CONTRIBUTION OF BANKING SYSTEM INTO FINANCIAL STABILITY OF UKRAINE

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Abstract

The role of banking system in protecting of financial system from internal and external threats is defined; the requirements for banking system to ensure financial system stability are identified. The liaisons between banks and society are presented as agents' liaisons amid agency theory; it's conceptual and methodological apparatus. Different alternatives for reconciliation of banks' commercial interests and socio-economic interests in ensuring financial stability are considered: development of required regulatory policy; incentives for banks to deal with threats within financial stability; development of specific qualities of banking system to facilitate financial system protection; extend influence of banks on financial stability. Institutional, legal and organization potential of banking system of Ukraine and institutional abilities of National Bank of Ukraine to maintain financial stability of state are analyzed.

Keywords: banking system, financial stability, agency dilemma, stable banking system, prices stability.

JEL Classification Codes: E52; E58

Introduction

Banking activity is closely connected with different areas of social life and affects fiscal system, monetary system, stocks, currencies and insurance markets. During last decade widening of

financial intermediation has taken place, hence, enforcing banks influence on economy. This influence may be both constructive and destructive. Therefore, theoretical justification of banking system essential qualities, that will foster successful realization of socio-economic interests in financial field, has gained great importance. Banks fulfill a number of social (i.e., transformative function, money issue and monetary system regulation, intermediation in transactions etc.) and specific functions (i.e., act as strategic institutions, which affect financial system stability and determine financial system security). Hence, appropriate qualities and structural organization of banking system are essential for efficient execution of named above functions. But at the same time, these qualities are not imminent; they are developed through enhancement of regulative background for banking activities, development of compliance control system, and implementation of new approaches to financial stability maintaining. Fixing of specific banks' functions by law means that society recognizes special role of banks not only in providing financial intermediation services, but also admits it's potential to facilitate financial stability upholding.

While banking activity is considered to be set, the involvement of banking system into financial stability safeguarding is yet to be recognized by society. Because of that it is important to identify appropriate motivation for banks to contribute into financial stability maintenance even though it goes crosswise with their commercial interests. Although it is important to build appropriate comprehension of banks' ability to contribute into financial stability provision in state and develop requirements for qualities of banking system in this regard. That will facilitate creation of efficient defense system in order protection financial stability from internal and external shocks.

The approach described above allows considering liaisons between banks and society as that having features of agents' liaisons and could be analyzed by employment of conceptual and methodological apparatus of agency theory.

Agency theory was a result of research of problem in distribution of risk in relations between individuals and groups in 1960s -1970s. Pioneers in development of this theory were Armen Alchian and Harold Demsetz [1972: 777-795], Michael C. Jensen and William H. Meckling [1976: 305-360]. Starting from 1980s new round of this theory development has begun and demonstrating deviation in two directions: theory of positivism and principal-agent theory.

The explorers of positivism studied relationships between principal and agent in terms of corporate governance, considering interests of abovementioned parties usually diverge. The positivism was developed in studies of Kathleen Eisenhardt [1985: 134; 1989: 57] and Joseph Stiglitz [1987: 966-971]. In 2001 a group of American scientists - Joseph Stiglitz, Michael Spence and George Akerlof – were granted with Nobel Prize in Economics for research in area of markets in conditions of asymmetric information, with principles of agency theory as a core idea of research [The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel; 2001].

The second direction of agency theory supposes study of agency relationships in generalized manner and in different areas of economic liaisons. Material contribution into development of this direction was made by Ray Rees [1985: 3-26]. The starting point in principal-agent theory was assumption that agents' relationships appear on background of balance in their interests and risk perception by participants. With that in some cases conflict of interests between principal and agent may occur given that their goals are different. Agent is interested in minimization of costs connected with risk, while principal wants to be sure that agent fulfills contract terms duly, and also minimizes costs of risk. This principal-agent problem, also known as "agency dilemma", can be decomposed into two parts: problem of development of mutually beneficial relationships and problem of risk redistribution among parties.

Considering special status of banks as financial agents, society and state face essential challenge to match banks' commercial interests with social interests with regard to financial stability provision. On one hand, to solve this problem it is important for banking system to have a number of features that will enable them to facilitate financial stability protection from threats and will increase their weight in financial system. On the other hand, development of regulative background and incentives for banks to stimulate them offset financial threats, is also of great importance.

Let's pay attention to first option in solving agency dilemma – implementation of targeted qualities of banking system, which would help to protect financial system from adverse pressure. Based on analysis of quantitative parameters of banking system (see table 1.1) we can conclude that banking system of Ukraine has so far reached stable development stage in terms of its participants: the number of banks in Ukraine remains stable during last several years.

Banking system of Ukraine became attractive for foreign investors, what is proven by presence of foreign banks and their rep offices in Ukraine. As of April 1, 2012 there were 176 banks (JSCs) with

NBU license, including 53 banks with foreign capital and 22 banks with 100% foreign capital (Key performance indicators of banks in Ukraine, March 2012).

Table 1.1:Banking system of Ukraine: structure development in 2005–2011

Parameter	2005	2006	2007	2008	2009	2010	2011
Number of banks (e.o.p.)	186	193	198	198	197	194	198
Including							
registered during the period	5	13	6	7	5	3	4
Number of banks, that have license for providing banking activity (e.o.p.)	165	170	175	184	182	176	176
including banks with foreign capital, %	14	21	27	29	28	31	30
including banks with 100% foreign capital, %	5	8	10	9	10	11	13
Number of banks excluded from Register (during the period)	1	6	1	7	6	6	0
Including							
due to reorganization	0	2	1	1	0	2	0
due to liquidation	1	4	0	6	6	4	0

(Source: estimations based on National Bank of Ukraine Bulletin)

Banking system of Ukraine is the major element of financial system and account for 70% of its total assets. Banks' assets and liabilities grew by UAH 810,1bln and UAH 687,9bln respectively during 2005-2011 (see table 1.2). During the same period banks' equity increased only by UAH 123bln and accounted for 11% of GDP.

Equity-to-assets ratio during aforementioned period hasn't changed materially and on average amounted 0,15.

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Table 1.2: Dynamics of financial indicators of banking activity in Ukraine in 2005-2011

Indicator	2005	2006	2007	2008	2009	2010	2011
Equity, % GDP	4,2	4,8	6,0	7,4	13,3	11,7	10,8
Assets, % GDP	30,5	39,0	47,2	63,1	101,5	82,3	71,8
Liabilities, % GDP	26,2	34,2	41,2	55,7	88,2	70,6	61,1
Net profit/loss, % GDP	0,3	0,4	0,6	0,7	0,8	-2,9	-1,0
Equity-to-Assets Ratio	0,16	0,14	0,15	0,13	0,15	0,17	0,18
Regulatory capital to risk-weighted assets ratio, %	15,0	14,2	13,9	14,0	18,1	20,8	18,9
NPLs net of provision to capital ratio, %	326,0	352,4	313,8	9,2	32,0	29,2	25,8
Liquid assets to total assets ratio, %	18,0	14,3	11,6	9,4	11,5	10,2	10,6
NPLs to total loans ratio, %	58,0	59,8	48,1	3,9	13,7	15,3	14,7

ROA, %	1,3	1,3	1,2	0,9	4,4	-1,4	-0,7
ROE, %	10,4	11,4	10,5	7,3	-32,3	-9,7	-5,0
Interest margin to gross income ratio, %	48,4	54,5	60,8	53,0	61,1	61,9	63,1

Source: estimations based on National Bank of Ukraine Bulletin; Preliminary results of banking activity (NBU, March 2012); Financial Soundness Indicator (IMF, July 2012)

Comparative analysis of financial indicators of banking system performance in Ukraine and in number of other Emerging Markets countries (based on IMF methodology) is presented at chart 1.

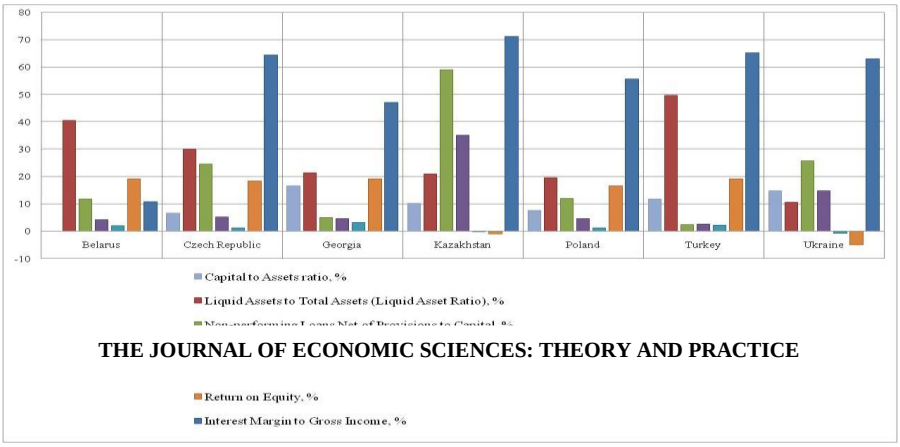


Chart 1 – Financial indicators performance in Emerging Markets countries as of end-4Q 2011 (Source: estimated based on Preliminary results of banking activity (NBU, March 2012); Financial Soundness Indicator (IMF, July 2012))

Compared to other countries, banks in Ukraine:

- have sufficient assets liquidity, while NPLs volume is higher than in other countries;
- the most part of banks' income arrives from interest margin, what is common practice for emerging markets;
- ROA and ROE are extremely low;
- capital adequacy ratio is met, hence banks are able to pay off in time all of their obligations accumulated as a result of credits, trade and other operations;
- regulative capital to risk-weighted assets ratio in Ukraine is in line with average value among peer countries, that proves appropriate distribution of risk between banks' owners and creditors and compliance with international standards of bank supervision.

Hence, in terms of quality and efficiency of assets, banking system of Ukraine is in line with other peer emerging markets countries. Although lack of assets liquidity, significant volumes of NPLs, low capitalization of banking system, and high susceptibility to business environment testify high systemic risks of national banking system.

One of the most important parameters of each banking system is its efficiency, which is identified by quality of key banks functions performance. In particular, one of these key functions is ability of banking system to manage financial risks through identification of sources of this risks and their elimination.

One of the possible sources of financial risk for bank is misbalance in its assets and liabilities. Correspondence of assets and liabilities in terms f maturity, currencies and structure defines liquidity risk, interest risk, and currency risk exposure for bank.

The core financial means sources for banks are considered to be deposits of individuals and corporations, resources of central bank, loans attracted from other banks, bonds etc. Loans have proven to be most profitable source for banks. The results of Ukrainian banks' deposits and loans concurrency analysis are demonstrated in table 1.3. Considering high uncertainty regarding tenure, call deposits weren't included in total deposits volume.

Table 1.3: Tenure of loans and deposits

Indicator	2005	2006	2007	2008	2009	2010	2011
Deposits, UAH bln	134,8	185,9	283,9	359,7	335,0	416,7	491,8
< 1 year	j	1/4	1/4	1/4	2/4	1/4	1/4
> 1 year	2/4	2/4	2/4	2/4	1/4	1/4	1/4
Loans, UAH bln	143,4	245,2	426,9	734,0	723,3	732,8	732,8
< 1 year	2/4	1/4	1/4	1/4	1/4	1/4	2/4
> 1 year	2/4	3/4	3/4	3/4	3/4	3/4	3/4
Deposits – Loans	-0,01	-0,1	-0,1	-0,4	-0,4	-0,3	-0,2
Deposits (< 1 year) / Loans (< 1 year)	60%	50%	46%	42%	59%	55%	52%
Deposits (>1 year) / Loans (> 1 year)	58%	51%	44%	31%	16%	27%	32%

Source: estimations based on National Bank of Ukraine Bulletin

During 2005-2011 tendency of deposits and loans volumes growth is observed. Simultaneously share of deposits with tenure over than 1 year decreases and starting from 2010 shares of deposits with tenure over and less than 1 year were equal. For extended period from 2006 to 2010 share of loans with tenure less than 1 year remains stable. Starting from 2011banks has boosted volumes of loans with tenure less than 1 year, reaching their level as of 2005. But deposits volume with tenure less than 1 year

account for approximately a half of loans volume with same tenure. And deposits volume with tenure over 1 year accounts for one third of loans volume with same maturity.

Therefore, we can conclude that currently imbalance in banks' assets and liabilities is observed, enforcing liquidity risk and interest rate risk. Hence, banking system of Ukraine fulfils funds transformation functions inefficiently and by itself imposes risk for financial stability.

To evaluate resistance of national banking system to currency risk we have analyzed structure of assets and liabilities in terms of currencies (table 1.4).

Table 1.4: Loans and deposits in terms of currencies, UAH bln.

Indicator	2005	2006	2007	2008	2009	2010	2011
Deposits							
share of national currency	3/4	2/4	3/4	2/4	2/4	2/4	2/4
share of foreign currency	1/4	2/4	1/4	2/4	2/4	2/4	2/4
Loans							
share of national currency	2/4	2/4	2/4	2/4	2/4	2/4	3/4
share of foreign currency	2/4	2/4	2/4	2/4	2/4	2/4	2/4
Deposits in national currency / Loans in national currency	108%	93%	90%	67%	49%	61%	59%
Deposits foreign currency / Loans in foreign currency	76%	58%	43%	36%	44%	53%	65%

Source: estimated based on National Bank of Ukraine Bulletin

As can be seen from table, the volumes of deposits and loans increase gradually, while banks attract deposits and place loans almost evenly in national and foreign currencies. But starting from 2011 the share of national currency denominated loans increased as a result of administrative limits applied with regard to loans denominated in foreign currencies. Most rapid decline in deposit to loans ratio in national currency has taken place in 2009. The same dynamics with one year lag was observed and for deposits to loans ration in foreign currency. That can be explained banks' attempts to gain arbitrage income in conditions of exchange rate growth, what is consistent from point of view of income growth, but at the same time – exacerbates systemic financial risks due to exchange rate fluctuation. Preservation of exchange rate fluctuations in acceptable limits fall short to justify expectations of banks to gain extra profit, what is proved by deposits-to-loans ratio stabilization.

Now let us analyze deposits and loans breakdown from point of view of credit risk sources (table 1.5). As demonstrated in table, enterprises (financial corporations) and individuals are the major funds providers for banks and major borrowers.

Starting from 2008 the households' deposits accounted for more than 60% of total deposits. But households are more susceptible to changes in income, prices fluctuations and are limited in savings diversification. Also inflationary expectations affect saver's behavior. Because of that deposits of households are accompanied by possible deposits withdrawal and moral hazard (unpredictable changes in savers' behavior). For example, in 2008 abovementioned risks has realized during the financial crisis: the panics among households caused massive deposits withdrawal.

Table 1.5: Loans and deposits in terms of clients sectors

Indicator	2005	2006	2007	2008	2009	2010	2011
Deposits							
share of non-financial corporations	38%	35%	34%	33%	28%	28%	31%
share of households	55%	59%	59%	61%	64%	66%	63%
share of other financial corporations	5%	5%	5%	5%	5%	5%	4%
other	2%	1%	2%	1%	3%	2%	1%
Loans							
share of non-financial corporations	74%	65%	61%	60%	64%	68%	72%
share of households	25%	33%	38%	38%	33%	29%	25%
share of other financial corporations	1%	1%	1%	1%	2%	2%	2%
other	0,02%	0,01%	0,02%	0,01%	0,80%	1,21%	1,07%
Deposits growth rates		16%	21%	12%	-4%	11%	8%
non-financial corporations		13%	19%	11%	-11%	10%	14%
households		19%	21%	13%	-1%	12%	6%
other financial corporations		18%	27%	11%	-11%	10%	7%
other		-3%	36%	-13%	41%	-24%	0,1%
Loans growth rates		26%	27%	26%	-1%	1%	4%
non-financial corporations		20%	24%	26%	2%	4%	7%
households		39%	32%	27%	-8%	-7%	-2%
other financial corporations		24%	38%	25%	18%	-2%	10%
other		10%	45%	3%	97%	21%	-2%

Source: estimations based on National Bank of Ukraine Bulletin

Today growth of NPLs volumes (loans placed by banks for individuals and corporations that are not serviced duly) remain an important problem for developed countries and also for emerging markets. In table 1.6 IMF data regarding share of NPLs in total loans volumes is described. Ukraine has the highest ratio among CIS countries and one of the highest – among other countries (table 1.6).

Table 1.6 – Share of NPLs in total banks' loans volume (%)

Country	2007	2008	2009	2010	2011
Lithuania	1,0	4,6	19,3	19,7	19,1
Ukraine	3,0	3,9	13,7	15,3	15,4
Moldova	3,7	5,2	16,4	13,3	10,7
Poland	5,2	4,5	8,0	8,8	8,4
Russia	2,5	3,8	9,5	8,2	8,0
Turkey	3,6	3,8	5,6	3,8	3,1
Belarus	1,9	1,7	4,2	3,5	3,1

Source: estimated based on Regional Economic Outlook (IMF, October 2012)

NPLs volumes growth during last several years is a result of financial and economic crisis in Ukraine. The sharp growth of NPLs in Ukraine has begun in 4Q 2008. The most part of loans was denominated in foreign currency, while borrowers received most part of their revenues in national currency (UAH). Hryvnia devaluation by 63% during September – December 2008 has exacerbated situation with loans servicing (Transfer of bad assets in Ukraine, IFC, 2012).

Based on NBU data, as of 01.04.2012 there were UAH 140.3bln (c. USD 17.6bln) of negatively classified loans (NPLs) or 14.3% of total loans volumes (Transfer of bad assets in Ukraine, NBU, March 2012). The most part of NPLs is generated by such industries as construction, trade, processing industry and agricultural sector. In terms of borrowers types, based n IFC data, as of 30.09.2011 the volume of overdue loans in Ukraine amounted USD 10.4bln or 10,7% of total loans, while corporations contributed USD 7.5bln and individuals – USD 2.9bln. Under IFC estimations, level of NPLs in Ukraine is expected to amount USD 40.0bln or 42% of total volume of loans (Transfer of bad assets in Ukraine, IFC, 2012).

The differences between appraisals of NPLs volumes by NBU, IMF and IFC are based on special approaches to estimations of overdue debt. IFC defines loans as ones being overdue if occur circumstances under which bank may have doubt regarding loan repayment. IMF classifies loans as bad loans in case interest and principal amount of debt are overdue for 90 days or more and there are other evidence that loan will not be serviced duly.

Today growth of NPLs in banking system has suspended. Partially this is due to banks' proactive attitude in implementation of bad assets management policy. The most widely spread instruments for bad assets management among Ukrainian banks are self-maintained management of overdue loans, transfer of bad loans to collectors on conditions of agency agreement, sale of loans portfolios to collectors and factoring companies, including ones connected with seller. Most banks use combinations of instruments: on early

stages they employ self-maintained management and use outsourcing on later stages of bad loans management. Regarding last time – tendencies for portfolio sale prevails.

Among latest instruments we would like to emphasize reassignment of individuals' loans to other individuals, bank's involvement into business of borrower, transfer of bad loans to mutual fund, repayment of loans of perspective companies by other companies in lieu of share in business (if so agreed).

As was noticed earlier, special incentives, being implemented into legislation and, particularly, banking legislation, also may facilitate arrangement of agent's and principal's interests.

Elaboration of financial stability provision issue in Ukraine has begun quite recently. More significant progress was reached in development of issue of financial security of state. Currently key principles and definitions, covenants, subjects and objects in safeguarding of financial security of state are identified by Ukrainian low (The Constitution of Ukraine, Law of Ukraine "On Principles of National Security of Ukraine", National Security Strategy of Ukraine, Military Doctrine of Ukraine, Law of Ukraine "On the Foundations of Domestic and Foreign Policy"). However, there is still no clear understanding of the concept of financial stability.

That is why the most actions of regulatory policy are mainly situational and focused on addressing the current imbalances of development, there are shortcomings in the coordination of actions of regulators, also there is no system to ensure financial stability and macro-prudential regulation. Government regulation in these matters is unclear to the public and unpredictable, adversely affecting the level of trust to regulatory policy in the financial sector.

However, interest for the problem of the financial stability development from year to year is fueled by financial disasters and their increasingly negative impact on the domestic economy. Hence, crucial requirements for the banking system and the institutional ability of regulators to ensure the smooth functioning of the financial system have occurred. Consequently, the solution of the financial stability provision issue is of great importance for Ukrainian.

Given the positive experience of Western countries in assignment of responsibilities for financial stability to the monetary authorities, we have examined activities of the National Bank of Ukraine and evaluated the effectiveness of monetary regulation in achieving financial stability.

Based on systematization and analysis of legal documents governing the status and activities of the National Bank of Ukraine, we have reasons to believe that there is no legal basis for central bank's responsibility for guaranteeing financial stability. According to the

Constitution of Ukraine the main function of the National Bank is to ensure the stability of national currency of Ukraine.

The main document, that regulates activities of the National Bank of Ukraine is the Law of Ukraine "On the National Bank of Ukraine" [Vidomosti Verkhovnoyi Rady (VVR) 1999, N29: 238], which was adopted in May 1999. The law has undergone numerous amendments and the latest ones were made in September 2012. In particular, in July 2010, the main function of the central bank was clarified, the central bank was imposed with responsible for national currency stability, price stability and stability of the banking system. By doing so National Bank of Ukraine should also encourage sustainable economic growth and promote economic policy of the government if it does not impede the achievement of the abovementioned objectives [VVR 2010, N49: 570]. Thus, financial stability ensuring is not the primary function of the National Bank of Ukraine, and can be provided only through facilitating stability in the monetary and banking areas. This institutional inconsistency undoubtedly leads to operational failure of the central bank to provide financial stability.

Ad hoc use of the instruments of monetary policy cannot effectively manage the financial stability because these tools are designed to solve different problems: stability of national currency, price stability, ensuring reliable payment system etc.

Therefore, the influence of monetary instruments is often indirect and comes into effect after long time lags. This does not rule out any conflicts between the long-term financial stability goals and current problems in the monetary field.

Turning back to the evaluation of current practices in financial stability maintenance at the level of National Bank of Ukraine, we have to admit that, in spite of the lack of institutional design, limitations in operations, there are still some elements of the financial stability maintenance policy are evidenced in Ukraine.

Monitoring and analysis are elements of the first step that aims to obtain information on the status of threats to the banking system, by using which it is planned to develop and implement regulatory measures at national and international levels.

The National Bank of Ukraine preventive measures to ensure financial stability include: analysis and monitoring of the markets, the assessment of the impact of market trends on the state of the monetary system, analysis and monitoring of capital inflows and outflows in the country, framing and analysis of indicators of financial stability, analysis of payments system, indicators of the

banking system performance, public finance and their impact on inflation and other measures. Along with this efficiency of these activities in terms of supporting financial stability is depressed by imperfect coordination both within the bank and with other state regulators.

But progress was achieved in other fields - participation in the development of the international system of financial stability. Clear allocation of responsibilities between government regulators and enforced control over the implementation of measures with respect to obligations fulfillment according to international treaties and the compliance with the requirements of technical assistance programs certainly have contributed to that. Joint preparation of Memorandums on economic and financial policies in terms of the technical assistance program "Stand-by" realization have facilitated to accurate definition of the priorities of economic policy, appropriate coordination of government activities, exchange of information on financial stability risks assessment in accordance with the adopted interdepartmental agreement. In general, the experts of the National Bank of Ukraine have accumulated years of experience working with international financial institutions, including those under the "Stand-by" and the technical assistance. Cooperation with the International Monetary Fund on exchange of statistical data in accordance with the Special Data Dissemination Standard in the General Data Dissemination System in underway (IMF, 2007).The information for IMF on the indicators of the financial stability of banking sector is prepared on quarterly basis. Data on indicators of financial stability is posted on the official website of the National Bank of Ukraine, as well as in electronic Dissemination Standards Bulletin of the International Monetary Fund on the Internet.

With technical assistance from international financial institutions, the National Bank of Ukraine has improved the legal framework and methods of monitoring and analysis of financial stability; at the beginning of 2009 stress testing of the banking system was introduced at the National Bank of Ukraine level, as well as at the banks' level on demand of NBU.

The need to ensure simultaneously stability of the national currency, price stability and the stability of the banking system, in fact, entrusts the National Bank of Ukraine with challenge of achieving three mentioned objectives at the same time in the context of stability ensuring, while the solution may cause controversy in the regulatory strategy. Such trilemma can be solved only by establishing priorities for the central bank goals. Recent changes in banking laws determine these priorities as follows: the highest priority is designated to the stability of the national currency of Ukraine, followed by the maintenance of price stability in the state, and, finally, the promotion of

the banking system stability. However, this approach does not solve the problem of operational inefficiency, but rather complicates the situation since establishing the priorities which prescribe sequence of tasks, never eliminating the problem of achieving them.

Price stability is considered to be a necessary but not sufficient condition for financial stability, since stable prices do not prevent crises, maintain the stability of the exchange rate does not mean the elimination of systemic risk, and compliance with prudential standards does not guarantee the stability of the banking system.

Establishment of the highest priority for financial stability could be the optimal solution, as this priority involves completion of all the points - the stability of the money market, the prices and the banking sector. In such a case significant expansion the central bank’s function by making appropriate changes in legislation would be required.

Given the legally defined trinity of purposes of National Bank of Ukraine, we analyze its operational capacity to provide stability in each of the three areas.

1. National currency stability.

The transition to the flexible exchange rate regime has been repeatedly declared in the different versions of Memoranda of Understanding on technical assistance programs "stand-by". However, on practice the hryvnia exchange rate, in fact, was fixed. Long-term support of a fixed exchange rate in Ukraine has led to the accumulation of risks in the banking system. In particular, risk of a critical decline in foreign currency reserves that ensure external solvency of the state, was exacerbated. Speculative pressure on the currency has increased due to increasing banks' debt in international markets, which is used to provide loans to domestic borrowers who do not have regular income in foreign currency. The country has become more susceptible to currency crises, as well as to the double currency and banking crises.

In order to increase the flexibility of the exchange rate, the National Bank of Ukraine has introduced new instruments of currency market regulation, improved the system of macroeconomic situation and business expectations monitoring, the methodology of monetary policy, and strengthened the communication policy. Expansion of the central bank's communication with the public on the causes and dynamics of the exchange rate forecast, targets and regulatory measures had a positive impact on inflation expectations, which were intensified by exchange rate changes.

Today, the stability of the national currency is treated by specialists of the National Bank of Ukraine as support to particular dynamics of the exchange rate and preventing sudden changes in the exchange rate, while allowing minor fluctuations compliant with guidelines established by long term goals (Actions of NBU during the period of global financial crisis exacerbation, NBU, 2009). Such exchange rate dynamics need to have a positive impact on inflation dynamics, in particular, to reduce inflationary expectations, strengthen financial stability and improve external competitiveness. Also, it gradually destroys the stereotype around a fixed exchange rate, hence, expanding capacity of monetary policy.

Introduction of flexible exchange rates regime in the mechanism of financial stability can be considered as preventive measure, but creates long-terms preconditions for violations of exchange rate stability.

Other tactical measures in terms of maintaining stable exchange rate mostly have administrative and restrictive nature. The main drawback of these measures is their short effective period, after which economic agents find alternative ways to circumvent the established restrictions, or limitations have negative implications for the financial system development. Thus, the reverse side of foreign currency lending limits is the outflow of capital from the economy, the exacerbation of social discontent and increasing volumes of currency speculations.

Significant restrictions on banks' foreign currency operations, as part of anti-crisis measures, were established by the National Bank of Ukraine in the period of recession in October 2008 (NBU Decree N319). The greatest social and business response was triggered by prohibition of early deposits withdrawal by banks' clients, as well as a ban on foreign currency lending to counterparties that do not have foreign currency earnings. The moratorium on early withdrawal of deposits was introduced in Ukraine twice so far, but these actions are still a subject for debates among policy regulators. All restrictions were lifted soon after the stabilization of the banking system. However, evidenced risk of possible restrictive measures from banks' side continues to affect significantly the behavior of depositors and borrowers, and hinders the process of restoring confidence in the banking system.

2. Price stability.

The European Central Bank defines inflation targeting as acceptable monetary policy regime for emerging markets and developed countries, as it effectively promotes controlled price dynamics and

minimizes variations in the inflation forecasts from the announced inflation target (Andersson M. and Hofmann B, 2009).

Along with this, experience of various countries in introducing inflation targeting also points on the challenges faced by countries in case of shift in monetary regime. In particular, gradual reduction of the central bank's capacity to affect the monetary system in terms of additional money supply creation was noticed among the disadvantages of inflation targeting. The role of foreign currency interventions in the maintenance of price stability gradually reduces, while the risk of significant exchange rate fluctuations increases. In case there is no specific exchange rate target, the foreign currency interventions became to be limited in size to meet the needs for adjustment of the exchange rate and correspond with the potential of the central bank to maintain the required level of reserves.

One of the risks of inflation targeting is the potential expansion of exchange rate fluctuations range, and, as a consequence, increased inflation expectations. There are still feasible risks of speculative attacks against the national currency, the risk of loss of confidence in the central bank in case of failure to guide the inflation, although the reasons may be outside of the direct influence of instruments and mechanisms of monetary policy.

For a proper introduction of inflation targeting is important to carry out a number of legal, institutional and structural changes:

- To ensure the full independence of the central bank in the formulation of monetary policy based on inflation targeting;

- A certain goal should be defined for the central bank for a certain period to create appropriate conditions for the development of a set of measures and instruments to achieve the goal;

- It is reasonable to take action with respect to the development of markets and additional hedging instruments, to develop a transparent mechanism for intervention to limit the adverse exchange rate fluctuations;

- It is essential to expand analytical and predictive capability of the central bank with regard to relative assessment of the impact of monetary policy instruments on the economy;

- The communicative system of the central bank should be improved, including mechanisms mutual information exchange with other governments, banks, businesses, the public, which will contribute to a better understanding of the actions of the central bank to achieve inflation targets,

improve the quality of predictions on the dynamics of inflation expectations, will boost confidence in the banking system .

Currently, the introduction of inflation targeting in Ukraine is at the discussion stage. The main reason for delaying the implementation of inflation targeting is an insufficient degree of central bank independence.

Employing modern European methodology and experience of foreign consultants, expert group of the National Bank of Ukraine has identified priorities and proposals to minimize political influence on monetary policy. Most of them were reflected in the changes to the banking law - the Law of Ukraine "On amendments to some legislative acts of Ukraine on the National Bank of Ukraine" from 09.07.2010 № 2478-VI.

According to the latest amendments to the Law of Ukraine "On the National Bank of Ukraine", guarantees of political independence of the National Bank of Ukraine ware strengthened:

- qualification requirements for the Chairman of the National Bank of Ukraine were established; longer cadence tenure of up to 7 years was introduced in order to avoid overlapping with the term of authority of the Verkhovna Rada of Ukraine and the President of Ukraine (5 years), with the Chairman to be appointed by the Supreme Council of Ukraine by recommendation of the President of Ukraine;

- also cadence tenure of members of the Council of the National Bank of Ukraine was increased up to 7 years, with the chairman of the Council of the National Bank of Ukraine to be elected for three years;

- the criteria were defined for the Chairman of the National Bank of Ukraine to be dismissed, in particular, to avoid the influence of the President of Ukraine on the Chairman's decisions, and the ability of the Verkhovna Rada of Ukraine to dismiss the Chairman based on the President's recommendation was abolished;

- a set of clear requirements for the members of the Council of the National Bank of Ukraine were defined, including their non-membership in political parties, the absence of representative mandate or engagement as head of the authority, as well as the reasons for their appointment and termination of their powers;

- the membership of the Board of the National Bank of Ukraine was settled, as well as the qualification requirements for members of the Board, similar to those identified for the members of the Council of the National Bank of Ukraine;

- the suspense veto of the Council of the National Bank of Ukraine on the decision of Board of the National Bank of Ukraine to clarify the jurisdiction and procedure of interaction between the Council and the Board was revoked.

Also the principle of non-interference of public authorities and other public bodies or their officials and officers, and other legal entities and individuals in the functions and powers of the National Bank of Ukraine, the Council and the Board of the National Bank of Ukraine or employees of the National Bank of Ukraine is clearly stated in banking law.

Additional operational capacity of monetary policy of the central bank was reinforced by established norm to prevent the practice of granting loans in national and foreign currencies, both directly and indirectly through a government agency, other entity whose property is owned by the state, to finance expenditures of the State Budget of Ukraine. Moreover central bank is prohibited to buy in the primary market securities issued by the Cabinet of Ministers of Ukraine, government agencies, other legal entity, whose property is owned by the state.

Along with this the half of net profits for distribution is transferred by the National Bank of Ukraine to the State Budget of Ukraine. Such a transfer of funds is basically a money issue by the central bank to cover the budget expenditures with all the negative consequences for the economy.

However no support was found by legal initiative to provide the National Bank of Ukraine's with permission to use its own macroeconomic estimates and forecasts for decision-making in monetary policy, including the development of the basic principles for monetary policy. According to the new wording of the corresponding law, in the development of the Basic Principles on the monetary policy by the National Bank of Ukraine macroeconomic indicators calculated the Cabinet of Ministers of Ukraine are used.

3. Stability of the banking system.

Today there is no sole authority in Ukraine to development a common policy for the financial sector. According to Article 21 of the Law of Ukraine "On Financial Services and State Regulation of Financial Services", state regulation of financial services is conducted: for the market of banking services – by the National Bank of Ukraine, for the markets of securities and derivative instruments - National Commission on Securities and Stock Market, relatively to other markets of financial services - by the National Commissions, exercising the state regulation in the field of Financial Services markets (Official Bulletin of Ukraine, 2001, N 32: 1457).

Most acceptable case for Ukraine would be the introduction of the two separate regulatory and supervisory authorities - the Financial Services Authority under the central bank and financial market regulator. Abovementioned regulation model is also known as the «twin peaks» model and is widely used in the international practice for its distinctive advantages over other models:

- responsibilities for policy development between are assigned the regulators of the financial sector;

- the risks of the introduction of new approaches into regulation and supervision are reduced;

- the protection of interests of the investors and consumers of financial services is enforced;

- the consolidated supervision over financial institutions and macro-prudential supervision are introduced;

- a single database of financial institutions is used, reporting is simplified and unified;

- approaches to the regulation and supervision of financial institutions are standardized;

- the opportunities for the professional development of the employees of regulators and financial institutions are expanded.

At the same time, the implementation of the Western experience to ensure the financial stability should be balanced – one should understand how objectively possible to introduce certain measures, how effective are certain instruments, given the existing relationship between economic entities, development of markets infrastructure and so long. Thus, the results of research on the ways banking institutions fulfill their basic functions in the economy gives grounds to consider the relationships between the banking system and the society are essentially agency relations, because of:

i) while fulfilling immanent functions, banks affect the key qualities of the financial system, which determine its stability. This enables to define banking institutions as systemically important institutions whose activities affect the stability of the financial system;

ii) realization by the banking system of its functions requires an appropriate legal mechanism (legal framework for banking activities, control and supervision systems, compliance with regulatory requirements, etc.). In this case the functions are "delegated" by society to the banking system.

In fact, society delegates to the banking system right to act as an agent not only in providing efficient financial intermediation, but also in financial security issues settlement.

Solution for reconciliation of commercial interests of banks with social and economic interests in the context of financial stability providing is offered in two levels: development of necessary regulatory policy and incentives for banks to make them influence the threat in the financial system, and the formation of the special features of the banking system that will help to protect the financial system from threats and to increase the influence of banks on the financial stability.

Conclusion

Based to the analysis of the availability and quality of incentives at the level of the general and the banking legislation of Ukraine, which could help to harmonize the interests of principal and agent in the field of financial stability, it follows that:

- Ukrainian law has no systematic approach for understanding of financial stability and the legal basis for the organization of the financial safety net, coordination of actions of regulators and macro prudential regulation;

- measures to ensure financial stability are mainly situational and are focused on addressing the current imbalances;

- state regulation is not transparent for the public and unpredictable, which negatively affects the level of confidence in the regulatory policy of in the financial sector.

In the context of the second direction of solving the "agency dilemma," according to the analysis of quantitative and qualitative parameters of banking activities, the presence of imbalances in the banking system of Ukraine that potential could be sources of risks, was confirmed: assets-liabilities mismatch by terms, currencies and structure determines liquidity risk, interest rate risk, currency risk, low liquidity of assets, the abundance of non-performing loans in total loans volume, inadequate capitalization of the banking system.

Structural and institutional weaknesses of the banking system led to the accumulation of systemic risk and structural inconsistencies in the Ukrainian economy, and require the development of an integrative assessment of financial stability, which takes into account the specific structure of the financial sector of Ukraine, the interconnectedness of its sectors, the nature of systemic risk. It is also necessary introduce new approaches of regulation.

Analysis of the current system of financial regulation in Ukraine shows a lack of appropriate institutional, legal and organizational conditions for financial stability maintenance.

Comparative analysis of the developed countries experience and domestic practice of creation financial stability securing system allows us to define the following priority of reforming of the current regulatory system:

- extension of the mandate of the National Bank of Ukraine on ensuring financial stability;

- development of the institution for coordination and interaction of financial regulators;

- arrangement of micro-prudential supervision at the level of individual banks and the macro prudential supervision at the level of the whole system;

- implementation and use of international approaches to the analysis of financial stability in Ukraine;

- improving of system's resistance to information and psychological influences that threaten the stability of financial markets, the focus on the formation of appropriate expectations regarding the performance of financial markets by developing of communication policy.

- to attract public attention to the discussion of current issues of financial stability, which is an instrument to prevent financial instability;

- increase of the financial literacy of the population, which will lead to a new level of understanding of modern financial processes.

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