Ukraine on December 23, 2010, the average loan rate in the US dollars in Ukraine in November 2010 was 10.11 percent.\textsuperscript{36}

In this way, foreign banks, through branches, may represent a substantial and valuable source of capital for local Ukrainian companies. Foreign banks may not only have better access to the capital on foreign financial markets than domestic banks, but may also contribute to entrepreneurship by providing funding for promising projects that local banks refuse to support. In addition, an analysis of empirical data from Eastern European economies suggests that foreign investment stimulates growth in equity share sales, assets and use of financial debt.\textsuperscript{37}

\textsuperscript{36} National Bank of Ukraine, online:
The liberalization of global trade in financial services brings changes to the economies of developing countries such as Ukraine. As financial commentators note, “[T]he financial sector, due to its appeal as a high-skilled, high-income industry, is sometimes identified by these countries as a potential source of future income activity. Hence, the effects of freer trade in financial services under the GATS have special significance for developing economies.”

There are at least two equally important and valid reasons why policymakers should take a closer look at how foreign banks operate in Ukraine. Firstly, the branch-based organizational form of foreign bank operations may significantly influence the competitive structure of the domestic banking system and introduce positive effects on the interest rates and the quality of banking services. Secondly, branches and other forms of presence typically have different levels of parent bank liability and financial support. Subsidiaries have separate legal personality from their parent banks and, as such, have limited liability. In contrast, parent banks, under most circumstances, are responsible for the liabilities of their branches.

It should be noted that not all observers of the banking system in Ukraine are of the view that foreign bank entry through branches would benefit the Ukrainian economy. For example, the Association of Ukrainian Banks (AUB) has vociferously expressed its concerns and skepticism as to the appropriateness of relaxing foreign access to the Ukrainian banking market. In particular, the AUB noted the real possibility of potentially unequal competitive conditions developing for local banks from foreign bank branching in Ukraine, the potential outflow of capital from Ukraine, and increased risks for local business clients. In addition, the AUB predicted a major disruption to the integrity of the Ukrainian economic system, a deceleration in the growth and development of the national economy.

38 Victor Murinde & Cillian Ryan, supra note 27, at 752.
industry and small and medium-sized business, and, eventually, increased unemployment, and a jump in various social problems.\textsuperscript{39}

Given all the above-said, the issue of admittance of additional capital through foreign banks’ branches is of particular concern for the Ukrainian transitional economy. Proper and prudent regulation is crucial to mitigate the potential risks that new foreign bank branching practices may bring to Ukraine.\textsuperscript{40} As a result, Ukrainian policymakers face a trade-off between the regulatory protection of the local market and the economic importance of making possible foreign bank presence and their consequent operations. In this context, if foreign banks face too difficult a time with banking restrictions and onerous compliance requirements, they might be seriously discouraged to open branches in Ukraine. As a result, the wholesome effects of foreign bank branching will not take place. On the other hand, overly lax regulations may result in putting at risk the developing local banking system and jeopardize safety of the budding financial sector.\textsuperscript{41}

To summarize, the urgency of this research topic is dictated by the effort to determine the role that foreign bank branches may make in facilitating the development of the Ukrainian economy, bringing all positive effects as partly described above. The current legal framework provided by the Ukrainian legislation will be scrutinized and compared to the relevant Canadian regimen in order to find out whether the local rules and regulations indeed inhibit foreign bank branching, and what legal developments might be suggested. This work will provide a better understanding of the issue of foreign bank branching in Ukraine and possibly introduce new ideas to improve the situation.

\textsuperscript{39} The Letter of the Association of Ukrainian Banks to Committee on Finances and Banking Activity of the Parliament of Ukraine (6 April 2009), Association of Ukrainian Banks, online: <www.aub.org.ua>.

\textsuperscript{40} For discussion of advantages and disadvantages of foreign bank branching in Ukraine see Part IV (b).

\textsuperscript{41} “Should Foreign Banks be Allowed to Open Branches in Ukraine?” (June 2004), Institute for Economic Research and Policy Consulting in Ukraine German Advisory Group on Economic Reform at 6; online: <http://www.beratergruppe-ukraine.de>. 
d. Research Methodology

Why compare Ukraine and Canada?

There are many reasons for comparing Ukraine and Canada. Historically, both counties enjoy very close and mutually benefiting political, economic, cultural and social relationships. These relationships are grounded on the rich heritage of large Ukrainian community in Canada that has been formed as a result of four waves of immigration that took start in the late nineteenth century and continue up to the present time. Canada was the first Western country that recognized independence of Ukraine in 1991, and the second country who ever did this after Poland. Moreover, Canada has always been continuous supporter of economic reforms in Ukraine, as well as of its aspirations of integration into Euro-Atlantic and global economic and political structures and organizations, including the WTO. Canadian experience of regulating foreign bank branching may serve as a model for Ukraine since Canada is a developed market economy whereas Ukraine is in the process of overcoming the stage of development. Also, these two counties have a relatively close number of populations (approximately 45 and 34 million people respectively) which means that potentially Ukraine may achieve the same banking market capacity as Canada.

In addition, the banking sector is significant for both countries’ economies supplying capital for businesses. Banks also play very important social role providing consumer, student, and other types of loans to physical persons. However, unlike in Canada, where the banking system is considered to be comparatively safe, developed, and steadfast, the very young Ukrainian banking industry still experiences problems of development, including opening the banking market to foreign investors. Canada enjoys a successfully completed twelve-year period in regulating foreign banks’ branching and
their business activities in the country. Hence, it appears that an effective legal mechanism has been elaborated during this time in this jurisdiction. Although overall economic environment, market size and capacity are very important factors, the effective legal framework in which the Canadian banking system functions plays a significant role in maintaining the stability and further development of the system. Many reputable banks, such as ABN AMRO Bank N.V. (the Netherlands), Barclays Bank PLC (Great Britain), Deutsche Bank AG (Germany), Société Générale (France), have their branches efficaciously operating in the Canadian banking market, supplying additional capital to its economy, and providing very sophisticated financial services to local clients.\textsuperscript{42}

Bank’s expansion into foreign markets has been widely researched and discussed in academic literature, both Western and Ukrainian. Most of the studies, however, put their focus on analyzing empirical data as a way to determine the factors influencing international banks’ organizational form or the consequences of liberalizing the market access for foreign banks. For example, Eugenio Cerutti, Giovanni Dell’Ariccia and Maria Soledad Martinez Peria in “How banks go abroad: Branches or subsidiaries?” (2007) 31 Journal of Banking & Finance 1669) examine the main factors that influence banks’ choice of organizational form, using data on the operations in Latin America and Eastern Europe of the world’s top 100 banks. Among other conclusions, Cerutti \textit{et al.} find that banks are inclined to operate via branches in countries with high taxes and low regulatory restrictions on bank entry. Moreover, the authors find that economic and political risks are also important determinants.

Cludia Buch in “Opening Up For Foreign Banks: How Central and Eastern Europe Can Benefit” (1997) 5:2 The Economics of Transition 339) analyses the role of foreign banks in the Czech Republic, Estonia, Hungary, and Poland and how these

\textsuperscript{42} OSFI, online: \textless http://www.osfi-bsif.gc.ca\textgreater .
countries implemented regime of free trade in financial services. The author argues that liberalizing the market access for foreign banks entails comparative advantage for the production of financial services, fosters competition, facilitates bank privatization, and encourages transfer of know-how into the developing financial systems.

Robert Lensink and Niels Hermes in “The short-term effects of foreign bank entry on domestic bank behavior: Does economic development matter?” (2004) 28:3 Journal of Banking & Finance 553) investigate the short-term effects of foreign bank entry on the behavior of the domestic banking sector. Among other results, their investigation shows that the lower level of economic development the higher costs and margins for domestic banks from foreign bank entry.


One of the ways to understand why foreign banks do not operate in Ukraine through branches is to compare relevant Canadian and Ukrainian legal requirements and regulations as one of the main determinant factors for choice of organizational. On the basis of comparison, I will analyze whether there are indeed legal (regulatory) hurdles hidden in Ukrainian law that preclude foreign banks from branching in Ukraine. By examining particular requirements of both jurisdictions, I will discuss how such requirements may affect a foreign bank’s decision to enter the market via a branch or other organizational entity. The Canadian experience may be useful for Ukrainian
policymakers in the banking sector. To the best of my knowledge, the issue of foreign bank branching in Ukraine has not yet been examined in the context of comparative analysis to the Canadian regimen.

**e. Structure of the Thesis**

Following the foregoing Introductory Part this thesis is structured as follows.

Part II, *Historical Perspective*, provides a general overview of the Ukrainian banking system, briefly discusses its structure, and highlights certain problems currently affecting this sector. Also, this part analyses the share of foreign banking capital and forms of foreign bank establishments in the Ukrainian banking market prior accession to the WTO.

Part III, *Accession to the WTO: Commitments Undertaken by Ukraine Under the General Agreement on Trade in Services (GATS) in the Banking Sector*, explores the obligations that Ukraine undertook under the GATS in the banking sector of its economy and analyses the resulting liberalization effects that these obligations had on the foreign bank activity in Ukraine.

Part IV, *Main Changes for Foreign Bank Presence after Ukraine’s Accession to the WTO*, discusses the expediency of permitting foreign banks to establish branches in Ukraine: what are the main advantages and disadvantages of foreign bank direct branching for the local economy? Also, this part analyses the legal status of a branch as a new business entity of banking business in Ukraine. The main focus of analysis in this part is placed on identifying the legislative requirements for foreign bank branching established by the Ukrainian *Law on Banks* and the procedure for establishing a branch as described by the National Bank of Ukraine.
Part V of this thesis, *Canadian Legal Regime for Foreign Banks*, considers the relevant Canadian criteria, requirements and procedure for establishment and commencement of business of a foreign bank branch. This part also provides a brief outline of other legal forms available for foreign banks in Canada.

Part VI, *Comparative Analysis of Canadian and Ukrainian Regulatory Regimes for Foreign Bank Branching*, compares the legal requirements and procedures of both jurisdictions. A comparison of the two regimes reveals similarities and important differences in the regulation of foreign bank branching. This part provides the answer to the thesis question: are the requirements and regulations as set forth by Ukrainian legislation too onerous and cumbersome, or otherwise distracting, for foreign banks, making other legal entities for operating banking business, such as subsidiaries or representative offices, more preferable?

The last part of this thesis, *Final Conclusion*, provides the results of my comparison analysis.
II. Historical Perspective

a. Banking System in Ukraine

The country’s banking system plays a key function in any economy, regardless of the level of the economy’s development. Banking system may be likened to a blood-vascular system of a state’s economy because of its role in supplying vital financial resources, ensuring flow of capital, securing settlements between businesses, and performing many other important functions.

Nowadays, the banking system of Ukraine is one of the most developed elements of the Ukrainian economy as compared to manufacturing, energy, or agriculture. Its growth began much earlier than many other sectors such as transport, wholesale and retail trade, telecom, or construction. This was determined by the role of banking institutions in the process of transition from the plan-based to market economy. Indeed, banks play the key role in forming optimal condition and environment for mobilization of funds and capital flow from one sector to another, accumulation of capital and structural rearrangement of economy, privatization and development of business and entrepreneurship. The evolution of the national banking system in Ukraine was launched in March 1991 after the adoption of the Law of Ukraine "On Banks and Banking Activity" (Law on Banks) by the Ukrainian Parliament - Verhovna Rada. Subsequently, in December 2000, the Law on Banks was significantly amended.

The Ukrainian banking system is constructed as a two-tier structure consisting of the National Bank of Ukraine (NBU), commercial banks of various types and forms of ownership, and branches of foreign banks that are established and operate in Ukraine.

44 The Law on Banks, supra note 8.
according to the local legislation.\textsuperscript{45} The NBU serves as the country's central bank and regulator which pursues a uniform state monetary policy to ensure stability of the national currency.\textsuperscript{46} The NBU represents Ukraine in relations with foreign central banks and financial regulators.

In Ukraine commercial banks are formed either as public joint-stock companies or as cooperative banks.\textsuperscript{47} Most of Ukrainian banks are domestically-owned (i.e. by local shareholders). The range of commercial banks’ activities includes deposits taking, wholesale and retail lending, investments in securities, generating of cash balance and reserve, cash handling and settlements services, foreign currency exchange operations and other services to individuals and companies.\textsuperscript{48} The most of Ukrainian banks are universal and a few are specialized in specific types of operations (e.g., savings, investment, clearing, mortgage, etc.).

As of March 2011, the number of operating banks in Ukraine was 195.\textsuperscript{49} The majority of banks are small or very small establishments and function as so-called “pocket banks”, i.e. as extended financial departments of large industrial holding groups. The relative transparency of Ukrainian banks together with strong growth before the 2008 global financial crisis led to the subsequent purchase of several large and medium banks by foreign investors in 2005 - 2008. The ultimate ownership holding of many banks is often hard to reveal because the ownership is often “layered” through large branched

\textsuperscript{45} Article 4 of the \textit{Law on Banks}, \textit{supra} note 8.
\textsuperscript{47} Article 6 of the \textit{Law on Banks}, \textit{supra} note 8.
\textsuperscript{48} National Bank of Ukraine, online: <http://www.bank.gov.ua>.
\textsuperscript{49} National Bank of Ukraine, online: <http://www.bank.gov.ua/Bank_supervision/dynamics.htm>.
structures of legal entities.\textsuperscript{50} Currently, there are only two 100 percent state-owned banks – Oshchadbank (The Savings Bank) and the Ukreximbank (The Export-Import Bank).

Although the \textit{Law on Banks} permits foreign banks to establish branches in Ukraine, at the time of writing of this thesis no a foreign bank has done so. Nonetheless, according to recent statement of the Head of the NBU, the NBU anticipates opening of foreign bank branches in the near future.\textsuperscript{51} Unlike other post-soviet countries, Ukraine does not establish quotas for presence of foreign banking capital. In contrast, Russia, for example, limits the share of foreign capital in the national banking sector to 50 percent. The Central Bank of Russia will cease issuing banking licenses to banks with a foreign investment in their share capital after this quota is exhausted.\textsuperscript{52}

The development of the banking system in Ukraine can be traced based on the index of banking sector reform\textsuperscript{53} provided by the European Bank for Reconstruction and Development – EBRD. The index for Ukraine began from the level of 1.0 in 1989 and had been raised 4 times until it reached its current level of 3.0.\textsuperscript{54}

It should be also mentioned that since the Financial Action Task Force removed Ukraine from its 'black list' at the beginning of 2004 after enacting by Ukraine of a new law on measures against money-laundering, the new stage in the sector's development during following years was marked by a wave of significant foreign investments into

\textsuperscript{50} The International Monetary Fund (IMF), “Ukraine – Financial Stability Assessment” (November 2003), online: <http://www.imf.org>.
\textsuperscript{51} Interview of Volodymyr Stelmakh, Head of the National Bank of Ukraine, \textit{Dzerkalo Tyzhnya} (29 September 2010), online: Dzerkalo Tyzhnya <http://news.dt.ua/news/37745>.
\textsuperscript{53} The EBRD index evaluates banking reform progress by the following criteria: the liberalization of interest rates and of the credit allocation process, the volume of lending to the private sector, private ownership in the banking sector, the level of competition between banks, bank solvency, the establishment of a framework for regulation and prudential supervision. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialized market economy.
\textsuperscript{54} European Bank for Reconstruction and Development (EBRD), online: <http://www.ebrd.com>.
Ukrainian banking market. The relative transparency of the Ukrainian banking sector achieved with introducing of the aforementioned measures together with strong economic growth led to the subsequent purchase of several large and medium banks by foreign investors in 2005-2008. The foreign capital entry increased the capacity of the bank system. Apparently, the national banking sector appeared to be one of the most opened long before the WTO in comparison to the other national service markets.

The competition in the banking industry is fairly high: no bank holds a dominant position in the most sectors of banking services and faces strong competition with many rivals for market share. Active entry of foreign banking capital through purchasing local banks during the pre-crisis period made competition on both deposit and credit markets stronger. However, this competition has not yet resulted in the decrease of loan interest rates or improved quality of banking services.

Despite the positive signs, the Ukrainian banking system remains vulnerable to macroeconomic shocks. Currently, the state of the banking sector can be characterized in a number of significant weaknesses, such as undercapitalization, poor corporate governance and management, and excessive political intervention in some banks. According to Barisitz, the most salient problems of the Ukrainian banks before the financial crisis of 2008 were insufficient accumulation of capital, poor asset

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56 Ilja Belobragin & Alena Dashkevich, Are Foreign Banks Any Good For Ukrainian Firms? (M.Fin. Stockholm School of Economics 2009) [unpublished] [<http://www.hhs.se>], at 3.
57 Stephan A. et al., supra note 54, at 8.
diversification, credit risk exposure through foreign currency loans, widespread connected lending, low profitability and unsatisfactory risk management capacity.\textsuperscript{58}

\textbf{b. Foreign Banking Presence in Ukraine before Accession to the WTO}

\textit{i. Foreign Banking Capital Share}

Ukraine is an example of a developing country whose banking sector has become increasingly attractive for foreign credit granting institutions over the past decade. For instance, Raiffeisen International has been operating in Ukraine via its subsidiary JSBC Raiffeisenbank Ukraine since 1998. With total assets of € 627 million as of December, 2004 it was the country's seventh-largest bank, employing, as of the end of June, 2005, a staff of nearly 1,000 at 22 outlets.\textsuperscript{59} The attraction of the Ukrainian banking sector may also be confirmed by “the amount of agreements on sale of banks’ control shareholding to foreign investors”.\textsuperscript{60} Therefore, before accession of Ukraine to the WTO in May 2008, foreign banks were already “a strong presence and a dynamic force”\textsuperscript{61} on the Ukrainian financial market.

During 2007, the year preceding Ukraine’s accession to the WTO, the tendency towards increasing the foreign capital share in the banking sector of Ukraine continued. As of 01 January 2008, 198 banks were registered in the State Register of Banks. The number of banks with foreign capital share grew from 35 at the beginning of 2007 to 47 (26.9% of all banks) by the end of the year, including 17 banks (9.7% of all banks) established with 100% foreign capital. The portion of bank assets with foreign capital


participation grew from 45.6 per cent at the beginning of the year to 49.7 per cent by the end of 2007. In 2007, the amount of foreign capital in the authorized (registered) capital of banks increased by UAH 7.7 billion or more than doubled, and as of 01 January 2008 it was equal to UAH 15.1 billion and constituted 35.20 per cent of registered authorized capital of all banks operating in Ukraine (see Chart 1 bellow).62

Table 1. Origination of the foreign capital in the Banking Sector of Ukraine in 2007

<table>
<thead>
<tr>
<th>No</th>
<th>Country registration of non-resident of Ukraine bank-member</th>
<th>Foreign capital share in registered authorized funds of banks, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cyprus</td>
<td>7.15</td>
</tr>
<tr>
<td>2</td>
<td>Austria</td>
<td>7.15</td>
</tr>
<tr>
<td>3</td>
<td>France</td>
<td>4.41</td>
</tr>
<tr>
<td>4</td>
<td>Russian Federation</td>
<td>3.42</td>
</tr>
<tr>
<td>5</td>
<td>The Netherlands</td>
<td>2.90</td>
</tr>
<tr>
<td>6</td>
<td>Poland</td>
<td>2.78</td>
</tr>
<tr>
<td>7</td>
<td>Sweden</td>
<td>2.14</td>
</tr>
<tr>
<td>8</td>
<td>Hungary</td>
<td>1.53</td>
</tr>
<tr>
<td>9</td>
<td>Ireland</td>
<td>0.99</td>
</tr>
<tr>
<td>10</td>
<td>United States of America</td>
<td>0.75</td>
</tr>
<tr>
<td>11</td>
<td>Luxembourg</td>
<td>0.70</td>
</tr>
<tr>
<td>12</td>
<td>Georgia</td>
<td>0.32</td>
</tr>
<tr>
<td>13</td>
<td>United Kingdom</td>
<td>0.29</td>
</tr>
<tr>
<td>14</td>
<td>Germany</td>
<td>0.21</td>
</tr>
<tr>
<td>15</td>
<td>Turkey</td>
<td>0.17</td>
</tr>
<tr>
<td>16</td>
<td>Greece</td>
<td>0.12</td>
</tr>
<tr>
<td>17</td>
<td>Switzerland</td>
<td>0.10</td>
</tr>
<tr>
<td>18</td>
<td>Finland</td>
<td>0.02</td>
</tr>
<tr>
<td>19</td>
<td>Cayman Islands</td>
<td>0.01</td>
</tr>
<tr>
<td>20</td>
<td>Virgin Islands (British)</td>
<td>0.01</td>
</tr>
<tr>
<td>21</td>
<td>Lithuania</td>
<td>0.01</td>
</tr>
<tr>
<td>22</td>
<td>Slovenia</td>
<td>0.01</td>
</tr>
<tr>
<td>23</td>
<td>Bahama Islands</td>
<td>0.01</td>
</tr>
<tr>
<td></td>
<td><strong>Total:</strong></td>
<td><strong>35.20</strong></td>
</tr>
</tbody>
</table>

Source: NBU annual report for 200763

62 The National Bank of Ukraine, supra note 59, at 82.
63 The National Bank of Ukraine, supra note 59, at 88.
As seen from the Table 1 above, Cyprus and Austria were the largest investors into the domestic banking market in 2007. The high percentage of Cyprus’ share capital in Ukrainian banking sector may be explained by the fact that Cyprus is a highly attractive jurisdiction for international business with an inviting taxation system and has very liberal double tax treaty with Ukraine. Therefore, many Ukrainian companies enter the Ukrainian market designing their corporate structures through Cyprus intermediary entities to take advantage of the tax benefits. The Austrian inflow of capital in Ukraine is represented by Raiffeisen International activities on Ukrainian banking market. In August 2005, Raiffeisen International acquired 93.5 per cent of the second-largest Ukrainian bank, “Bank Aval”. The deal was the largest acquisition for Raiffeisen International.  

Given the above short discussion it appears that Ukrainian banking sector had been open for foreign investors long before Ukraine’s accession to the WTO. The pace of the banking market growth and available business opportunities were attractive for foreign banks despite the fact that they were limited in organizational forms to establish their presence. The two ways of entering Ukraine available for foreign banks before the WTO are discussed below.

**ii. Forms of Foreign Banks Presence**

Before the WTO membership foreign banks could operate in Ukraine only via two organizational forms: representative offices and locally incorporated subsidiaries.

A **representative office** is the most limited but the most easily established organizational form. It is a separate territorial structural subdivision of foreign bank

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which is established to represent and protect interests of the bank without performing banking operations. Representative office of a foreign bank is not allowed to perform lending and depositing operations or conduct settlements of various currency accounts. Generally, representative offices are prohibited from engaging in any profit-making operations. Commonly, their main scope of activity is to collect data on the local market. One of the main functions attributed to this organizational form is to sustain connections with actual and potential clients in the host country. Opening of a representative office requires less investments and spadework. Accordingly, a representative office is the most limited form of a foreign bank involvement in a host country and is usually considered as the first step in penetrating the local financial services market.

A representative office of a foreign bank must be accredited by the NBU. Before a representative office can start its operations, a head office must file with the NBU documents required for accreditation by local regulations. During the last decade many foreign banks have opened representative offices in Ukraine. Representative offices of foreign banks were actively engaged in marketing and arranging financing for the corporate sector, both on the commercial and investment sides.

Before the WTO, the most common way of entering the Ukrainian banking market for foreign banks pursuing the purpose of setting up an actual banking business had been acquisition of the registered bank holding all required licenses or establishing de novo subsidiary.

**Subsidiary** may be defined as a type of foreign bank that has been incorporated and registered in the host country and operates under the host country’s legislation but is

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66 Article 2 of the Law on Banks, supra note 8.
68 Article 24 of the Law on Banks, supra note 8.
69 Oleg Zagnitko at al., supra note 30.
owned by a foreign bank. A distinctive feature of subsidiary is its separate legal entity from its parent that usually has no legal obligation to support it if it falls into distress. Subsidiaries are licensed and supervised by the local financial regulator. Subsidiaries have their own registered capital and their own local board of directors.

In Ukraine subsidiary is a separate legal entity and referred to locally incorporated bank with over 10 per cent foreign ownership.\textsuperscript{70} Foreign bank’s subsidiaries are regulated under the same requirements as Ukrainian banks with no exceptions. The operations of the subsidiaries of foreign banks are not restricted to any extent as compared to the local banks. Unlike a representative office, this organizational form can, subject to obtaining a banking license from the NBU, to engage in consumer and business lending and providing mortgages as well as deposit taking on the same grounds as domestically-owned banks. Many foreign bank subsidiaries, such as Hungarian OTP Bank, French BNP Paribas, Swedish SEB Group, and Dutch TBIF Financial Services Group, are retail banks, whose customers include many individuals and smaller businesses.\textsuperscript{71}

Under the Ukrainian law, subsidiary is also referred to as a bank “with foreign capital”.\textsuperscript{72} In order to establish a bank with foreign capital, its founders must obtain the preliminary permit from the NBU. In order to obtain the status of a bank with foreign capital for an operating bank (e.g. when a foreign bank acquires a share equal or more than 10 per cent of the share capital of a local bank), its Board (Board of Directors) is required to obtain the preliminary permit from the NBU. The bank must submit the certain amount of documents to obtain the preliminary permit of the NBU. The NBU has one month to issue the preliminary permit or reject the application.

\textsuperscript{70} Article 1 of the Law on Bank, supra note 8.
\textsuperscript{72} Article 21 of the Law on Banks, supra note 8.
Once the preliminary permit is obtained the bank with foreign capital shall be registered with the NBU. It should be noted, that the procedure of registration of the bank with foreign capital is the same as for a Ukrainian bank. However, founders of a bank with foreign capital are required to submit larger package of documents as compared to founders of a local bank. Hence, it appears advantageous for foreign investors to acquire a functioning local bank rather than establish a de novo subsidiary and go through the cumbersome registration procedure as well as through the process of tuning up a new banking business from the outset.73

As indicated above, subsidiary has served as the main vehicle for foreign banks to enter the Ukrainian market. Before the WTO the Ukrainian banking market was heavily regulated favoring the local banks. Foreign banks were banned form direct branching in this country. The main purpose of the ban was allegedly the protection of domestic banking industry and financial market from invasion of non-reliable financial institutions and safeguarding independence of the financial system from foreign capital. However, accession of Ukraine to the WTO brought important changes to the legal framework for foreign bank business in this country. These changes are canvassed in details in the following Parts III and IV of this thesis.

III. Accession of Ukraine to the WTO Club: Commitments under the General Agreement on Trade in Services (GATS) in the Banking Sector

The World Trade Organization ("WTO") is a legal and institutional basis for the international trade rules. The WTO serves as a global forum for defining the core principles and obligations that member countries follow in designing and implementing internal and foreign trade policies. The main goal of the WTO is to facilitate open and liberal international trade in goods and services between its members.

Long-lasting negotiations regarding the accession of Ukraine to the WTO, which had began in 1993, were completed in late 2007. On 5 February 2008, a meeting of the General Council of the WTO approved Ukraine’s accession to the Marrakesh Agreement Establishing the WTO, and the Protocol on the Accession of Ukraine was signed. On 4 April 2008, the Ukrainian Parliament - Verkhovna Rada – passed the Law on the Ratification of the Protocol on the Accession of Ukraine to the World Trade Organization (No. 250-VI), and on 16 May 2008 Ukraine acquired official WTO membership.74 Pascal Lamy, the Director-General of the World Trade Organization, stressed in his speech that “Ukraine’s WTO membership will strengthen the multilateral trading system and provide this country with a stable and predictable trade environment that will boost its growth and prosperity.”75 Accession to the WTO was an integral part of overall domestic economic reform and a major component of Ukraine's economic policy.76 As the world press observed “[T]he membership represented a coming of age, of sorts, for trade relations

of former Soviet countries. The deal is expected to lift living standards and increase investment in Ukraine, one of Europe’s poorest countries.”\textsuperscript{77}

One of the main commitments of each member state to the WTO involves liberalization of market access for goods and services as well as liberalization of export policy. Among other fundamental treaties of the WTO, Ukraine joined the General Agreement on Trade in Services (GATS)\textsuperscript{78}.

The GATS is the first multilateral agreement promoting the liberalization of international trade in services around the world. It applies to measures by member states affecting international trade in services\textsuperscript{79} and covers eleven basic service sectors as well as “other services”. Financial services are subject to the GATS rules and include insurance and insurance-related services, banking and other financial services. According to the GATS, in these sectors service suppliers must be given free access to market except where the member state specified in its commitments certain conditions, restrictions or requirements concerning access in a specific service sector. These specific terms, limitations and conditions are agreed and specified in the Schedule of Specific Commitments in Services (the Schedule).

The Schedule is a complex document in which each country identifies the service sectors to which it will apply the market access and national treatment obligations of the GATS and any exceptions from those obligations it wishes to maintain.\textsuperscript{80} In every case the commitments and limitations are entered with respect to each of the four supply modes which constitute the definition of trade in services in Article I of the GATS. These


\textsuperscript{78} Supra note 10.

\textsuperscript{79} Article I of the GATS, supra note 10.

\textsuperscript{80} WTO: Guide to reading the GATS schedules of specific commitments and the list of article II (MFN) exemptions, online: the World Trade Organization \texttt{<www.wto.org>}.\textsuperscript{80}
modes include (1) cross-border supply (the possibility for non-resident service suppliers to supply services cross border into the member-state’s territory); (2) consumption abroad (the freedom for the member-state’s residents to purchase services in the territory of another member-state); (3) presence of natural persons (the possibilities offered for the entry and temporary stay in the member state's territory of foreign individuals in order to supply services), and (4) commercial presence (the opportunities for foreign services supplier to establish business presence on the territory of the member-state).

Given the above, a specific commitment in a Schedule is an undertaking to provide market access and national treatment for the services in question on the terms and conditions specified in the Schedule.\textsuperscript{81} Although liberalization in all service supply modes is crucial for facilitating international trade in services, for the purpose of this thesis I narrow the discussion down to one of them, specifically, the commercial presence mode as a legal basis for foreign bank branching.

Often barriers that impede trade in services are connected with certain characteristics of the supply modes of particular service industries. Accordingly, a commercial presence may prove to be necessary in order to effectively provide services in the other country.\textsuperscript{82} Commercial presence means any type of business or professional establishment, including through (i) constitution, acquisition or maintenance of a juridical person, or (ii) creation or maintenance of a branch or a representative office.\textsuperscript{83}

According to the WTO liberalization rules, it is desired that foreign banks should be allowed to establish a local presence in all possible ways, including setting up branches. Ukraine had the right to maintain restriction on foreign bank branching as a form of entry

\textsuperscript{81} Supra, note 79.
\textsuperscript{83} Subsection (d) of Article XXVIII of the GATS, supra note 10.
to the local financial market based on Article XVI: 2(e) of the GATS (“Market Access”). This provision allows the adoption of measures that would impose restrictions or require specific types of legal entity or joint venture through which a service supplier may supply services in the territory of a member state. In order to do so only one essential condition has to be followed, that is, such restricting measures should be particularly specified in the Schedule.

There is a point of view that the GATS does not directly require mandatory access of branches of foreign banks to the banking market of the WTO member state.\(^{84}\) As discussed above, according to the wording of subsection “d” of Article XXVIII of the GATS (“Definitions”) the term “commercial presence” is defined as (i) constitution, acquisition or maintenance of a juridical person, or (ii) creation or maintenance of a branch or a representative office. This could be interpreted as that the GATS does not oblige the member state to provide access to its markets via both modes but rather through either of the two.\(^{85}\) Therefore, not all the WTO member states committed to allow foreign suppliers of banking services direct branching. Among such countries are Columbia, Costa Rica, the Dominican Republic, and Honduras which became members of the WTO in 1995.\(^{86}\)

In the Ukrainian context, however, a prohibition of branch entry for foreign banks would be a major obstacle during the negotiations regarding accession of Ukraine to the WTO. Liberalization in the banking sector was of crucial importance for WTO talks

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\(^{84}\) Baranovskiy, supra note 51, at 13-14.
\(^{85}\) Id.
\(^{86}\) Id.
between Ukraine and other member states. In fact, without permitting foreign bank branching, Ukraine had little or even no chances to be admitted to the WTO.

International practice evidences that nowadays many developing countries are oriented on phased rather then single-stage opening of domestic financial markets to foreign banks. Nonetheless, Ukraine, as an export oriented economy, was extremely interested in the WTO membership that would benefit Ukrainian exporters from the facilitated access to the important foreign markets. Therefore, despite active protests of the Association of Ukrainian Banks, Ukraine committed to provide national treatment to banking services and service suppliers from the WTO member states without any conditions, qualifications or transitional periods, including, inter alia, permitting direct foreign bank branching on its territory. Specifically, Ukraine’s Schedule of Specific Commitments in Services in section VII (2) (“Banking and other financial services (excluding insurance”), provides that Ukraine establishes no limitations on the forms of commercial presence of foreign banks from the WTO member states and allows performing all types of financial services as determined in the Schedule (i.e. sets no limits for modes of services supply). Although amendments to the Ukrainian Law on Banks introducing a right for foreign banks to establish branches were adopted by the Ukrainian Parliament as early as 2006, they came into legal force only on May, 16, 2008, the day of the official acquiring of the membership in the WTO by Ukraine.

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88 Smovzhenko T.S. at al., supra note 18, at 101.
90 Supra note 38.
91 Ukraine’s Schedule of Specific Commitments in Services, pp. 25-28, online: WTO <www.wto.org>.
92 Article 24 of the Law on Banks, supra note 8.
To summarize, accession of Ukraine to the WTO “will push Ukraine toward a more open and transparent trade regime and help improve the investment climate.” On its way to the WTO Ukraine made deep market-opening commitment and agreed to grant a full access to its banking services market to foreign banks domiciled in the WTO member-countries, including supplying banking services on its territory via locally established branches. Ukraine confirmed this commitment by introducing in its Schedule, the integral part of the GATS, no specific requirements, limitations or qualifications as to the modes of supply of banking services by banks from the WTO member-countries, thereby granting them the national treatment regime, as well as by adopting respective amendments to the Law on Banks, whereby formally providing the foreign banks with the right to set up their branches in Ukraine. These were the main commitments of Ukraine under the GATS in banking sector.

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94 For an extensive discussion of the Ukrainian requirements and procedure for establishing a foreign bank branch see Part IV (c) below.
IV. Main Changes for Foreign Bank Presence after Ukraine's Accession to the WTO

a. Branch as New Form of Doing Banking Business

Banks enter and conduct business on foreign markets through different organizational modes. These modes can be grouped into three main categories: representative offices, subsidiaries and branches. There are numerous factors that foreign banks take into consideration before choosing between these options, such as the target market capacity or level of economic development of the country. Legal and supervisory frameworks for banking business of the host country are also very important factors that impact the decision regarding the type of entity to be employed for expansion purposes.  

As discussed in Parts I and III of this thesis, before the WTO foreign banks were not permitted to carry out business in Ukraine via branches but rather through representative offices and subsidiaries. After Ukraine’s accession to the WTO and acceding to the GATS, branching came up as a new business presence option for foreign banks suggesting potential enhancement of foreign bank capital in the country.

Branch of a foreign bank may be defined as a functional and legal extension and an integral part of a bank that operates in a foreign country. The characterization of branches as an organizational form of doing banking business goes inevitably in the context of comparison with subsidiaries, an alternative form of business.

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96 These two organizational forms of banking presence are discussed in detail in Part II above.
presence.\textsuperscript{97} Branches, unlike subsidiaries, are not independent legal entities and thus do not have separate legal personality.\textsuperscript{98} Hence, parent banks are usually responsible for liabilities of their branches.\textsuperscript{99} Also, branches do not commonly maintain separate accounts.\textsuperscript{100} One of the specific features of a branch is that it is required to follow dual regulations of both the home and the host country. For example, if a Canadian bank opens a branch in Ukraine, the branch would be legally obliged to follow both Canadian and Ukrainian banking rules. The supervision of foreign bank branches is performed primarily by the bank’s home country regulator. This is logical because branches, as indicated above, are legally inseparable from their parent banks domiciled in foreign countries. The host country’s regulator also imposes its own rules on foreign bank branches because they operate under its jurisdiction. However, control and regulatory influence of the host country’s regulator is generally considered weaker.\textsuperscript{101}

Another very important characteristic of this organizational form is that, being an integral part of a parent bank structure, a branch can draw on the parent’s capital.\textsuperscript{102} Generally, a foreign bank branch’s loan limits are calculated based on its parent bank’s aggregate capital. Thus, a branch is potentially able to provide more loans than a subsidiary because loan limits of the latter are usually calculated based on the amount of its own separate capital.

\textsuperscript{97} As discussed in Part II (b) above, representative office is the most limited form of foreign bank involvement in the banking market of the host country. A representative office neither takes deposits nor grants loans. Its main function is generally limited to providing the parent bank with the information on the market and general economic trends in the host country as well as sustaining connection with actual and potential clients. Because representative offices do not conduct actual banking business and thus do not represent full immersion in a host country, I will not compare them to branches.

\textsuperscript{98} Institute for Economic Research and Policy Consulting in Ukraine, supra note 40, at 3.


\textsuperscript{100} Institute for Economic Research and Policy Consulting in Ukraine, supra note 40, at 3.


There are several other distinctive features peculiar to foreign bank branching. For
example, establishing a branch is generally associated with lower expenses as compared
to opening a subsidiary because in many countries foreign banks are not required to
supply their branches with significant regulatory capital.\textsuperscript{103} Also, branches’ management
structure can often be much leaner than that of an incorporated subsidiary which has to
comply with local corporate requirements. In addition, branches can attract new clients
enjoying the parent bank’s business reputation and have direct access to the managerial
and technical support of the parent bank. Moreover, branches can borrow and lend at
favourable rates as they have the same credit rating as their parent bank. The advantages
of a branch vis-à-vis a subsidiary depend significantly on the regulatory framework of the
host country.\textsuperscript{104} If branches encounter excessively burdensome regulatory requirements,
their difference to subsidiaries will actually disappear and foreign banks will thus have
little incentive to enter via branch.

Commonly, foreign bank branches provide more specialised services than
subsidiaries and are more closely connected to the operations of the parent bank. Their
business is more likely concentrated on relatively small banking market segments where
they have a comparative advantage, such as wholesale and investment banking that tend
to be underdeveloped in the host countries.\textsuperscript{105} Also, banks often open foreign branches to
provide services to their multinational corporate clients operating in the host country.

To sum up, with the accedence of Ukraine to the GATS rules of international
trade in banking services foreign banks acquired a new option to establish their business
presence in the Ukrainian financial market, specifically, by opening branches. This

\textsuperscript{103} Institute for Economic Research and Policy Consulting in Ukraine, \textit{supra} note 40, at 3.
\textsuperscript{104} For detailed discussion of advantages and disadvantages of foreign bank branching in Ukraine see Part
IV b below.
\textsuperscript{105} Eugenio Cerutti \textit{et. al.}, \textit{supra} note 27, at 1670.
organizational form has its specific features that distinct it from subsidiaries. Branching is a new form of foreign banking in Ukraine and there is no much relevant regulatory experience in this sphere. This entails further discussion of whether the liberalization of the access to Ukraine of foreign banks is a positive development or it may disrupt stability of the financial system.

**b. Advantages and Disadvantages of Foreign Bank Branching in Ukraine**

Foreign bank branching in Ukraine should introduce a number of advantages but it also brings a number of potential risks to the domestic economy. In many transitional economies foreign bank branching has been one of the last stages of liberalizing access to banking markets. This may be contrasted to the experience of the countries of Latin America and Asia where branches have been the main mode of foreign banks penetration.106

Further opening of the Ukrainian banking sector to foreign banks may have strong positive effects on the financial system, on the volume of capital inflow and the size of foreign direct investments, on trade and capital markets, and on the economy in toto. “[T]he increased penetration of foreign institutions”107 should bring predictability and transparency to the Ukrainian market as well as encourage consolidation and raise the financial sector’s efficiency and capitalization. This, in turn, should boost economic growth across the country.108 However, the process of entry via a branch has to be properly and prudently regulated in order to mitigate or eliminate the risks usually associated with branches’ activities, such as entry of non-reliable banks, negative influences on stability of the banking system, and deposit safety. The world practice of

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107 “Entry Secured”, *supra* note 60.
108 *Id.*
regulating activities of foreign bank branches is very dissimilar in different countries. However, it is common for all countries to develop conditions for foreign bank branches that are adequate to the economic situation and development directions of their banking systems in order to minimize potential financial risks to the highest possible extent. It is a regulatory challenge. In what follows I expose the main potential benefits and risks of foreign bank branching in Ukraine.

Advantages:

(i) *Enhanced access to international capital though foreign direct investments (FDI) and loans*

Establishing foreign bank branches may attract FDI in Ukraine. Increased presence of foreign banks would add credibility to the local financial system and improve the market conditions for foreign companies. This could be the major determinant for directing FDI into the Ukrainian economy. Arguably, a foreign investor facing a high degree of risks and uncertainties peculiar to the Ukrainian banking system would be inclined to work with a ‘familiar’ foreign bank represented by its branch. Also, certain services provided by foreign banks are not easily reproducible by the domestic banks due to the lack of relevant experience and managerial expertise. Foreign investors may need the same advanced banking products that are available to them in their home countries but are not provided by local banks. This is where branches may step in.

Moreover, branches of foreign banks may become a significant intermediary in supplying long-term financing to the economy in addition to the capital already brought in by subsidiaries. Big local corporate clients may benefit largely from the availability of additional capital, whereas branches can better engage in wholesale financing because,

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Unlike subsidiaries, they are less restricted in terms of loan limits. On top of that, as discussed above, branches enjoy the credit rating of their parent banks, and thus, may borrow funds on the international markets at lower rates. This advantage of lower capital cost would possibly allow them to reduce interest margins, which would benefit depositors and lenders alike.\(^{110}\) Finally, in most cases foreign banks with higher capitalization are capable of providing financing via branches even during an economic downturn in the host country, unlike domestic banks, which would have to be very cautious in light of their limited financial possibilities. According to Peek and Rosengren, for example, foreign bank branches did not cut down financing supply during the economic decline in Latin American countries during the crisis in the yearly 2000s.\(^{111}\)

(ii) Increased efficiency and known-how transfer in the banking sector

It goes without saying that foreign banks represented by their branches will render the Ukrainian banking market more competitive and diversified. Direct branching of foreign banks is likely to foster the overall efficiency of the sector. Specifically, the challenge from experienced foreign banks would force domestic banks to enhance their performance by improving risk management procedures, quality of service, cost structure, pool of services and reliability, as they would otherwise become less attractive to clients. Generally, foreign bank presence positively influences banking sector of the host country. This is confirmed by empirical evidence. Claessens, Demirguc-Kunt and Huizinga, analysing the experience of 80 countries, find evidence that the entry of foreign banks into the market improves the efficiency of domestic banks, since income,


profitability and costs of these banks may be seen negatively with the presence of foreign banks.\textsuperscript{112}

In addition, foreign banking institutions may bring important attributes that domestic banks lack. Through their branches they transfer innovative high-quality services, essential know-how and new informational technologies\textsuperscript{113} which could complement the products available on the banking market of Ukraine. Finally, foreign bank branches would create new jobs and facilitate the training of local employees, giving them the possibility to learn about state-of-the-art finance and banking practice.

\textit{(iii) Development of capital markets}

Foreign branches are likely to enlarge the range of financial products available to Ukrainian customers. As previously discussed, foreign bank branches often occupy relatively narrow niches of the banking market. They are often active in such spheres as merger and acquisitions, derivative trading, arranging syndicate loans, bond issuing or initial public offerings.\textsuperscript{114} The demand for such specialized services in Ukraine will probably increase in future. Foreign bank branches could be a suitable and convenient vehicle to supply them.

Many other less significant but important benefits from foreign bank branching in Ukraine may be enumerated here. Korniliuk, for example, also suggests such positive developments as contributing to the stability of the national banking system, lessening the vulnerability of the banking sector to domestic political and economic instability, reinforcing financial supervision, improving banking discipline, bringing in high


\textsuperscript{114} Institute for Economic Research and Policy Consulting in Ukraine, \textit{supra} note 40, at 5.
international standards of financial reporting, internal control and audit, further improvement of the quality of banking legislation and many other.\footnote{Roman Korniliuk, “Consequences of Expansion of Foreign Banks to National Banking Systems” (2010) 28 Problemy i Perspectyvy Rozvytky Bankiv’skoi Systemy Ukraïny at 152.}

Despite the advantageous perspectives of foreign bank branching in Ukraine outlined above, there are still many opponents to liberalizing the access to Ukrainian banking market. Among the most active protesters is the Association of Ukrainian Banks (AUB), an umbrella organization which represents interests of the local banks. In essence, the AUB points out potential negative consequences of admitting foreign bank branching. These concerns may be grouped as follows.\footnote{Supra note 38.}

**Risks:**

(i) Possible entry of non-reliable banks

There is an argument that foreign bank branching would pave the way to unreliable foreign banks with insufficient capitalization and bad reputation from countries with poor banking supervision. Consequently, this may put the deposits of local banking customers at risk. Another concern is that such unreliable banks may engage in money laundering and export of illicit capital. These risks have to be taken seriously but can be mitigated by scrutinizing potential entrants and making sure that only banks from countries with efficient supervisory framework and institutions are admitted to the Ukrainian market.

(ii) Economic stability

Opponents to foreign bank entry via branches contend that branches in times of crises may bring down financing more than locally incorporated banks and initiate rapid outflow of capital from the country. Foreign bank branches are thought of being less “loyal” to the host country’s situation and more inclined to “cut and run” when it comes
to economic turbulences.\textsuperscript{117} This seems to be a very disputable argument. Foreign bank branches tend to have access to a more diversified international pool of liquid capital and therefore may be a stabilizing force before or during financial crises rather than the opposite.\textsuperscript{118} Even if the access to external funds is limited, they may still count on financial support from their parent banks.\textsuperscript{119} Detragiache and Gupta find that foreign banks not only did not flee the Malaysian market during the financial crisis in 1996-98 but actually increased their market share.\textsuperscript{120} Other studies of foreign banks behaviour during crises infer that they do not retrench their lending substantially during periods of difficulties, especially if compared to local banks. Dages and others, for instance, demonstrate that foreign banks in Argentina and Mexico had stronger loan growth than domestic banks between 1994 and 1999, that is, during and after so-called “Tequila crisis”.\textsuperscript{121}

Altogether, foreign bank branching should benefit the Ukrainian banking market and its customers. Foreign branches can contribute to capital inflow and FDI, transfer knowledge and experience, import new banking products, increase competition and thus boost efficiency in the banking sector of Ukraine. Issues discussed above should be seriously taken under consideration. Nevertheless, potential risks may be mitigated though prudent regulation. The existence of significant net benefits to the economy was seen by a number of countries in transition that permitted entry of foreign banks via branches.

\textsuperscript{117} Institute for Economic Research and Policy Consulting in Ukraine, supra note 40, at 5.

\textsuperscript{118} Clarke G. \textit{et al.}, supra note 101, at 43.


\textsuperscript{120} \textit{Id.}

<table>
<thead>
<tr>
<th>Countries that allow Foreign Banks Branching</th>
<th>Countries that don’t allow Foreign Banks Branching</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia, Azerbaijan, Bulgaria, China, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania, Slovakia, Slovenia, Ukraine</td>
<td>Belarus, Russia</td>
</tr>
</tbody>
</table>

Source: Institute for Economic Research and Policy Consulting in Ukraine

To summarize, there are more advantages from permitting foreign bank branching in Ukraine, and the risks associated with the liberalization of the banking market access are relatively controllable. In fact, many arguments against foreign bank branching in Ukraine are expressed by those who are concerned about their ability to compete effectively, while benefits are likely to accrue across the whole financial system of the country. Therefore, it appears that Ukraine made the right decision when it acceded to the GATS rules of free trade in services without any conditions that would limit access to its banking market. In any case, if it turns out in the future that foreign bank branching somehow harms Ukraine’s financial system, Article XXI of the GATS allows Ukraine to modify or withdraw any commitments in its Schedule following the established procedure. Ukraine could restrict or even ban branching of foreign banks.

c. Requirements and Procedure for Establishing a Foreign Bank Branch

Since the 2006 amendments to the Ukrainian *Law on Banks* which came into effect in May 2008, a foreign bank can do business in Ukraine directly through its branch without being required to establish a separate subsidiary. In context of the discussion whether the regulatory demands imposed on foreign banks to establish their branches are too onerous, as a possible reason for absence of the branches in Ukraine to date, it is important to analyse these demands in detail. The substantial requirements for foreign
banks to open and operate a branch are set out in Article 24 of the *Law on Banks*. These requirements are as follows.\(^{122}\)

1) the country where the foreign bank has been registered is a country that participates in international cooperation to prevent and combat legalization (laundering) of proceeds from crime and terrorism financing and cooperates with the FATF;

2) banking supervision in the country where the foreign bank has been registered complies with the Core Principles of Banking Supervision of the Basel Committee on Banking Supervision;

3) the NBU and the supervisory authority of the country where the foreign bank has been registered have signed an Agreement on Cooperation in Banking Supervision, Harmonization of its Principles and Terms;

4) the minimum amount for the assigned capital of the branch at the time of its accreditation is not less than EUR 10 million;

5) the foreign bank has issued a written unconditional undertaking to fulfill the obligations arising from its branch’s activities in the territory of Ukraine.

In August 2009 the National Bank of Ukraine (NBU) adopted the Resolution No. 446 “On Amendment of Some Regulatory Acts of the National Bank of Ukraine”\(^{123}\), whereby the formal procedure for accreditation\(^{124}\) of foreign bank branches was introduced.\(^{125}\) Accreditation of a foreign bank branch that satisfies the above

\(^{122}\) Original is in Ukrainian, translated by me.

\(^{123}\) Original is in Ukrainian, translated by me.

\(^{124}\) See *supra* note 21.

\(^{125}\) Amendments were introduced to Postanova Natsional’nogo Banku Ukrainy Pro zatvetzhennia Polozhennia pro Poriadok stvorennia i derzhavoi reestratsii bankiv, vidkryttia ih filiy, predstavnytsiv, viddilen [Resolution of the National Bank of Ukraine On Approval of the Regulation on the Procedure of Establishing and State Registration of Banks, Opening Their Branches, Representative Offices, Departments] dated 31.08.2001 No. 375, Ofitsyi Visnyk Ukrainy [The Official Bulletin of Ukraine] 07.09.2009, No. 66 (hereinafter *Resolution No. 375*).
requirements is performed by the NBU subject to approval of the application filed by the foreign bank and accompanied by the required documents.126

Among the most important documents that have to be submitted to the NBU are the documents confirming the registration of the bank in its home country, copy of the bank’s articles of incorporation, financial statements for the last three years confirmed by a certified auditor, corporate resolution of the applicant’s governing body (Board of Directors) authorising the establishment of the branch in Ukraine, notification from the applicant’s home jurisdiction supervisory authority on performing supervision over the applicant’s activities, written permission from the applicant’s home jurisdiction supervisory authority to open a branch in Ukraine (if such is required under the home jurisdiction regulations), the branch’s statute or charter, documents confirming payment of the assigned capital of the branch, as well as a written unconditional commitment of the applicant to fulfill the obligations arising from the activities of its branch in Ukraine.127 The NBU takes three months to decide whether to accept or reject the application. A foreign bank branch is allowed to commence its business in Ukraine from the date of the introduction of the branch to the State Registrar of Banks and issuing of a banking license by the NBU.128 The procedure of accreditation of a foreign bank branch in Ukraine is essentially similar in many aspects to the incorporation of a separate foreign bank subsidiary.129

Generally, branches are subject to similar restrictions as local banks (e.g. prohibition of providing insurance services)130 and are allowed to provide similar

126 Article 24 of the Law on Banks, supra note 8.
127 Id.
128 Id.
130 Article 48 of the Law on Banks, supra note 8.
financial services. Operations and taxation of foreign bank branches must be exercised in compliance with the laws of Ukraine as applied to domestic banks. All operations of foreign bank branches have to be recorded according to Ukrainian reporting standards. A foreign bank branch must be managed by a manager and a chief accountant. There are no requirements as to citizenship or residency of the manager or chief accountant. Branches of foreign banks are subject to all regulations, economic and financial requirements applicable to locally incorporated banks, whereas the NBU is authorized to enforce them.

Ukrainian banking law establishes a minimum assigned capital of EUR 10 million for a foreign bank branch. Interestingly, this amount is higher than the minimum authorized share capital for locally incorporated banks which is fixed at approximately eight million Euros. The assigned capital is the branch’s authorized capital equivalency which must be deposited with the NBU and may be used only for discharging financial liabilities including penalties incurred by the branch in Ukraine.

Ukrainian regulations require foreign bank branches to comply with the same economic standards regarding their capital as applied to domestic banks (i.e. local Ukrainian banks and subsidiaries of foreign banks). Among these economic standards is the Capital Adequacy Ratio (CAR). The CAR is a ratio that determines the capacity of the bank in terms of meeting time liabilities and other risks, such as credit risk, operational risk etc., from its trade, loan or other operations of monetary nature. The CAR is a measure of the amount of a bank's capital, expressed as a percentage of its

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131 Article 24 of the Law on Banks, supra note 8.
132 UAH 75 million, Article 31 of the Law on Banks, supra note 8.
133 Section 11.19 of the Resolution No. 375, supra note 124.
135 Section 1.1 of Part IV the Regulation No. 368, supra note 133.
assets weighted credit exposures. The NBU defines and monitors the CAR to protect depositors, thereby maintaining confidence in the banking system. The lower the CAR is, the higher is the risk of exposure for the bank’s creditors (e.g. depositors). If a bank’s CAR ratio is lower than the minimum required by the banking regulations, the bank must either increase its capitalization (e.g. increase its share capital) or decrease its credit exposure within the prescribed period of time. Should a bank fail to do so, it may be subject to compulsory liquidation by the NBU. Currently, the banks in Ukraine are required to maintain their CAR at no less than 10 per cent.\textsuperscript{136}

The above leads to the discussion of one of the main features of foreign bank branching. As mentioned before, one of the main advantages of branching as a legal mode of entry to a foreign banking market is that a branch’s lending limits in the host country are usually computed based on the aggregate capitalization of the parent bank. This allows branches to attract financial resources from its parent bank more easily as compared to separately capitalized stand-alone subsidiaries. This distinctive feature of branches facilitates intra-group cross-border asset transfer, and from this perspective makes a branch an attractive organizational option.\textsuperscript{137}

However, pursuant to the regulations of the NBU, for the purpose of calculation of the CAR, the assigned capital of a foreign bank branch is deemed to be equated to the authorized share capital of domestic banks.\textsuperscript{138} The authorized share capital is a part of the formula for calculating another economic indicator called “regulatory capital”. Regulatory capital is the capital level that is required to cover the bank’s losses with a

\textsuperscript{136} Section 1.5 of Part IV of the \textit{Regulation No. 368, supra} note 133.

\textsuperscript{137} Jonathan Fiechter \textit{et al}, “Subsidiaries or Branches: Does One Size Fit All?” (March 7, 2011) IMF Staff Discussion Note, SDN/11/0 at 8; online: International Monetary Fund <http://www.imf.org>.

\textsuperscript{138} Section 3.1 of the \textit{Regulation No. 368, supra} note 133.
certain probability or confidence level, which is related to a desired rating.\textsuperscript{139} Not going into too many technical details, it is important to note a bank’s CAR is calculated based on its regulatory capital, loan loss reserves\textsuperscript{140} and other variables.\textsuperscript{141} This implies that foreign bank branches face the same loan limits as locally incorporated banks. To put it simply, each time a foreign bank branch provides a loan in Ukraine it has to increase its loan loss reserves accordingly. This will decrease the bank’s CAR indicator which has to remain within the prescribed minimum. In order to offset this negative effect of increased loan loss reserves on the CAR the parent foreign bank will have to provide its branch with an additional capital injection, in other words, increase the branch’s assigned capital. This effectively significantly limits a branch’s capabilities to credit. If the Ukrainian regulations allowed calculating the regulatory capital of a foreign bank branch based on its parent’s capital rather than based on the assigned capital paid in Ukraine (and this appears to be logically correct because a branch is a mere legal extension of its parent), the branch would thus have much greater loan limit than it currently has in Ukraine, because its CAR would be much higher due to the parent’s capitalization.

To summarize, the correlation in legal status of assigned capital of foreign bank branches to authorized stock capital of local banks means that Ukrainian banking regulations virtually tie up the lending limit of a branch to the amount of its assigned capital paid in Ukraine rather than to the cumulative capital of the parent foreign bank. Both foreign bank branches and domestically incorporated banks are obliged to maintain their CAR above the required minimum. This approach effectively negated the ability of


\textsuperscript{140} In short, loan loss reserves represent a valuation reserve against a bank's total loans on the balance sheet and show the amount deemed to be adequate to cover estimated losses in the loan portfolio. When a loan is paid off, it is withdrawn from the loan portfolio as an earning asset, and its book value is deducted from the reserve account for loan losses.

\textsuperscript{141} Sections 1.2-1.4 of Part IV of the Regulation No. 368, supra note 133.
a foreign bank branch to draw on its parent’s capital, which is the primary advantage of this organizational form of doing banking business overseas. From this perspective, the Ukrainian regulations effectively erased the difference between foreign bank branches and locally incorporated subsidiaries.

Moreover, it appears that the Ukrainian banking regulatory framework is much more stringent to foreign bank branches with respect to their liability in comparison to domestic banks and subsidiaries of foreign banks. 142 Specifically, the Law on Banks requires the foreign bank to provide the NBU with a written unconditional undertaking to fulfill the obligations arising from its branch’s activities in Ukraine in addition to depositing EUR 10 million of assigned capital with the NBU. Hence, a branch’s financial liabilities are ensured by the capital of its parent bank, in addition to the assigned capital of the branch. Accordingly, foreign banks are potentially exposed to unlimited liability for their branches’ obligations, whereas subsidiaries, being legal entities distinctive from their parents, ensure the liability limited to their own capital.

Given all of the above, it is evident that cross-border branching in Ukraine has its downsides when compared to entering via subsidiaries because of the local regulatory framework:

(i) Firstly, the procedure of foreign bank branch accreditation is fairly similar to the registration of a de novo subsidiary (similarly extensive list of documents required for both organizational forms and the same three months period available to the NBU to make a decision on an application).

(ii) Secondly, a foreign bank is required to deposit the assigned capital of at least EUR 10 million for its branch with the NBU. This amount is higher than the minimum required authorized share capital for subsidiaries and local banks. Moreover, the assigned

142 Nayda Y., supra note 128.
capital is “frozen” in the account opened with the NBU, since it cannot be used in financial operations of the branch and can only be returned upon liquidation of the branch subject to offsetting against all unsettled financial liabilities incurred in Ukraine. In contrast, the authorized share capital of a subsidiary is cash that is meant to be used in financial operations of the subsidiary.

(iii) Thirdly, it appears that similar rules apply to both branches and subsidiaries with respect to loan limits. Branches are not allowed to rely on their parent’s aggregate capital but rather have to stick to the assigned capital paid in Ukraine for the purpose of calculating their capital adequacy ratio. This particular rule sets a regulative impediment for cross-border capital flow between the branch and the parent foreign bank similar to that between subsidiary and its foreign parent. In other words, it divests the branch from its primary organizational advantage over a subsidiary.

(vi) Finally, the Ukrainian regulations set out unlimited liability for branches requiring their parent foreign banks to unconditionally guarantee the fulfillment of all financial obligations of their branches. In contrast, foreign banks are not responsible for liabilities of their subsidiaries.

In conclusion, despite the optimism expressed by the Head of the NBU, who recently forecasted impending opening of branches by foreign banks in Ukraine, it appears that the Ukrainian regulatory regime for branching is to some degree off putting for foreign banks, making other legal forms, such as subsidiaries, more preferable from the business and legal perspective. There may be many factors, such as the level of economic development, multinational organization strategy, risk management policies, target market capacity and competition, that may have an impact on a bank’s choice.

143 “The National Bank forecasts opening of foreign banks branches” Dzerkalo Tyzhnia (29 September 2010), online: Dzerkalo Tyzhnia <http://www.dt.ua/online/articles/65883#article>.
between different legal modes of entry to a foreign market.\textsuperscript{144} However, the legal framework for banking activity in the host country is among the most important factors to consider. The Ukrainian rules regarding foreign bank branches appear to be unconducive to the employment of this form and thus may serve as one of the important reasons why foreign banks prefer conducting business via subsidiaries rather than branches in this country. Under the current regulations I find it more advantageous for a foreign bank to operate through a subsidiary rather than a branch in Ukraine.

\footnote{\textsuperscript{144} See Fiechter J. \textit{et al.}, supra note 136.}
V. Canadian Legal Regime for Foreign Banks

a. Forms of Foreign Banking in Canada

Foreign banks play important role in Canadian financial sector. Apart from 22 domestic banks, the banking industry of Canada includes 26 foreign bank subsidiaries, 23 full-service foreign bank branches and six foreign bank lending branches.\(^{145}\) Most of foreign banks operating in Canada specialize in such sectors as corporate and investment banking and have only one or two offices/branches.\(^{146}\) A notable exception is HSBC Bank Canada, which maintains a strong retail presence with network of branches across Canada.\(^{147}\)

Foreign banks that wish to conduct business in Canada must first seek entry approval from the Minister of Finance and the Superintendent of Financial Institutions. Once established here, they are subject to various regulatory requirements depending on the kind of entities they operate in Canada. Many large banks have a presence in Canada through one of the three legal modes of entry – subsidiary, representative office or branch; the three options of organizational forms are available to foreign banks under the *Bank Act*\(^{148}\) for extension of their business activity to Canadian banking market.

**Subsidiary** is a locally incorporated and separately capitalized entity. Foreign-owned banking subsidiaries are listed in Schedule II of the *Bank Act* and subject to the same rights (e.g. accept deposits, provide loans) and to same limitations (e.g. to engage in automobile leasing or insurance) as applicable to domestic banks listed in Schedule I.\(^{149}\)

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\(^{146}\) “Banks Operating in Canada”, online: Canadian Bankers Association <http://www.cba.ca>.

\(^{147}\) Id.

\(^{148}\) Supra note 23.

Both domestic banks and subsidiaries of foreign banks as well as foreign bank branches are taxed similarly in Canada.  Subsidiaries are allowed to take retail deposits under the condition of being a member of the Canada Deposit Insurance Corporation (CDIC). Wholesale deposits of no less than CAD 150,000 may be accepted by subsidiaries without being a member of the CDIC. Also, foreign bank subsidiaries are required to be members of the Canadian Payment Association (CPA).

As discussed earlier, generally the lending limits of subsidiaries are based on their own capitalization rather then capital of their parent banks. This rule is applicable in Canada. Specifically, according to the Large Exposure Limits Guideline, the credit risk exposures limit of a subsidiary in Canada is fixed at 100% of the total capital of the subsidiary. Moreover, a subsidiary is subject to reporting requirements when incurs exposure exceeding 50% of its total capital.

There are few other important requirements to foreign bank subsidiaries in Canada that should also be mentioned here. Specifically, foreign banking subsidiaries, being distinct legal entities, are subject to the same corporate governance rules as applicable to domestic Canadian banks. This entails the necessity for subsidiaries to maintain a board of directors of at least seven directors, at least half of which must be residents of Canada. As opposed to foreign bank branches, the related party transactions rules

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150 Barbara Ofner, *Foreign Banking Services in Canada Compared with the Swiss Position* (LL.M, Thesis, University of Toronto Graduate Department of the Faculty of Law, 2004) [unpublished] at 27.
151 CDIC is a federal Crown corporation functioning to protect deposits made with CDIC-member financial institutions in case of their failure. See online: <http://www.cdic.ca>.
153 The mandate of the Canadian Payments Association (CPA) is to establish, operate, and maintain systems for the clearing and settlement of payments among member institutions on behalf of their clients. See online: <http://www.cdnpay.ca>.
155 The *Bank Act*, s. 159 (1), *supra* note 23.
156 The *Bank Act*, s. 159 (2), *supra* note 23.
apply to subsidiaries. The minimum capital requirement for a subsidiary is CAD 5 million. Finally, subsidiaries must adhere to the capitalization standards, including the capital adequacy ratio, as prescribed by the OSFI.

**Representative Office** is an office established to represent a foreign bank in Canada. Representative offices are not permitted to carry on any business activity in Canada other than promoting the services of the foreign bank and acting as a liaison between the foreign bank and its clients in Canada. A foreign bank representative office is prohibited from accepting deposits in Canada. The procedure to establish a representative office in Canada and other relevant rules are determined in the Foreign Bank Representative Offices Regulation (RO Regulations). The RO Regulations limit activities of representative offices to (1) promoting the services of the foreign bank, or (2) acting as a link between customers in Canada and the foreign bank.

**Foreign Bank Branches** are defined as branches of foreign banking institutions that have been authorized under the Bank Act to do banking business in Canada. Before 1999, foreign banks were not allowed to open branches in Canada. At that time “Canada was one of the few developed countries that [did] not permit branching”. However, being a party to many international treaties, in particular the GATS, the government of Canada committed to reconsider its position concerning the legal modes of the access to its banking market by foreign banking establishments.

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159 OSFI, Guideline A-Part I, “Capital Adequacy Requirements”.
162 *Id.*, s 6(1).
In 1996 the Minister of Finance announced plans to conduct a full review of the entire financial institutions sector. Consequently, the Task Force on the Future of the Financial Services Sector in Canada (“Task Force”) was formed. The Task Force, *inter alia*, performed exhaustive review of foreign banking regime in Canada. Among other important recommendations, the resulting Report of the Task Force proposed relaxing the entry barriers for foreign banks by permitting direct foreign bank branching in Canada without incorporation but subject to Canadian and home jurisdictions. One of the major arguments was that the provisions of the NAFTA and the GATS basically require alike treatment of Canadian banks and banks from the countries that are parties to these multilateral treaties, whereas deferential approach would likely result in violation of the NAFTA and the GATS.

These recommendations were brought by the Canadian Government to the Parliament which abolished the restriction on foreign bank branching by amending the *Bank Act* in 1999. The implementation of the new regime was expected to “herald an era of greater contribution to the Canadian financial services sector by foreign banks”. All statutory requirements for establishing and operating a foreign bank branch are set out in Part XII.1 the *Bank Act*. The *Bank Act* refers to branches as “authorized foreign banks”, that is, foreign banks in respect of which an order under s. 524(1) of the *Bank Act* has been made.

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165 Ofner B., *supra* note 149, at 11.
170 s.C. 1999, c. 28.
The authorized foreign banks (i.e. their branches) are listed in Schedule III of the *Bank Act*. Subject to specific rules and limitations discussed below, branches are generally allowed to provide same financial services as banks listed in Schedule I (domestic Canadian) and Schedule II (foreign subsidiaries). Similarly, branches face the same restrictions as local banks, such as the prohibition to engage in insurance business or automobile leasing.

It is very important to note that in Canada, unlike in Ukraine, the lending limit of a foreign bank branch is based on the consolidated capital of the foreign parent bank. This makes branching more advantageous as compared to opening a subsidiary from the perspective of cross-border capital transfer.\(^{173}\) The OSFI requires that the aggregate credit exposure of a foreign bank branch to any entity or a connection must not exceed 25 per cent of total capital of the foreign bank.\(^{174}\) Moreover, the OSFI expressly states that regulatory limits, including the exposure limit, apply to the foreign bank branch based on the parent bank’s regulatory capital\(^ {175}\) and not on the capital equivalency deposit of the branch (discussed below).

In Canada foreign banks have the choice of two vehicles for establishing branches: a “full-service branch” or a “lending branch” (hereinafter both referred to as “foreign bank branch”). There are number of core distinctions between the two types. Full-service branches are allowed to take only wholesale deposits of CAD 150,000 and above but are not allowed to accept retail deposits (i.e. less than CAD 150,000), except for certain exemptions provided in the *Bank Act*.\(^ {176}\) Certain exceptions to the above rule are also

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\(^{174}\) OSFI, Guideline B-2, “Large Exposure Limits”, at 2.

\(^{175}\) Guide to Foreign Bank Branching, s. 8.0 (e), *supra* note 25.

\(^{176}\) The *Bank Act*, ss. 545, 546(1), *supra* note 23.
established by the *Prescribed Deposits (Authorized Foreign Banks) Regulations*.\(^{177}\) As a consequence, the deposits in a full-service branch are not eligible for the CDIC insurance.\(^ {178}\) Also, full-service branches are required to maintain assets on deposit with a Canadian financial institution approved by the OSFI of at least CAD 5 million or five per cent of the branch liabilities. This deposit must consist of either cash or acceptable securities.\(^ {179}\)

Lending branches, in turn, face even more stringent limitations with regards to deposit-taking activities. Specifically, lending branches are not permitted to accept deposits or otherwise borrow money except from financial institutions by means of financial instruments that cannot be subsequently traded.\(^ {180}\) A landing branch cannot be a member of the CDIC since it may not take deposits. The minimum capital equivalency requirement of a lending branch is CAD 100,000 that must be maintained with a Canadian financial institution approved by the OSFI.\(^ {181}\)

Both full-service and lending branches must have the principal officer to head the branch appointed by the parent bank. The officer must reside in Canada.\(^ {182}\)

**b. Requirements and Procedure for Establishing a Foreign Bank Branch**

A foreign bank wishing to set up a branch in Canada must seek approval from the Canadian financial authorities. Specifically, the approval procedure to open and operate a branch is a two-step process requiring (1) the authorization from the Minister of Finance

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\(^{178}\) Guide to Foreign Bank Branching, s. 8.0 (a), supra note 25.

\(^{179}\) The *Bank Act*, ss. 534(3)(a)(ii), 582(1)(b), supra note 23; Guide to Foreign Bank Branching, ss. 3.0 (a)(i), 8.0 (d), supra note 25; See also OFSI’s Guideline A-10, “Capital Equivalency Deposit”.

\(^{180}\) The *Bank Act*, s. 540(1)(a), (4)(a), supra note 23; Guide to Foreign Bank Branching, s. 8(a), supra note 25.

\(^{181}\) The *Bank Act*, ss. 534(3)(a)(i), (6), 582(1)(a), supra note 23; Guide to Foreign Bank Branching ss. 3.0 (a)(i), 8.0 (d), supra note 25.

\(^{182}\) Guide to Foreign Bank Branching, s. 8.0 (f), supra note 25.
(Minister) to establish a branch in Canada, and (2) the approval of the Superintendent of Financial Institutions (Superintendent) of commencement and carrying on business in Canada. Each of these approvals is based on its own set of criteria, both statutory and non-statutory.

A foreign bank establishing a branch in Canada should first file a draft application with the OFSI. The applicant is required to publish once a week for four consecutive weeks in the Canada Gazette and in a newspaper in general circulation at or near the place where principal office of the branch is planned to be located, a notice of its formal intention to apply to the Minister for an order to establish the branch. The OSFI is not generally constrained by any timeframes in assessing the draft application and the process “may take up to six months or longer”. The Minister’s decision on an application is not constrained by any time limits as well.

i. Statutory provisions relating to the Minister

It is totally at the Minister’s discretion to authorize the establishing of a foreign bank branch in Canada. Any terms or conditions that the Minister considers appropriate may be imposed on the foreign bank. The applicant must meet all statutory requirements and, if a foreign bank is domiciled in a country that is not a member of the WTO, the Minister has to be satisfied that in that country the treatment of banks is as favorable as it exists under the Bank Act. Before making an order, the Minister must be of the opinion that the foreign bank is regulated in an acceptable manner in its home jurisdiction and that its principal activity is the provision of financial services that would be permitted in

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183 The Bank Act, ss. 524, 534, supra note 23.
184 The Bank Act, s. 525(2), supra note 23.
185 Guide to Foreign Bank Branching s. 1.1 (f), supra note 25.
186 Id.
187 The Bank Act, s. 524(3), supra note 23.
Canada under the *Bank Act*.\textsuperscript{188} Furthermore, it is the Minister’s discretion to take into consideration all matters that the Minister considers relevant including, *inter alia*, the nature and sufficiency of the financial resources of the foreign bank, its reputation, business record and past performance, the soundness and feasibility of the business plans, whether the foreign bank branch will be operated by the persons with adequate competence and experience, and the best interest of the financial system in Canada.\textsuperscript{189} If the Minister is satisfied with the application of a foreign bank and has issued an order permitting a foreign bank to establish a branch in Canada, the banks’ application goes to the Superintendent.

*ii. Statutory provisions relating to the Superintendent*

The Superintendent may make an order approving the commencement and carrying on of business in Canada by a foreign bank branch only if the foreign bank has (1) deposited in Canada assets\textsuperscript{190} of total value CAD 5 million in case of a full-service branch, and CAD 100,000 in case of a lending branch;\textsuperscript{191} (2) submitted a copy of power of attorney provided to the principal officer of the branch; and (3) complied with all other relevant requirements of the *Bank Act*.\textsuperscript{192}

*iii. Non-statutory requirements*

In addition to the above statutory requirements, a foreign bank applying for the authorization to establish a branch in Canada, must also comply with additional non-statutory criteria. These criteria are very important since they represent the minimum entry requirements for foreign bank branching. Specifically, a foreign bank must

\textsuperscript{188} The *Bank Act*, s. 524(4), *supra* note 23; Guide to Foreign Bank Branching s. 2.0 (b), *supra* note 25.

\textsuperscript{189} The *Bank Act*, s. 526, *supra* note 23; Guide to Foreign Bank Branching s. 2.0 (c), *supra* note 25.

\textsuperscript{190} The assets may be either cash or acceptable securities, free of any encumbrances. See Guide to Foreign Bank Branching s. 8.0 (d), *supra* note 25. See also OFSI’s Guideline A-10, “Capital Equivalency Deposit”.

\textsuperscript{191} Subsequent to the commencement of operations, the Superintendent may consider it necessary to impose more stringent asset maintenance requirements on a foreign bank branch (the *Bank Act*, s. 617(b)).

\textsuperscript{192} The *Bank Act*, s. 534(3), *supra* note 23.
demonstrate that its risk-based capital ratio meets the minimum international standards
established by the Bank for International Settlements (BIS) the OSFI’s *Guideline A –
Capital Adequacy Requirements*. The foreign bank must also provide a three-year
business plan explaining in details the business opportunities it proposes to undertake in
Canada via its branch.

Also, the foreign bank must be of sufficient size, experience and financial health to
support the operations of it branch in Canada. This means that the foreign bank is
required to have:

a) a minimum of CAD 5 billion in consolidated assets;
b) a proven track record in international banking (e.g. existence of correspondent banking
relationships, subsidiaries, branches, representative offices);
c) a favourable financial performance over the last five years;
d) a controlling parent which is widely held in its home jurisdiction (i.e., has no major
shareholder, that is, a person who beneficially owns more than 20 per cent of any class of
voting shares or 30 per cent of any class of non-voting shares).

Moreover, a foreign bank is also required to provide a statement from its home
country’s supervisory authority giving consent to the establishment of the branch in
Canada. Where the home country is not a signatory to the WTO, there have to be
reciprocity arrangements between Canada and the home country, which are acceptable to
the Minister.

Finally, a foreign bank must furnish along with its application an extensive volume
of information to the Minister and the Superintendent for analysis. Among the most
important documents is the information on the corporate authorization (resolution of the

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193 Guide to Foreign Bank Branching s. 4.0 (b), *supra* note 25.
194 Item a) does not apply to a foreign bank applying for an order to establish a landing branch.
applicant’s Board of Directors to establish a branch in Canada; the applicant’s incorporating documents, etc.); on the ownership structure (an organization chart including all entities associated with the applicant and other documents); on the shareholders that own more that 10 per cent of any class of shares of the applicant; on any voting agreements between shareholders; a summary of the applicant’s experience and of the current banking business undertaken in the home jurisdiction and internationally; financial information on the applicant (including the annual report containing consolidated audited financial statements of the applicant and its parent, a report on the applicant by a recognized credit-rating agency, detailed capital calculations based on the OSFI’s capital rules, etc.), and many other types of information relevant to the applicant as specified by the OSFI.195

Similar to the Minister, the Superintendent is not constrained by any time limits while considering an application of a foreign bank. An order issued by the Minister authorizing a foreign bank to establish a branch is revoked, if an order approving the commencement and carrying on of business is not made by the Superintendent within one year of the Minister’s order becoming effective.196

As it can be seen from above, Canada has set out a complex, rigid and demanding legal framework to foreign banks wishing to establish their branches in this jurisdiction. A foreign bank must meet the high threshold to be admitted to operate in Canada through a branch. This may be explained, inter alia, by the efforts of the Canadian government to ensure stability and protection of the domestic banking sector from possible risks for the national financial system from the enhanced penetration of foreign banks to the local banking market. It appears that these efforts have proven to be efficient since the World

195 For a more detailed list of the information required from an applicant see the Guide to Foreign Bank Branching, s. 5.0, supra note 25.
196 The Bank Act, s. 534(10), supra note 23; Guide to Foreign Bank Branching, s. 1.2 (e), supra note 25.
Economic Forum has ranked Canada’s banking system as the most sound in the world three years in a row, including in 2010-2011.\textsuperscript{197} At the same time, despite the stringent statutory and regulatory requirements, today’s relatively large number of foreign bank branches operating in Canada\textsuperscript{198} may serve as an indication that direct branching appears to be an attractive mode for doing banking business in Canada, while the legal regime provided by the \textit{Bank Act} and regulations thereunder is fair, expedient and reasonable for foreign banks.

\textsuperscript{198} There are 23 full-service and seven lending branches as of March 31, 2011.
VI. Comparative Analysis of Canadian and Ukrainian Regulatory Regimes for Foreign Bank Branching

The banking sector is undisputedly a fundamental pillar of any country’s national economy. Any government legitimately pursues the goal of maintaining stability and soundness its banking system, as well as confidence of banking service consumers by developing a prudent and efficient regulatory regime to establish effective control. At the same time, globalization and liberalization processes in cross border trade in services have significantly affected national policies. These developments are illustrated by the relaxation of restrictions on the access of foreign banking institutions to domestic financial markets via branches, adopted in the late nineties by the countries signatory to the GATS.

As explained in earlier parts of this thesis, it is generally advantageous for national economies to permit foreign bank branching due to the increase of competition on the market and the increased inflow of foreign capital. However, potential risks that arise from liberalized access opportunities, such as possible entry of non-reliable foreign banks threatening the stability of the financial system, must be addressed by the national regulations. Hence, policymakers face a trade-off between the need for the regulatory protection of domestic banking sector and the economic benefits of facilitating possible foreign bank presence and operations through different organizational forms.

In order to address potential risks, both Canada and Ukraine set out extensive minimum entry requirements for foreign bank branches and comprehensive rules for their activity, as well as certain mandatory compliance requirements. Despite the new entry option eventuated from the accession of Ukraine to the WTO, foreign banks avoid direct branching in this country. Foreign banks consistently prefer operating in Ukraine through
subsidiaries rather than branches. On the other hand, branching is actively employed by foreign banks for expanding their businesses in Canada.\textsuperscript{199} The reason for this may lie in differences in legal approaches to the issue. In this Part of my thesis I will compare relevant Canadian and Ukrainian entry requirements and certain important compliance rules in order to determine whether the Ukrainian regulatory framework is indeed inhibiting foreign bank branching.

As evident from the comparative analysis, in Canada foreign banks face more rigid minimum entry requirements and are more limited with respect to the types of activities that they are allowed to perform as compared to the Ukrainian rules. Below I present the comparison of the most distinctive aspects of the regulatory frameworks of both jurisdictions. In Table 2 a foreign bank is referred to as “Applicant”; a foreign bank branch is referred to as “FBB”.

Table 2.\textsuperscript{200}

<table>
<thead>
<tr>
<th>No.</th>
<th>Requirements to foreign bank branching in Canada that may be more burdensome than the relevant Ukrainian rules</th>
<th>Corresponding requirements under the Ukrainian legislation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>An Applicant needs to have a minimum of CAD 5 billion in consolidated assets</td>
<td>No such requirement exists</td>
</tr>
<tr>
<td>2.</td>
<td>An Applicant must have a proven track record in international banking</td>
<td>No such requirement exists</td>
</tr>
<tr>
<td>3.</td>
<td>An Applicant must demonstrate favourable financial performance over the last five years (confirmed by audited financial statements)</td>
<td>Favourable financial performance must be demonstrated over the last four years (confirmed by audited financial statements)</td>
</tr>
<tr>
<td>4.</td>
<td>The controlling parent of the Applicant which is widely-held in its home jurisdiction</td>
<td>No specific requirements as to shareholders structure of an Applicant’s parent exists</td>
</tr>
<tr>
<td>5.</td>
<td>An applicant needs to present a three year business plan for the FBB explaining its business opportunities</td>
<td>No such requirement exists</td>
</tr>
</tbody>
</table>

\textsuperscript{199} For more details see Part V above.

\textsuperscript{200} Requirements to foreign bank branching that are identical or very similar in both jurisdictions are not presented in this table.
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>6.</td>
<td>The approval procedure to open and operate a FBB is a two-step process requiring (1) the authorization from the Minister, and (2) the approval of the Superintendent</td>
</tr>
<tr>
<td></td>
<td>The accreditation of a FBB is a one-step process involving only the NBU</td>
</tr>
<tr>
<td>7.</td>
<td>It is the Minister’s discretion whether to authorize an Applicant to open a FBB or reject the application[^201]</td>
</tr>
<tr>
<td></td>
<td>The NBU may refuse in accreditation of a FBB only based on a clearly defined set of circumstances[^202]</td>
</tr>
<tr>
<td>8.</td>
<td>Neither the Minister, nor the Superintendent are constrained by any time frameworks in taking their decisions with respect to an application to establish an FBB</td>
</tr>
<tr>
<td></td>
<td>The NBU has only three months to accredit a FBB or reject the application</td>
</tr>
<tr>
<td>9.</td>
<td>Before submitting the final application, an Applicant is required to submit a draft application with the OSFI (pre-notice period). OSFI is not constrained by time limits for considering the draft application</td>
</tr>
<tr>
<td></td>
<td>No such requirement exists</td>
</tr>
<tr>
<td>10.</td>
<td>Once a week for four consecutive weeks an Applicant is required to publish a notice of its formal intention to apply to the Minister in the Canada Gazette and in a local newspaper where the FBB is planned to be located</td>
</tr>
<tr>
<td></td>
<td>No such requirement exists</td>
</tr>
<tr>
<td>11.</td>
<td>Principal officer of a FBB must reside in Canada</td>
</tr>
<tr>
<td></td>
<td>No such requirement exists</td>
</tr>
<tr>
<td>12.</td>
<td>FBBs face limits on taking deposits: - full-service FBBs are not permitted to accept deposits of less than CAD 150,000; - landing FBBs cannot accept deposits or except from financial institutions by means of financial instruments that cannot be subsequently traded</td>
</tr>
<tr>
<td></td>
<td>FBBs are not subject to any limitations regarding deposit-taking activities</td>
</tr>
<tr>
<td>13.</td>
<td>Any time after commencement of a FBBs operations, the Superintendent</td>
</tr>
<tr>
<td></td>
<td>The minimum capital equivalency of a FBB is the amount fixed by the statute.</td>
</tr>
</tbody>
</table>

[^201]: For instance, the Minister may reject the application if the establishment of a FBB is not in “the best interest of the financial system of Canada” (Guide to Foreign Bank Branching, s. 2.0 (c) vii) supra note 25.

[^202]: More specifically, (1) documents submitted by the foreign bank are not in compliance with the requirements of the laws of Ukraine; (2) premises and equipment of the foreign bank branch do no meet the requirements of the NBU; (3) Nominees for the principal officer or the chief accountant do not meet the requirements of the laws of Ukraine as to their professional competence and business reputation; and (4) financial or legal issues of the foreign bank that may potentially entail negative consequences for the clients as a result of opening a branch were revealed (Article 24 of the Law on Banks; original in Ukrainian (supra note 8), translated by me).
The NBU has no discretion to impose more stringent requirement.

14. A full-service FBB is subject to an examination by the OSFI at least once a year. The Superintendent has the discretion to establish the frequency of examination of lending branches.

FBBs may be subject to an examination by the NBU not more than once a year.

15. An Applicant in Canada faces an incomparably more extensive list of documents requested by the financial authorities to be furnished along with the application.203

A relatively modest list of supporting documents is required.

A legitimate question may arise from the above comparison as to why then foreign banks establish their branches in Canada, given all the regulatory requirements they face and yet refuse to do so in Ukraine? The answer can be found in the following Table 3 where I provide the Ukrainian requirements and compliance rules that are more cumbersome to foreign banks as compared Canadian regulatory framework and make branching an unattractive form of entry.

Table 3.

<table>
<thead>
<tr>
<th>No.</th>
<th>Requirements to foreign bank branching in Ukraine that are more burdensome than the relevant Canadian rules</th>
<th>Corresponding requirements under the Canadian legislation</th>
</tr>
</thead>
</table>
| 1. | The minimum capital equivalency of a FBB is 10 million Euros that has to be deposited with the NBU | FBBs are required to maintain the minimum capital equivalency deposit as follows:  
- full-service FBB – at least 5% of its liabilities or CAD 5 million, whichever is greater;  
- lending FBB – CAD 100,000 |
| 2. | The capital equivalency deposits must consist of cash only | The capital equivalency deposits may consist either of cash or acceptable securities |
| 3. | The *Law on Banks* requires the applicant to provide a written | No such requirement exists |

203 For a detailed list of required information see Guide to Foreign Bank Branching, ss. 5.0 and 6.0, *supra* note 25.
unconditional undertaking to fulfill the obligations arising from the activities of its branch on the territory of Ukraine

4. The regulatory limits of a FBB, including the loan limits, are based on the deposited assigned capital of the FBB rather than on the Applicant’s (i.e. foreign parent bank’s) regulatory capital

The regulatory limits of a FBB, including the loan limits, are based on the applicant’s regulatory capital

5. Regardless of whether the applicant is from the country that is a member to the WTO, there has to be a signed Agreement on Cooperation in Banking Supervision, Harmonization of its Principles and Terms between the NBU and the supervisory authority of the Applicant’s home country as a precondition for establishment of a FBB in Ukraine

Where the home country of an applicant is not a signatory to the WTO Agreement, confirmation of reciprocity arrangements, which are acceptable to the Minister, is required

6. The accounting records of a FBB have to be maintained according to the Ukrainian accounting standards. Thus, the FBB has to maintain records according to both the Ukrainian standards (to comply with the local rules) and IFRS or GAAP principles (for internal group purposes)

The accounting record of a FBB have to be maintained according to the GAAP accepted in Canada

As evident from the Table 3, there are two most significant regulatory requirements that potentially may inhibit foreign bank branching in Ukraine. Specifically, the minimum amount of capital equivalency deposit and the rules regarding the calculation of the regulatory limits for operations of foreign bank branches can be rather burdensome. The minimum capital equivalency requirement is twice as high in Ukraine than in Canada. However, it appears that 10 million Euros should not be an insurmountable barrier for a large financial group and may prove to be an insignificant amount compared to potential future profits derived from the rapidly growing banking market of Ukraine.

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204 Generally Accepted Accounting Principles.
The second issue, however, is more problematic. The foreign bank branches in Canada are in a much more advantageous position than in Ukraine because their regulatory limits are calculated based on the parent’s capital; which is obviously significantly higher than the required capital equivalency of a branch deposited in Canada. This rule provides foreign bank branches with greater freedom in their credit operations. In contrast, the Ukrainian compliance requirements bereave a foreign bank branch of its primary advantage over other organizational forms, e.g., subsidiaries. The regulatory limits for Ukraine-based foreign bank branches are calculated based on their capital equivalency deposited with the NBU (i.e. the assigned capital), rather than their parents’ regulatory capital. These rules effectively equate branches and subsidiaries of foreign banks in terms of their ability to rely on the parents’ capital. Moreover, foreign bank branches face unlimited liability, whereas a foreign bank is shielded from the liabilities incurred by its subsidiary in Ukraine by virtue of the separate legal personality of the latter from the foreign bank. This is an apparent advantage of the subsidiary over branching.

The banking regulations have to be adequate to the economic situation, creating a favourable legal framework for foreign banking business and, at the same time, being effective enough to minimize the risks entailed by the amplified influence of foreign actors on the national financial system. In order to benefit from the potentially increased inflow of additional foreign capital, Ukraine needs to reconsider its approach to regulating foreign bank branching. The most obvious solution that could, in theory, stimulate opening of branches in Ukraine is to introduce changes to the current compliance requirements that would allow calculating local regulatory limits of branches based on their parent banks’ regulatory capital, and not the capital equivalency deposited
in Ukraine (i.e. the assigned capital of the branch). On the legal side this would render branching an attractive alternative to incorporation of subsidiaries or acquisition of domestic banks for expansion of foreign banking business to the Ukrainian economy because of the greater ease allowed by this organizational form in moving capital across borders.

On the other hand, potential risks that foreign bank branching may bring to the developing, and therefore vulnerable, financial system have to be addressed as well. The Ukrainian rule providing that branches of foreign banks are completely equated in their rights with domestically incorporated banks in rendering of all types of banking services without any limitations appears to be very controversial. There are no restrictions on deposit taking activities for foreign bank branches in Ukraine. This allows them to engage in retail deposit taking. Retail depositors appear to be the category that is the most exposed to potential mismanaging or misconduct by financial organizations. This is the reason why foreign bank branches in Canada are permitted to accept wholesale deposits only, i.e. no less than CAD 150,000. This measure protects the depositors, primarily natural persons, who are not insightful enough to adequately assess the risks from depositing money with a foreign financial institution. A similar rule for foreign bank branches in Ukraine would add to the security of local depositors. This rule appears to be fair also because it would not have an overly negative impact on the principal business of branches, since usually the main purpose of banks establishing their branches overseas is crediting activities.

Another important concern that is often put forward against branching of foreign banks in Ukraine is the potential entry of non-reliable banks from countries with poor
This risk is partially addressed by the requirement of a signed Agreement on Cooperation in Banking Supervision, Harmonization of its Principles and Terms between the NBU and the supervisory authority of the applicant’s home country as a precondition for establishment of a branch in Ukraine. In order to add to security of the national financial system, Ukraine could introduce additional safeguards similar to those existing in Canada. Specifically, Ukrainian regulations should set out a requirement regarding the minimum amount in consolidated assets that the foreign bank must have before opening a branch in Ukraine (e.g. in Canada this amount is CAD 5 billion). This helps to ensure that only well-capitalized and responsible foreign banks capable of meeting the obligations they may incur in future in Ukraine through their branches are admitted to operate in this country. The effectiveness of this measure may be challenged. However, this particular precondition for market entry serves as one of the regulatory filters and, in combination with other requirements, helps to strain out foreign banks that do not have enough resources to meet potential liabilities in the host country.

In conclusion, the rules for calculating the regulatory limits for foreign bank branches, including the regulatory capital and the capital adequacy ratio, represent the main regulatory shortcoming of the Ukrainian legal regimen for foreign banks and appear to be one of the principal reasons why foreign banks tend to avoid branching and are more inclined to incorporate legally separate subsidiaries or purchase existing banks for expanding their business in Ukraine. The Canadian regulatory framework appears to be

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205 For more details see Part IV b.
206 As noted above in this thesis (see pages 9-10), apart from the regulatory regimen for foreign banks’ activities there may be many other factors that influence foreign banks’ choice of organizational form for expanding their businesses to foreign banking markets, including establishing a physical presence. Among such factors are taxation, competition on the market, macroeconomic environment of the host country, investment and political risks, desired degree of penetration, target banking clientele (corporate or individual customers), capacity of the host country banking market, and level of economic development of the host country. This thesis is focused on the regulatory frameworks of both Ukraine and Canada as one of
more demanding to foreign banks wishing to open branches in Canada. It places a higher entry threshold that foreign banks must meet in comparison to Ukrainian rules (e.g. CAD 5 billion in consolidated assets of a foreign bank or the Minister’s discretion in ordering the authorization of the establishment of a branch). On the other hand, the Canadian law and regulations provide more relaxed compliance rules, particularly for calculating branches’ regulatory loan limits, making this form a convenient vehicle for cross-border capital supply. In order to make branch an expedient organizational mode for foreign banks to enter the Ukrainian market, the current regulations have to be reconsidered as to provide more freedom for crediting activities for branches. At the same time, Ukraine needs to follow the Canadian approach in ensuring entry of reliable banks only by raising the entry requirements threshold and minimizing the potential risk for domestic depositors by limiting deposit taking activities of foreign bank branches.
VII. Final Conclusion

The well-being of any economy heavily depends on the soundness of its banking system. Although banking institutions themselves create no wealth, they serve as a major intermediary in mobilization and allocation of money. They enable the movement of financial resources from those who have them in surplus to those who are in deficit. Through borrowing, lending, exchange, remittance and other related functions banks facilitate the processes of production, distribution and consumption of wealth, thus contributing to development of economies. Through lending, for example, banks create incentives for producers to enhance production and allow consumers to increase consumption. Also, banks play a very important social role. They create jobs themselves and help others to expand their businesses and employ more people. In addition, banks are significant taxpayers in any country, and by contributing to the state budget banks help the state to perform its social and other functions.

Canada and Ukraine are no exception, and for the same reasons the banking sector has fundamental significance for the economies of both countries. Until approximately three decades ago, the national banking systems of Ukraine and Canada consisted predominantly of domestic banks. The relatively recent active globalization processes, however, made foreign banks an integrated part of both countries’ banking sectors. Over the last decade Canada and Ukraine have notably liberalized the access of foreign banks to their national financial markets, fulfilling their commitments undertaken under the GATS within the WTO framework of free international trade in services.

One of the most important changes in the banking regulatory regimes of both countries in this respect was permitting foreign banks to establish their branches directly without being required to incorporate locally a separate legal entity. Before that moment,
foreign banks could conduct actual banking business in Ukraine or Canada only by establishing a de novo subsidiary or acquiring an existing local bank. This limitation was based on the concern that the facilitated access and consequent substantial increase of the role of foreign financial institutions in the financial sector creates a number of potential risks for the domestic economies. However, it turned out that the strict prohibition of foreign bank branching served no valid policy or prudential regulation rationale and put forward the protection of domestic banks as a weak justification for confining foreign banks in their choice of forms of entry. At the same time it needlessly restricted competition on the financial markets. Numerous theoretical models as well as empirical data analyses concluded that foreign banks significantly contribute to the development of the host countries’ banking systems and economies in whole. There is evidence that even during hard times of financial crises foreign banks behaved as reliable partners rather opportunists.\textsuperscript{207} As a result of the evolution of international banking and accedence of both countries to the WTO and the GATS, the relevant amendments, both on statutory and subordinate legislation levels, were enacted in Canada and in Ukraine in 1999 and 2008 respectively.

The new Canadian regulatory framework proved to be fairly efficient, considering its banking system is widely regarded as the soundest and safest in the world.\textsuperscript{208} In spite of all concerns, the enhanced penetration of foreign banks apparently did not harm the Canadian economy. The comparatively high entry requirements instituted by the Canadian legislation do not impede foreign bank branching; branching appears to be an attractive organizational mode of access to the Canadian banking market which is confirmed by the number of currently operating foreign bank branches. As of April 2011,

\textsuperscript{207} See supra pp. 41-42.
there were 23 full-service foreign bank branches and six foreign bank lending branches, whereas the number of subsidiaries of foreign banks was twenty six.

In Ukraine, in contrast to Canada, the situation in the banking sector has not changed dramatically after direct foreign bank branching was permitted. Despite the relatively low entry threshold, no foreign bank has opened a branch in this country to date. The foreign banks that currently operate on the Ukrainian market and hold 40.4 per cent of the banking capital in the country prefer to carry on their business via subsidiaries. This fact provoked my interest in researching the question whether there are any legal impediments for foreign bank branching in Ukraine and, if yes, what are they.

There are many determinants for a bank’s choice of a particular organizational form for operating abroad: as locally incorporated and independently capitalized subsidiaries or as branches. Among such determinants commentators name the host country’s economic and political risks (branches are less common in countries with risky and unsteady economic climates); the intended degree of penetration in the host market (branches are more likely to be employed when operations are smaller in size and do not have retail orientation); local market size; taxation system (branches are more common in countries with high corporate taxes). These factors, however, are out of the scope of my research and analysis. This paper is concentrated purely on the legal side of the issue, i.e., the regulatory frameworks existing in both countries for foreign bank branching because of the paramount effect of the home-country’s regulatory environment on foreign banks’ organizational form.

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209 As at March 2011, see Main Indicators of Banking Activity, online: National Bank of Ukraine <http://www.bank.gov.ua/Bank_supervision/dynamics.htm>.
208 Eugenio Cerutti et. al., supra note 27, at 1671.
210 Eugenio Cerutti et. al., supra note 27, at 1685.
As discussed earlier in this paper, the urgency of this research topic is dictated by the importance that foreign bank branches may have in facilitating the development of the Ukrainian transitional economy and, subsequently, in raising the social standards of life in Ukraine. They may represent an important source of additional foreign capital that is so desperately needed by many sectors of the Ukrainian economy, potentially attract direct foreign investments and, thus, facilitate the development of local businesses, render the banking market more competitive and diversified, improve the efficiency of the financial system, transfer banking known-how, technologies and experience, favour the growth of capital markers, and create new jobs.

The principal conclusion of this paper is that the Ukrainian statutory and regulatory requirements to foreign bank branches, as currently in effect, render branch an impractical organizational form compared to subsidiary; this conclusion confirms the hypothesis of my research. The main findings of the research leading to this conclusion can be summarized as follows:

(1) The procedure of the state registration (accreditation) of foreign bank branches in Ukraine is by no means easier that the procedure for registration of subsidiaries and, in fact, almost duplicates it. It has to be mentioned that the situation is similar in Canada (i.e. very similar legal process for registration of branches and subsidiaries).

(2) The minimum required capital equivalency of a foreign bank branch (i.e. the assigned capital) that has to be deposited with the NBU is EUR 10 million. This capital cannot be used in the branch’s operations. The minimum share capital of subsidiaries is lower – approximately EUR 8 million. This capital can be used in the operations of subsidiaries.
(3) Ukrainian regulations establish unlimited liability for foreign banks for financial obligations incurred by their branches in Ukraine. In contrast, foreign banks are not responsible for the liabilities of their subsidiaries, being shielded by the separate legal personality of the latter.

(4) The most salient rule that diverts foreign banks from direct branching in Ukraine is that a branch’s loan limits are linked to the assigned capital paid in Ukraine rather than to the parent bank’s regulatory capital. This dramatically limits lending capabilities of a branch. Apparently, this approach divests a branch as an organizational form of its main advantage over a subsidiary – the ability to directly draw on the parent’s capital. In other words, this is a regulative impediment for cross-border capital flow between the branch and the parent bank similar to that between subsidiary and its foreign parent. This is quite different from the current rules in Canada, where the loan limits applied to foreign bank branches are based on the parent’s regulatory capital; thus even a small branch in Canada is able to grant large loans.

The rule regarding loan limits in conjunction with unlimited liability represents the main legal reason why foreign banks tend to operate in Ukraine through subsidiaries rather than branches. The reason why Ukraine effectively indirectly ousts foreign bank branches from its financial market can be explained by its desire to protect the market from possible risks of enhanced penetration by foreign actors, in particular, by banks with doubtful reputation. Maintaining a high level of soundness and reliability of the banking system is obviously necessarily for any country. For this reason governments impose various regulatory limits on operations of banks under their jurisdiction. Still, the
regulation must be reasonable in order to facilitate the development of the banking sector and the economy, rather than to shield inefficient local banks from competition.

In order to protect depositors and maintain confidence in the banking system, financial regulators in all countries introduce regulatory limits on banking operations, including capital adequacy ratio which determines the bank’s capacity in terms of meeting time liabilities and other risks. The capital adequacy ratio is calculated based on the foreign bank branch’s regulatory capital, loan loss reserves and other variables. In Ukraine the capital equivalency of a branch (i.e. the assigned capital) deposited with the NBU is deemed to be its regulatory capital for the purposes of calculation of the regulatory limits. In Canada regulatory limits for foreign bank branches are based on their parent banks’ regulatory capital rather than on the capital equivalency of a branch deposited in Canada.

In my opinion, strict rules regarding regulatory limits for foreign bank branches in Ukraine, including the capital adequacy ratio, may be justified by the government’s attempt to safeguard the local depositors. Unlike in Canada, foreign bank branches are not regulatory restrained from engaging in retail deposit-taking activities in Ukraine. If the regulatory limits were more relaxed, the Ukrainian depositors of branches would be exposed to the greater risk of potential misbehaviour of the branches and their parent foreign banks. This contrasts with the Canadian rule that permits full-service branches of foreign banks to take wholesale deposits only, that is, no less than CAD 150,000 (lending branches are totally prohibited from accepting deposits). The rationale for this limit is that wholesale depositors are sophisticated and have enough resources to adequately assess the risks of depositing money with particular foreign financial institutions. At the same time, Canada establishes much more relaxed rules for lending activities of foreign
bank branches, because the only risk of such operations is non-return of the loans. This risk rests completely with foreign banks. Failure to return a loan by a borrower per se has no apparent negative impact on the local economy.

In order to benefit from potential advantages that foreign bank branching may bring to the Ukrainian economy, as discussed throughout this thesis, Ukraine should reconsider its regulatory framework. More specifically, the lending limits of foreign bank branches should be calculated based on their parent banks’ regulatory capital rather than on the assigned capital paid in Ukraine. At the same time, the risk that arises from enfeebling financial regulatory limits should be addressed following the Canadian approach by restricting foreign bank branches from retail deposit taking operations and fixing a reasonable minimum monetary threshold for wholesale deposits. Also, in order to minimize the possibility of entry of non-reliable banks, Ukrainian regulations should introduce a requirement regarding the minimum amount in consolidated assets that the foreign bank must have before opening a branch in Ukraine. Currently, there is no such requirement in Ukraine, while Canada permits opening branches only to those banks that can demonstrate availability of CAD 5 billion in consolidated assets (this requirement, however, does not apply to lending branches). This is the way to ensure that only well-capitalized foreign banks capable of meeting their obligations operate in the market of the host country.

To summarize, Ukraine’s acceding to the WTO and the GATS posed both challenges and opportunities to the banking system of this country. Starting from 2008 foreign banks can open their branches directly in this country. This brought the opportunity for additional capital inflow to the economy and other potential benefits. However, the Ukrainian regulator has failed to meet the challenge of prudent regulation
of foreign bank branching by creating a legal framework that is not conducive to operating via branches. Branches effectively have no peculiar advantages over subsidiaries in this jurisdiction, whereas the disadvantages, such as unlimited liability, are preserved. One possible explanation for this state of affairs is an attempt to protect local depositors from potential misconduct by foreign financial establishments. In this context the experience of developed countries, such as Canada, whose banking sector is regulated efficiently enough to create fair conditions for both national and foreign banks to compete for local customers, could be useful to follow.

Given the above, today’s action plan for Ukraine should be amending its banking legislation in order to assure favorable regulatory environment for foreign bank branches. These changes, if implemented, could improve the investment climate and make banking business in Ukraine easier and more transparent and, thus, benefit the country’s economy. This means that a lot of work has yet to be done in order to ensure full integration of Ukraine into the world system of free trade in financial services.
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