



**Maryna Shuba**  
PhD (Economics), Associate Professor,  
V. N. Karazin Kharkiv National University  
4 Svobody Sq., Kharkiv, 61022, Ukraine  
marinashuba@karazin.ua  
ORCID ID: <https://orcid.org/0000-0003-2581-6914>

## The unification of national banking systems regulation in the EU countries: experience for Ukraine

**Abstract.** In order to prevent the emergence and spread of crises in the future, there is an undeniable need for reform of the regulatory and supervisory functions of state structures in the banking sector. This issue has already been the subject of many publications and discussions at various levels. However, no unitary decisions have been made, and recommendations of international economic and financial organisations, governments of individual countries and financial institutions are sometimes diametrically opposed. Thus, the purpose of the article is to investigate regulatory initiatives of the EU banking sector in terms of global financial instability and the possibility of their use in Ukraine. The need for state regulation of various spheres of society should be taken into account when developing recommendations for reforms of the regulation of national banking systems. In order to implement international standards of banking regulation in Ukraine, it is essential to adapt the Ukrainian standards to the regulation relevant to the national banking systems of EU member-states and the EU requirements of banking supervision. Despite some difficulties, the modern period of transition to international standards, the continued dialogue with regulators of the banking activity from the EU and the implementation of Basel III in Ukraine is an important and integral part of both the European and global integration processes for our country. At present, the banking sector in Ukraine is aligned with the Basel I and part of Basel II standards, the gradual implementation of which should be completed by 2020. The implementation of the Basel III standards in Ukraine are realised mainly by banks with foreign capital. Further studies of the regulation of the national banking system should be based on the EU experience in this area and focused on identification and implementation of effective mechanisms and tools to ensure strengthened and effective banking regulation and supervision in terms of the European integration of Ukraine.

**Keywords:** Bank; Banking Regulation; European Union; Basel Committee; Basel III; Financial System

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### Шуба М. В.

кандидат економічних наук, доцент, кафедра міжнародних економічних відносин, Харківський національний університет імені В. Н. Каразіна, Харків, Україна

#### Уніфікація регулювання національних банківських систем країн ЄС: досвід для України

**Анотація.** У статті загалом теоретичну базу формування державної політики щодо регулювання банківських систем. Розглянуто основні моделі наглядових систем: секторну, за завданнями та модель єдиного нагляду. Визначено основні регулятивні ініціативи ЄС у банківській сфері щодо її уніфікації. Проаналізовано сучасні тенденції уніфікації регулювання банківської системи України з урахуванням досвіду країн ЄС.

**Ключові слова:** банк; банківське регулювання; Європейський Союз; Базельський комітет; Базель III; фінансова система.

### Шуба М. В.

кандидат экономических наук, доцент, кафедра международных экономических отношений, Харьковский национальный университет имени В. Н. Каразина, Харьков, Украина

#### Унификация регулирования национальных банковских систем: опыт для Украины

**Аннотация.** В статье обобщена теоретическая база формирования государственной политики по регулированию банковских систем. Рассмотрены основные модели системы надзора: секторная, по задачам и модель единого надзора. Определены основные регулятивные инициативы ЕС в банковской сфере по ее унификации. Проанализированы современные тенденции унификации регулирования банковской системы Украины с учетом опыта стран ЕС.

**Ключевые слова:** банк; банковское регулирование; Европейский Союз; Базельский комитет; Базель III; финансовая система.

### 1. Introduction

In order to prevent the emergence and spread of crises in the future, there is an undeniable need for reform of the regulatory and supervisory functions of state structures in the banking sector. This issue has already been the subject of many publications as well as of plenty discussions at various levels. However, no unitary decisions have been made, and recommendations of the international economic and financial organisations, governments of individual countries and financial institutions are sometimes diametrically opposed. The problem is compounded by the contradictory interests of governments, professional participants of the global financial market, banks and consumers of banking services. That is why those problems require further in-depth research.

### 2. Brief Literature Review

An analysis of recent research and publications shows that the theme is the subject of attention for Ukrainian and foreign scientists. Thus, the research by S. Naumenko (2010) [1] is dedicated to consolidation of regulatory bodies in modern conditions and mechanisms of subordination of national financial systems

to ensure global financial stability. G. Balyant (2011) [2] analyses the main types of supervisory system models, emphasises the advantages and disadvantages of a single supervisory body model and provides estimation of possibility of creation of the super-regulation body in Ukraine. Bank regulatory experience, as well as regulatory initiatives in the European Union, is considering by M. Hoyvanyuk (2012) [3], T. Musiyets, J. Ohloblya (2015) [4], G. Williams, J. Low, S. Topping (2013) [5], A. F. Rosignolo, M. D. Fethi, M. Shaban (2013) [6], A. Dietrich, K. Hess, G. Wanzenried (2014) [7], P. Prisecaru (2014) [8], J. E. Douglas (2012) [9], V. Dedu, D. C. Nitescu (2012) [10], M. Carboni, F. Fiordelisi, O. Ricci, F. Lopes (Carboni, Fiordelisi, Ricci, Lopes, 2017) [11].

The works by M. S. Schehlyuk (2015) [12], and E. O. Bulyk and A. I. Shklyar (2016) [13] are dedicated to the features of the banking regulation and supervision in Ukraine in terms of European integration.

### 3. Purpose

The purpose of the article is to investigate regulatory initiatives of the EU banking sector in terms of global financial instability and the possibility of their use in Ukraine.

#### 4. Results

In terms of the implementation of the state policy relating to the regulation of the banking system, the position of the representatives of the classical school of political economy (A. Smith, W. Petty, D. Ricardo, S. Sismondi, T. Malthus, J. Mill) is very important. The main idea of this scientific direction is based on the operation of economic laws, which denies the need for state intervention in economic processes. We may take that the scientific school does not recommend state intervention in economic processes including banking.

Representatives of Neoclassicism, such as K. Menger, J. Clark, A. Marshall, J. Hicks, M. Friedman and V. Leontiev, considered partial state intervention in economic processes, along with ensuring freedom of market forces, to be appropriate. In other words, the scientific school suggests the need for state regulation of the development of the banking system.

Keynesianism (J. Keynes) has proved that the degree of state intervention in the economy should depend on economic conditions. It is believed that in terms of the Keynesian theory the banking system can stimulate economic activity of other entities, on the one hand, but on the other, it needs state support and control measures itself.

Monetarist theory (represented by M. Friedman for example) also plays a special role in the justification of theoretical and methodological principles of the formation and realisation of state policy towards regulation of the banking system. The monetarists' position regarding the role of the banking system in the formation of important country's macroeconomic indicators is very crucial [14].

Provisions of institutional theories (J. Galbraith, F. Perry) are extremely valuable in the context of defining institutions regulating banking systems. Research in these theories is focused on institutions which are a set of manmade rules and regulations that act both as restrictions with regard to economic agents and predictions of actions that contribute to the expected results. In other words, these theories not only prove the need to regulate, but also determine those institutions which may implement such regulations.

Thus, the theoretical base of public policies relating to regulation of banking systems reflects different scientific views concerning the need for state intervention.

Depending on the characteristics of functioning of national banking systems, we can distinguish three main models of supervisory systems due to specific periods of historical development, laws, traditions, political structure, and the level of economic development and economic regulation. They are the sector model, the objective model and the unitary supervision model.

The sector model is based on a clear distribution of tasks and functions of supervisory authorities over the activities of certain sectors, e.g. banking, insurance and securities. For most countries, this is a base model, since the formation of supervision of the financial sector began with it. This is because some sectors appeared independently from a historical perspective and developed at different rates through the use of legislation, various tools and techniques. A change of trend from the sector model started for most European countries from the year 2000 and lasted over the 2000-2006 period. Thirteen European countries rejected the sector model during 2000-2006. At present, several countries, namely Greece, Spain, Cyprus, Lithuania, Slovenia, Bulgaria and Romania, fully maintain the sector model. Meanwhile, Finland and Luxembourg only partly keep to it: these countries have one body which supervises and regulates the banking and securities sectors [1].

According to the objective model, the supervisors' responsibilities are distributed on the basis of various tasks and supervision functions: prudential supervision of financial intermediaries and business regulation of the financial sector (the two peaks model). This model is applied only in four European countries: it is fully used in the Netherlands, while some elements of it are used in France, Portugal and Italy. This model should be seen as a transition from the sector model to the unitary supervision model.

In terms of the unitary supervision model, the concentration of supervision functions within a single supervisory body

has been presupposed. In some countries, e.g. the Czech Republic and Slovakia, such functions are performed by central banks, whereas single supervisory authorities are separated from central banks in other countries, e.g. Estonia, Latvia, Malta and Hungary. Since 2007, the third model of supervision of the financial sector has been used by 14 EU member states, including Denmark, Sweden, Norway and some others. Given that strengthening of the role of the Central Bank's supervisory functions and expansion of its powers is a common trend in the European Union, there exist all prerequisites for the transition to this model in other countries [2].

The formation the European banking system was in line with the formation of the European Union. The creation of a single European capital market led to a gradual convergence of national banking regulation and supervision, resulting in harmonisation of the banking legislation of EU member states. The creation of a single market for banking services in EU was based on the established principles which include:

- 1) the principle of harmonisation of the EU banking legislation through the creation of EU directives regulating banking activities;
- 2) the principle of a single banking licence based on the doctrine of mutual recognition;
- 3) the principle of mutual recognition of national prudential supervision of banking activities; this principle creates equal opportunities for banks based in EU;
- 4) the principle of supervision by the state establishment [3].

Before the emergence of the global financial crisis, the epicentre of which was the US banking system, where there was the black swan effect [15], the world had been in the process of liberalisation of financial markets and financial institutions. The global financial crisis of 2007-2008 showed financial market regulators that the financial system cannot resist crises and recover after them independently, i.e. without any government intervention.

Lagging of prudential supervision and regulation institutions from the current development level, as well as from the use of financial instruments, resulted in the inability of regulators to take adequate measures to impact the EU crisis. In addition, the problem is amplified by the fact that national regulators cannot control non-resident financial institutions. In 2008, 27 different systems regulating banking operated in the EU, based largely on national rules and anticrisis measures, although the relevant European rules and coordination mechanisms had been established.

Among the main regulatory initiatives in the banking sector of the European Union proposed in response to the crisis, it is important to pick out the following ones:

1. The establishment of a single harmonised set of rules for EU banks (Single Rulebook) in the 2009, which is aimed to: «unify the implementation of Basel III (in 2009 the Basel Committee on Banking Supervision developed the new international standards for assessing the reliability of banks, which meant «Improving the mechanism of Basel II and the overhaul of the market risk under Basel II»), under which the reform of the global financial system and the enhancement of the stability of the banking system should be done by increasing liquidity reserves and quality of banks' capital improvement. In 2010, the Group of Central Bank Governors and Heads of Supervision announced higher global minimum capital standards for commercial banks. That followed an agreement regarding the overall design of the capital and liquidity reform package, now referred to as Basel III» [16]. According to the European Banking Authority (EBA) requirements «Basel III provides for the introduction of three new factors - leverage and two new ratios of liquidity and tightening of requirements for equity banks and the creation of capital buffers in all EU member states through the use of identical definitions of regulatory indicators and methodology to calculate the key requirements» [17]. Basel III is an important step in strengthening of national banking systems and requires the use of mathematical modelling tools, as evidenced by researches in this area [6]. The new liquidity rules will enhance the stability of the financial institutions [7].
2. Since 2009, wide-ranging stress tests (EU-wide Stress Tests) have been introduced to ensure stable functioning of financial systems. In 2011, those banks of the EU, which had

- undergone wide-ranging stress tests, had the Capital to Risk Weighted Assets Ratio at 9%, which is higher than that required under Basel III [5]. Not long ago, the EBA published «the results of the 2016 EU-wide stress test of 51 banks from 15 EU and EEA countries covering around 70% of banking assets in each jurisdiction and across the EU. Along with the results, the EBA is providing again substantial transparency of EU banks' balance sheets, with over 16,000 data points per bank, an essential step towards enhancing market discipline in the EU. The stress test will therefore be an important input into the supervisory review process in 2016» [18].
3. At the beginning of 2011, EU started the reform of financial supervision. Four new pan-European regulatory bodies were created - three new supranational regulators, as well as one consultative and analytical agency. They are the European Securities and Markets Authority (ESMA) that «contributes to safeguarding the stability of the European Union's financial system by enhancing the protection of investors and promoting stable and orderly financial markets» [19]; the European Insurance and Occupational Pensions Authority (EIOPA) with its core responsibilities «to support the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries» [20]; the European Banking Authority (EBA), which ensures the stability of the financial system, transparency of markets and financial products and the protection of depositors and investors with its main task to «create an effective mechanism for the introduction of harmonized technical standards in financial services» [17], and the European Systemic Risk Board (ESRB) which is responsible for «the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk» [21].
  4. In 2014, the European Commission offered a plan for solving the problem of «too big banks» («too big to fail» - TBTF) using the EU regulators, including the European Commission; structural changes include reducing the instability risk, decreasing the risk of banks to become TBTF, namely prohibition to be engaged in speculative activities (e.g. private trade for company's own account) and demand of the partition of some forms of trade (market trade) from the part of the bank that takes deposits, provided that the bank trade exceeds a certain limit [4].
  5. In 2013, a single supervisory mechanism (SSM) started to operate. Its purpose was to gather information for investors, which gave the opportunity to identify weak banks [11]. In 2014, the asset quality review was started. The ECB estimates banks and then provides a list of those who need rehabilitation. This should encourage independent rating agencies to make their ratings more precise to avoid losing reputation.
  6. Since 2016, the bail-in procedure has been used. Participation of the state in bailing out banks has been limited.

The abovementioned regulatory initiatives in the EU banking sector was the first step towards a European banking union that will oversee a unified policy for all banks within the euro zone. The corresponding agreements on the creation of the banking union were signed in 2012. At the first stage, a single supervision mechanism was created. A single resolution mechanism (SRM) was implemented at the second stage, while the next step was to introduce a common deposit guarantee scheme, amounting to EUR 100,000. All of these steps involve large-scale banking reforms [17].

Much hope was placed on the European banking union in the process of reforming of the European financial architecture and further economic integration, as evidenced by European institutions and scientists' significant interest in this topic [8; 10; 22]

Unfortunately, the implementation of the concept of the banking union is facing huge challenges because «national governments have been extremely reluctant to give up control over more than EUR 30 trillion of bank assets» [9].

Ukraine has begun to liberalise the domestic banking market after joining the World Trade Organization in 2008. It was an important step towards the European integration process of our country.

At the current stage of development, Ukraine's banking system is under considerable influence of the European integration

processes. Therefore, the implementation of the standards developed by the Basel Committee on Banking Supervision and Regulation with regard to the domestic banking system will reduce the negative impact of banking risks on the country's economic development and expand lending to the real economy. It should be noted that in 2007 Ukraine was assessing the implementation of the Basel «Core Principles for Effective Banking Supervision» (Basel I and Basel II) in the frames of the Financial Sector Assessment Programme of Ukraine conducted by experts of the joint mission of the IMF and the World Bank. It should be pointed out that the National Bank of Ukraine has made significant steps towards effective implementation of the standards and best international practices developed by the Basel Committee on Banking Supervision. Ukraine has wholly or mainly performed 25 Basel principles, among which are the conditions for effective banking supervision, licensing and structure, prudential standards and requirements, methods of current banking supervision, accounting standards, measures of supervisory response, international interbank activities and others [12].

According to the National Bank of Ukraine, in order to introduce modern European experience and approach the standards of capital management Basel III and provisions of the EU Directive on Capital Requirements (CRD IV) in 2015, the National Bank of Ukraine announced its intention to gradually introduce new capital requirements for banks, including the adequacy capital H3, buffer stock (conservation) and a countercyclical capital buffer for all banks and buffer system for systemically important banks stand. New capital requirements for banks have been approved by the National Bank of Ukraine Resolution No. 312 «On Amendments to the Instruction on Regulation of Banks in Ukraine» as of 12 May 2015 [23].

At present, the banking sector in Ukraine is aligned with the Basel I and part of Basel II standards, the gradual implementation of which should be completed by 2020. The implementation of the Basel III standards in Ukraine are realised mainly by banks with foreign capital. European banks with their subsidiaries located and working in Ukraine have been carrying out their activities according to the international requirements of Basel III since 2013. Namely, Basel III recommendations may be considered to be a reason why some European banks have terminated their activity in the so-called risk areas in terms of investment. Ukraine belongs to such areas, according to international rating agencies (Moody's; S&P; Fitch). Thus, the international rating agency Standard & Poor's has confirmed the long-term Ukraine sovereign ratings under foreign currency obligations at B-/B [24]. Fitch Ratings has confirmed the long-term Ukraine foreign and national currencies issuer default rating at CCC [25]. Scale Moody's sovereign rating of Ukraine is now at Caa3, indicating a high risk [26]. The more risky the country for investment, the higher the risk coefficient which weights all the assets located in that country. To fulfil the sufficiency standard set by Basel III, the European Central Bank needs to raise capital in an amount equivalent to the assets of its Ukrainian subsidiary, multiplied by the minimum capital adequacy [27].

An important task of the National Bank of Ukraine (NBU) is to transit to international standards most adapted to the Ukrainian bank system. Even if the NBU decides to implement the maximum softened capital requirements option, the market may face a lot of problems. The consequences of the transition to new standards are a lack of capital, market withdrawal by small banks and termination of credits to small and medium-sized enterprises. Additional capitalisation of state banks is viewed to be another problem for Ukraine. From one third to one half of the state banks' credit portfolio volumes are securities. Under the current rules, they are regarded to be risk-free assets. Yet, according to the requirements of Basel III, these assets will not be taken as risk-free, especially considering the decreasing credit ratings of the state [28].

One of the main problems of the Ukrainian banking system is a significant shortage of capital. By 2019, some banks will have gradually followed the Basel III recommendations; others will not have even met the recommendations of the previous version, which is Basel II. The relevant changes will affect the capital of most Ukrainian banks. Basel III implies that under the Common Equity Tier 1 (CET1), bank's capital

should consist mostly of common stock. All banks should achieve the minimum required CET1 ratio of 4.5% by 2019. Ukrainian banks with large subordinated debt will have to substitute it if they wish to meet basic Basel III criteria.

Currently, it is difficult to make forecasts regarding the reform of the banking system because some banks, who a few months ago positioned themselves as reliable banks, are now under liquidation.

The National Bank of Ukraine identifies a group of systemically important banks, whose requirements are more stringent. However, the banks will be eligible for priority support, as needed. According to the Decision No. 78 by The Committee on Banking Supervision and Regulation, Payment System Monitoring (Oversight) of the National Bank of Ukraine as of 16 February 2016, Privatbank, Oschadbank and Ukreximbank were related to the group of systemic banks [29]. Such systemic banks are important because of their size and ability to generate systemic risk and directly or indirectly affect the stability of the banking system.

The status of systemically important banks gives the latter several advantages in comparison with other institutions. First of all, it concerns the common «too big to fail» approach in terms of the current financial crisis, in the frames of which systemically important institutions receive huge government financial support. Similarly, the NBU announced support for the identified systemically important banks in Ukraine. In addition, due to the significant financial and reputational potential, the big banks get exceptional competitive advantages in the market. In Ukraine, almost one half of the banking system belongs to the three banks, with 44.6% of assets and 45.4% of liabilities in the system also occurring in the three systemic banks. At present, in terms of the trends in the closure of banks, we have every reason to assert that an oligopoly is being formed in the banking sector of Ukraine [13].

## 5. Conclusions

In order to implement international standards of banking regulation in Ukraine, it is essential to adapt the Ukrainian standards to the regulation relevant to the national banking systems of EU member-states national banking systems and the EU requirements of banking supervision.

The National Bank of Ukraine began to implement Basel I standards after the country had clearly determined the European

vector of its further development. In 2007, the Ukrainian banking system considered the implementation of the Basel principles of banking supervision within the Financial Sector Assessment Programme of Ukraine. According to the experts' of the joint mission of the IMF and the World Bank, actions of the National Bank of Ukraine were found to be effective in terms of the implementation the standards developed by the Basel Committee on Banking Supervision.

Today, the banking sector of Ukraine is aligned with the Basel I and part of Basel II standards, the implementation of which should be realised by 2020. However, the Basel III requirements will mainly apply to systemically important banks.

Overall, the implementation of the Basel III requirements in the banking system of Ukraine will be individual and gradual. Therefore, it is not possible accurately determine their effects now. Yet, there exist some predictions about the consequences of the implementation of the Basel III requirements with regard to the Ukrainian banking system. Most experts believe that the application of the relevant Basel III standards will have the following negative consequences: small banks may have considerable difficulties in the formation of additional capital, also small and medium-sized enterprises with low or even normal credit rating will have fewer opportunities to obtain credits. Aforementioned may adversely affect Ukraine's economic growth. Meanwhile, the increasing confidence in the domestic banking sector from the part of existing and potential investors is considered to be one of the positive effects of the Basel III requirements implementation. In addition, the investment attractiveness of Ukrainian banks is expected to increase, which will regain interest in Ukraine from the part of European banks. Ukrainian banks are also expected to return to traditional banking operations on servicing the real economy (loans and flexible payment transactions) and minimise risky operations. Despite some difficulties, the modern period of transition to international standards, the continued dialogue with regulators of the banking activity from the EU and the implementation of Basel III in Ukraine is an important integral part of both the European and global integration processes.

Further studies of the regulation of the national banking system should be based on the EU experience in this area and ensure strengthened and effective banking regulation and supervision in terms of the European integration of Ukraine.

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