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Peculiarities of Formation and Regulation of Financial Conglomerates in Ukraine

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Abstract. Structural changes in the economy of Ukraine are causing changes in the financial services, which are becoming more diverse and complex. With the development of financial intermediaries their structure has modified from individual companies that operate in a specific segment of the financial market to integrated financial intermediaries – conglomerates. Although considerable amount of research has been devoted to the origin, development and functioning of financial conglomerates and their role on the global financial markets, little attention has been paid to the features of the organisational forms of financial conglomerates, as well as the specifics of regulation and supervision of their activities in Ukraine. So in the article the legal forms in which financial conglomerates can function in Ukraine are defined. Positive and negative traits of functioning of financial conglomerates are discussed. It is proved that banks occupy the leading position in the system of financial intermediaries and that determines their leading role in the financial integration and financial convergence.

Keywords: financial intermediary, financial conglomerate, financial integration, financial convergence.

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Особливості формування і регулювання фінансових конгломератів в Україні

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Анотація. Розглянуто особливості створення і регулювання фінансових конгломератів в Україні. Визначено організаційно-правові форми, в яких можуть функціонувати фінансові конгломерати в Україні відповідно до національного законодавства. Виявлено позитивні і негативні аспекти щодо функціонування фінансових конгломератів як інтегрованих фінансових посередників. Доведено, що провідне становище в системі фінансових посередників посідають банки, а це визначає їх лідируючу роль у процесах фінансової інтеграції та фінансової конвергенції.

Ключові слова: фінансовий посередник, фінансовий конгломерат, фінансова інтеграція, фінансова конвергенція.

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Особенности формирования и регулирования финансовых конгломератов в Украине

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Аннотация. Рассмотрены особенности создания и регулирования финансовых конгломератов в Украине. Определены организационно-правовые формы, в которых могут функционировать финансовые конгломераты в Украине в соответствии с национальным законодательством. Выявлены положительные и отрицательные аспекты функционирования финансовых конгломератов как интегрированных финансовых посредников. Доказано, что ведущее положение в системе финансовых посредников занимают банки, что определяет их лидирующую роль в процессах финансовой интеграции и финансовой конвергенции.

Ключевые слова: финансовый посредник, финансовый конгломерат, финансовая интеграция, финансовая конвергенция.

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Formulation of the problem. Structural changes in the economy of Ukraine are causing changes in the financial services, which are becoming more diverse and complex. With the development of financial intermediaries we can see the modification of their structure from individual companies that operate in a specific segment of the financial market to integrated financial intermediaries – conglomerates. In the late 70s of the 20th century, there appeared a situation on the global financial market that created favorable conditions for the alignment of banking and insurance businesses. Financial institutions were operating in conditions of easing state control, reforms in the financial sector, increased competition and rapid development of information technology. This was one of the reasons for the convergence and unification of banking and insurance businesses and these trends were characteristic of all developed countries.

Analysis of recent research and publications. The features of the origin and development of financial conglomerates and their role on the global financial markets were considered in the works by R. Levine, L. Laeven, H. Jackson, Y. Evlakhova. The functioning of financial conglomerates and their impact on the development of domestic financial markets were studied by V. Korneev, I. Shkolnik, A. Zemlyachova, A. Seleyman and others.

The aim of the article. Existing studies do not provide a complete picture of the features of the organisational forms of financial conglomerates, as well as the specifics of regulation and supervision of their activities in Ukraine, that resulted in the need for a better understanding of these issues.

Basic material. The term «financial conglomerate» can be used for any group of institutions that have a common

property, and with their activities carried out in the financial sector. The minimal prerequisite of a financial conglomerate is that its members should include at least two institutions that represent the banking, insurance and / or investment sector.

From a larger perspective, based on the areas of financial intermediation, financial conglomerate is a market participant, whose work extends to not less than two out of five areas: loans, deposits and cash management services; insurance; corporate finance, subscription and placement of securities; asset management, investment funds services or consulting; retail investment services. According to Y. Evlakhova, the main reasons for the emergence of financial conglomerates are: the need for more diverse and sophisticated financial services; finding new ways to increase profitability; the need to adapt to economic globalisation; distribution of financial innovation; deregulation; finding new ways to attract potential clients; and the need to protect the interests of the managers [2, p. 23].

A. Zemlyachova notes that the economic conditions for creating a financial conglomerate are: cheaper services provided by each of the participants; attracting new and retaining old customers by implementing an individual approach to customer requests with minimal time and effort; image forming groups that can solve all the problems of the client; creation of new products, combining the positive characteristics of a variety of goods (services) into a single unit; reducing the risk and improving control over cash flows within the group [5, p. 87].

In Ukraine the right of the financial institutions to voluntarily merge their activities, if that does not contradict antitrust law and the requirements of the laws on the regulation of certain financial markets, is legally enforceable.



Such a merger is subject to state registration and automatically becomes a legal entity from the date of its registration.

Types of groups that can be formed by domestic business entities are named in Article 120 of the Commercial Code of Ukraine. They may be associations, corporations, trusts and consortia. However, the classification of associations of undertakings is not exhaustive, since the article provides that enterprises may associate and form unions in other forms determined by the law (unions, associations, etc.) [6].

The legal basis of the formation of integrated financial intermediaries in Ukraine is the Law of Ukraine «On Financial Services and State Regulation of Financial Markets», which according to Chapter 1, Article 16 «Association of Financial Institutions» stipulates that financial institutions have the right to voluntarily integrate their activities if they are not contrary to the law on protection of economic competition and the requirements of the laws on the regulation of certain financial markets. Legal status, types, the establishment, operation and legal regime of the termination of the association are determined in accordance with the laws of Ukraine [7].

According to Ukrainian legislation, banks may establish banking groups, be a member of the financial, banking and financial holding companies.

The law of Ukraine «On Banks and Banking» determines that a banking group is a group of entities that have a common controller. The definitions of a banking group are:

- the group consisting of the parent bank and its Ukrainian and foreign subsidiaries and / or associated companies, financial institutions;
- the group including two or more financial institutions and activities of the banking group.

Banking is considered to be the predominant activity of the group if the combined value of the banks' assets – the participants of the banking group over the past four reporting quarters is 50% or more of the total amount of the average values of the assets of all financial institutions that are part of this group for the period.

The participants of the bank association are responsible for the obligations of other participants in accordance with the agreement concluded between them.

According to Ukrainian legislation, the bank holding company is a financial holding company in which the overwhelming financial institutions that are its subsidiaries and associated companies are banking institutions. The legal status of holding companies is defined by Article 126 of the Civil Code of Ukraine and the Law of 15.03.2006 «On Holding Companies» according to which the holding company is a public company that owns, uses and disposes corporate shares of two or more corporate enterprises.

The procedure for the creation, management and termination of the holding company is regulated by the Law «On Holding Companies.» According to Article 3 of this Law, holding companies can be created in two ways:

- in the process of corporatisation and privatisation of relevant bodies (the body that is authorised to manage state property or privatisation authority) alone or together with other shareholders by

combining the authorised fund holding corporate shares;

- other subjects (not specified in the law) on a contractual basis.

It should be noted that since this law came into force in Ukraine, any holding company has not been established in accordance with its provisions because it is supposed to create the Unified State Register of holding companies that are an integral part of the Unified State Register of Legal Entities and individual entrepreneurs. Moreover, according to Chapter 4, Article 3, a holding company acquires the status of a legal entity from when it is entered into the Unified State Register of holding companies [7]. A specially authorised body on state registration provides the State Register of holding companies in Ukraine. Today the State Committee of Ukraine for Regulatory Policy and Entrepreneurship has this authority. However, maintaining the Unified State Register of holding companies of Ukraine has not been made part of the range of this Committee's powers, the order of state registration of holding companies was also not approved by The Cabinet of Ministers [6].

According to the Law «On Protection of Economic Competition», the creation of a holding company requires the prior authorisation of antitrust authorities or the Cabinet of Ministers of Ukraine.

In the Commercial Code (Chapters 5–7, Article 126) and the Law of 15.03.2006 «On Holding Companies» [4] the lawmaker avoids the concept of «a holding group». But operates the terms that denote two categories of members of a holding group: a holding company and its corporate enterprises, and defines the framework of their legal status. A holding company in this association (a holding group) is the subject of organisational and economic powers to its / corporate subsidiaries through ownership of controlling stakes in the latter.

According to the Law of Ukraine «On Amending Certain Laws of Ukraine on Consolidated Supervision» a bank holding company and the company that provides ancillary services that has the same controller as the participants of the banking group, are members of the banking group [3].

One of the positive aspects of the formation of the bank holding company is that every bank, that is a part of this entity, will be able to improve their financial situation by focusing unprofitable loans in a particular bank. An example of such a merger is when a large bank buys a small bank, with the required license and takes back a functional part of its assets and most importantly, the functioning of its liabilities, including customers. Debts and creditors remain within the old bank. In this case the bulk of the business is sound and customers won't suffer.

The next positive aspect of such an association within the banking sector is that if banks from different regions are merged within the group, it will be possible to extend the inter-relationships, turning them into an intra-group that will solve the problem of the lack of a branch network. This will help to develop new geographical markets. This also increases the financial stability of the group. But in general, this model is difficult to consider effective in solving the basic problems of the banking system, since the degree of integration and centralisation of management in it are weak.



According to Article 1 of the Law of Ukraine «On Financial Services and State Regulation of Financial Services» it is possible to create financial holding companies and banks can be members of them.

A financial holding company is a legal entity whose main activity is participation in the authorised capital of legal entities, and activities of financial institutions that are its subsidiaries and / or associated companies.

The main aim of creating a financial holding company is to gain control over the assets of enterprises of different financial sectors to improve management at a group level. This form of business organisation allows to better adapt to the changing situation in the global financial markets – the accelerated development of the financial infrastructure and the removal of restrictions on banking activities provide an opportunity to increase competitiveness by reducing costs in the consolidation of financial institutions and the universalisation of services. In addition, it is believed that with the emergence of financial holding companies the level of trust within the group is increased.

Functioning of financial conglomerates has both positive and negative traits. One of the advantages of this association is observed in the short term – improving the efficiency of the financial system. The emergence of financial conglomerates is the result of a conscious strategy for business owners, who are oriented on the growth of capitalisation based on networking, adjustment of conflict of interest with management and the use of tax benefits. The main advantage of the cooperation of financial institutions in the form of a financial conglomerate is expanding their market presence and increasing sales by reducing the cost of services and economy of administrative, marketing and technology costs.

The negative aspect is evident in the long run and is accompanied by cornering the market, which is characterised by a reduction in the number of participants or sectors, the rising cost of financial services to consumers and, ultimately, reduced competition in the financial market and reduced the effectiveness and efficiency of the financial system as a whole.

The problems that accompany the activities of conglomerates and can later cause their «death» are as follows:

- excessive diversification. This leads to the fact that the competitiveness of goods and services of a conglomerate is gradually reducing;
- suboptimisation. Though the technological similarities between the companies that make up the conglomerate are weak, the companies still try to gain intragroup cooperation relations, as manifested in the pursuit of each company to establish the most favorable price for a transfer, and as a result, the final product is expensive and uncompetitive. Therefore, the parent company faces a constant problem of solving disputes about the transfer pricing;
- motivation of managers of the companies of the conglomerate. The effectiveness of management depends on change of ownership or on conversion of their owners in the ordinary employees;
- significant funds that are required for the acquisition of the company.

The study made it possible to identify a number of risks that financial intermediaries of integrated type are dealing with. According to A. Seleyman, risks or adverse effects of conglomeration are: spatial arbitration to avoid government regulation; spreading harmful effects; moral hazard; lack of transparency; conflict of interests; abuse of economic power [8, p. 187].

In addition to the above risks specific to financial conglomerates scientists also name the following:

- the likelihood of conflict within the group on the distribution of powers and responsibilities;
- inefficient expansion of the network of branches and representative offices;
- the likelihood of a chain reaction – deteriorating financial condition of one party leads to a deterioration of the other;
- constant increase of the range of financial services makes it difficult to manage and control.

Regulators around the world consider it necessary to provide special legal status to the financial conglomerate to ensure appropriate supervision of their activities in order to manage the risk of such associations, since the risks that are characteristic of a financial conglomerate, have a different nature than the individual risk of financial institutions within the group.

In terms of mutual penetration and integration of international capital markets, economic globalisation, the rapid development of information technology, one of the most promising options for business expansion is to strengthen the system of dependence and interaction between financial intermediaries and major segments of financial markets around the world.

Characteristic features of cross-border cooperation of financial intermediaries are financial liberalisation, which extends the use of modern financial technology and integrated financial instruments.

Penetration of foreign financial conglomerates in the financial markets of other countries has both positive and negative traits. The positive points can include: accelerating the formation of financial markets in these countries; introduction of new technologies and management; development of relations with the international market and others.

The negative points are: the displacement from the national market of resident financial institutions by foreign conglomerates; the possibility of losing the economic independence of the country.

The integration of financial markets of individual countries into global financial markets leads to synchronisation of national economic cycles with the world cycles, which can be viewed as a positive development i.e. a stabilising effect on the national economy is being performed, that makes it possible to minimise the negative effects of local shocks as well as negative development – the crisis phenomenon can be imported. Thus, financial conglomerates reduce the national risks and increase the global ones.

Conclusions. From the results of the study a conclusion can be made that a financial conglomerate has not only become a new member of the financial market but a new object regulated by the authorities who are in charge of state supervision of the financial sector. The need for



such regulation is due to the specifics of the formation (integrated financial intermediary): firstly, the financial conglomerate may include financial intermediaries that are already being regulated by the state by the established rules, and secondly, can include non-financial institutions that are not subject to state regulation.

Taking into account the first feature, regulators should consider the fact that the relationship between the companies that are a part of a financial conglomerate makes it easier for risk transfer between them and as a result, companies are at risk, not inherent for their activities in the financial market.

Taking into account the second feature, regulators are denied the opportunity to pinpoint the types of risks that are inherent in the financial conglomerate, as well as to measure the degree of threat, as it includes entities whose activities are not subject to public oversight and regulation.

Therefore, experts define financial conglomerates as a new source of threat to the stability of the national financial systems, which can only be limited by the application of prudential supervision, based on a risk analysis in a financial conglomerate.

In Ukraine, the regulation of integrated financial intermediaries is not relevant nowadays because there are no financial conglomerates in the domestic financial market. It should also be noted that the Ukrainian legislation does not operate such a notion as a financial conglomerate. Only the activity of bank holding companies, banking groups, non-bank financial groups, non-bank financial holding companies and financial holding companies, which are viewed as a form of financial conglomerates, are defined and could be regulated.

Despite the existence of unifying processes and trends in the financial services market there are no financial groups that would fully correspond the signs of finan-

cial conglomerates defined in Directive 2002/87/EC in Ukraine [1]. One reason for this discrepancy is the low capitalisation of domestic banks and non-bank financial institutions and financial markets in general.

The main macroobstacles to the creation and operation of financial conglomerates in Ukraine are the differences in the implementation of business processes by banks, insurance companies and collective investment institutions; prevailing «supremacy» of banks in dealing with insurance and investment companies. In addition, inhibition of these processes is due to the fact that participants of an integrated association are not familiar with the peculiarities of the segment of the financial market of a partner.

The disadvantage, that prevents an active process of unification, is the fact that in Ukraine various financial institutions are, firstly, governed by different control bodies, banks – by the National Bank of Ukraine and the Deposit Guarantee Fund, the insurance and financial companies, private pension and investment funds – by the National Commission, acting in the regulation of financial services markets of Ukraine, professional participants of the securities market – by the National Commission on Securities and Stock Market, and secondly, there is no interaction between those authorities to develop policies for the market. International experience shows the need to move to macroregulation of financial markets, i.e. the creation of a single financial market megaregulator.

Prospects for further research. So, the current stage of development of financial markets is characterised by an enhanced process of financial integration, the emergence of new forms, modification and modernisation of existing institutional structures, that require a paradigm shift of state supervision and regulation of integrated financial intermediaries which will be the subject of subsequent scientific studies.

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