THE CORPORATE GOVERNANCE REFORMS OF THE STATE-OWNED BANKS OF UKRAINE

Abstract. The main purpose of the article is to analyze the reforming process of the corporate governance of state banks in Ukraine. The research is based on the review of existing theories, statistical data and official documents.

The article discloses information on financial results and provides the main activity indicators of state banks of Ukraine. It is considered the main risks of Ukrainian banking system stability, among which are the high level of the state share and the presence of poor-quality assets in the state-owned banks of Ukraine.

The features of existing corporate governance of state-owned banks in Ukraine were investigated. The results of comparing the international principles of corporate governance in banks with domestic practice have made it possible to highlight the main issues of Ukrainian state banks. It has been shown that the corporate governance system in Ukrainian state banks did not correspond to the best international practices, owning to the fact that legislation determined the status, powers, composition and work principles of the board of directors locally. The consequences of the low level of corporate governance (insider lending for business of individual politicians and their associated individuals, state-owned enterprises with a low level of creditworthiness) were considered.

The new approaches for corporate governance in state-owned banks, which were focus on revision of the principles and mechanism of corporate management of state-owned banks and have to change the business and operating models of state banks in order to achieve the highest efficiency of their activities, were considered. The article shows the positive aspects of reforms, as well as possible risks.
The findings are useful for practitioners and researchers to gain knowledge of the implementation of corporate governance reforms in state-owned banks.

**Keywords:** state-owned banks, corporate governance in state-owned banks, Central Bank, banking, state property

**Formulas:** 0, **fig.:** 2, **tabl.:** 1, **bibl.:** 21

**JEL Classification:** G28

**Introduction.** The activity of state-owned banks plays a significant role in the socio-economic development of the state.

Owing to good governance, the functioning of state-owned banks enables to achieve the following objectives: maintaining confidence in the whole state financial system (due to the fully guarantee of deposits); the development stimulation of the technological level of economy through a significant cost reduction of financial resources for priority sectors, industry clusters and enterprises; directing financial resource support for socially important projects.

Ukrainian practice of state-owned banks activity is characterized by mixed results. In despite of the significant support of state-owned banks, the desired effect from their activity has not been obtained. Moreover, experts have noted that the main risks for Ukrainian banking system stability are the low operational efficiency and poor asset quality of state-owned banks.

There are two possible ways for solving these issues: to improve the governance efficiency of state-owned banks by the state directly or through the process of their privatization.

The choice of this topic is attributable to the fact that the problem of the corporate governance in state-owned banks is a new one in Ukraine and the most narrowly studied in practice.

**Literature review and the problem statement.** In our opinion, the current stage is only the beginning of the corporate governance theory development in state-owned banks. Practice shows that the growth in the number and the extent of banking crises are the causes of close attention to the specifics and issues of the corporate governance in the banks.

After the Asian crisis, the main differences of corporate relations in the commercial banks were thoroughly investigated by B. Imbierowicz, C. Rauch [Berger, Imbierowicz & Rauch], Laeven L., Levine R. [Laeven & Levine], Mülbert [Mülbert 2010], J. Macey, M. O’Hara [Macey & O’Hara 2003], Bose S., Khan H., Rashid A., Islam S. [Bose, Khan, Rashid, Islam 2018], Felício J.A., Rodrigues R., Grove H., Greiner A. [Felício, Rodrigues, Grove, Greiner 2018], Ge W., Kim J-B., Song B.Y. [Ge, Kim, Song 2012], Guercio D.D., Woidtke T. [Guercio, Woidtke 2018], Isukul A.C., Chizea J.J. [Isukul, Chizea 2017], Kusuma H., Ayumardani A. [Kusuma, Ayumardani 2016], Turner J., Arun T.G. [Turner, Arun 2004]. The scientists have proven that the specifics of corporate relations in commercial banks are the following: 1) the presence of two groups of investors in the bank - shareholders and depositors, whose financial interests are contradictory; 2) the high level of information asymmetry associated with difficulties in monitoring the use of finance; 3) strengthening regulation of banking activities.

The recognition of specific sectoral features and issues of the corporate governance in banks also impacted on the activity of famous international institutions. International
Finance Corporation, Basel Committee, OECD and others began to focus on various aspects of the corporate governance of banking, both at micro and macro levels. For example, the International Finance Corporation (IFC) started to focus on the problems of the corporate governance at the micro level – the level of individual banking institutions. The World Bank has chosen a different approach and has developed the corporate governance methodology that allows to assess the legal and regulatory framework for the corporate governance in banks at the country level. The Basel Committee has developed its own recommendations in order to improve the corporate governance in commercial banks.

At the same time, a high proportion of state-owned enterprises and the mixed effects of their activities have stimulated the search for ways to manage them effectively. In 2015 the general approaches for the governance of state-owned enterprises (which include state-owned banks too) were highlighted in the OECD guidelines [OECD Guidelines on Corporate Governance of State-Owned Enterprises 2015]. The main attention of OECD guidelines is focused on the role of the state as the well-informed and active owner providing state-owned enterprise management on the basis of transparency and accountability with a high degree of professionalism and efficiency.

According to OECD guidelines the main rules of good governance of state-owned companies are the following: the centralization of state property management in one state department; clear definition of the goals of functioning of state enterprises; simplification and standardization of organizational and legal forms of their activities; the continuous monitoring of the implementation of powers and objectives; acceptance of proper participation in the process of management; ensuring the autonomy of operational activities and independent supervisory boards; paying particular attention for transparency and relevance of the appointment of boards members.

However, the unico approaches for the formation of the corporate governance exactly in state-owned banks has not formed yet, because of the small number of researches.

Therefore, we believe that regional studies of the corporate governance reform in state-owned banks will be relevant and useful.

The purpose of this article is to analyse the corporate governance in state-owned banks of Ukraine and evaluate the approach to its reform.

This research is organised in the following way. Firstly, the study provides an overview of the positions of state-owned banks in Ukraine. Then, it analyzes the previous corporate governance system of state-owned banks in Ukraine and shows its main issues. In addition, by the comparing of the best practice recommendations for governing of state-owned companies and the new approach for reforms in Ukraine, this article shows our point about the relevance of reforms. Finally, the last section includes the main conclusions.

**Research results.** Nowadays, there are four state-owned banks in Ukraine with the largest number of assets, among which are “PrivatBank”, “Ukreximbank”, “Oschadbank” and “UkrGasbank”. State-owned banks in Ukraine have appeared for various reasons.

Until 2009 there were two state-owned banks in Ukraine - “Oschadbank” and “Ukreximbank”. These institutions historically were created as the state banks. "Oschadbank" became the legal successor of the State Specialized Commercial Savings Bank of Ukraine in 1991. "Ukreximbank" was established by the Government of Ukraine in 1992. The main goal of "Ukreximbank" was to implement the state policy to such
spheres, as industry, foreign trade, economy and finance. The expansion of the state share in the banking sector of Ukraine occurred after 2009 for two main reasons.

Firstly, it was a significant reduce of private commercial banks due to “cleaning” of Ukrainian banking sector from insolvent banks. With the start of sustained system financial crisis during 2014-2017 the National Bank of Ukraine brought out 83 banks from the market.

It is natural that the reduction of the share of private banks led to the increasing of state share assets (the dynamics of the number of banks in Ukraine and share of state assets between 2005 and 2017 is shown in Figure 1)

![Figure 1](image)

**Figure 1** – The dynamics and the share of state assets in Ukrainian banks during 2005-2017  
**Source:** [Natsionalnyi bank Ukrainy]

Secondly, the nationalization of two system important banks ("PrivatBank" and "Ukrgasbank") for avoiding a system crisis further strengthened the position of the state as of a bank owner.

"UkrGasBank" was nationalized in 2009. Although, now the bank has a fairly decent condition, however, according to the National Bank of Ukraine, fiscal costs for the rescuing the bank exceeded the possible losses from timely liquidation.

The reasons for the nationalization of the largest system important bank "Privatbank" were the failure of capitalization program (148 billion hryvni at the end of 2016) and the arrears of debt refinancing (14 billion hryvni) by the bank. “PrivatBank” held 20% of Ukrainian banking system before nationalization. For this reason, nationalization of “PrivatBank” caused the most fundamental structural changes in ownership [Ohorodnyk, Demko & Kozmuk 2018].

Due to these actions of the National Bank of Ukraine and the Government, state-owned banks have occupied a significant share in the national banking system. (Indicators of the concentration of state-owned banks in the banking system of Ukraine before and after nationalization of “Privatbank” are shown in the Table 1).

The financial performance analysis of state-owned banks shows different results. We can note that between the years 2011 and 2017 these banks (without “PrivatBank”, which became the state-owned later) acted as both profitable and unprofitable (Figure 2).
At the same time, the consequences of their activities were very ambiguous.

Table 1 – Indicators of the concentration of state-owned banks in the banking system of Ukraine*

<table>
<thead>
<tr>
<th>Period</th>
<th>Active payment cards</th>
<th>Funds of individuals</th>
<th>Assets</th>
<th>Funds of clients (individuals and legal entities)</th>
<th>Funds of legal entities</th>
<th>Loans and customer debts</th>
</tr>
</thead>
<tbody>
<tr>
<td>After the nationalization of &quot;Privatbank&quot;</td>
<td>75%</td>
<td>62%</td>
<td>55%</td>
<td>56%</td>
<td>51%</td>
<td>38%</td>
</tr>
<tr>
<td>Before the nationalization of &quot;Privatbank&quot;</td>
<td>20%</td>
<td>25%</td>
<td>34%</td>
<td>32%</td>
<td>40%</td>
<td>26%</td>
</tr>
</tbody>
</table>

*Indicators were calculated by the Economic Strategy Center

Source: [Shho robyty derzhavi zi svoi’my bankamy 2017]

On the one hand, as experts have noted, state-owned banks have the highest level of investor’s confidence. During the crisis, state-owned banks played the positive role of "quiet harbor" for the individual depositors.

In addition, they were more important for the companies, the deposits of which were not covered by the deposit guarantee system [NBU: nacionalizacija Ukrgazbanku bula pomylkoju].

Figure 2 – Profit (loss) of state-owned banks in Ukraine during 2011-2017 (million hryvnia)

Source: [Natsionalnyi bank Ukrainy. Shho robyty derzhavi zi svoi’my bankamy 2017]
On the other hand, the highest credit risks are concentrated exactly in state-owned banks. The Ministry of Finance estimates the portfolio of non-working assets of state-owned banks in 400 billion hryvnias. The level of the non-performing loans in "Oschadbank" and "Ukreximbank" are 64% and 65% (for comparison – the level of the non-performing loans in privat banks is 43%). The share of the non-performing loans in "Privatbank" is even higher - 83%. If commercial banks deal with this problem due to the restructuring or selling debts, state-owned banks are more inert [Kahkonen 2017].

Obviously, this fact has caused large-scale losses for the state. Mostly, the losses from the non-performing loans are covered by reserves formed from the state investments into the bank capital (actually from the expenses of taxpayers).

During 2008-2016 "Oschadbank" and "Ukreximbank" received 61.8 billion hryvnias as a new capital and reflected 41.3 billion hryvnias as total net losses. In general, during the crisis of 2008-2017, the State spent an amount equivalent to 13,9 % of GDP for the support of banks (including the rescue of "Privatbank"). Despite the previous investments, according to the National Bank of Ukraine, bank reserves still do not cover the entire amount of the state-owned banks problem debts [Repko & Soltysjak 2018].

Theoretically, this situation is temporary, because the Strategy "Ukraine-2020" requires from state-owned banks to sell the shares to foreign investors. The aim of the Ministry of Finance of Ukraine is the reducing of state-owned banks shares in total assets of the banking system to 24% from 55% by the end of 2022 [Drobjazko 2017].

According to expert data, the entrying of foreign investors into the capital of state-owned banks can improve the activity of banks and provide a significant additional revenue to the budget (from UAH 15 to 39 billion hryvnias), which can substantially affect its revenue side.

The fact that investors will not be interested in a bank with an inconsistent corporate governance system has required a revision of existing practices and radical changes in the corporate governance approaches in state-owned banks.

For a long period of time, the corporate governance system of state-owned banks has not met the best international practices.

Moreover, the level of the corporate governance in private banks was significantly higher than in state-owned ones. In addition, we need to add that if the practice of the corporate governance of the commercial banks has been actively reformed since 2007 due to the establishment of additional requirements for members of the supervisory boards in banks, the shares of independent members and the additional accountability of the supervisory boards before the National Bank of Ukraine, then the corporate governance system of state banks was practically unchanged.

The legislation, which existed until 2018, locally determined the status, powers, composition and principles of the board of directors.

In accordance with the current legislation, the supervisory board of the state bank was considered as its supreme governing body. It controlled the activities of bank management in order to preserve the deposit funds, ensuring their return to depositors and protecting the interests of the state, as of a shareholder [Zakon Ukrainy «Pro banky i bankivsku diialnist» (zi zminamy ta dopovnenniamy)].

The supervisory boards of state-owned banks consisted of representatives of the various branches of the government. In general, the supervisory boards could include 15 people: five representatives from the Verkhovna Rada, the Cabinet and the President.
At the same time, the meetings of the supervisory boards were valid provided with ten members. In practice, the supervisory boards often have not been fully formed, which did not provide the necessary quorum and, in essence, paralyzed their work. For example, as on 01.02.2019, the board of "PrivatBank" had 5 people, and "Ukrgasbank" - 7 people.

The supervisory boards were often formed on a principle far from the professionalism of its members. This led to the fact that the supervisory boards did not form an independent view on the activities of managers and the implementation of the bank strategy. In addition to the formal nature of the work, the key features of the corporate governance of state-owned banks were the connection of supervisory boards with political elites and low level of independence. That was also facilitated by the fact that the term of authority for members of the supervisory board of state-owned bank was five years. Therefore, the functioning of state-owned banks was characterized by a permanent politically motivated replacement of top managers during the change of political elites and the lack of proper monitoring of banks.

In addition, members of the supervisory board of state-owned banks performed their functions without receiving any material remuneration, which also did not stimulate a responsible attitude.

The law that was in force at that time did not impose additional appropriate requirements for such important issues of the corporate governance as:
- the part of the independent members in the supervisory boards and criteria for determining independence;
- the presence of committees in the supervisory boards for studying the certain issues of the bank activities;
- the issues of conflicts of interests of supervisory board members;
- the procedures for the adoption of important managerial decisions;
- the responsibility of members of the supervisory boards for improper management of the banking institution;
- the transparency of state-owned banks.

The consequence of such an approach to the formation of the supervisory boards was often the high risk of insider lending - the business of individual politicians and their associates, and the state-owned enterprises with a low level of creditworthiness. As a result of inadequate risk management, at the present stage more than half of the non-performing loans in state-owned banks are loans from state-owned companies and related parties. The total amount of such loans in three banks is 66 billion hryvni as. As it was already noted, most of the losses caused by the non-performing loans are covered by reserves formed from public investment into the capital.

It was obvious that this situation required urgent changes.

Taking into account the fact that the transformation process of the state-owned sector could only be realized by the corporate governance model based on the best international standards, the process of the corporate governance reform in state-owned banks has begun in Ukraine.

The purpose of the corporate management reform in state-owned banks was to create a system for managing state-owned banks that would be isolated from political levers, as well as creating supervisory boards, most of which would be represented by independent members.
The promulgation of the law on changes in the corporate management of state-owned banks in 2018 was a decisive moment. It is worth mentioning, that the draft law was preliminary approved by the IMF, the EBRD, the World Bank and the International Finance Corporation.

A new legislation fundamentally changes the strategic management approaches in state-owned banks.

The article identifies such important positive changes in the reforming process by comparing the provisions of the law, the theory of the corporate governance in banks and the successful experience of the countries with an appropriate management system in state-owned banks.

Undoubtedly, the main positive point is the definition of new approaches to the formation of the supervisory boards in state-owned banks and the part of the independent members there.

According to the reform, the supervisory board of state-owned bank should consist of nine members, six of which should be independent, and three members should be representatives of the government (the President of Ukraine, the Cabinet of Ministers of Ukraine and the Verkhovna Rada of Ukraine proportionally) [Zakon Ukrainy «Про внесення змін до деяких законодавчих актів України щодо удосконалення функціонування фінансового сектору в Україні»]. It should be mentioned, that there are not common approaches to the number of members of the supervisory board in international practice, although generally a tendency to increase their number is noticed (for example, in Germany, the supervisory board of the state-owned bank consists of 37 people).

The majority of the independent members in the supervisory boards should ensure that there is no political engagement that can create a high-risk of insider lending. In addition, the definition of requirements for making managing decisions, eliminates the advantage of state representatives and lobbying of the governmental interests. The meeting of the supervisory board of state-owned bank is quorate only if there are at least six members. Decisions of the supervisory board of the state-owned bank are adopted by a simple majority of votes of the members, who are present at the meeting and have the right to vote, if the provision of the state-owned bank statute does not establish a greater number of votes for the adoption of the corresponding decision.

Predetermination of the term of authority for members of the supervisory board of state-owned bank (three years) and the impossibility of permanent presence in the supervisory board (according to the law, a person can not hold a post of a member of the supervisory board of state-owned bank for more than two consecutive terms) will also contribute to the political impartiality of its functioning. As a result, this should ensure the rotation of the board, which differs from the change of the President, the Parliament and the Cabinet of Ministers.

The impossibility of direct government interference in the management of state-owned banks is provided by the prohibition of the key owner to make decisions that fall within the competence of the supervisory board. Determining a broad list of requirements that should be met by independent members of the supervisory board and governmental representatives should ensure the presence of truly independent members in the board.
We also consider that establishment of requirements for the creation of committees of the supervisory boards and the presence of independent members there are undoubtedly positive points. Reforms stipulate that the supervisory board of state-owned banks has to establish an audit committee, a risk committee and a committee on appointments and rewards for officials. The committees of the supervisory board of state-owned bank on the questions of risks, appointments and rewards of officials are headed by the independent members of the supervisory board of state-owned bank.

The majority of the members of the mentioned committees should be independent of the supervisory board of state-owned bank. The committee of the supervisory board of state-owned bank on audit matters consists solely of the independent members of the supervisory board of state-owned bank.

Two other innovations of the reformers are the following: 1) establishment of the requirements for the criminal liability of members of the supervisory boards for unlawful interference with the activity of state-owned bank officials; 2) the definition of the approach to the work of the supervisory boards of state-owned bank on a paid basis.

As for conclusion, we should mention one more positive point in the corporate management reform - the establishment of requirements for the proper level of transparency of state-owned banks. For each of four state-owned banks ("PrivatBank", "Ukrgasbank", "Ukreximbank", "Oschadbank"), the crucial information (shareholders, bank management, organizational structure, number of clients, etc.), as well as key indicators activities, both in tabular and in graphical forms (visualization of the dynamics of the individual indicators) are foreseen to be disclosed. Particularly, data on volumes of the active and passive operations, the size of loans and deposit portfolios, financial results, information on turnover in the POS-terminal network, amounts of payments by the population, etc.

In general, the reformers have foreseen the compliance of the new legislation with the key principles of the corporate management in state-owned banks: ensuring balance of interests between government, depositors and other stakeholders; forming the supervisory boards in accordance with the best acknowledged standards; ensuring an adequate level of the transparency of state-owned banks.

It should be noted that despite the positive assessment of a number of reform provisions and their compliance with the best international practices, there are certain aspects of risk.

A special feature of Ukrainian model of the corporate management is the tendency toward a centralized model, rather the collection of rights and responsibilities for management “under one roof” [OECD Guidelines on Corporate Governance of State-Owned Enterprises 2015].

This meets key OECD recommendations, namely:
- decisions should be made in accordance with the interests of the entire government;
- separating ownership / management and control functions is easier to achieve when a property function is assigned to a separate specialized body;
- reducing the portfolio of the state-owned enterprises makes use of the "team of specialists" approach.

However, the state-owned banks are a specific type of state-owned enterprises, which work with money of someone else. Considering this fact, their strength is always influenced by the position of the bank regulator.
In Ukraine, the functions of the banking regulation and supervision throughout the period of independence were assigned to the National Bank of Ukraine, which is independent and has no direct connection with the Cabinet of Ministers or the Ministry of Finance.

As a consequence of the increase in the share of state-owned banks and the adoption of a new law, the levers and instruments of management of financial markets that the National Bank of Ukraine never had in previous years have crossed over to the Ministry of Finance. As a result, the banking market is actually controlled by two regulators. Moreover, the Ministry of Finance has a direct resource and administrative influence on the banking market [Drobyzko 2017].

The most problematic and controversial aspects are approaches to the selection of members for the supervisory boards of state-owned banks.

To determine the applicants for the positions of independent members of the supervisory board of state-owned bank, it is provided that the Cabinet of Ministers of Ukraine sets up a competitive commission consisting of:

- one representative from the President of Ukraine
- three representatives from the Cabinet of Ministers of Ukraine
- one representative from the Profile Committee of the Verkhovna Rada of Ukraine, subjects of which include banking issues.

Requirements to the members of the competitive commission are determined by the Cabinet of Ministers of Ukraine. Representatives of the international financial organizations may also participate in work of the competition committee with the right of an advisory vote. In the point of fact, 2/3 of the members of the supervisory boards of the state-owned banks will be determined by the competitive commission, which will consist of 3/5 representatives of the Cabinet of Ministers. The National Bank of Ukraine, which is the main regulator of banking activity and has a great experience in evaluating the professional suitability of applicants for key positions in banking institutions, does not accept participation in work of the competitive commission in accordance with the reforms. Other stakeholders, including self-regulating bank organizations, are also divested of influence.

In our opinion, the full centralization of dominant functions in the Cabinet of Ministers is somewhat dubious. A similar management model for state-owned banks exists in UK, but the central bank is an agent of the Ministry of Finance there. So, all functions are centralized.

Evaluating the processes of corporate governance reform in state banks in general, the main goal of which was to radically revise the principles and mechanisms of corporate management of government-owned banks and to focus business and operating models of state banks in order to achieve the highest efficiency of their activities, we noted positive aspects, as well as risks. Despite significant changes in the process of reformation, the risk of political influence on state-owned banks, although at a lower level, remains.

**Conclusions.** The article allows to make the following conclusions and generalizations. The key difference between state-owned banks is that with political influence on their decisions, state-owned banks can become an instrument for meeting the financial interests of certain political elites. In addition, in banks there may be a threat of violation of the competitive environment in the financial services market, economic
and financial inadequacy of the results of the functioning of a state bank, manipulation of the movement of credit and investment funds by the government due to excessive administrative and financial regulation of the state.

The specificity of forming corporate relations in state-owned banks requires other approaches to the formation of a corporate management system in state-owned banks - the supervisory boards, which should be aimed at providing both public interests, primarily the interests of consumers of banking services, and economic security of the state; ensuring an adequate level of transparency; balanced governmental regulation.

Although for a long period of time, statistical and legal information signaled about significant problems of the corporate management in Ukrainian state-owned banks, but the state did not take any steps to address these problems. The crisis highlighted all the problems of corporate management in Ukrainian state-owned banks - a high proportion of insider loans, which was covered by public funds, a formal approach to the work of the supervisory boards and the lack of their independence.

Public confidence in state-owned banks, problems and their enormous impact on all banks required corporate management reforms. Corporate management reforms in state-owned banks are going in the following areas: centralization of management, a new approach to the formation of the board of directors in state-owned banks, limiting the possibilities of direct intervention of the government into state-owned banks, and a higher level of transparency.

Positively evaluating a number of reform provisions and their compliance with the best international experience, we also note certain risks connected with excessive concentration of functions in the Cabinet of Ministers of Ukraine and insufficient impact of the National Bank of Ukraine.

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