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BANK CORPORATE GOVERNANCE: THE EMERGING UKRAINIAN MARKET COMPARED TO INTERNATIONAL BEST PRACTICES

Maksym V. Burlaka[*]

I. INTRODUCTION

Over the last several years Ukrainian banks have grown rapidly, reflecting the improving operating environment as well as a rise in public confidence in the banking system.[1] However, such rapid growth in the banking sector raises concerns about risk management and the corporate governance system in place. While the system can function well in times of economic prosperity, periods of economic downturn can lead to deterioration in asset quality and a systemic banking crisis. As Fitch Country Report points out, a number of significant weaknesses characterize the Ukrainian banking system, particularly low capitalization and high concentration levels.[2]

The National Bank of Ukraine ("NBU") has a dual function. It serves as the country's central bank, as well as the regulator of the banking sector. It has increasingly toughened regulatory capital requirements for banks.[3] The NBU risk-based capital standards restrict

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1. *See The Ukrainian Banking System,* Fitch Country Report, at 1 (March 16, 2004), *available at* www.fitchratings.com.

2. *Id.*

3. E.g. scheduled increases in capital requirements for Ukrainian banks began on January 1, 2006. Under NBU Regulation No. 368, local banks must hold at least € 1.4m, regional banks (for banks that carry out their activity on the territory of a specific oblast) must hold at least € 4.5m, and national banks must hold at least € 7m.

opportunities for further growth of the assets of Ukrainian banks, as do limits on the amount of loans allowed to an individual borrower. Due to these restrictions, Ukrainian banks eagerly seek new sources of capital. Large banks have already outgrown the amount of capital that their owners can contribute, thus necessitating capital additions from "outsiders." In the absence of a developed national securities market, the only possible choice for banks is to solicit foreign institutional investors. However, the participation of foreign investors in Ukrainian banks is not possible without transparency and the implementation of principles of effective corporate governance. All these factors provide banks with the incentive to change, increasing the demand for implementation of modern corporate governance principles and best practices. Nevertheless, even with strong demand for reforms and the progress that has been made in recent years with Ukrainian corporate governance, the banking sector has been very resistant to change. There is much more to do in terms of filling gaps in corporate governance practices.

II. BACKGROUND

Advancing corporate governance standards presents large cultural hurdles for managers of Ukrainian banks. Over the last ten years, their ownership structure and activities have remained relatively unchanged.[4] This can be explained by the particular ownership culture in Ukraine. Large financial industrial groups and politically influential individuals have been reluctant to loosen control over their banks which too often serve particular interests of these major shareholders. Pressure from these major shareholders makes bank managers unable to change the situation on their own; they expect regulators and legislators to be the main driving force for the development of corporate governance practices.

4. *See* International Finance Corporation (IFC), *A Survey of Corporate Governance Practices in the Ukrainian Banking Sector* 7, *available at* http://www.ifc.org/ifcext/ubcg.nsf/AttachmentsByTitle/UkraineBankingSurveyENG.pdf/$FILE/UkraineBankingSurveyENG.pdf.

A. Corporate Governance in Ukraine

1. The Soviet Legacy

Corporate governance is an extremely new concept in Ukraine. Before 1991, Ukrainian corporate law had been based primarily on a Soviet legal and economic doctrine that the state, as represented by various governmental organizations and authorities, acts as owner of the majority of large- and medium-sized enterprises in Ukraine.[5] To put it simply, there were no corporations. The state itself functioned as a huge corporation, with a nexus of ministries and departments as its management bodies. The whole notion of the principal-agent model in Soviet Ukraine had a rather perverse nature. The idea of who is the "principal" and who is an "agent" in terms of corporate governance was very vague. In the Soviet Union, control over the management was exercised by the state (i.e. various ministries and departments) through bureaucratized administrative methods.[6] The enterprises operated under the conditions of soft budget constraints and stable state order, which guaranteed them access to very cheap inputs and financial resources.[7] State banks enthusiastically extended credit to enterprises without guarantees of repayment from future income. The budget and state subsidies in various forms also provided direct financing.[8] In line with socialist traditions, enterprises fixed costs and profit in accounting reports. Any profit reflected in the documents did not provide any tangible advantage for them, and losses did not change their behavior. Managers were supposed to fulfill and over-fulfill planned targets set by the state.[9] Thus, de facto, there were no principals in the Soviet Union;

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5. *See* Oleg Batyuk, *Shareholder Rights, Equitable Treatment and the Role of the State*, The Third Meeting of the Eurasian Corporate Governance Roundtable, at 2 (Apr. 17-18, 2002), *available at* http://www.oecd.org/dataoecd/41/28/2097823.pdf.

6. *See* Steven Lee Solnick, *The Breakdown of Hierarchies in the Soviet Union and China: A Neoinstitutional Perspective*, *in* WORLD POLITICS Vol. 48, at 223-30 (Johns Hopkins Univ. Press 1996), *available at* http://muse.jhu.edu/journals/world_politics/v048/48.2solnick.html

7. *Id.*

8. *Id.*

9. *See* Kostiantyn Shkurupiy, *The Corporate Governance Environment in Ukraine and its Impact on Corporate Performance and Finance* 5, *available at*

the formal owners of state property were the "Soviet people," who had minimal influence on state policy and affairs, and thus their property.

The only actual risk for Ukrainian managers was the risk of party disciplinary and state law-enforcement actions. A complicated system of remuneration allowed top managers to receive decent salaries, high bonuses, and other privileges. At the same time, they knew what would have happened if they failed to fulfill the state plans. They would be fired and expelled from the Communist party, terminating their career path.[10] There were three types of control over the management in their work: control exercised by the appropriate ministry, the party leader, and the KGB representative.[11] In addition, there was a so-called People's Control, which was in fact another form of state control.[12] As the former Ukrainian President L. Kravchuk admitted, the overwhelming purpose of Ukraine's legal system up to the time of the break-up of the Soviet Union was to "catch and punish."[13]

In the end, the Soviet system ultimately proved its economic ineffectiveness. The Communist political elite split into two categories – the "orthodoxes" and the "pragmatists." The latter were a new generation of party elite, who were interested in using the capitalist economy to make state property their own private property. The collapse of the Soviet Union can, therefore, be viewed as a victory of the "pragmatists" over the "orthodoxes." During Soviet times, "pragmatists" adapted their work ethic: they formed a complex set of the "right instincts" which became the rules of the game for a successful career. These "instincts" included hypocrisy, law nihilism, and personal loyalty to their patron. Although they publicly pushed for democratic reforms and adopted concepts such as the free market, open competition, and economic liberty, new Ukrainian rulers only did so to the extent such change did not interrupt their de facto control over the main state assets.

After Ukraine declared independence in 1991, the system of

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http://www.oecd.org/dataoecd/6/0/1930649.pdf.

10. *Id* at 5.

11. *See* Solnick, *supra* note 6, at 215.

12. *See* David Lempert, *The Proposed Constitution of Ukraine: Continuity Under the Banner of Change*, DEMOKRATIZATSIYA: J. OF POST-SOVIET DEMOCRATIZATION, Vol. 2 No. 2 (Spring 1994), http://www.demokratizatsiya.org/Dem%20Archives/DEM%2002-02%20lempert.pdf.

13. *Id.*

governance existing with the Soviet Union radically changed through the adoption of a number of legal acts by the new Ukrainian parliament, which largely comprised of so-called "red directors."[14] The "red directors" were the former pragmatists — Communist Party and Komsomol functionaries, managers, administrators or supervisors of big enterprises, and their supporters.[15] Poorly drafted and ambiguous laws passed by the Ukrainian parliament and other levels of authority were generally characterized by broad declarations of intent, and by the absence of either conceptual coherence or specifics as to application or enforcement.[16] Subsequent processes of initial accumulation of private capital initiated the formation of financial and industrial groups in Ukraine.

All types of state control over managers ended once enterprises were privatized, and should have been replaced by private owners' control. However, under the conditions of a dispersed ownership and small packages of shares allocated free of charge, managers perceived themselves as the "only true owners of plants and factories" and did not treat their employees with packages of shares as "principals."[17] Lack of control over the corporate behavior of managers by the state or new owners led to the situation where the "red directors" managed to acquire *actual control* over the companies and started to benefit substantially from their operation.[18]

> "Red directors" were gradually becoming de facto masters (having right to dispose) of assets and profit of enterprises, launching the era of shadow economy and corruption in Ukraine. Probation of "schemes" for self-serving, self-dealing via leech firms, stripping of assets, dubious bartering, flowing of capital abroad, etc. took place at that time. Understandingly, that part of gained capital was used to corrupt government officials and as pay to criminal and semi-

14. *See* Shkurupiy, *supra* note 9, at 4.

15. *See* Andrew Wilson and Clelia Rontoyanni, *Security or Prosperity? Belorusian and Ukrainian Choices*, *in* SWORDS AND SUSTENANCE: THE ECONOMICS OF SECURITY IN BELARUS AND UKRAINE 23, 36 (Robert Legvold and Celeste A. Wallander eds., 2004).

16. *See* Daniel A. Bilak, *Prometheus Unbound or Achilles Heel?: Implications of Emerging Legal Structures in Ukraine for Foreign Investment*, Practicing Law Institute Commercial Law and Practice Course Handbook Series, at 465 (Mar. 22-23, 1993).

17. *See* Shkurupiy, *supra* note 9, at 5.

18. *Id.*

> criminal groups, which provided protection and support to businesses as well as contract enforcement.
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> Cooperative and criminal capital, stripped funds and skimmed profit of enterprises as well as grabbed budgetary resources were channeled to the statutory funds of investment companies and investment funds, trust companies, banks and newly established companies. A great deal of this capital has come in legalized form from abroad mainly from offshore zones. Not being officially formed as financial industrial groups on the basis of formal criteria they are in fact typical banking-industrial holdings. Main objectives of such amalgamations were to take control over group of enterprises or sectors of industry and their financial flows. Control has been achieved by acquisition of shares in privatization and at the secondary market, accesses to the management of the state holdings in these companies, by transfer of their accounts to affiliated banks, by acquisition of assets during the bankruptcy procedure, etc.
>
> Dubious history and their initial capital, past and present technology of work make these groups conceal any kind of information regarding them. It is extremely difficult to figure them out clearly in horizontal and vertical planes, to assess accurately their financial might, spheres of their control and all affiliated entities. Negative perception of these groups by the society could be illustrated by informal label stuck to them — clans and oligarchs. . . . As a rule very important role in these industrial and financial groups belongs to banks. Banks that are part of corporate groups own large stakes in enterprises connected with banks' principals in their activity . . . . Currently members of these financial and industrial groups practice additional issues of shares and issues of corporate bonds since in this case they have a chance to find support of other members and their bank that would guarantee underwriting for these securities.[19]

Since 1991, a system was created in Ukraine consisting of "crony capitalism" with corrupted public-serving economic and political ideals, entrenched ownership interests, and a hostile business and investment climate. New Ukrainian corporations depended heavily on an extremely close relationship between their new "owners" and state political and governmental institutions rather than on market economy principles. The relationships between these entities formed a kind of aristocratic social hierarchy influenced by self-serving friendships and family ties. Moreover, the new Ukrainian economy inherited from its Soviet past

19. *Id.* at 5, 6, 11, 12.

severe structural problems which were heightened by the lack of any regulatory regime (banking, corporate, or securities legislation) essential to the proper functioning of market institutions. The weak banking sector, a distorted tax system, bureaucracy, corruption, poor transparency and corporate governance, and uncertainty over the rule of law is a short list of problems left from the Ukrainian historical past.

2. Current law

The Law on Economic Companies,[20] adopted on September 19, 1991, is the foundation for corporate legislation in Ukraine. Although this legislative act has undergone numerous amendments, it has lost some of its regulatory functions and presently requires global reconsideration.[21] Part of the problem undoubtedly lies in the lack of a comprehensive Stock Companies Law. A draft is currently being considered by the Verkhovna Rada (Ukrainian Parliament), but this process has been ongoing for more than five years.[22] Corporate governance provisions are also found in the new Civil Code,[23] but the provisions are too general and mostly contain references to special legislation in particular areas of law. These documents lay the legal foundation for organizing and operating entrepreneurial subjects as entities regulated by private law. They also define the specific characteristics of stock companies.

According to the Ukrainian Civil Code and the Law on Economic Companies, the main bodies of corporate governance are: general

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20. *See generally* Law of Ukraine on Economic Companies, No.1576-XII (Sept. 19, 1991), *available at* http://www.brama.com/law/business1/busin_as.txt [hereinafter Law on Economic Companies] (translated as "Law of Ukraine on Business Associations").

21. Natalia Kuznetsova, *The Legal Framework of Corporate Governance in Ukraine*, at 5, *available at* http://www.oecd.org/dataoecd/6/13/1930958.pdf.

22. *See generally* Draft Law of Ukraine "On Joint Stock Companies" No. 8326 (Oct. 21, 2005), *available at* http://www.rada.gov.ua:8080/pls/zweb/webproc4_1?id=&pf3511=25852 (last visited Mar. 6, 2006). For reasons to adopt the Stock Companies Law, see Darrin Hartzler and Hugh Patton, *Why Ukraine Needs a Joint Stock Company Law*, IFC CORPORATE GOVERNANCE BULLETIN, at 2 (June 1999), *available at* http://www2.ifc.org/ukraine/ucdp/materials/bulletin/1999_04e.pdf.

23. *See generally* Civil Code of Ukraine, No. 435-IV (Jan. 16, 2003), *available at* http://www.commerciallaw.com.ua/ukr/legislative/ENGL/.

shareholders' meetings, a supervisory board, management and a revision commission.[24] The general shareholders' meeting is recognized as the supreme body of a stock company, having practically unlimited competence and authority. Ukrainian legislation determines the range of topics on which the general shareholders' meeting can decide, and the issues that cannot be delegated for consideration and resolution to other bodies of stock companies.[25] The company charter may refer additional issues to the general shareholders' meeting except for those issues stipulated by law.[26] The law mandates that all corporations with greater than fifty shareholders have a supervisory board.[27] The board represents the interests of the shareholders in the period between general shareholders' meetings.[28] Its main function is to control the activities of the executive body (management board).[29] In accordance with the company's charter, some functions, which are referred to as functions within the competence of the general shareholders' meeting, may be delegated to the board of directors. Functions which may not be delegated are a class exclusive to the competence of the general shareholders' meeting.

The management board is the executive body that governs the corporation's routine activities.[30] It handles all the issues that arise from the company's day-to-day activities, except for those that belong to the competence of the general shareholders' meeting and the supervisory board.[31] The general meeting may decide to delegate some of its

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24. *Id.* at arts. 159-61; Law on Economic Companies, *supra* note 20, at art. 41, 46, 47, 49. The "supervisory board" is the body that is elected by the shareholders to represent them and to oversee the implementation of approved policies by the full-time senior managers. The U.S. concept of "board of directors" corresponds to the concept of "supervisory board."

25. *See* Civil Code of Ukraine, *supra* note 23, at art. 159 ¶ 2; Law on Economic Companies, *supra* note 20, at art. 49 ¶¶ 5, 6.

26. *See* Civil Code of Ukraine, *supra* note 23, at art. 159 ¶ 1; Law on Economic Companies, *supra* note 20, at art. 41 ¶¶ 1, 2.

27. Law on Economic Companies, *supra* note 20, at art. 46 ¶ 3. Banks are an exception to this rule; they need to establish supervisory boards regardless of the number of shareholders. Many banks would actually fall under this exemption as they have far less than 50 shareholders. *See* IFC, *supra* note 4, at 29.

28. Law on Economic Companies, *supra* note 20, at art. 46 ¶ 1.

29. *Id.* at art. 46 ¶ 1.

30. *Id.* at art. 49 ¶ 1.

31. *Id.* at art. 49 ¶ 3.

authority to the management board.[32] As the executive body of a stock company, the management board is accountable to the supervisory board and the general shareholders' meetings, and organizes the implementation of their decisions.[33]

The management board is controlled by the revision commission, members of which are elected by the shareholders.[34] Members of the management board, supervisory board, and other officials may not be members of the revision commission.[35] Functions, competence, and organizational principles of activities for the bodies of corporate governance of the company are merely outlined in a general form in the Law on Economic Companies. As a rule, internal company by-laws detail the functions of the general shareholders' meeting, the supervisory board, management, and the revision commission. As a result, these documents are adopted in different ways within individual companies, and consequently possess local characteristics. Thus corporate governance functions contain considerable deviations.

3. Current Practices

Current Ukrainian legislation contains a number of provisions that constitute a good start in establishing effective corporate governance practices. However, the law gives preference to the legal form and ignores the substance. There are a number of loopholes that prevent giving corporate stakeholders effective protections. For example, in contrast to U.S. corporate legislation and shareholder-related legislation in other states, Ukrainian corporate law does not integrate fundamental concepts, such as fiduciary duties.[36] Due to flaws in the Ukrainian judicial system and the civil and labor laws, there are no adequate mechanisms to hold officers and directors of stock companies

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32. *Id.*

33. Civil Code of Ukraine, *supra* note 23, at art. 161 ¶ 1; Law on Economic Companies, *supra* note 20, at art. 47 ¶ 4.

34. Law on Economic Companies, *supra* note 20, at art. 49 ¶ 1.

35. *Id.* at art. 49 ¶ 2.

36. The exception constitutes the banking legislation which provides that bank managers (and directors), in carrying out their duties under the present Law, must act in the best interest of the bank and its clients, and must consider the bank's interests superior to their own. *See* Ukrainian Banking Law, *infra* note 40, at art. 43 ¶ 1.

responsible for causing harm to the company.

The gaps in the Ukrainian legislation likely occurred because of several factors: the Ukrainian stock market has not been sufficiently developed, and circulation of securities occurs in negligible volume.[37] More than two-thirds of all Ukrainian stock companies were established in the form of closed stock companies, shares of which, in accordance with Article 25 of the Law of Ukraine On Economic Companies, cannot be bought and sold in the market.[38] Stock company charters often stipulate that a shareholder who wants to sell his shares offer them to the company or other shareholders first, and then only if the company or other shareholders expressly refuse the shares, can the shareholder sell to outsiders.[39]

In addition to the above-mentioned weaknesses, the appearance of big strategic investors in the Ukrainian market forms a new need to implement corporate governance principles. International creditors often require, in addition to paying off past debts and as a condition of the loan, that corporations improve their governance structures. However, this is only done on an individual basis through private agreements, and does not affect statewide legislation.

The banking sector is actually further developed than the general business sector, insofar as the Law of Ukraine on Banks and Banking Activities ("Banking Law") contains specific provisions regarding governance and management of banks.[40] The legislation in the banking sector is nearly compliant with all relevant European Union Directives.[41] Unfortunately, due to ambiguity and internal conflicts in bank legislation provisions, banks suffer from many of the same difficulties as other types of business enterprise in Ukraine.

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37. *See* Kuznetsova, *supra* note 21, at 1.

38. *See id.*

39. *Id.*

40. *See generally* The Law of Ukraine on Banks and Banking, No. 2121-III (Dec. 7, 2000), *available at* http://www.ukremb.com/business/docs/law_on_banks_and_banking.pdf (last visited Mar. 24, 2006) [hereinafter Ukrainian Banking Law].

41. Ukrainian-European Policy and Legal Advice Center (UEPLAC), Banking Law Scoreboard Paper, (Sept. 2003).

B. International Standards of Good Corporate Governance

The issue of corporate governance continues to attract considerable attention in various national and international forums. In particular, the Organization for Economic Co-operation and Development (OECD) issued a revised version of corporate governance principles in 2004.[42] Recent events, such as the Enron and Parmalat scandals, and other noisy failures, have put corporate governance on the front pages of major newspapers.

At the same time, recent developments in corporate governance are based on a firm foundation of more than a century of studies on this issue by academics in both law and economics in the United States and other Western countries. Obviously, without this fundamental knowledge the whole idea of modern corporate governance would be hard to understand. Current Ukrainian problems in this area stem from large cultural hurdles and misunderstanding of corporate governance issues not only by managers and directors, but also by legislators, lawyers, shareholders, and the general public. Unfortunately, Ukrainians will probably never grasp these ideas without the knowledge of some fundamental concepts which form the cornerstones of modern corporate governance practices. We will, therefore, proceed with a discussion of the particular corporate governance problems in Ukrainian bank legislation after an overview of some basic topics of corporate law, a discussion of particular importance for effective corporate governance in the case of banks.

1. What is "Corporate Governance?"

Although corporate governance is considered to be a relatively new topic, corporate governance practices are well established. Governance issues arise whenever an enterprise acquires a life of its own, i.e., whenever ownership of an entity is separated from its management. A quick glance at Adam Smith's *Wealth of Nations* demonstrates that the concept of corporate governance was understood as early as the eighteenth century, even though the phrase was not in use. Smith states, "the directors of companies, being managers of other people's money

42. *See generally* OECD, *OECD Principles of Corporate Governance* (2004), *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf.

than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."[43]

The idea of corporate governance was further developed in the Berle-Means (1932) paradigm of the separation of shareholders' ownership and management's control in the corporation.[44] According to the paradigm, agency problems arise when the principal (shareholders) lacks the necessary power or information to monitor and control the agent (managers).[45] There are three types of problems that shareholders encounter when they seek to exercise their control over managers. First, small shareholders frequently lack the expertise to monitor and assess the work of managers who have a huge discretion over the flow of information. Furthermore, large costs associated with monitoring managers coupled with small investors who hold small stakes in a firm, may induce a "free-rider" problem; that is, each investor relies on others to undertake the costly process of monitoring managers, resulting in too little monitoring. Additionally, given the difficulties of acquiring information, the voting rights mechanism may not work effectively to assuage the questionable practices of management. Second, large shareholders may have a conflict of interest, which can undermine their incentives to maximize firm value. For example, large shareholders may enjoy private benefits of control that may inappropriately influence their decision-making. Third, large shareholders may themselves be part of organizations that face governance problems (such as Ukrainian financial industrial groups).

As Chancellor Allen in *Lewis v. Vogelstein* points out, in the case of shareholder ratification (as well as control) there is "*no single individual acting as principal*, but rather a class or group of divergent individuals — the class of shareholders."[46] The aggregate nature of the principal means that: (1) "decisions to affirm or ratify an act will be subject to *collective action disabilities*"[47] which occur when there are numerous voters and no one voter expects his individual ballot to be pivotal to the

43. ADAM SMITH, THE WEALTH OF NATIONS (1776).

44. Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 91, 95 (2003).

45. *Id.* (citing ADOLF A. BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (MacMillan 1932)).

46. *See* Lewis v. Vogelstein, 699 A.2d 327, 335 (Del. Ch. 1997) (emphasis added).

47. *Id.* (emphasis added).

contest, and consequently such voters lack the incentive to study the firm's affairs and vote intelligently;[48] (2) some portion of the body doing the ratifying may in fact have conflicting interests; and (3) dissenting class members may be able to "assert more or less convincingly that the 'will' of the principal is wrong, or even corrupt and ought not to be binding on the class. In the case of individual ratification these issues won't arise, assuming that the principal does not suffer from multiple personality disorder."[49]

Several mechanisms work to reduce these principal-agent problems. Shareholders can create a governance system that will mitigate manager conflicts by providing for monitoring, creating incentive-based compensation where pay is tied to the success of a corporation (such as option-plans), and removing managers if they are inefficient. Additionally, the risk of corporate control via a hostile takeover also constrains management incentive to act contrary to the firm's interest. If management is inefficient, the price of the company will go down, thereby increasing the odds of a corporate takeover that could replace the current officers with better management. Thus, corporate governance mechanisms put managers' incentives on a par with those of shareholders. They displace unfit and inefficient management and penalize management teams that try to advance their own interests at shareholders' expense.[50]

2. Corporate Governance Models

The scholarly debate on corporate governance revolves around two different models of corporate governance: the Anglo-American model and the Franco-German model. The Anglo-American model takes the "shareholder primacy theory" view, which focuses on maximizing shareholder wealth. Shareholder priority is a deeply embedded (albeit implicit) value in American corporate law rather than a legal rule in any normal sense.[51] As Jonathan R. Macey and Maureen O'Hara observe,

48. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).

49. Lewis v. Vogelstein, 699 A.2d 327, 335 (Del. Ch. 1997).

50. *See* Macey & O'Hara, *supra* note 44, at 95-96.

51. WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION § 9.1.1 (2003).

"the issue of importance to corporate governance scholars [who follow the Anglo-American model] begins with the assumption that corporate governance should concern itself exclusively with the challenge of protecting equity claimants, and attempts to specify ways in which the corporation can better safeguard those interests."[52] According to the shareholders primacy rule, in the case of conflicts between shareholder wealth maximization and other company stakeholders and constituents (employees, customers, suppliers, local communities, and other groups), the interests of the stakeholders and other constituents should be ignored, unless management is legally permitted to take those other interests into account.[53] In contrast, the Franco-German approach to corporate governance puts forth the belief that corporations should protect the interests of all long-term stakeholders, at least to the same extent it protects the interests of shareholders.[54] The Anglo-American model of corporate governance also differs from the Franco-German model in its choice of preferred solutions to core problems of governance.[55] Specifically, at the heart of the Anglo-American system of corporate governance lies the idea of "market discipline," which generally means private sector monitoring by investors. Conversely, the central idea in the Franco-German governance model is the salutary role of non-shareholder constituencies, particularly banks and employees. While the differences between two models exist, there is also a common ground on which they intersect. Both models maintain that good corporate governance practices allow corporations to manage their affairs effectively and increase their value.

3. *What is a "Corporation?"*

The dominant definition of the corporation in law and economics

52. Macey & O'Hara, *supra* note 44, at 91.

53. *Id.* Many states have so-called "other constituencies" statutes permitting corporate boards' decision-making to take account of the interests of stakeholders, in addition to shareholders' interests. Although Delaware does not have such a statute, however, its case law gives boards the right to consider the effect of a hostile takeover bid on non-shareholder constituencies when taking the decision to resist the takeover. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

54. *See* J. N. Ziegler, *Corporate Governance and the Politics of Property Rights in Germany*, 28 POL. AND SOC'Y 195, 200 (2000).

55. Macey & O'Hara, *supra* note 44, at 91.

stems from the original 1937 work by Ronald Coase, *The Nature of the Firm*.[56] In his work, Coase suggested that firms exist because it is more efficient to organize complex tasks within a hierarchical organization with established authority and compensation structures, than through the market and a series of individualized contracts. Coase's successor, Professor Oliver Williamson, described the corporation as a set of transactions and cost-reducing relationships or, in Williamson's terminology, "governance structures."[57] Under this approach, the corporation is a complex web or "nexus" of contractual relationships among the various claimants to the cash flows of the enterprise.[58] The above-mentioned claimants of the "nexus of contracts" include not only corporate shareholders, but also creditors, employee-managers, local communities, suppliers, customers, and, as in the case of banks, regulators acting as protectors of depositors and lenders of last resort. Under the "nexus of contracts" approach there is not necessarily a presumption of preference for one class of claimants over another. Instead, each claimant or group of claimants deserves to receive the exact benefits of the particular bargain with the firm. Thus, issues of corporate governance could be re-characterized as problems of incomplete contracts.

Because the parties cannot anticipate every contingency, contractual arrangements of any complexity necessarily will be incomplete.[59] It follows that if parties were to rely only on these incomplete contracts there would be unbearably high monitoring costs on both sides. Rules of corporate governance, therefore, are aimed at resolving gaps left in these contractual arrangements in ways consistent with maximizing the value of the firm. In the United States, these gap filling rules are called "fiduciary duties."

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56. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA no. 386 (1937), *reprinted in* RONALD H. COASE, THE FIRM THE MARKET AND THE LAW 33 (1988).

57. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTES OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (First Free Press Books 1985).

58. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).

59. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 291 (1986).

4. Fiduciary Duties

Fiduciary duties serve as implicit standard terms in all contractual agreements that lower the cost of contracting.[60] Properly interpreted, fiduciary duties should meet the bargain the parties themselves would have reached had they been able to negotiate at a low cost.[61] Therefore, in their gap-filling role, fiduciary duties require the agents of the corporation (i.e. directors) to promote the interests of corporate stakeholders above their own. Thus, fiduciary duties are imposed on members of the board of directors of a firm who are ultimately responsible for managing and supervising the business and affairs of the corporation.[62] If fiduciary duties are breached, directors of the corporation may be held personally liable for the damages. There are two duties created by the fiduciary duty of board members: the duty of care and the duty of loyalty.

Under the duty of loyalty, directors must fully disclose their conflicts of interest and must not use their position for personal gain at the expense of the corporation (including fraudulent conduct and inappropriate self-dealing). The duty of care requires directors to act as a "reasonable prudent person" would act in the same circumstances and take corporate decisions on an informed basis.[63] The duty of care also imposes an ongoing responsibility on directors to monitor a firm's compliance with the law as well as the corporation's performance.[64] In making corporate decisions, directors are entitled to rely on information provided by the company's officers as well as outside consultants. However, this ability does not release directors from their responsibility of making independent business decisions; directors are only "entitled to good faith, not blind reliance" on experts.[65]

The "fiduciary duties" are not only a common law system concept, but also an international standard. For example, under German law,

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60. *Id.*

61. *Id.*

62. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (holding that "directors owe fiduciary duties . . . to the corporation and its shareholders").

63. *See* Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985) (stating that "a director's duty to exercise an informed business judgment is in the nature of a duty of care").

64. *See* In re Caremark, 698 A.2d 959, 971 (Del. Ch. 1996).

65. *Van Gorkom,* 488 A.2d at 881.

directors must apply the same degree of care as is normally applied by persons in responsible positions of authority who manage the finances of other persons.[66] According to the German Corporate Governance Code "[a]ll members of the supervisory board are bound by the enterprise's best interests; [n]o member of the supervisory board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself."[67] French legislation requires corporate directors to act as "bons pères de familles" ("good parents of families").[68] Under the French Commercial Code, directors must refrain from taking any action contrary to the company's best interests, and must not promote their own personal interests when acting in the company's name.[69] And finally, the OECD Principles of Corporate Governance set forth the fiduciary duties of the board of directors, stating that "board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders."[70]

5. Business Judgment Rule

In applying duty of care standards there is, however, the danger that courts may second-guess good-faith decisions made by "honest but mistaken" directors.[71] This danger "could induce a board to avoid authorizing risky investment projects to any extent," which is not in the shareholders best interest.[72] To settle this problem, over roughly the past 150 years, U.S. courts have developed the so-called "business judgment rule."[73] That rule, in effect, provides that where a director is

66. *See* The German Stock Corporation Act §93.

67. German Corporate Governance Code § 5.5.1, *available at* http://www.corporate-governance-code.de/eng/download/E_CorGov_Endfassung2005-markiert.pdf.

68. *See* French Commercial Code, *available at* http://195.83.177.9/code/index.phtml?lang=uk.

69. *See generally* French Commercial Code, *available at* http://www.legifrance.gouv.fr/html/codes_traduits/commercetextA.htm#Sub-section%202:%20Management%20and%20supervisory%20boards.

70. *See* OECD, *supra* note 42, at Principle VI(A).

71. Gagliardi v.Trifolds Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996).

72. *Id.* at 1052.

73. *See generally* S. Arsht, *The Business Judgment Rule Revisited, in*

independent and disinterested, there can be no liability for corporate loss, "unless the facts are such that no person could possibly authorize such a transaction . . . attempting in good faith to meet their [fiduciary] duty."[74] Absent fraud, illegality, or a conflict of interest, the "business judgment" of a majority of the directors "will not be disturbed if they can be attributed to any rational business purpose."[75] When the business judgment rule applies, the plaintiff carries the burden of rebutting the presumption in favor of sound business judgments by showing that the directors were not sufficiently well informed, the directors could not rationally believe that the decision was in the best interest of the shareholders, or the decision was not made in good faith. Accordingly, the business judgment rule substantially reduces the risk that directors will be held liable for simple mistakes of judgment.

At the same time, the "business judgment rule" has very limited applicability in bank supervision cases. In reviewing these cases, "courts must defer to the banking agencies' determinations" on whether actions or inactivity of bank directors were consistent with the "safe and sound" operating of a bank.[76] Under the enforcement provisions of the Federal Deposit Insurance Act, bank directors or officers may be removed from office or prohibited any further participation in the conduct of the affairs of any insured depository institution if they "committed or engaged in any act, omission, or practice which constitutes a breach of [their] fiduciary duty."[77] Furthermore, a substantial civil monetary penalty may be imposed on a director or officer if a breach of fiduciary duty: (1) was a part of a pattern of misconduct; (2) caused or is likely to cause more than a minimal loss to such depository institution; or (3) resulted in pecuniary gain or other benefit to such party.[78] In addition, the Gramm-Leach-Bliley Act (GLBA) explicitly incorporates a corporate governance perspective by requiring that a depository institution be "well managed" as a condition

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COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, 242 (William T. Allen & Reinier Kraakman eds., 2003).

74. *See Gagliardi*, 683 A.2d at 1053.

75. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

76. Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 175 (1995).

77. 12 U.S.C. §1818 (e)(1)(A)(iii).

78. 12 U.S.C. §1818 (i)(2)(b)(ii).

for engaging in expanded activities.[79]

C. Stricter Standards for Banks

1. Significance of Banks

The Basel Committee on Banking Supervision (hereinafter "Basel Committee") in 2005 issued a new edition of its guide on corporate governance in banks published in 1999.[80] The purpose of the document is to assist banks and their supervisors in the implementation and enforcement of sound corporate governance, and to offer practical guidance that is relevant to the "unique characteristics facing banking organizations."[81]

What are the characteristics of banks that make them unique? First, they are depository institutions and, much more than any other institutions, operate with "other people's money."[82] Therefore, bank directors are charged with a special public trust to safeguard depositors' wealth, and must act in a way that promotes "confidence" to the public.[83] Second, banks play a significant role in affecting the money supply and exercising a liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy.[84] Third, banks play a crucial role in the flow of capital within an

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79. 12 U.S.C. §1843 (j)(4)(B)(i).

80. *See* Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (July 2005), *available at* http://www.bis.org/publ/bcbs117.pdf; *see also* Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organizations* (Sept. 1999), *available at* http://www.bis.org/publ/bcbsc138.pdf.

81. *Id.*

82. Although it is not uncommon for typical manufacturing firms to finance themselves with more debt than equity, banks typically receive ninety percent or more of their funding from debt.

83. *See* Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, speaking at the Second Islamic Financial Services Board (IFSB) Summit 2005: The Rise and Effectiveness of Corporate Governance in the Islamic Financial Services Industry, *Basel II and Corporate Governance Issues* (May 24, 2005), *available at* http://www.bis.org/review/r050525a.pdf.

84. *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 403 (1983).

economy. They are the principal providers of capital in many parts of the world. Finally, they comprise the country's payment system. Thus, the business of banking has a number of intrinsic risks that may jeopardize the entire financial system of an economy: (a) high debt-to-equity ratios, which can make banks vulnerable to losses; (b) a possible mismatch in maturities between assets and liabilities;[85] (c) dependence on the confidence of depositors and the financial markets for securing necessary funds; and (d) the general opaqueness of the business of banking.[86]

To put it simply, the success or failure of banks has more significant external consequences than the success or failure of most other types of firms, particularly in an economy with a bank-centered financial system. Therefore, a stable and healthy banking system is critical to the long-term growth of the economy.

2. *"Moral Hazard"*

The "mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run. Bank runs are essentially a collective-action problem among depositors."[87] If, for any reason, large, unanticipated withdrawals begin at a bank, depositors as individuals may rationally conclude that they must do the same to avoid being left with nothing. This is exactly what happened during the "Orange Revolution," when imprudent statements by former political leaders combined with an unstable political system spurred public belief of the banking system's instability, which in turn led to liquidity problems for most Ukrainian banks. Government safety nets, such as deposit insurance funds, are often justified on the grounds that they solve the problem of bank runs by eliminating the incentive for any single

85. Newly developed secondary markets have mitigated to some extent the mismatch in the term structure of banks' assets and liabilities.

86. See Ross Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence* 8 (World Bank Pol'y Res., Working Paper No. 3404, Sept. 2004), *available at* http://wdsbeta.worldbank.org/external/default/WDSContentServer/IW3P/IB/2004/10/08/000012009_20041008124126/Rendered/PDF/WPS3404.pdf (stating that "informational asymmetries between insiders and outsiders in banking make it very difficult for diffuse equity and debt holders to monitor bank managers").

87. *See* Macey & O'Hara, *supra* note 44, at 97.

depositor to rush to demand repayment of his deposits.[88] Despite the positive effect of deposit insurance on preventing bank runs, the implementation of deposit insurance creates a cost of its own — it gives the shareholders and managers of insured banks[89] incentives to engage in excessive risk-taking. This effect in financial literature is whimsically called "moral hazard."[90] "Moral hazard" is particularly important in Ukraine, which has a deposit insurance program.

The transfer of risk affects behavior incentives: if bank shareholders can impose their losses onto the insurance funds, they no longer have an incentive to take precautions to avoid the harm. One is tempted to argue that the party insured here is the depositor, not the bank, and if a bank engages in exceedingly risky behavior it may go broke and shareholders will suffer loss. However, in situations where a corporation is at or near insolvency, shareholders have a strong incentive to increase risk because their losses are limited to the amount of their investment, while gains that might result from the risky behavior could be disproportionately high. This problem is heightened in the banking context because of the high debt-to-equity ratio.

Companies outside the banking industry that are close to insolvency also have an incentive to take added risks. However, non-financial firms that are in financial distress usually have significant liquidity problems. In the case of banks, the situation is different; they can continue to attract liquidity in the form of deposits protected by government insurance. Moreover, in a system in which creditors are protected against borrower default insolvency, the risk is shifted away from depositors. Accordingly, the depositors have little incentive to monitor a bank's risk-taking behavior.[91] Deposit insurance eliminates the market forces that starve non-financial firms of cash. Depositors of insured financial institutions cannot be expected to exert the proper degree of restraint on banks. This enhances the influence exerted by shareholders, whose preference is to assume high risk levels. Moral hazard not only creates a problem of excessive risk-taking by banks, but also leads to a

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88. *Id.*

89. *Id.* Federal deposit insurance technically insures the depositor, not the bank, even though we speak of "FDIC-insured banks."

90. *See* MACEY, MILLER & CARNELL, BANKING LAW AND REGULATION 247 (3d ed., Aspen 2001).

91. *See id.* at 248.

reduction in the normal levels of internal monitoring of the firm's business, "resulting in a higher incidence of bank failures due to fraud" and other duty of loyalty violations, such as self-dealing.[92]

3. Importance of Corporate Governance in Banks for Bank Supervision

Corporate governance aims to protect the interests of depositors by minimizing the flow of inconsistent information between a bank's managers, its owners and its customers. Corporate governance is normally administered and monitored by bank supervisors within an institution. Banks are held to a higher standard of prudent behavior as compared to other sectors because of the adverse incentives for high risk-taking caused by deposit insurance, a high debt-to-equity ratio, and other specific features of the banking industry. Exceptionally prudent behavior is effectuated through the implementation of strict accountability requirements within a banking institution in many countries including the Ukraine. It is therefore crucial that banks have strong corporate governance policies, especially in the Ukraine where there is not a developed securities market yet in place and banks serve as the principal intermediaries between savers and borrowers.

Sound corporate governance is key to creating an effective banking supervision system. Consequently, bank supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organization. A fundamental understanding of bank supervision is a necessity for having the appropriate levels of accountability and a system of maintaining checks and balances within a banking institution. Alan Greenspan, the former Chairman of the U.S. Federal Reserve Board affirms this important notion, stating, "[w]e need to adopt policies that promote private counterparty supervision as the first line of defense for a safe and sound banking system."[93] Simply put, sound corporate governance makes the important work of bank supervisors infinitely easier. Consequently, confidence in the corporate governance processes at the bank may enhance the supervisor's overall

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92. *See* Macey & O'Hara, *supra* note 44, at 98.

93. *See* Jonathan Charkham, *Guidance for the Directors of Banks,* at v, (World Bank 2003) *available at* http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus_2_Guidance_for_Directors/$FILE/Focus_2_Guidance_for_Directors_of_Banks.pdf.

confidence that the bank is being operated prudently,[94] which may be reflected in the intensity of supervision applied. Thus, good corporate governance and supervisory actions complement one another.

D. Ukraine Banking System

The evolution of the national banking system in Ukraine may be traced back to March 1991, following the adoption of the Law of Ukraine "On Banks and Banking" by the Ukrainian Parliament.[95] The Ukrainian banking system is a two-tiered structure consisting of the National Bank of Ukraine and commercial banks characterized by various types and forms of ownership.[96] The National Bank of Ukraine serves as both the country's central bank and bank regulator. The range of commercial banks' activities includes all traditional banking activities, as well as investments in securities.[97] Commercial banks serve an important role in this respect because in Ukraine, where alternative sources of capital, such as corporate bond offerings or developed equity markets, are in the infancy stages of development, banks are the principal providers of capital.

1. Banking Sector Growth

The Ukrainian banking sector has experienced rapid growth in recent years. According to the National Bank of Ukraine (NBU), net wealth (total assets not including formed reserves) of the Ukrainian banking system increased in 2005 by 59.2% to almost Hyrvnia (UAH) 214 billion ($42.8 billion), which is equivalent to 60% of the country's GDP.[98] Nevertheless, even with this impressive banking industry growth, the banking sector continues to operate far below its potential, especially in comparison to its European neighbors. For instance, in

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94. *See id.* at 8 (noting the bank supervisor's interest in ensuring strong corporate governance is in place).

95. National Bank of Ukraine, Structure of the Banking System of Ukraine, http://www.bank.gov.ua/ENGL/ B_syst/index.htm.

96. *Id.*

97. *Id.*

98. UNIAN Informational Agency, http://www.unian.net/ukr/news/news-95156.html (last visited Mar. 25, 2006). Hyrvnia, or UAH, is the Ukrainian currency.

2003, the ratio of total banking assets to GDP in Ukraine was only 40%, which was 1% lower than the asset ratio in Russia, 32% lower than Hungary, 27% lower than Poland, three times lower than the Czech Republic, and seven times lower than that of the Euro-zone. A comparative analysis of the total balance ratio between Ukraine and other European countries also reveals huge disparities. The ratio of total balance capital of Ukrainian commercial banks to GDP was 5%, whereas in Russia this ratio was 6%, the Czech Republic 7%, in Hungary and Poland 8%, and in Euro-zone countries 120%.

Banking System of Ukraine in Comparison to Russia, Countries of Central and Eastern Europe and the Euro Zone

	Ukraine	**Russia**	**Hungary**	**Poland**	**Czech Rep.**	**Euro zone**
GDP per person US $	1037	3100	5150	4600	5500	26000
Total number of banking institutions	179	1329	64	64	37	7219
Total number of branches	1430	3219	1125	10509	1751	179360
Total number of banks per 1 million of population	4	9	6	2	4	24
Participation of foreigners in the capital of banks	11	5	66	69	94	—
Share of 5 biggest banks by the amount of assets, %	38	43	60	70	66	55
Assets of banking system, % GDP	40	41	72	67	121	280
Credits to private sector, % GDP	26	20	32	26	36	118
Capital of banking system, % GDP	5	6	8	8	7	120
Profits of banking system, % GDP	0.3	0.8	3.2	3.7	4,0	—

Average amount of profits per 1 bank, millions of US $	0.9	2.6	8.1	17.8	13.6	—
Amount of deposits / population, US $	127	350	2700	2400	4850	17500
Amount of deposits / able-bodied population, US $	207	704	4000	3400	7000	—

According to the NBU data available as of February 1, 2006, there were 164 licensed banks.[99] The National Bank of Ukraine has divided the Ukrainian commercial banks into four groups according to their performance data. The top twelve banks with more than UAH 3.9 billion ($780 million) of assets were classified in the first group. The second group (15 banks) consists of banks with total assets of UAH 1.8-3.9 billion ($360-780 million), the third group (29 banks) has banks with UAH 0.5-1.8 billion ($120-240 million) in assets, and the fourth group has banks with less than UAH 0.5 billion ($100 million) of assets.[100] More than 100 banks are included in the fourth category of banks, including almost 80 banks (half of all Ukrainian banks), which have less than UAH 0.3 billion ($60 million) of assets, and around 40 have less than UAH 150 million ($30 million).[101]

2. Concentration

Despite the large number of banks, a high, albeit declining, proportion of the banking sector's assets and bank transactions are concentrated in the hands of the largest Ukrainian banks. This concentration has noticeable effects on the economy. The banks in the first and second groups of the NBU classification accumulated 71.6% of the total assets of all commercial banks.[102] Moreover it is significant

99. National Bank of Ukraine, http://www.bank.gov.ua/ENGL/Bank_supervision/Results/2006/01.02.2006e.htm (last visited Mar. 25, 2006).

100. *See* National Bank of Ukraine, Resolution No. 291 from Dec. 30, 2005, *On Division of Banks into Groups*, *available at* http://www.ufs.kiev.ua/stories/showlaw.php?id=405 (last visited May 9, 2006).

101. *See id.*

102. Ihor Vlasyuk, *Own Tomatoes are Closer. How Many Banks Does Ukraine*

that the top ten banks account for 54-55% of total assets, credit portfolios, and liabilities. This allows these banks to earn almost three-fourths of all investments in securities, two-fifths of total balance capital and one-fourth of the authorized capital.[103] They have attracted more than half of the total funds of economic agents and 2/3 of the deposits of people.[104] Their earnings make up 56% of the total income of Ukrainian banks and 46% of net earnings.[105] The top five banks account for 37-39% of the total assets of all Ukrainian commercial banks.[106] A microanalysis of the banks also illustrates the huge market share of a few banking institutions. For example, Privatbank, a "private-sector bank based in Dnepropetrovsk, in southeast Ukraine, now has the largest market share (15%) of retail deposits, ahead of Oschadny Bank, the former state savings bank of the USSR."[107] Oschadny is the only bank in Ukraine to benefit from a full-scale state guarantee of retail deposits.[108] "This is very different than the situation in Russia, where the state-owned Sberbank (the former savings bank of the USSR, also with a state guarantee on retail deposits), retains a dominant position in the retail banking market" (65% market share of retail deposits).[109]

Ten Largest Ukrainian Banks by Total Assets and Equity at 1 January 2006[110]
UAH million. (UAH 1 is approximately equal to $0.2)

	Assets	Equity	Liabilities
1. Privatbank	21 664.3551 ↓	2 266.9890 ↑	19 397.3661 ↓
2. Aval	19 258.7423 ↑	1 745.5455 ↓	17 513.1968 ↑
3. Ukrsotsbank	10 762.9632 ↓	1 027.1737 ↑	9 735.7895 ↓
4. UkrSibbank	10 669.1905 ↑	947.7483 ↑	9 721.4422 ↑

Need and Where They Can Find so Much Capital?, ZERKALO NEDELI, Feb. 4, 2006, *available at* http://www.zn.kiev.ua/nn/show/583/52510/ (last visited Mar. 25, 2006).

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. Fitch Country Report, *supra* note 1, at 3.

108. *Id.*

109. *Id.*

110. Finance.ua, Bank's Financial Results Asset & Liabilities, *available at* http://tables.finance.ua/en/finres/~/1/2006/01/01/2/0 (last visited Mar. 27, 2006).

5. Ukreximbank	10 376.1141 ↑	1 067.1551 ↑	9 308.9590 ↑
6. Oschadny Bank	9 515.3150 ↑	775.5794 ↑	8 739.7356 ↑
7. Raiffeisenbank Ukraine	7 048.9884 ↑	626.5132 ↑	6 422.4752 ↑
8. Nadra Bank	5 922.4967 ↑	551.3246 ↑	5 371.1721 ↑
9. Brokbusinessbank	4 768.8315 ↑	606.1612 ↑	4 162.6703 ↑
10. Finansy Ta Kredit	4 421.7115 ↑	488.6704 ↑	3 933.0410 ↑

3. Ownership Structure of Commercial Banks

Commercial banks are formed as stock companies, limited liability companies or cooperative banks with both legal and natural persons as their owners.[111] In Ukraine there are 132 commercial banks formed as stock companies (forty-one of them as closed stock companies), and thirty-two commercial banks that were set up as limited liability companies.[112] Twenty of these banks are funded by some foreign investment (seven banks are funded completely by foreign capital).[113]

Ukrainian banks usually constitute a part of larger business groups with highly complex structures, which makes the effective supervision of banks more difficult.[114] The legal and managerial structures of Ukrainian groups differ; some groups have adopted a management style where staff members report on particular aspects of their work to a range of directors or senior managers based in other group companies.[115] In the worst case scenario, controlling persons of banking groups deliberately choose a complex structure, purposely concealing the bank in the middle of a conglomerate in order to obscure its operations or true ownership, and thereby avoid supervision of their activities.[116]

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111. *See* Ukrainian Banking Law, *supra* note 40, at arts. 6, 14.

112. National Bank of Ukraine, http://www.bank.gov.ua/ENGL/Bank_supervision/Results/2006/01.02.2006e.htm (last visited Mar. 25, 2006).

113. *Id.*

114. *See, e.g.*, Fitch Country Report, *supra* note 1, at 2; IFC, *supra* note 4, at 7; Shkurupiy, *supra* note 9, at 11, 12.

115. *Id.*

116. *Id.*

4. Deposit Insurance

In 1999, a separate deposit insurance fund ("Fund for the Guarantee of Deposits of Natural Persons") was set up by the government to provide deposit insurance for commercial banks.[117] Participation in the fund is mandatory for banks that are licensed to accept deposits. Banks contribute to the fund with an up-front payment of 1% of their statutory capital, followed by a payment of 0.25% of average retail deposits on a semiannual basis.[118] The sum of individual deposits covered by this scheme was set forth at a level not less then UAH 1200 ($240), which the Fund may increase from time to time.[119] Currently deposits are guaranteed for up to UAH 8,000 ($1,600).[120]

III. BANK CORPORATE GOVERNANCE IN UKRAINE

Recently, the International Finance Corporation (IFC) completed a *Survey of Corporate Governance Practices in the Ukrainian Banking Sector* (the "Survey").[121] The Survey summarizes certain key issues in the corporate governance of banks in Ukraine. As the Survey points out:

> Overall, the surveyed banks are in compliance with legal and regulatory requirements with regard to governing bodies, and most banks are in the process of improving their Supervisory Board and Management Board practices. Most Management Boards are staffed by qualified and experienced professionals, capable of both providing strategic guidance, and managing day-to-day operations.
>
> A significant proportion of the banks, however, do not yet fully understand the specific roles and functions of the Supervisory Board and the Management Board. In many banks there is no clear division of functions between the various governing bodies – either the Supervisory Board and the General Shareholders' Meeting have overlapping and interchangeable responsibilities, or the Supervisory Board is actively involved in controlling day-to-day operations

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117. *See generally* The Law of Ukraine on Banks and Banking, No. 2740-III (2001), *available at* http://www.ukremb.com/business/docs/law_on_banks_and_banking.pdf.

118. *Id.* at arts. 22, 23.

119. *Id.* at art. 3.

120. The Fund for Guaranteeing Deposits of Natural Persons, *available at* http://www.fg.org.ua/koninf.htm (last visited Mar. 6, 2006).

121. *See generally* IFC, *supra* note 4.

> alongside with the Management Board.
>
> Most [Ukrainian] banks have relatively concentrated ownership with Boards consisting of (or representing) major shareholders. The meetings of the Supervisory Boards thus become almost identical to a General Meeting of Shareholders and roles get confused. . . . [It is common that certain large] shareholders directly appoint members to the Supervisory and Management Boards.
>
> It is exactly this lack of clarity in the separation and formalization of duties and responsibilities that is the reason for other shortcomings and deficiencies in board practices of Ukrainian banks – inadequate board structures, weak composition and balance of membership, lack of Supervisory Board committees and independent directors, poor working methods, accountability, performance appraisal and remuneration.
>
> The Ukrainian banking system is . . . characterized by an intricately spun network of interests as well as economic and political relationships among major shareholder groups. Outsiders find it difficult to decipher this web of dependencies and to identify the real driving force behind a bank's strategy and business decisions. Transparency and the separation of ownership and management, crucial for generating trust and achieving an appropriate balance of accountability between the governing bodies of a corporation, have thus been regularly cited as a key corporate governance concern for the Ukrainian banking sector.[122]

Therefore, symptoms of current corporate governance problems in Ukrainian banks can be described simply as unclear lines of responsibility of corporate governance bodies, weak supervisory boards, and overdependence on their major shareholders. These problems are caused by ambiguous and inconsistent Ukrainian banking legislation.

Currently the main deficiencies of Ukrainian bank corporate governance legislation are:

1. Excessive shareholder authority;

2. Unclear structure and responsibilities of the bank governance bodies such as the supervisory board, management board, and revision commission;

3. Lack of supervisory board committees; and

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122. *See* IFC, *supra* note 4, at 7, 12, 30, 42.

4. Absence of requirements for the internal structure of supervisory boards.

A. Role of Shareholders

1. Current Problems

The Ukrainian Banking Law refers to the general shareholders' meeting as the "management body" of a bank.[123] Under the Banking Law, the general shareholders' meeting shall exclusively have authority on the following matters:

> (1) outline of the basic trends of bank activity and approval of reports on implementation thereof [i.e. bank strategy]; (2) introduction of changes and amendments to the bank charter; (3) change of size of bank authorized capital; (4) appointments and dismissal of the Chairmen and members of the bank Supervisory Board and Revision Commission; (5) approval of annual reports of bank activity including its subsidiaries, approval of reports and conclusions of the auditing commission and independent auditors; (6) profit distribution; and (7) termination of bank activity, appointment of a liquidator, approval of the liquidation balance sheet.[124]

According to Article 40 of the Banking Law, the management board acts on behalf of the bank and reports to the general meeting of shareholders and the supervisory board of the bank. The management board acts on the basis of a policy approved by the general meeting of shareholders or by the supervisory board of the bank.[125]

Moreover, the Ukrainian Banking Association (a powerful banking lobby in Ukraine) advocates that legislators should reinstate a provision of the Banking Law that was in effect until 2000, which gave final authority for hiring and replacing the management board to shareholders.[126] The Association argues that management boards should be protected from arbitrary dismissal by supervisory boards through a

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123. Ukrainian Banking Law, *supra* note 40, at arts. 37, 38.
124. *Id.* at art. 38.
125. *Id.* at art. 40.
126. *See* Association of Ukrainian Banks, http://www.aub.com.ua/en/.

shareholder approval procedure.[127]

2. *International Norms*

While the theory of direct shareholder control is understandable, it is not appropriate for banks. First, banking is a highly specialized business. Dispersed shareholders lack the necessary knowledge in specific issues such as the bank mission and strategy, distribution of profits, and the appointment of key executives. It is important that a body, such as the supervisory board, whose members are chosen based on their business reputation and experience, defines such issues. Second, it is not practical for the entire shareholders' meeting to evaluate strategic initiatives, and ultimately select candidates for senior management positions. It is much more efficient to place these functions in the hands of a smaller body, such as the supervisory board, which is elected to represent the shareholders and will normally be comprised of persons with business expertise who can properly define bank strategy and evaluate the suitability of prospective senior management officials. Third, if changes in the market environment (or a vacancy on a management board) occur between annual shareholders' meetings, a special shareholder meeting would need to be convened to approve respective amendments or appointments. It may be difficult to convene special meetings in sufficient time to allow the supervisory or management board to respond to pressing business matters. Finally, as the IFC Survey notes, in some Ukrainian banks where large shareholders directly appoint members of the management board and define corporate strategy, the shareholders' authority has led to misplaced loyalties and blurred lines of accountability.[128] Management board members have given priority to the interests of this large shareholders' group rather than to their responsibilities to the bank as a whole.[129]

Moreover, as we have seen in the discussion of corporate governance fundamentals, direct control by shareholders does not adequately protect the rights of all shareholders and may not enforce minority shareholders' and other constituencies' rights. In international

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127. *Id.*

128. *See* IFC, *supra* note 4, at 29.

129. *Id.*

practice, therefore, corporate governance arrangements, almost without exception, limit direct shareholder involvement. In some cases, particularly in the United States, this is facilitated by dispersed ownership, which limits direct shareholder involvement to at most periodic interference via proxy fights, hostile takeovers, or other mechanisms that seek to mobilize shareholders. Although in the European Union concentrated ownership is the norm, such centralized ownership does not translate into greater shareholder control. In a two-tier Franco-German corporate governance system, supervisory boards of non-executive directors operate semi-independently from shareholders and effectively shield management from direct shareholder involvement.[130] Moreover, in some countries (e.g. Germany) cross-holdings and pyramid structures may shield firms from shareholders.[131]

As the Annotations to the OECD Principles of Corporate Governance point out:

> Equity investors have certain property rights. For example, an equity share in a publicly traded company can be bought, sold, or transferred. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participation in general shareholder meetings and by voting.
>
> As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board.[132]

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130. *See* FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS (MIT Press 2000).

131. *See* Macey & O'Hara, *supra* note 44, at 96.

132. *See* OECD, *supra* note 42, at 32.

Therefore, the responsibility for the corporate strategy and operations of banks should be in the hands of a properly established supervisory board, and a management team that is selected, motivated and replaced by that board.

B. *Responsibilities of Bank Governance Bodies*

1. *Current Problems*

Ukrainian Banking Law prescribes a two-tier board structure with a supervisory board and a management board (board of directors)[133] with mutually exclusive membership. This formal division of functions is especially welcome in the Ukrainian banking context where very often the same person/industrial group is simultaneously a major shareholder, a director, and/or a manager.[134] Although it is prescribed in the Banking Law, the law does not clearly define the formal division of bank governance bodies' functions.

Under Article 37 of the Banking Law, bank management bodies comprise the general participants' (shareholders) meeting, the supervisory board, and the management board (board of directors) of the bank.[135] The supervisory board of the bank is elected at the general shareholders' meeting from among bank participants (shareholders) or their representatives.[136] Members of the bank supervisory board cannot be members of the management board or the bank's revision commission.[137] The supervisory board of the bank performs the following functions: (1) appoints and dismisses the chairman and members of the bank's management board; (2) controls the activity of the bank's management board; (3) appoints an external auditor; (4) sets

133. The Ukrainian Banking Law creates a certain amount of confusion in referring to full-time senior managers as a "board of directors," — the body that in many countries is elected by the shareholders to represent them and to oversee the implementation of approved policies by the full-time senior managers. The Ukrainian Banking Law in describing such a representative body uses the term "supervisory board."

134. *See* IFC, *supra* note 4, at 29.

135. Ukrainian Banking Law, *supra* note 40, at art. 37.

136. *Id.* at art. 39.

137. *Id.*

forth a procedure for revision and control over the bank's financial and economic activity; (5) makes decisions on covering losses; (6) makes decisions on the establishment, reorganization and liquidation of the bank's subsidiaries, branches, and representative offices, and approves their statutes and regulations; (7) approves the terms of compensation and incentives for management board members; (8) prepares proposals on issues to be considered at the general shareholders' meeting; and (9) exercises other authorities, delegated by the general shareholders' meeting.[138]

Article 37 also refers to the revision commission and internal audit as controlling bodies of the bank.[139] The Banking Law requires the supervisory board to "set forth the procedure for review and control over financial and economic activity of the bank,"[140] while the revision commission "exercises control over" these financial and business activities.[141] This arrangement would be understandable if the commission were a committee of the supervisory board, acting on its behalf and reporting to it. Under the Banking Law, however, the commission is appointed by, and reports to, the general meeting of the shareholders.[142] Thus, the law establishes two governance bodies that are responsible to the shareholders for the bank's financial and economic activity. Moreover, the Banking Law assigns responsibility for controlling the bank's adherence to the legal and regulatory requirements to internal audit, a body under the ongoing control of the supervisory board.[143] There is no mention in the law of the board's role in either defining a bank's corporate strategy, or operating the bank. It is thus not clear who — the supervisory board or the revision commission — is ultimately responsible for ensuring the overall safety and soundness of the bank.

The Banking Law provisions do not clearly define the roles and responsibilities of a supervisory board. Due to the law's ambiguity, Ukrainian banks struggle to define the supervisory board's proper functional role. In some banks, supervisory boards do not actively shape

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138. *Id.*
139. *Id.* at art. 37.
140. *Id.* at art. 39 ¶ 2(4).
141. *Id.* at art. 41.
142. *Id.*
143. *Id.* at art. 45 ¶ 2(2).

the bank's strategy, or exist only for compliance purposes.[144] In some cases, boards do not act as collective decision-making bodies; often board members do not fully understand their role and their authority in performing oversight and fiduciary duties to the bank and its shareholders as a whole.[145] Many Ukrainian bankers associate a seat on the supervisory board more with prestige rather than with responsibility and active stewardship.[146]

2. *International Norms*

According to the OECD's Principles of Corporate Governance,

> the [supervisory] board should fulfill certain key functions, including: reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets, and business plans; overseeing major capital expenditures, acquisitions, and divestitures; ensuring the integrity of the corporation's accounting and financial reporting systems, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.[147]

The Basel Committee views the supervisory board as the body that establishes the strategic objectives and ethical standards that will direct the ongoing activities of the bank, taking into account the interests of stakeholders.[148] The board should take the lead in establishing the "tone at the top" by approving ethical standards and corporate values for itself, senior management and other employees.[149] The board should ensure that senior management implements policies to (1) identify, (2) prevent or appropriately manage, and (3) appropriately disclose potential conflicts of interest which may arise as a result of the bank's various activities and roles (e.g. as a lender, provider of investment and ancillary services, and proprietary trader).[150] Moreover, supervisory boards

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144. *See* IFC, *supra* note 4, at 12.
145. *Id.* at 29.
146. *Id.* at 30.
147. *See* OECD, *supra* note 42, at Principle VI(D)(1), (7).
148. *See* Basel Committee on Banking Supervision (July 2005), *supra* note 80, at ¶ 16.
149. *Id.*
150. *Id.* at ¶ 18.

should clearly define the authorities and key responsibilities for themselves, as well as for senior management.[151]

The framework of the New Capital Accord (Basel II)[152] reinforces the role of the supervisory board by stressing the importance of its ability to assess the bank's risks, and to ensure that capital levels adequately reflect such risk. Pillar 2 of the Basel II Framework requires a bank's board to ensure that a sound system of oversight and control is in place and that risk management procedures are appropriate in relation to the institution's risk profile.[153] The supervisory board also needs to ensure adequate disclosure of key information under Pillar 3 so that market discipline becomes an integral part of the control framework for senior management.[154]

Therefore, under this guidance, a supervisory board should be clearly defined as a body that is ultimately accountable for ensuring that that the bank adheres to legal requirements, and that the bank is operated in a safe and sound manner.

C. Audit Committee

1. Current Problems

As was previously mentioned, the current Banking Law requires that each bank have a "revision commission," which is responsible for controlling the bank's financial and economic activity.[155] The revision commission has the following powers: (1) to control the bank's adherence to Ukrainian legislation and NBU regulations; (2) to review reports of internal and external auditors and prepare respective proposals for the general shareholders' meeting; (3) to submit proposals to the general shareholders' meeting or the bank's supervisory board on any issues within the authority of the revision commission, which concern financial safety and stability and protection of the interests of bank

151. *Id.* at ¶ 23.

152. *See generally* Basel Committee for Bank Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (June 2004) (updated Nov. 2005), *available at* http://www.bis.org/publ/bcbs107.htm.

153. *Id.*

154. *Id.*

155. Ukrainian Banking Law, *supra* note 40, at art. 41.

clients.[156] The revision commission consists of bank participants (shareholders) or their representatives elected by and accountable to shareholders.[157] Members of the revision commission may not be bank employees.[158] Shareholders do not have the right to approve the bank's financial statements without first consulting the revision commission.[159]

2. International Norms

In light of the board structure discussion,[160] such provisions are very problematic. In modern corporate governance practice, the supervisory board controls the financial and business activities of an enterprise (including banks) and ensures appropriate risk management, internal controls, and compliance with applicable laws and regulations. All of this is not done by a separate body elected by the shareholders. At the same time in virtually every Western, market-oriented country, the review of a bank's annual statement and evaluation of appropriate internal control procedures is exercised by the audit committee, which is a specialized committee of the board of directors (supervisory board) that assists the board with its oversight functions.

In some cases, audit committees are legally required. For example, under U.S. law, the Federal Deposit Insurance Act requires that each insured depository institution has an independent audit committee entirely made up of outside directors who are independent of the management of the institution, and who satisfy any specific requirements the Corporation establishes.[161] U.S. law requires that an independent audit committee review, with management and the independent public accountants, the basis for the firm's annual reports on: management responsibility for financial statements and internal controls, internal control evaluation, and the independent audit of the annual financial statements.[162]

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156. *Id.* at art. 41 ¶ 2.
157. *Id.* at art. 41 ¶ 3.
158. *Id.* at art. 41 ¶ 4.
159. *Id.* at art. 41 ¶ 7. There is no provision in the law for review of the bank's financial statements by the supervisory council.
160. *See infra* Parts IV.B.1.
161. 12 U.S.C. § 1831m (g)(1)(A).
162. *See* 12 U.S.C. § 1831m (g)(1)(B).

The Basel Committee presumes that, at a minimum, the supervisory boards of large and internationally active banks will have a specialized audit committee.[163] According to the Basel Committee, the audit committee is typically responsible for providing oversight of the bank's internal and external auditors, approving their appointment, compensation and dismissal, reviewing and approving audit scope and frequency, receiving audit reports, and ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors. To achieve sufficient objectivity and independence, this committee should be comprised of a majority of board members who are not executives of the bank.

Therefore, under these accepted international practices, the concept of the revision commission should be eliminated from the Banking Law and replaced by an audit committee, which is an independent subset of the supervisory board.

D. Board Structure

1. Current Problems

The Banking Law does not impose any requirements on the internal organization of supervisory boards, currently barely meeting internationally accepted guidelines. As the IFC Survey mentions, 50% of Ukrainian banks have only three or four board members in total, and only 30% have one or more independent directors.[164] Even then, the level of independence or the extent of influence of those directors is suspect. The absence of legislative requirements on the specialized board committees may help to explain the small size of supervisory boards.

Further, currently only 18% of the banks have any supervisory board committee.[165] It is, however, unclear whether such committees are exclusively subordinated to the supervisory board, or have dual

163. *See* Basel Committee on Banking Supervision (July 2005), *supra* note 80, at ¶ 34.

164. *See* IFC, *supra* note 4, at 12.

165. *See id.* at 12.

subordination to both boards.[166]

2. International Norms

As the Basel Committee points out, "banks should have an adequate number and appropriate composition of directors, who are capable of exercising judgment independent of the views of management or political or other outside interests."[167] Three or four board members are not sufficient for a bank to perform and function effectively. Supervisory board members should not only represent the interests of the shareholders, but also ensure that the bank is managed in such a way as to protect the bank's depositors. The IFC recommends at least seven members for companies with more than 1,000 shareholders, and at least nine members for companies with more than 10,000 shareholders. For banks, it may make more sense to base the requirements for the number of supervisory board members on the asset size of the bank instead of on the number of shareholders.

Therefore, the law should detail the internal organization of supervisory boards, and in particular, set the overall number of directors, proportion of independent directors and establish specialized board committees.

IV. PROGRAM FOR REFORM

Correcting the current corporate-governance deficiencies in Ukrainian banks is not an easy task. Reforms in the banking sector have been a slow process, mainly owing to a Ukrainian parliament comprised of representatives of the largest industrial and financial groups, many of whom are the de facto, undisclosed beneficial owners of banks. Unfortunately, many will continue to represent the Ukrainian people after the parliamentary elections of 2006. At the same time, the election of the Ukrainian President Victor Yushchenko following the "Orange Revolution" of 2004 definitely marks a turning point in Ukrainian history. His political supporters are expecting to win a "golden share" in the new Parliament and to lead Ukraine out of its corrupt, post-Soviet

166. *Id.*

167. Basel Committee on Banking Supervision (July 2005), *supra* note 80, at ¶ 30.

past and into a new and productive relationship with the international community. If their plan is successful, the reform of the banking sector is likely to quicken.

To correct current corporate governance deficiencies, the Ukrainian Parliament should amend the Banking Law to:

1) Place responsibility for corporate strategy and operations of the bank in the hands of properly established supervisory boards instead of having the direct involvement of shareholders;

2) Clearly define the role and the responsibilities of the supervisory board as a body ultimately accountable for ensuring the safety and soundness of a bank;

3) Require the establishment of an audit committee of the supervisory board of a bank, instead of a revision commission under the control of the shareholders; and

4) Set requirements for an overall number of bank directors, proportion of independent directors, and establishment of specialized committees of the board.

The NBU, in its role as the bank regulator, should also take steps to promote corporate governance reform. Up until now, the NBU's course has frequently been that of inaction. For fear of making more enemies than friends, it applies a legalistic approach that reads a statute with the hope of finding limitations upon its authority rather than power with which to act decisively.[168] To accelerate reforms, the NBU should try to actively solve statutory ambiguity and take responsibility for its interpretation of vague and inconsistent legislative provisions in a way which promotes international standards of corporate governance. It should also utilize its legislatively-mandated functions, such as its authority to issue regulations and its enforcement powers to require governance reforms in Ukrainian banks (e.g. number of bank directors, proportion of independent directors and establishment of specialized committees of the board, etc.). The NBU can also use banks' dependence on their reputations and public confidence as a tool for

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168. Although there are provisions to identify controlling persons and essential participants (more than 10% ownership) of Ukrainian banks (see the Banking Law art. 2, 34), the NBU takes no steps to investigate opaque corporate ownership structures of Ukrainian Banks. According to the NBU's own admission, it officially does not know the owners of 2/3 of Ukrainian banks. *See* Alexander Dubinskiy, *Trifle but Pleasantly,* ECONOMICHESKIE IZVESTIYA, Mar. 3, 2006, *available at* http://www.eizvestia.com/?a=article_review&id=16093530.

enforcement. It is well known that everyone who does evil hates the light. The NBU should require banks to publicly disclose their ownership and governance structures, and let the public decide whether such a bank is trustworthy. Finally, it can use not only a "stick" but also a "carrot," by supervising "well managed" banks less intensively.

Bank managers and directors seeking capital additions should also take the initiative in promoting corporate governance reforms in their banks. They should reorganize their banks' governance and ownership structures in a clear and understandable way, enlarge their supervisory boards, and create specialized board committees and adequate internal control systems. International organizations, such as USAID, the World Bank and the IMF should also promote international corporate governance best practices.

These reforms have the potential to correct the current corporate governance deficiencies in Ukraine, ensure a healthy banking sector and the safety of assets entrusted to banks, and promote democracy.

V. CONCLUSION

The "Orange Revolution" at the end of 2004 clearly demonstrated a triumph for Western values in Ukraine. The battle between the people and Soviet-era power structures finished with a victory for democracy. But the victory has not automatically transformed what had been a political autocracy into a political democracy, and transitioned the Soviet form of economy into a market economy. Much remains to be accomplished to eliminate cronyism and corruption, and to achieve financial soundness and economic stability.

A sound economy is impossible without a strong banking system. In order to function properly, the Ukrainian banking system needs systemic corporate governance reform. Without sound corporate governance practices, Ukrainian banks will continue to suffer crippling shortages of capital, which will prevent the Ukrainian economy from obtaining the capital needed to produce high quality goods. Moreover, bank corporate governance reform could serve as the model for a much broader reform in the corporate sector. Corporate governance reform could increase economic efficiency and help reinforce democracy in Ukraine.

Notes & Observations