

# **NEW NON-BANK FINANCIAL SECTOR REGULATION**

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## TERMS AND ABBREVIATIONS

The following terms have the meaning attributed to them below.

<b>Consumer Lending Law</b>	Law of Ukraine "On Consumer Lending" No. 1734-VIII adopted on November 15, 2016
<b>Draft Law No. 2413-a</b>	Draft Law of Ukraine "On Amending Certain Legal Acts Regarding Consolidation of Functions on State Regulation of Financial Services Market" No. 2413-a
<b>EU</b>	European Union
<b>FSR</b>	National Commission for State Regulation of Financial Services Markets
<b>Law on Financial Services</b>	Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets" No. 2664-III adopted on July, 12 2001
<b>NBFI</b>	Non-bank financial institution
<b>National Bank</b>	National Bank of Ukraine
<b>NSSMC</b>	National Securities and Stock Market Commission of Ukraine

## INTRODUCTION

The financial system is key to the efficient functioning of a country's economy and its economic development. As the Comprehensive program for the development of Ukraine's financial sector by 2020 envisages, Ukraine intends to build a financial system that will ensure stable, sustainable economic growth through the efficient allocation of the economy's resources and capital and sound, competitive market practices. In addition, reforms of Ukraine's financial sector should be aligned with international standards.

The achievement of these objectives requires a suitable regulatory and supervisory framework. An important element of any such framework is the institutional regulatory model, i.e., whether there is one or several regulatory agencies in charge of the supervision of the financial sector, how responsibilities and functions are defined and allocated, and how they interact with each other (if there is more than one regulator).

At present, Ukraine uses the sectoral regulatory model, with the National Bank supervising the banking services market, transfer of funds activity, and currency transactions. The National Securities and Stock Market Commission (NSSMC) supervises the securities and derivatives markets, and the National Commission for State Regulation of Financial Services Markets (FSR) supervises other financial services markets. In Ukraine, the sectoral model in its present form has been in place since 2003, when the FSR was created. However, its practical application has revealed numerous disadvantages.

On July 7, 2016, the Parliament of Ukraine passed in the first reading a Draft Law of Ukraine "On Amending Certain Legal Acts Regarding Consolidation of Functions on State Regulation of Financial Services Market" No. 2413-a (Draft Law No. 2413-a), that was submitted to the Parliament by the President of Ukraine.

The Draft Law No. 2413-a that is being supported by the National Bank is designed to introduce a partially consolidated model of financial market regulation in Ukraine, whereby the entire financial sector will be regulated by two regulators. This will be achieved by assigning the functions of the FSR to the National Bank and the NSSMC.

Under the Draft Law No. 2413-a, the National Bank, in addition to banks, will regulate and supervise:

- insurance companies and insurance intermediaries;
- leasing companies and legal entities, which are not financial institutions by their legal status but have a right to render financial leasing services (legal entities-lessors);
- factoring companies;
- credit unions;
- credit history bureaus;
- pawnshops; and
- other financial companies (engaged in currency exchange, transfer of funds, lending, and guarantee issuance activity, etc.).

As of January 1, 2018, almost 2,000 financial institutions with total assets of UAH170.8 billion operated in the non-bank financial market. If one is to add the amount of the valid financial leases (UAH22.5 billion) entered into by legal entities – lessors, the total volume of the non-bank financial market to be regulated and supervised by the National Bank will be approximately UAH193.3 billion. In other words, once the Draft Law No. 2413-a is passed and the respective Law comes into effect, the National Bank will be responsible for a significant share of the non-bank financial market.

The NSSMC, in addition to securities and derivatives market participants, will regulate and supervise non-state pension funds, construction financing funds, real estate funds and their administrators/managers.

The National Bank has prepared a draft of the White Paper on the new non-bank financial market regulation and has developed a further action plan to apply once the Draft Law No. 2413-a is passed.

This draft of the White Paper presents the National Bank's vision for the new regulation for the non-bank financial market under its future mandate. It summarizes the fundamental objectives underpinning such new regulation. In particular, the National Bank believes strongly that the new model for regulation of non-bank financial institutions should strive to achieve market efficiency, transparency, and approximation to the European and international standards.

The National Bank intends to publish the White Paper in the future and share it with financial service providers, their owners, their associations, their clients, policy makers, and the general public.

This draft of the White Paper does not claim to cover the entire scope of the new non-bank financial market regulation and supervision. For example, the issues of prevention of money laundering and terrorist financing activities are not addressed, although they are very important topics for the non-bank financial sector. Similarly, issues of the future regulation for credit intermediaries operating under the Consumer Lending Law and credit history bureaus are not covered. In the future, the National Bank intends to prepare and issue additional white papers dedicated to separate segments of the non-bank financial market. Such white papers will focus in more detail on objectives and challenges of the regulation and supervision of particular market segments.

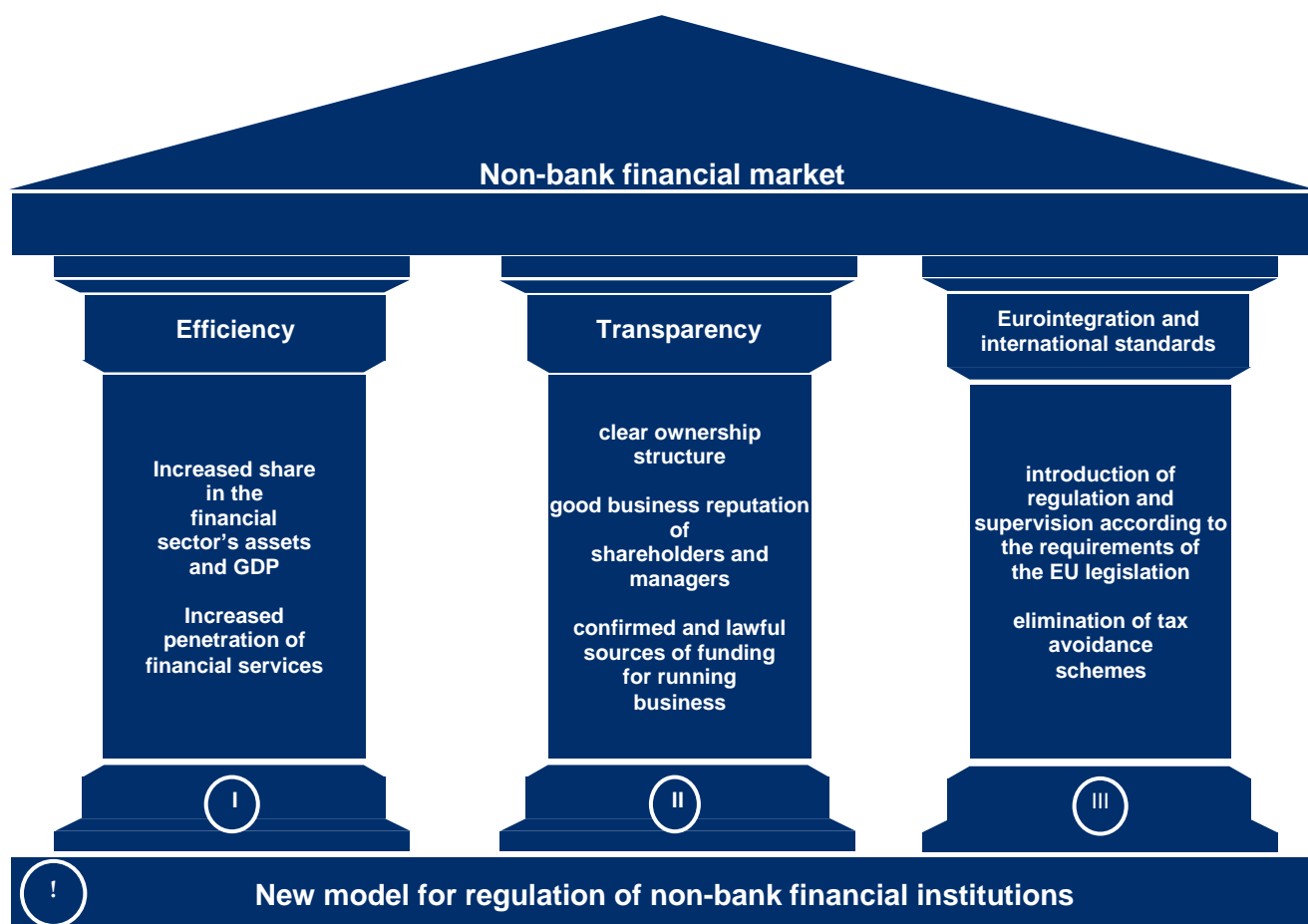
The document that is now proposed for review and discussion by market participants and other stakeholders aims to present to a wider public the main elements of the vision of the new regulation set out in the White Paper. In particular, this document outlines the National Bank's approaches to the market segmentation, licensing, prudential supervision, reporting, inspections, corporate governance, and consumer protection.

This document also addresses the principles and tasks for the "immediate future" once the Draft Law No. 2413-a is passed, i.e. for the transition/adaptation period for the new regulator and for the market. During this period, the top priority for the National Bank will be a seamless transition from one regulator to another and continuity of operation of NBFIs.

## VISION OF THE NEW NON-BANK FINANCIAL SECTOR REGULATION

The transfer of supervisory and regulatory functions of NBFIs from the FSR to the National Bank and the NSSMC, envisaged by the Draft Law No. 2413-a, should be considered the first step in a process of reform of the non-bank financial sector regulation. New regulation needs to be introduced gradually to make the non-bank financial sector more transparent and attractive for investors, to better protect the consumers of financial services, and to combat fraudulent market practices. New regulation should also aim to establish equal terms of operations for NBFIs and banks, and promote a competitive financial services environment.

The National Bank's vision of how the non-bank financial sector should be regulated is based on certain criteria.



First, non-bank financial institutions<sup>1</sup> must become an efficient component of the nation's financial system, growing in terms of volume, and level of financial services penetration, and, at the same time, contributing to the macroeconomic stability.

Second, the non-bank sector should adhere to high standards of corporate governance and transparency, which will have a positive impact on the level of confidence in the market and provide additional impetus to its development.

Third, the regulatory and supervisory system for the NBFIs should be based on international standards, including the implementation of the EU legislation requirements. Under the Association Agreement with the EU,

<sup>1</sup> Here and below, unless otherwise expressly provided, a reference to financial institutions or non-bank financial institutions include also legal entities, which are not financial institutions by their legal status but have a right to render financial leasing services, and insurance intermediaries.

Ukraine has pledged to modify substantially its financial services legislation in order to bring Ukrainian regulation of financial services closer to that adopted in the EU. In market segments where EU standards are lacking, national standards based on international experience will be introduced. In both cases, the National Bank plans to hold discussions of such issues with the financial market participants.

## 1 Raising of funds from the public

The National Bank believes that raising funds from the public<sup>2</sup> by financial institutions for providing financial services should only take place under appropriate regulation and monitoring by the regulator. This approach conforms to EU legislation, which sets high requirements for the operations of financial institutions that raise and intermediate funds from the public. Furthermore, EU legislation prohibits any persons that do not meet established regulatory requirements from raising repayable funds from the public.

Ukraine has already taken the first steps to implement these requirements. In 2016, a prohibition on raising repayable funds from *individuals* by financial institutions (except by banks and credit unions) was incorporated into the Law on Financial Services. This amendment was adopted mainly because of the fraudulent activities of Bank Mykhaylivsky PJSC.

This approach to raising repayable funds by financial institutions needs to be extended to legal entities. It should be emphasized that in important respects many legal entities (in particular, small businesses) are quite similar to individual clients of financial institutions. Frequently, the owners and/or managers of such enterprises do not possess sufficient knowledge about the financial system to understand and manage efficiently the financial risks.

Therefore, the National Bank endorses the position that current limitations on raising of funds by financial institutions from individuals should also apply to funds from *legal entities other than financial institutions*.

The *forms* of such raising also need to be specified in more detail. Such forms are planned to include deposits, loans, repayable financial aid, or other similar instruments, which imply a financial institution's obligation to repay funds on demand or at a specific time, both with or without paying any fee in any form for using such funds (hereinafter referred to as "repayable funds"). In particular, the issue of debt securities by financial institutions is planned to qualify as the raising of repayable funds<sup>3</sup>.

Certain exceptions to the above general rule are being considered. All financial institutions will still be permitted to provide financial services by using funds raised from:

- *banks;*
- *other financial institutions;*
- *their shareholders*<sup>4</sup>;
- *any other persons on subordinated debt terms*<sup>5</sup>.

Moreover, funds paid to an insurance company as premiums, as well as funds sent to a payment provider for funds transfer purposes, and funds paid as an advance payment under a financial leasing agreement, will not be deemed as publicly raised funds.

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<sup>2</sup> From individuals and legal entities other than financial institutions.

<sup>3</sup> These rules will not extend to the issue of debt securities by enterprises not providing financial services so that limitations to the raising of funds could not affect the operations of non-financial enterprises that raise funds by issuing bonds.

<sup>4</sup> Here and further in the text, a reference to "shareholders" includes also participants in a limited liability company or other business companies.

<sup>5</sup> It is expected that for the NBF a subordinated debt concept and the procedures for its raising will be defined in the law (currently defined for banks) (see chapter 2).

This classification of permitted sources and forms of raising funds will be applied to the market segmentation of financial institutions supervised by the National Bank, as described in chapter 2.

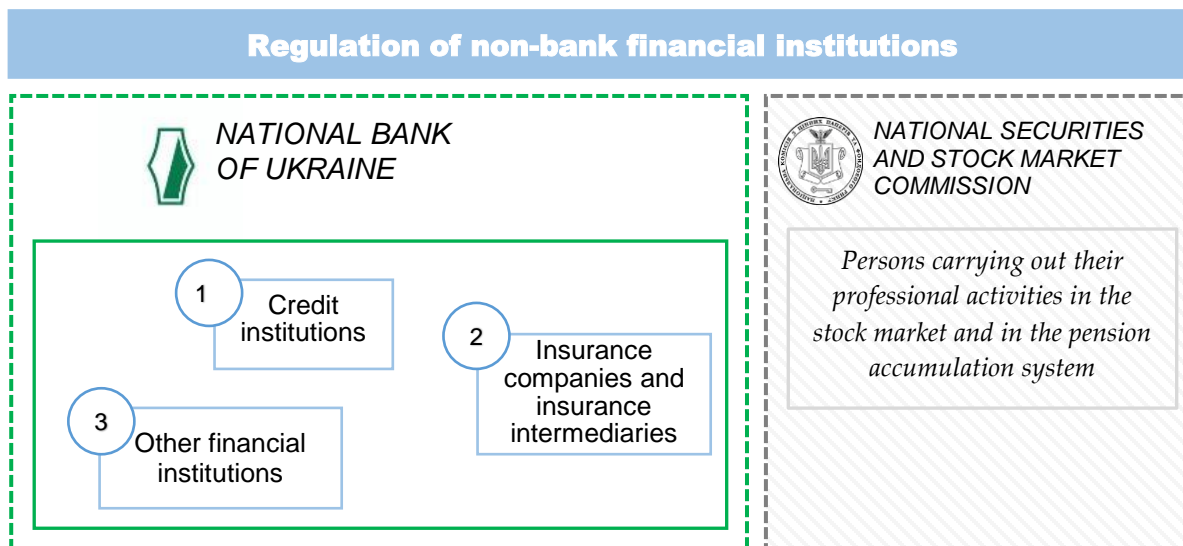
Therefore, in the non-bank financial sector:

- only *credit unions* will be allowed to raise repayable funds from individuals, and only *credit unions and other credit institutions*<sup>6</sup> will be permitted to raise repayable funds from legal entities other than financial institutions. Such raising of funds must be combined with lending. In addition, these institutions may, at their discretion, provide a number of other financial services (see chapter 2);
- *other financial institutions*, which provide financial services by using their equity or funds received, in particular, as a credit or loan from a bank, another financial institution or shareholders, will not be required to obtain the status of a credit institution. Therefore, they will not have to comply with more stringent requirements set for credit institutions.

The National Bank is aware that financial institutions have revised the structure of their liabilities only with respect to repayable funds of individuals, and not legal entities other than financial institutions. Therefore, the new approach to the sources and forms of funds raised by financial institutions will have a certain impact on the non-bank financial market. New requirements for raising funds used to provide financial services will be imposed only after a detailed analysis, evaluation of the market, and consultations with its participants. It is also likely that the new requirements will be phased in over a certain transition period, of which market participants will be notified in advance, to allow financial institutions to structure their liabilities in line with the new requirements.

## 2 Segmentation of non-bank financial institutions in the new regulation and supervision system

The classification of the sources and forms of raising funds should serve as a basis for an approach to regulation and supervision of non-bank financial institutions. A new policy must enable the National Bank to correctly distribute resources and efficiently manage risks in the market. For this, the National Bank plans to introduce an approach to regulation that would be based on the division of financial institutions into three categories.



<sup>6</sup> Prior to 2016, «other credit institutions» existed as a separate kind of non-bank financial institutions, regulated and supervised by the FSR. However, following the amendments to the Law on Financial Services (made in November 2016), only banks and credit unions correspond to the definition of a credit institution, as only their activities on lending using raised funds are governed by the respective laws. The National Bank now proposes to introduce the category of “other credit institutions”, the procedures for which operation will be defined at the level of the law (establishing in one law procedures of operations of banks and other credit institutions is being considered), which will be subject to the prudential regulation by the National Bank, and which will be permitted to raise repayable funds from legal entities other than financial institutions (see chapters 2, 4, 8).



## 1

**Credit institutions**

The first category will bring together **credit institutions**<sup>7</sup> permitted to raise funds from the public for lending and provision of other financial services. They will be subject to the capital requirements and other financial standards at the level of European requirements/standards set out by Directive 2013/36/EU on activity of credit institutions and Regulation No. 575/2013 on prudential requirements for credit institutions and investment firms. These EU acts have to be implemented in Ukraine under the EU Association Agreement.

These standards will include at least the following:

- the requirement for the minimum initial and regulatory capital (in an amount of 5 million euro);
- regulatory capital adequacy requirements (at a level of at least 8%);
- single counterparty credit risk concentration requirements (no more than 25%); and
- instant liquidity requirements (over 60%).

It should be noted that the National Bank plans to provide schedules for bringing operations of credit institutions in line with the new requirements only after a detailed study. Such schedules will take into account reasonable deadlines and the capability of institutions included in the first category to comply with such requirements.

*Credit unions* will enjoy a special status among credit institutions since they will be permitted to provide financial services by using repayable funds without having to comply with the capital requirements and prudential standards set by the EU legislation. The non-application of these capital requirements to credit unions generally conforms to the provisions of Directive 2013/36/EU on activity of credit institutions. However, the EU Association Agreement does not currently include this exception for Ukrainian credit unions. The National Bank will take necessary measures to propose relevant legal amendments to the EU Association Agreement.

According to the vision of the National Bank, *credit unions* will be the only non-bank financial institutions that will be allowed to raise repayable funds both from legal entities and individuals. *Other credit institutions* will be limited to the raising of funds from legal entities only (except in cases where repayable funds are raised from shareholders who are individuals and subordinated debt from individuals).

## 2

**Insurance companies and insurance intermediaries**

The second category of NBFi institutions are **insurance companies and insurance intermediaries**. The insurance sector will be regulated by taking into account the standards set forth by European legislation, including requirements for:

- capital and solvency, technical reserves, quality of the corporate governance and risk management systems (Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance, hereinafter referred to as Solvency II),
- disclosure of information, rules for drafting and making regulatory and financial statements (Solvency II, Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings), and
- market conduct and sales of insurance products (Directive (EU) 2016/97 on insurance distribution and Directive (EU) 2009/103 on insurance against civil liability (motor vehicles)).

First and foremost, this concerns imposition of the minimum capital requirement for insurance companies. It is expected that this requirement will amount to 3.2 million euro for life insurers and 2.2 million euro for other insurance companies.

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<sup>7</sup> Credit institutions hereinafter mean non-bank credit institutions (credit unions and other credit institutions).

In addition to the minimum capital requirement, the following requirements to insurance companies shall be established, taking into account EU Directives:

- solvency capital requirement;
- technical provisions;
- requirements to eligible own funds amount; and
- own funds limits.

The National Bank plans to develop schedules for bringing operations of insurance companies in line with the new requirements, only after a detailed study of the situation in the insurance market and taking into account reasonable deadlines and capability of insurers to comply with such requirements.

For insurance intermediaries, the National Bank intends to impose a requirement for continuing professional education and to increase qualification requirements applicable to insurance professionals. Further, it plans to introduce professional liability insurance for those insurance intermediaries, for which/whom insurance product distribution is not their main activity.

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### **Other financial institutions**

The third category, includes all **other financial institutions** that **do not** use funds raised from the public for providing services. These companies will use "internal" financial resources (equity and funds of their shareholders) with a possibility of raising funds from banks/other financial institutions. If the requirements for regulatory capital are established for this segment, then the National Bank will consider allowing such institutions to raise subordinated debt from persons other than their shareholders. This will not be considered as raising of funds from the public.

The National Bank believes that such institutions will pose a minor risk for the financial system. Thus, imposition of tough prudential standards on them will be unreasonably burdensome. If applied to this category at all, requirements for the capital and other prudential standards are likely to be much less stringent than for credit institutions<sup>8</sup>.

The National Bank expects that most non-bank financial institutions (particularly financial companies and pawnshops), which will be regulated by it as envisaged by the Draft Law No. 2413-a, will be included in this segment.

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### **All non-bank financial institutions**

Certain uniform requirements will be applied to all categories of NBFIs. First is access to the market. For this purpose, all financial institutions will have to obtain a license to provide a particular service (see chapter 3). Requirements for the business reputation of owners of qualifying holdings and senior management, financial standing of owners of qualifying holdings, and ownership structure disclosure will also be similar in substance for all categories (although they may differ in certain details, if needed – see chapters 3 and 6). Corporate governance standards (see chapter 6), requirements for market conduct regulation and consumer protection (see chapter 7) will be common for all the categories as well.

### ***Combination of financial services***

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<sup>8</sup> Prudential requirements will have to apply to financial institutions that provide funds transfer services as the Directive (EU) 2015/2366 on payment services provides for the application of a special regime of prudential regulation and supervision to them.

The National Bank will also introduce flexible rules for the provision of multiple financial services by an institution. Financial institutions will be allowed to provide various financial services in cases where such services harmoniously fit into the business model of the company, are not deceitful, pose no threats to consumers, and have no negative consequences for the stability of the financial market or some of its segments.

Thus, when a financial institution obtains a license permitting it to carry out a specific activity defined as its core business, it may obtain additional licenses for providing certain additional financial services.

For instance, credit institutions (category 1) may combine the raising of repayable funds and lending (both activities will constitute their core lines of business) and:

- issue of guarantees,
- transfer of funds,
- currency exchange services,
- factoring,
- financial leasing (all of these will be permitted additional activities)<sup>9</sup>.

These same additional activities may be chosen by financial companies (category 3), for which lending is a core activity.

In contrast, financial companies, the core activity of which consists in providing services of transfer of funds, will be able to obtain an additional license only for currency exchange transactions. Financial companies, for which factoring is a core business, will be allowed to obtain additional licenses allowing them to grant credits and issue guarantees.

The issuance of guarantees is planned to be an additional activity for insurance companies (category 2), and for life insurers an additional activity may include provision of loans to insured persons.

### **3 Flexible approach to licensing**

Licensing is a key element in the new model of regulation of non-bank financial institutions. New licensing requirements are intended to bring greater transparency to the market, improve financial disclosure and business standards. The concept of NBFIs licensing developed by the National Bank envisages the following main changes.

First, the National Bank intends to reduce the number of procedures for accessing the market. A legal entity will no longer be required to register first as a financial institution and then only afterwards apply to the regulator for a license. These two processes will be merged into a single initial licensing procedure (simultaneous registration as a financial institution and obtaining a license for one or several financial services).

Second, the National Bank intends to introduce standards sufficient to prevent fraudulent service providers from accessing the financial system. For this purpose, it must fully understand the ownership structure of a financial institution, even if its operations are not systemically important. The key priorities for initial licensing will include the evaluation of:

- the business reputation of owners of qualifying holdings and senior management,
- the ownership structure and sources of funds used to start up a financial business,
- professional acceptability of senior management (see chapter 6).

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<sup>9</sup> Credit unions will be limited in their possibility to provide factoring and financial leasing services. The above financial services do not correspond to the generally accepted model of operations of such institutions, in particular provision of these services is not stipulated by the Model Credit Union Law, which has been developed and is recommended to be used by the World Council of Credit Unions (see [https://www.woccu.org/documents/Model\\_Credit\\_Union\\_Law\\_2015](https://www.woccu.org/documents/Model_Credit_Union_Law_2015)).

Third, the National Bank is aware that, before operations start, it is impossible to ensure compliance with most financial standards. Therefore, at the initial licensing phase the National Bank plans to focus on the verification of compliance with the initial capital requirements.

Fourth, the National Bank intends to introduce an obligatory procedure to evaluate a financial institution's business plan at the initial licensing phase. It will also verify whether a financial institution has enough funds for the business plan performance for the first year. Business plan development by an institution is intended to increase the responsibility and awareness of its managers and shareholders of potential risks. The evaluation of the business plan by the National Bank will allow it to analyze the company's business model. This analysis is necessary to evaluate an institution's viability and resilience at the initial licensing phase and for efficient supervision by the regulator at a later stage.

The National Bank also proposes to conduct a basic evaluation of the corporate governance system of the business at the initial licensing phase. The National Bank will examine whether the corporate governance assures the proper level of risk identification, monitoring, and control by management. This evaluation will also enable the National Bank to make a relevant comparison of corporate governance at different stages of a company's operation.

The National Bank will also consider using a more flexible approach to the entry of companies to the market. Existing companies that are in non-financial businesses and wish to start providing financial services will be able to apply to the National Bank for a license. Special requirements for changes in the structure of assets and liabilities will be imposed on such companies. Positive work experience, transparent financial and non-financial statements, and an efficient corporate governance system will constitute an important advantage in the process of licensing these companies.

If a company intends to obtain additional licenses after the initial licensing, it will be required to file only those documents, which have not been provided to the National Bank during the initial licensing phase, and update information that was provided before, if necessary. For instance, a business plan will need to be updated only as it covers additional types of services.

Knowledge by the regulator of the composition of owners of qualifying holdings in NBFIs will be yet another aspect closely related to the licensing concept. An acquisition, or increase of a qualifying holding in a financial institution, will require a prior evaluation of the business reputation and financial standing of prospective owners of qualifying holdings. In this regard, the National Bank plans to move from a formalistic to a substantive approach to the analysis of financial institutions' shareholders. This will allow it to identify and evaluate relations among market participants in order to prevent possible disruptions on the financial market.

The National Bank also plans to evaluate carefully professional qualities, experience and knowledge of new managers when NBFIs change their senior management (see chapter 6).

Furthermore, the qualification requirements and certification of specialists working at insurance intermediaries will be based on the provisions of Directive (EU) 2016/97 on insurance distribution, which regulates operations of all the entities involved in the sales of insurance products.

At this, as the Draft Law No. 2413-a envisages, new regulations to be enacted by the National Bank on NBFIs' activities will not require NBFIs to have their respective licenses reissued (see section *Planned transition period for non-bank financial institutions: benchmarks and schedule*).

#### **4 Risk-oriented prudential supervision**

Financial stability and solvency of non-bank financial institutions is accomplished primarily through prudential supervision. Such supervision involves the imposition of certain quantitative and qualitative requirements (prudential requirements) on the operation of financial institutions. Monitoring of compliance with them enables timely detection of risky activities, prompt intervention measures, and prevention of negative consequences by the regulator.

In the National Bank's opinion, prudential supervision shall be mandatory for **insurance segment, credit unions and other credit institutions, and financial institutions providing funds transfer services**.

In the new regulatory model, prudential requirements will be specific for each market segment. To ensure more efficient supervision over insurance companies and credit institutions, the National Bank intends to introduce proportionate regulation by classifying institutions into large (systemic), medium-sized, and small. Therefore, the National Bank plans to apply different prudential requirements to these companies, depending on the risks their insolvency might pose for clients and the financial system. The main criteria for proportionate regulation will include:

- absolute amount of raised repayable funds or insured risks;
- types of business activity;
- scale and complexity of a business (geographic presence, number of clients, etc.).

This will ease the regulatory burden on financial institutions and will improve the competitive environment for small and medium-sized financial institutions.

Given the need for effective protection of policyholders, all insurance companies will be subject to prudential supervision by the regulator. Certain prudential requirements will also be set for insurance intermediaries and corporate insurance agents. This is in line with generally accepted international practices and is an EU legislation requirement. However, only large insurance companies will have to comply fully with Solvency II regulations. Given their operating risks, medium-sized and small insurance companies will be able to apply simplified Solvency II requirements.

Credit institutions other than credit unions will be able to provide services by using funds raised from corporate non-financial institutions. The National Bank plans to introduce prudential requirements for all such institutions at the level of European standards.

Credit unions, which will be able to provide services by using funds raised from individuals and corporate non-financial institutions, are not to be subject to Directive 2013/36/EU on the activity of credit institutions. They will be subject to "national" prudential requirements, which will permit the National Bank to ensure efficient supervision over their solvency and liquidity.

The National Bank considers advisable the creation of a deposit guarantee fund for credit unions (or placement of credit unions "under the umbrella" of the Deposit Guarantee Fund) and creation of an insurance payment guarantee fund for life insurance. Participation in such funds will be obligatory for all the credit unions accepting deposits from individual members and for life insurers. Naturally, main prerequisites for the fund creation will include an efficient prudential supervision over the market, compliance by the financial institutions with the new regulatory requirements, and exit from the market by those NBFIs which do not comply with such requirements. In the future, the National Bank plans, along with the market participants, to determine the parameters for the building and functioning of such guarantee funds and a procedure for accumulation of moneys to effect guarantee payments.

A special prudential regulation and supervision regime will apply to financial institutions providing funds transfer services, as this is directly envisaged by the requirements of the Payment Services Directive (EU) 2015/2366. The National Bank is considering introduction of prudential supervision in this segment for those institutions, which, during a certain period, have made transfers in the amount exceeding certain limit.

Prudential supervision in other non-bank financial market segments may be introduced in the instances determined by the National Bank (e.g., for factoring companies).

The National Bank does not rule out the possibility that, after a certain period, a part of its supervision powers might be delegated to self-regulatory organizations of the market participants. This concerns small credit unions and other credit institutions. Naturally, such delegation will be possible only if such self-regulating organizations will have adequate institutional maturity, independence, and competence to ensure efficient supervision over the market participants.

## 5 Reporting, inspections, and enforcement

Three important elements of regulatory and supervisory systems are:

- requirements for reporting by relevant producers/providers of services,
- scheduled and unscheduled inspections of their activities, and
- enforcement (application of certain enforcement actions in response to revealed law violations).

The National Bank is considering taking steps to change the scope of reporting required from NBFIs. For instance, it is considering eliminating some outdated forms. The frequency of submitting certain forms of statements also may be changed and financial institutions may be required to report solely in electronic form.

For all segments of financial institutions, requirements to information disclosure and regulatory and financial reporting will be developed in accordance with international best practices and the EU laws.

The National Bank will consider whether it is reasonable to plan inspections of non-bank financial institutions based on the guidelines of the European Banking Authority (Supervisory Review and Evaluation process) and the guidelines of the European Insurance and Occupational Pensions Authority (Supervisory Review process). This means that the frequency of inspections conducted by the regulator will depend on the size of a financial institution (its importance for the system) and its risks. In this case, financial institutions will be inspected according to the inspection plan approved by the National Bank Board based on the evaluation of risks of financial institutions made by the regulator during off-site supervision.

Ensuring the equal application and enforcement of rules across all market segments is a priority for the National Bank. In other words, the same enforcement action must be applied to the same violation (for example, against a pawnshop or a credit union). Likewise, protecting consumer rights is also a priority. Financial institutions must be accountable for violating these rights, for example through the provision of inaccurate information or the failure to provide required information (see chapter 7).

## 6 Corporate governance

Good corporate governance practices are a necessary precondition for creating an efficient and reliable market for financial services in Ukraine. The National Bank views corporate governance as an integral part of the risk management system that must be adopted and implemented by all the providers of financial services. It must be based on the following principles:

- corporate governance regulation through a system of obligatory requirements and voluntary compliance with guidelines (recommendations), taking into account legal and economic specifics of markets for financial services of Ukraine;
- conformity to obligatory requirements for corporate governance established by the Law "On Joint-Stock Companies" and the Law "On Limited and Additional Liability Companies" (depending on the institution's corporate form). There also will be obligatory special requirements for all the providers of financial services set by the Law on Financial Services, and special requirements typical of certain segments of the financial services market set in special laws (for example, the Law "On Insurance") and in regulations.
- use of a proportional approach that will take into account the company's size, its social importance, business model type, etc. to ease the regulatory burden on small organizations. This will permit financial institutions, which will not belong to the category of systemically important financial service providers, to choose between full or simplified corporate governance models. Accordingly, they will be able to form a two level (supervisory board and executive body) or one level (administrative body - unitary board of

directors<sup>10</sup>) governance body system. It is understood, however that systemically important financial service providers will be required to use the full (two level) corporate governance model;

- transition to the risk-based model of corporate governance aimed at identifying, monitoring, controlling, and managing risks;
- change of approaches to setting 'fit and proper' requirements for owners of qualifying holdings and senior management of financial service providers, namely:
  - establishment, at the level of the law, of the business reputation requirements for all the members of the management and supervisory bodies of financial institutions (meaning, depending on the chosen corporate governance model, members of the administrative body or members of the supervisory board and the executive body) and owners of qualifying holdings; revision of the criteria for the good business reputation by taking into account the EU legislative requirements and their unification for different segments of the financial market;
  - introduction of standards of professional acceptability of members of the management and supervisory bodies of such institutions; and also measures aimed at ensuring transparency of their operations;
  - empowering the regulator to refuse to grant a license in cases where it concludes that certain persons cannot be accepted as owners of qualifying holdings, particularly due to their failure to comply with the requirements for business reputation;
  - empowering the regulator to demand changes of members of the management and supervisory bodies of a financial institution, if it reveals facts of non-compliance with professional acceptability and/or business reputation requirements.

Creation of a new corporate governance system requires considerable changes in the approaches to corporate governance in the financial services markets, which implies:

- increasing the role, expanding the functions, and changing approaches to the structure and formation of supervisory boards;
- introducing new requirements for the internal audit and control, compliance and risk management systems;
- introducing certain standards (codes), including with respect to business conduct and ethics rules.

## **7 Market conduct and consumer protection**

Building an efficient and stable financial market is impossible without a high level of consumer confidence. Fair market conduct, along with efficient and systemic protection of the rights of consumers of financial services, are among the key components of the regulatory model for all the non-bank market segments.

The National Bank's efforts will focus on prevention of systematic unscrupulous practices that violate consumer rights. This will be achieved by inspecting financial institutions for their compliance with the rules on the provision of financial services, monitoring their observance of laws on advertising, and reviewing complaints from consumers.

Violations of the rules for providing financial services, revealed during inspections of financial institutions or as a result of consumer complaints review, will be the ground for application of considerable "deterrent" penalties to institutions. This will encourage them to revise their current practices and forbear from further violations. The National Bank will also generalize practices of applying legislation on financial services and make proposals for improving it. Granting powers to the National Bank in protection of the rights of consumers is stipulated by draft

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<sup>10</sup> New terms that are expected to be introduced at the level of the law.

Law "On Amendments to Certain Laws of Ukraine Concerning Improvement of Protection of the Rights of Consumers of Financial Services" No. 2456-d (awaiting second reading in the Verkhovna Rada of Ukraine).

In particular, under draft Law No. 2456-d, the National Bank will perform the following functions of protection of the rights of consumers of financial services:

- adopting regulations on consumer protection (for example, regulations imposing requirements to agreements on provision of financial services and the terms of such agreements that would be additional to requirements/terms imposed by laws);
- addressing consumer complaints (including with regard to terms of agreements limiting the rights of consumers of financial services);
- ensuring compliance with the laws on advertising in the area of financial services;
- verifying compliance with the rules for providing financial services and legislation on consumer protection, including receiving and checking documents from financial institutions on services provided to consumers;
- applying enforcement actions (in particular, penalties) due to violations of the rights of consumers of financial services;
- imposing additional requirements for information disclosure by providers of financial services;
- publishing quarterly reviews on its website of the application of laws on protection of the rights of consumers of financial services;
- developing proposals for improvement of the relevant legislation;
- providing methodical recommendations for raising financial awareness of consumers, including expanding financial inclusion;
- interacting and cooperating with other regulators of the financial services markets.

In order to build an efficient system of protection of the rights of consumers of financial services and increase consumer's role in Ukraine, the National Bank plans to continue its activities in the following areas:

- harmonization of regulatory requirements according to the international best practices and the relevant EU laws;
- development of a system of surveys (of the population, financial institutions, expert community, etc.) and comparison studies;
- information and consulting clarifications for consumers;
- cooperation with financial institutions to improve their staff qualifications (training and regular testing system, etc.);
- cooperation with financial institutions to improve the quality of financial services, including by introducing additional quality control mechanisms;
- interaction with nongovernmental organizations promoting protection of the rights of consumers of financial services, particularly to raise awareness of the public.

Comprehensive program for the development of Ukraine's financial sector by 2020 also envisages establishing a mechanism for extrajudicial resolution of individual disputes between consumers and financial institutions through a financial ombudsman institution. A respective draft law has been submitted to the Parliament of Ukraine (No. 8055).

Other important issues of interest for the National Bank include introduction of an efficient compensation system for the consumer, and increased liability of financial institutions for unscrupulous market conduct and/or distribution of false advertisements.



The introduction of the guarantee schemes to cover credit union deposits and insurance payments should also enhance financial consumer protection (see chapter 4).

## **8 Model of new legislative regulation of financial services markets**

Reform of the non-bank financial sector and implementation of the National Bank's vision of regulation will necessarily require key changes to the legal framework. This is required to:

- set uniform approaches to, and standards for, financial institutions' establishment and operation for the different segments of the financial market;
- eliminate any discrepancies in the National Bank's powers to regulate banks and non-bank financial institutions, and also bring the national legislation in line with the EU laws in terms of powers of financial regulators;
- bring the requirements for licensing, operations, regulation of and supervision over financial institutions in line with the EU laws.

Accordingly, a new model of legislation for the financial services markets will require the Law on Financial Services to be revised fundamentally. This law must apply to all financial markets and introduce:

- a unified terminology for banking and non-bank financial services, aligning it with the terminology used in the EU legislation;
- general unified rules for provision of financial services (for example, requirements for the contents and procedure for executing financial services agreements);
- general requirements for disclosure of information by providers of financial services on their operations and terms of services (for example, requirements for reporting to the regulators, contents of information disclosed along with financial statements);
- general requirements for supervision over financial institutions, including measures to restore solvency of financial institutions and/or put them out of the market.

The Law "On National Bank of Ukraine" will specify in more detail the powers of the National Bank, its purposes, forms and methods of regulation, which will be outlined in general terms in the Law on Financial Services.

The National Bank intends to continue the sectoral approach to legal regulation of operations of financial institutions. Hence, special rules of operations and prudential requirements will apply to certain types of financial institutions as set by special laws such as the Law "On Credit Unions" and the Law "On Insurance").

The rules of market conduct and provision of services in certain financial markets, or with respect to certain financial services, will also be governed by specific laws (e.g., the Consumer Lending Law, the Laws "On Obligatory Insurance of Civil Law Liability of Ground Motor Vehicle Owners", "On Financial Ombudsman Institution" and others).

The development and adoption of new laws on certain financial services or financial institutions will be reserved for only the most important social relations. In most cases, regulations (bylaws) enacted by the regulator will govern the operations of financial institutions. For example, the National Bank finds it reasonable that activities of non-bank credit institutions shall be governed at the level of the law. For this, the National Bank is considering establishing in one law procedures of operations of banks and non-bank credit institutions.<sup>11</sup> In other cases, the rules of market conduct and/or prudential requirements that will apply, for example, to financial companies or

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<sup>11</sup> This law will not apply to credit unions, which, due to special principles of operations, in particular, non-application of the requirements of Directive 2013/36/EU on activity of credit institutions to them, will continue to be governed by the Law "On Credit Unions".

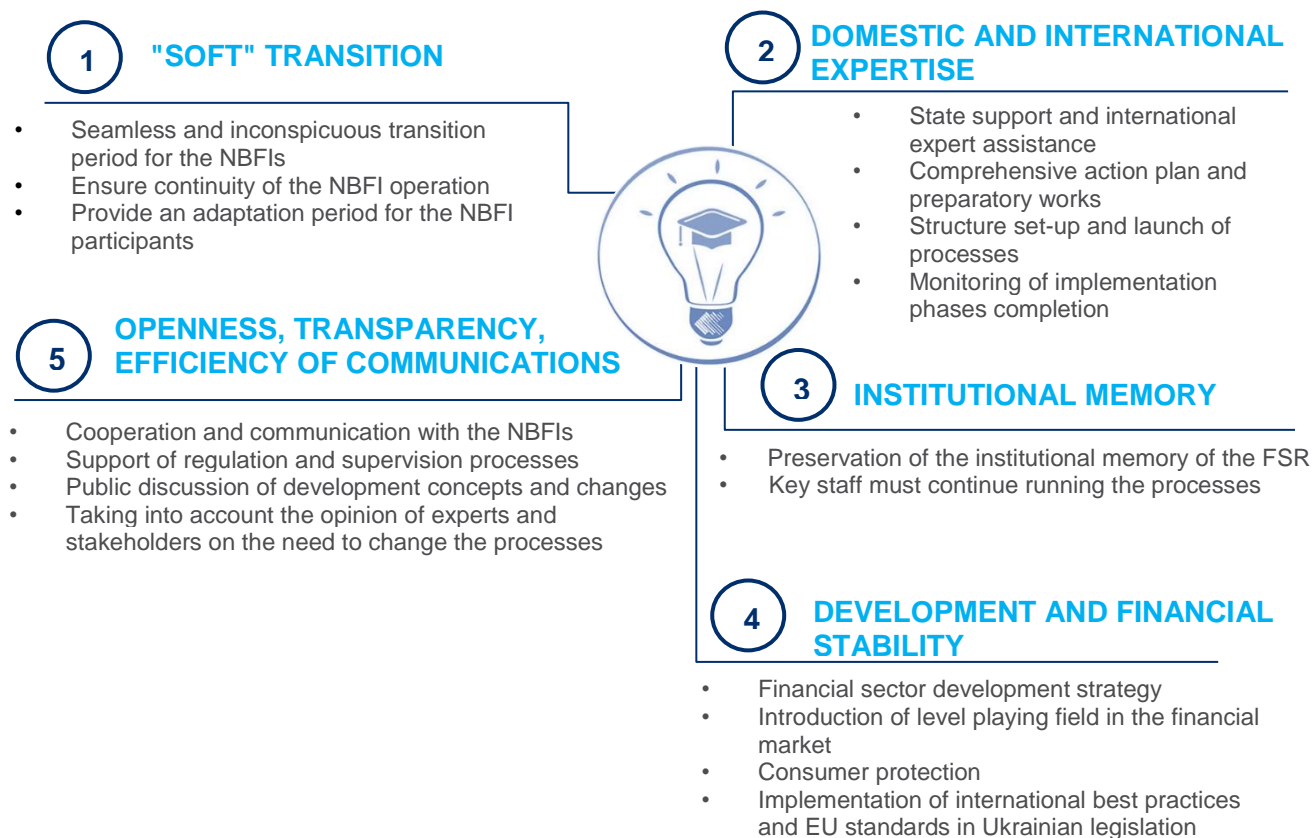
pawnshops (other than rules/requirements defined by the Law on Financial Services or other laws) will be set by regulations.

There are other, non-financial sector laws that are applicable to the NBFIs sector, and both the National Bank and NBFIs will take them into account. This legislation governs wider aspects of social relations, such as, for instance:

- provision of services, execution and contents of agreements (the Civil Code of Ukraine);
- corporate governance (the Laws "On Joint-Stock Companies", "On Limited and Additional Liability Companies", and the Civil Code of Ukraine);
- consumer protection (the Law "On Consumer Protection");
- accounting, financial statements, and audits (the Laws "On Accounting and Financial Statements in Ukraine" and "On Audits of Financial Statements and Auditing");
- solvency restoration (the Law "On Debtor Solvency Restoration or its Bankruptcy" or the Bankruptcy Procedure Code (once it comes into force)).

The National Bank intends to approach revision of the legal framework for financial services markets through dialogue with market participants. The National Bank also proposes to engage international and Ukrainian experts to develop concepts, suggest legal/regulatory changes, and draft legal language. Hence, the National Bank will follow an open public comment and discussion process for draft laws and regulations, involving concerned parties, such as consumers and providers of financial services.

## KEY PRINCIPLES OF TRANSITION/ADAPTATION PERIOD



1) The top priority for the National Bank over the 24 months following the Draft Law No. 2413-a's passing and promulgation of the respective Law is a seamless transition from one regulator to another. Non-bank financial institutions should not experience any disruptive consequences of transferring the regulatory function from the FSR to the National Bank, i.e. there must be continuity of operation of non-bank financial institutions.

The National Bank tentatively divides this period into 2 phases:

- 1) *Transition period*: the first 12 months after the Draft Law No. 2413-a is passed and the respective Law is promulgated, upon expiration of which the non-bank financial institutions will be regulated by the National Bank;
- 2) *Adaptation period*: 12 months following the transition period expiration.

During the transition period, the National Bank plans to focus its efforts on creating its internal capacity to carry out key regulatory functions (licensing, supervision, etc.) and organizing auxiliary functions. The National Bank's efforts will be aimed at an efficient and coordinated transfer of functions from the FSR to the National Bank.

A second area of focus of the National Bank during the transition and adaptation periods will be market analysis and development of draft laws/regulations based on results of this analysis. Changes proposed by the National Bank will require time to analyze the actual situation in the non-bank market, to get acquainted with the key players, and to decide upon and to draft regulations and laws. In particular, during the adaptation period the National Bank plans to conduct a comprehensive market evaluation, which will include evaluation of assets and liabilities, risks

and solvency of the participants of all the financial sector segments to come under the authority of the National Bank.

The National Bank intends to approach carefully legal and regulatory changes in the non-bank area. The two-year transition and adaptation period will be used for organizing work inside the regulator, developing new regulatory models and discussing them with the market participants.

It shall be noted that, as the Draft Law No. 2413-a envisages, new regulations to be enacted by the National Bank on NBFIs' activities will not require NBFIs to have their respective licenses reissued.

2 Modeling and development of a comprehensive action plan to develop the non-bank financial institutions market will be one of the most important elements of the National Bank's work during the transition/adaptation period. It is expected that representatives of the market and expert community will participate in the development of this action plan.

The National Bank, supported by international financial institutions and other donors, has already completed several studies and analyses that will be required to prepare this comprehensive plan. In particular, the National Bank:

- preliminarily analyzed selected segments of the non-bank financial sector;
- studied the laws and regulations applicable to the non-bank financial market;
- studied international experience in implementing efficient regulation models, particularly in the insurance sector;
- conducted a GAP analysis of the EU legislation and the laws of Ukraine in certain areas, particularly in the area of regulation of credit institutions;
- prepared a road map for the transition/adaptation period for transferring functions from the FSR to the National Bank, and for implementing new regulation for non-bank financial institutions;
- developed preliminary general regulation models, which need to be further detailed and specified based on results of the comprehensive market evaluation and discussions with the market participants.

International financial institutions and other donors intend to provide additional technical assistance to the National Bank in organizing the smooth transfer of regulatory powers and gradual introduction of new prudential requirements for non-bank financial institutions.

3 One of the key factors for an efficient reform (either in the area of public administration or in private companies) is the quality and experience of professional employees/staff. They can provide sector specific knowledge and "institutional memory."

Regulatory reform of the non-bank financial sector is no exception to this rule. Therefore, in order to avoid any decline in the regulator's efficiency and performance, certain measures aimed at preserving the institutional memory of the FSR must be developed and taken. This means, in particular, preservation of certain "written" experience of the FSR (i.e. operational rules and procedures) and "unwritten" experience - non-formalized knowledge of its staff. This will help avoid errors made in the past.

The National Bank intends to retain key staff of the FSR, and utilize their expertise in the transition process. This will also provide the National Bank an opportunity to evaluate individual capabilities for future employment. Further participation of the competent key staff in certain processes is important so that regulatory achievements are not lost in the course of transferring the functions of the FSR to the new regulator.

- 4 While developing draft laws and regulations, the National Bank will proceed from the premise that new regulation must be aimed at achieving the strategic objectives of Ukraine's development and financial stability.

New regulation will aim at implementing unified rules of work throughout the financial sector and ensure a proper level of protection of consumers of financial services. Implementation of the international best practices and the EU standards in Ukrainian legislation should be an integral component of new regulation.

Based on these basic principles/targets, the National Bank plans to develop a number of draft laws of Ukraine and its own regulations during the transition/adaptation period. In particular, it plans to develop draft laws/regulations on:

- Licensing requirements;
- Capital requirements;
- Provisioning requirements;
- Requirements for information disclosure and reporting by financial institutions;
- 'Fit and proper' requirements (particularly for senior management of financial institutions).

- 5 The National Bank expects that the concepts of the non-bank financial market development, draft laws and regulations will go through broad public discussions among representatives of financial institutions, experts, and other stakeholders.

There is no doubt that a high-quality reform will require joint efforts of the regulator, market participants, and political forces. The National Bank is open for an efficient and transparent dialogue and cooperation with representatives of non-bank financial institutions and other stakeholders.