Economic crime and its impact on the development of financial markets: the case study of Ukraine.

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Contents

List of Tables:

List of Figures:

Declaration

I declare that this dissertation describes my original work, except where acknowledgement is made in the text. I have made full reference throughout to the extent to which I have availed myself of the work of others. The dissertation does not exceed the maximum permitted length. No part of this dissertation has already been or is being concurrently submitted for a degree or other qualification at any other University.

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Introduction

The last two decades of the 20th century had witnessed changes in social, political and economic life. Advances in technology have globalised trade and financial markets. In the early 90s a substantial number of emerging markets started to develop financial industries. Some Central European transitional countries, such as Hungary and the Czech Republic, have already achieved positive results in establishing financial institutions. However, there are some countries, such as Ukraine, where the development of financial institutions has been slow. One of the advantages of being an emerging financial industry in a globalised financial market has been seen in the number of chances to obtain technical and financial assistance. However, the disadvantage is the constant necessity to protect the emerging industry from possible abuse and misconduct. That is why a safe business environment created by the state is a green light for the positive reforms outcome The question is whether or not the official devotion to reform the system would be 'positive' or 'substantial enough' to provide some positive outcome to lay the foundation for sound financial institutions. What is the role of the traditions and general culture in reforming the state, and financial sector in particular? How crucial is it to know the level of corruption inside the system? The answers to these questions tend to be subjective. Further, the questions and their answers may be meaningless if they are separated from their social and political contexts.

For more then a decade now Ukraine has been involved in an attempt to achieve economic stability, develop its own financial institutions, reform the legal system. All reforms have been conducted under the umbrella of transition towards democracy. But in reality, how close is the country to the sound success in economic and legal reforms? The avoidance of the political reforms is intentional here, because mere consideration of the economic reforms in Ukraine will necessarily bring the issue of the political reforms.

Following research is an attempt to understand the relationship between the law, the economic and financial reforms, and law enforcement mechanisms. It tends to be that these three components stay closely linked. To achieve success in reforming financial system in a country, there is a need to have a sound legal background and certain legal mechanisms to enforce the good law in books into practice. What tends to poison this

almost ideal ingredients of success is certain political pressure, or its opposite, lack of political will. Ukraine presents a unique example where at the beginning of the reforms the country's potential was named as the greatest among the former Soviet Union Republics, however, ten years after, and the country was named as 'a disaster'. There are a lot of facts to blame, such as hyperinflation, broken trade links, unstable legislation. However, what will be argued in this study is that the absence of political will to conduct reforms, and the presence of private interests in a big politics of managing the whole society have lead to the establishment of the 'ill' financial institutions, unable to react to the problems of economy, but able to cover easy money gained by means of big and corrupt deals.

Has this situation been known to the West? The answer is yes, and for many years. The abuse of the financial system has always been considered as a lucrative business. BCCI scandal in the early 90-s and more recent Bank of New York involvement in the money laundering case had been shadowed by scandals around financial crimes conducted by the representatives of such world-wide multinational companies as Enron and WorldCom.

The difference between the cases of financial crime conducted by Ukraine Bank and the Bank of New York, is that while the last one received a great publicity and shamed the guilty parties, and promised to tighten the regulatory requirements. The Ukraine Bank case had avoided publicity, investigators keep searching guilty parties, and can hardly name them for political reasons.

There are two general aims of this study: the first is to study economic crime phenomenon in broad terms, attempting to provide a theoretical framework to understand the causes of economic crime problems in Ukraine; the second aim is by conducting an expert study to identify the most important problems with regard to the development of financial institutions in the country and the disruption caused by economic crime.

Four hypothesis have been studied in the present work. The first one is that the success in democratic reforms can be judged according to the success achieved in financial reforms, addresses rather global issues faced by societies in transition. The following three hypothesis are: grand scale financial crime is associated with high level state officials or politicians; high quality of the law in books provides high quality financial

services, and high quality law on corruption provides better detection and preventative measures.

To address these issues the following chapters have been designed. Chapter 1 discusses the methodological issues of the study, provides the basic review of the definitions employed in this work, defends the choice of the expert case study, and discusses the issues of reliability of the state statistics in Ukraine and its use in the secondary data analysis. The study of the current situation in Ukraine is presented in Chapter 4, after the search for definitions of white-collar crime and economic crime in Chapter 2, and discussion of the role of the financial institutions in the economic development of the country in Chapter 3. Chapter 2 and 3 provide the foundation for the following discussion of the problems faced by transition Ukraine. Chapter 2 discusses the complexity of the phenomenon of white-collar crime, and economic crime, shows the examples of empirical studies conducted by the researchers in developed economies, contrast the 'white -collar' crime phenomenon in Western democracies and 'red-collar' crime phenomenon in the Former Soviet Union. Chapter 3 studies the relationship between economic development and financial institutions in the country. It starts by elaborating on the advantages found in white-collar type of crime, and continues with the financial market and economic development of advanced and transitional counties, and the modern day type of white-collar crime.

Considering this information as a background, Chapter 4 studies the period of transition Ukraine has experienced in a decade followed after the country gained its independence in 1991. The core of this chapter is three case studies. Case study 1 presents the results of the expert interviews conducted in the UK and Ukraine during spring -summer 2001. There are two groups of experts who constitute the general sample of expert study. The first group of respondents was formed from experts who are responsible either for the introduction of the new legislation in the financial area or enforcement agency, investigators and prosecutors. The second group consists of those experts who actively operate in the area of financial market. In total 24 experts were interviewed. Case study 2 provides some insights into the banking industry in the country. Case study 3 examines the enforcement issues in regard to the anti-corruption legislation in the country. It is hoped that these three studies provide some necessary insights and integrity into the current problems of the development of financial institutions in the country.

Chapter 5 discusses the international response to the problems of economic crime. It should be said, that this is the most challenging chapter, as it provides the discussion, which was almost unthinkable when this study began. The attack on the USA of 11th of September 2001 had lead to the dramatic changes introduced by the US government and regulatory agencies. These changes have addressed not only international terrorism and its finances, but foreign corrupt officials and their infiltration into the international financial system.

It has to be said that studying the emerging financial institutions in transitional countries especially in the time of changing international financial regulations have proved to be a very interesting but at the same time a very challenging topic. Since the beginning of this study a number of new regulations have been introduced in Ukraine, the new Criminal Code was adopted in September 2001. From the 'no one knows jurisdiction' Ukraine has become known as 'non-co-operative jurisdiction' due to the publication of the analysis conducted by the Financial Action Task Force. Continuing threat of international terrorism had dramatically changed the approach the developed economies employ to regulate the international financial market. So that the new question arises, would Ukraine be able and be willing to adapt its financial regulations to the standards required by the international community? While this study attempts to answer some stated questions the life brings a set of other questions to think about. It was important to decide when to stop reflecting to the new changes. The study conducted is based on the information collected by the end of summer 2002.

Chapter 1. The methodology of the research

1.1 The aim

This research aims to study the economic crime phenomenon in transition countries. Recent studies suggest that emerging financial markets are vulnerable to different types of illegal conduct (International Bank for Reconstruction and Development & The World Bank, 2001). The main focus of this study is the experience of one country- Ukraine. It is assumed that for a transition country, such as Ukraine, it is important to achieve sustained economic development. To do so, the country should establish some powerful financial institutions able to allocate resources and provide productivity enhancing investments. The development of independent financial institutions is also one of the indirect indicators used to estimate the level and achievements of democratic reform in the country.

This research has two main aims. The first is to study the economic crime phenomenon in broad terms, attempting to provide a theoretical framework to understand the causes of the economic crime problems in Ukraine. The second aim is, by conducting an expert study, to identify the most important problems with regard to the development of financial institutions in the country and the disruption caused by economic crime. To pursue this task, a two-staged project was designed. The first stage is the expert study, aiming to understand the general situation in Ukraine and to select an area for more specific study. The second stage is comprised of the study of a selected type of financial institution in the country (case study: banking in Ukraine), and the study of the socio-economic environment (case study: corruption and law enforcement). Both studies are presented in the main body of this work.

To fulfil the main aim of the second stage, the following topics should be considered: current trends in illegal economic activity; the most vulnerable sectors of the financial market in Ukraine; the group of perpetrators; and the impact of economic crime on the development of the financial market in Ukraine.

1.2 Introduction to the basic concepts

1.2.1 Economic crime

This section will briefly describe the terminology employed in the research. The following definitions can not cover all aspects of the problem studied, but nevertheless they provide some basic understanding of the concepts used.

The present study considers economic crime as a latent social phenomenon, which is difficult to discover, investigate and prosecute. The official statistics represent only a small proportion of crimes committed in the economic area. There is no easy answer to the question as to what the real scope of the problem is.

What does economic crime mean? There is no consensus in the academic world as to what should be defined as economic crime. "...it includes fraud, ...activities which tend to undermine the integrity and efficacy of the economic institutions of the state"(Rider, 1990). Such activities may include "corruption (government and corporate), customs and excise fraud, future and derivatives fraud, insurance fraud, fraud in international trade. Tax evasion and the misuse of tax havens, underground banking and money laundering" (Ledeneva, 2000, p.4). The present author will analyse the term economic crime according to its three main components: tax evasion, corruption and money laundering. These components are connected to each other and sometimes one can not exist without the other.

1.2.2 Corruption

Corruption has many definitions, and all of them centred around private profit or private gain. For example, the World Bank and Transparency International define corruption as the abuse of public office for private gain and the misuse of public power for private profit, respectively. The Council of Europe (1998) explains corruption as bribery and any other behaviour in relation to persons entrusted with responsibilities in the public sector, which violates their duties that follow from their status as public officials, private employee, independent agent and that is aimed at gaining undue advantage of any kind for themselves or for others.

The scope of corruption depends on a number of indicators, such as the government involvement in economic activity and the decision-making process, the transparency and clearly written laws and regulations of a country, and, the last but not least, the wages of public servants (Tanzi, 1998).

1.2.3 Money laundering and tax evasion

In criminology, the term money laundering is generally defined as an activity aimed at concealing unlawful sources of sums of money. The juridical terminology can be taken from the 1998 UN Convention Against Illicit Traffic in Narcotics Drugs and Psychotropic Substances. Money laundering can be considered as "the concealment

or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from an offence" (United Nations, 1998).

Money laundering can be distinguished according to legitimate and illegitimate purposes. The illegitimate purpose is "to avoid detection by tax investigators or criminal law enforcement agents" (Chaikin, 1998) and the legitimate "to conceal funds from public competitors, social, religious, or other institutions - for such reasons as maintaining confidentiality or privacy, preserving a reputation or competitive advantage- so that no criminal conduct is involved " (Ibid., p.470). Illegal money laundering presents a danger to the society because it allows criminals to consolidate power and penetrate the legitimate economy. It is also considered a lifeblood of organised crime and inevitable tool with the help of which the underground economy can grow (Chaikin, 1998).

Money laundering has three main stages: placement, layering and integration. Placement may help to the physical disposal of the bulk of cash proceeds by means of traditional financial institutions, like banks or non-regulatory financial business like exchange houses (Savona, 1997). In 1984, the US President's Commission on Organised Crime warned that 'every financial institution, including banks, savings and loans institutions, currency exchanges, and casinos, should assume that it is a potential target for use by organised crime in money laundering schemes' (The US President's Commission on Organised Crime, 1984). "Layering helps separating illicit proceeds from their source by creating one or more layers of financial transactions designed to interrupt any audit trial" (Savona, 1997). Integration is the final step of money laundering, there the criminally-derived wealth is introduced into the legitimate economy "without arousing suspicion and with an apparently legitimate source" (Savona, 1997).

Money laundering is a very complex phenomenon itself. It includes a great number of violations of different regulations and rules. It is also connected to tax evasion and corruption, and is sometimes called the 'blood supply' of the last two offences. It is actually the means with which to conduct an illegal act.

One of the aims of this research is to study the impact of economic crime on the financial market. At this point of research, we need to establish our working definitions regarding the financial sphere. What do we understand by such a broad

definition as the financial market and which sectors of the financial market do we need to consider?

1.2.4 The financial market

In a simple explanation, the financial market is the 'place' to raise capital and match those who want capital with those who have it. It sounds like a very simple task. A well-functioning financial system will have "...high domestic savings, private investment and growth in a market economy, channelling domestic savings into fixed investment and imposing financial discipline on enterprises" (Fries,1996, p.57).
In this study, the following sectors will represent the financial market: commercial and savings banks; insurance companies; trust companies and investment funds; the money market/ foreign currency exchange market; the stock and bond market; and the central bank.
The term "emerging market" entered the vocabulary of the investment world as a reference to identify the development of stock markets. It was first used by the International Finance Corporation when work on the concept of country fund and capital market development in the less- developed regions of the world had begun (Mobius, 1996).

> "Emerging stock markets can be variously defined. On the one hand, 'emerging' implies that change is underway, that a market is growing in size and sophistication in contrast to a market that is relatively small, inactive, and gives little appearance of change. Alternatively, emerging market in any developing economy, no matter how well developed the stock market itself may be, with the implication that the stock market's potential to emerge further is strongly linked to the economy's overall potential"(IFC, 1994).

There are a lot of different perspectives with which to consider the definition 'emerging market'. Some researchers employ the definition in reference to stock market development, while others refer to it as markets which represent less than a certain percentage of all the world's stock market capitalisation. For example, an emerging market can be identified as a market which represents less than 3 percent of the world's stock market capitalisation. Also, it is possible to use such an indicator of market development as the number of companies listed (Mobius, 1996). Mobius considered markets to be 'emerging' either because they have low or middle per capita incomes, or they have undeveloped capital markets, or they are not

industrialised (Ibid., p.10). In 1992, Ukraine and all the former USSR countries were added to the list of 'emerging' markets.

1.3 Research hypotheses

The objective of this research is to understand the current state of economic crime in different sectors of the financial market in Ukraine. This is a descriptive study, which aims to produce the actual hypotheses during the expert interviews. However, even at this stage it is possible to state some research hypotheses. As Sarantakos writes, hypotheses "help to rationalise the research process by concentrating on the important aspects of the research topic by avoiding peripheral and less significant issues" (Sarantakos, 1998, p.137).

The general hypothesis is that the level of the success of democratic reform in transition countries can be judged according to advances in the transformation of the financial institutions. The more specific hypotheses are: grand scale economic crime is associated with state officials and politicians; high quality of the law on statutes is associated with a high level of development of financial institutions; and high quality law on corruption is associated with better preventative measures, and a substantial increase in the number of cases considered.

The consideration of the results of the expert study and the analysis of the statistics will show whether the research hypotheses are accepted or rejected.

1.4 Methods of data collection

To answer the questions stated in the aim of the study, a variety of methods of data collection are used. A review of the current studies in the area provides valuable information about economic crime problems in different countries and at different times. An expert study on Ukraine allows discussion of different aspects of white-collar crime in the country and provides the research with insights into the economic crime phenomenon.

1.4.1 The search for reliable data

Of course, the picture created by this study is far from complete. The problem that surrounds most of the criminological research is that one can never be sure what percentage of crime went undetected. This is a particularly difficult problem for research conducted in the area of white-collar crime and economic crime. As one respondent said, "I am pretty sure that almost all our [Ukrainian] officials are involved in illegal economic activity, but how to prove it and how to know exactly what they do?" The difficulties of detecting and prosecuting white-collar crime are doubled in a system where corruption is endemic.

1.4.2 Expert study

The major source of information for this study is an expert group interview. The experts' interview was chosen as a method to collect opinions of knowledgeable experts. This work presents official data, such as data collected by different government and semi-government agencies and the reports of some regulatory bodies. In order 'to bring life' to all of these sources the expert study is conducted.
The advantages of expert focus group interview are:

- It provides data from a group of experts who have been involved in the area of financial regulation or who have experience of working in different sectors of the financial market and have an understanding of the insights of economic crime problems.
- The researcher-mediator has an opportunity to interact directly with the experts to obtain deeper levels of meaning and identify some important connections.
- It is quick and cost effective method of data collection which can function as a excellent addition to traditional crime statistics.

The use of the questionnaire surveys has long been discussed in social science (Clinard & Quinney,1973; Reiss & Biderman, 1980; Aromaa & Lehti, 1999). The author believes that such surveys may contribute relevant data, and improve and update statistics. "Survey results should not be interpreted in a vacuum, but should rather be validated by means of other information to the extent that this is possible" (Bergqvist, 2001, p. 136).
There are two groups of experts who constitute the general sample of the expert study. The first group of respondents was formed from experts who are responsible

either for the introduction of new legislation in the financial area or the enforcement agency, investigators and prosecutors. For example, in Ukraine this group was drawn from the following organisations and professionals: the Association of Entrepreneurs; corporations/private business; enforcement agencies, including the police, the prosecutor's office, lawyers and concerned departments of the National Security Service; representatives of local and national government who sit on the committees on financial development or related to economic crime matters; deputies of local and supreme councils who sit on the committees on financial development or related to economic crime matters; and the NGOs concerned. The second group consists of those experts who actively operate in the area of financial market. In Ukraine this group consists of representatives from players in the financial sectors, including commercial and savings banks, insurance companies, trust companies and investment funds, the money market/ foreign currency exchange market, the stock and bond market, and the central bank.

To select the respondents for the expert study the purposive sampling has been used. "In purposive or judgmental sampling the investigator does not necessarily have a quota to fill from within various strata...but neither does he or she just pick the nearest warm bodies as in convenient sampling. Rather, the researcher uses his or her own judgement about which respondents to choose, and picks only those who best meet the purpose of the study" (Bailey, 1982, p., 99). Therefore, one of the advantages of this type of sampling is that it is possible to use one's skills and knowledge to create the sample and to choose respondents.

1.4.3 Access

The present author was fortunate to participate in the project on legislative drafting in Ukraine carried out by the Institute of Advanced Legal Studies, University of London, where, during summer 2001, the author met a group of senior civil servants from Ukraine. The author conducted a few interviews that summer, and later on, went back to Ukraine, where people whom the author knew from the project introduced the author to some experts. The interviews with the representatives from the financial market were conducted during the author's field trip to Ukraine in spring 2001. The author former colleagues from the Kharkiv National University helped to arrange some of the interviews.

1.5 Sample size

Usually, the size of the sample depends on the size of population studied. There are no general rules warning how to develop the sample size of the general population, so it was rather difficult to estimate the sample size for our expert study. The present study aimed to conduct 25 interviews. This is considered to be a reasonable number given the time frame and the cost constraints involved.

1.6 Questionnaires/Interview schedules

The interview schedules have been employed as an instrument of data collection. The difference between an interview schedule and a questionnaire is in the way of filling in the form, in that in last instrument it is the researcher who fills in the form.

1.6.1 The interview schedule's construction

The interview schedule consists of an introductory statement and three parts[1]. The first part is an introduction in which there are four questions. The first question identifies the job profile, the second is about the political platform or political ideas which the respondent follows, and the last two questions ask to name the most popular types of economic crime in the country and any personal encounters with economic crime. The present author believes that it is essential to ask the last two questions in the beginning as it will, first of all, give the respondent a clear idea of what types of economic crime we are talking about and, secondly, enable the researcher to obtain information about the respondent's personal encounters with economic crime.

Table 1. Questionnaire: the introduction.

1. Introduction	Type of question
1.1. Job profile 1.2. Political ideas	open-ended
1.3. Most popular fin.crimes 1.4. Personal encounters	closed-ended with 'other' response category included

The second part of the interview schedule is about economic crime and the financial sector. This is the main part of the interview where the present author hopes to obtain valuable information about the most 'corrupt' sectors of the financial market. The

section starts with the introductory question "Which sector of economy may be named as the most affected by economic crime?". This question is a very important one for countries in transition. Recent studies suggest that some sectors of the economies of transition countries have been monopolised or ruled by corrupt officials (Panchenko, 2000). The second question is the key to the questionnaire as it aimed to identify the sectors of financial markets most affected by economic crime. The nature of the identified economic crimes is explored in the third question ("Please specify the exact nature of economic crime which occur in the operations of the institutions below"). To help our respondents a table was created. In the first column is a list of financial sectors and in the second column possible types of economic crime are provided. In the fourth question, respondents are asked to identify the impact of economic crime on the development of each sector of the financial market. In order to do so, the same table as in previous question is used. This is an attitude question for which we designed a scale ranging from positive to negative impact. Each scale of response is given a number which must be inserted into the right-hand column. Our response scale can be generalised in the following way:
'Waking up' the functioning of the sector (positive impact)/ prevents the future development (negative impact)/ no real impact at all.
The section ends with a question asking the respondents to summarise the general impact of the identified crimes on the development of financial market.

Table 2. Questionnaire: Economic crime and financial markets.

2. Economic crime and financial market	Types of question
2.1. Sectors of economy and economic crime 2.2. Sectors of financial market and economic crime	closed with 'other' response category included
2.3. Nature of economic crime	open –ended
2.4. Impact of economic crime	attitude question (an attitude scale)
2.5. General impact	open-ended

The final section of the questionnaire pays specific attention to the problem of regulation of the financial sector. The section starts with a question about the underlying motivation to conduct economic crime. The second question is about the adequacy of the existing regulatory framework. This is a filter question. By answering

[1] See appendix 1 for the actual questionnaire.

'yes', the respondent goes to the next question (4.3.) which is about the reason for the existence of economic crime, and by answering 'no', he or she skip Question 4.3. and goes to Question 4.4. which is about the adjustments which need to be made to improve the existing framework. Question 4.5. is about the nature of the existing framework and is a filter question as well. If the respondent thinks that the existing regulatory framework is over-constrained then the next question is "What relief/liberalisation needs to be implemented to improve the existing regulatory framework?". If the respondent thinks that the regulatory framework is under-constrained, then the next question is "What additional regulation/strengthening should be introduced into the regulatory framework?

Table 3.Questionnaire: Regulation and financial market.

3. Regulation and the financial market	Types of question
3.1. The underlying motivation	closed with 'other' response category included
3.2. The adequacy of the existing framework	closed filter question, if 'yes'-3.3.; if 'no'-3.4.
3.3. The reason for economic crime	closed with 'other' response category included
3.4. Need for restructuring	Closed
3.5. Over or under constrained	closed filter question, if 'over'-3.6.; if 'under'- 3.7.
3.6. Relief/liberalisation	open-ended
3.7. Additional regulation/strengthening	open-ended

1.7 Secondary data analysis

The study employs a wide variety of sources of information. The analysis includes such sources as government reports, reports of different financial agencies, as well as reports provided by the World Bank and IMF. The Ukrainian official financial statistics bulletins have been studied to find out data on the development of different sectors of the financial market in the country. This is a valuable source of information which will be employed to cross check the data obtained from the case studies. The statistics published monthly by the National Bank of Ukraine is employed in the case study on banking.

1.7.1 Reliability of the official data

The use of official statistics in social research has been discussed for over a long period of time (May 2001; Bulmer 1984). The reliability of official statistics is a major issue in developed countries with long democratic traditions. There are three perspectives in considering official statistics: realist, institutionalist and radical (May, 2001). The realist perspective considers official statistics as objective; for institutionalists, official statistics are a useful tool to measure the 'organisation's behaviour or the discretionary actions of individuals within them, rather than the phenomenon itself" (May, 2001, p.81); the radical perspective argues that statistics are useful to generate ideas about the dynamics and structure of society (Ibid., p.81). The credibility of official statistics in the former Soviet Union are a subject for another study. During the Soviet period, statistics were often 'abused' in order to hide negative tendencies in society, for example, drug use and violent crime, and underline only those tendencies which were in line with official ideology of that time. In order to show a better performance from hospitals doctors, low level statistics would be manipulated in a way which was beneficial for them and then submit their data to the next stage where, again, the data would be 'corrected' according to the results expected. This tradition is still alive and it is difficult to change people's practices in just one decade, even though the general situation and ideology have changed . The same issue exists with official financial statistics. Not only does the country need to change attitudes towards the collection of data, but also there is a need to establish new agencies responsible for data collection. However, the major concern is not in finding an agency to collect the data, but in the consistency of the data collected. The problem experienced by many former Soviet Union countries is that with the introduction of new legislative acts, and in some cases even the whole Criminal Code, a lot of new 'corpora delictis' emerged (Fituni, 2000). Fituni argues, that due to certain changes in Russian criminal law, a significant part of pre-1997 statistical data became incompatible with later figures (Fituni, 2000, p.20). In Ukraine, with the development of the banking industry in the beginning of the 90s, the question as to who would collect statistics on banking and how was very serious. Now, when we look back to the decade of the 90s, it is obvious that comparison of results from different years presents a serious problem. The National Bank of Ukraine started collecting statistics on banking in the early 90s employing one set of indicators. By 1996, the indicators had changed to adapt statistics to some

international standards. Official statistics on insurance companies is still a big problem. There is no single agency responsible for data collection. To resolve this problem, many researchers compare official data with estimates provided by experts working in the field or use some indirect indicators (see Chapter 4.5 Shadow economy in Ukraine for a discussion of the indirect measures of the unofficial economy).

Taking into consideration a number of difficulties arising in regard to the use of official statistics in transition countries, the adoption of the institutionalists' approach towards statistics appears to be the answer. This research will use official statistics, understanding that they represent only the 'tip of the iceberg' (May, 2001, p.,81).

To summarise, this section has identified the main elements of the present research. Particular attention has been given to the methodological issues of the expert study and the questionnaire employed during the study. The expert study is conducted to single out the problematic sectors and to narrow the topic of the research to the consideration of some specified sectors of the market.

In next two chapters, the author discusses the theoretical issues relating to economic crime and the financial market. Chapter 2 deals with the interdisciplinary approach towards understanding the essence of economic crime and tries to elaborate on the framework in order to consider the phenomenon from the perspective of a transition country.

Chapter 2. An interdisciplinary approach to the phenomenon of economic crime

2.1 Complexity of the study of economic crime

Economic crime is a complex phenomenon. A number of disciplines should be considered in order to understand it. Among them are those such as psychology, sociology and criminology. An interdisciplinary approach helps to find answers to such questions as how white-collar criminals differ from other criminals and what are the most effective preventative measures? In the present research, we are also interested in how economic crime criminals from advanced countries differ from their 'colleagues' in transition countries?

A micro perspective on deviant behaviour employs a variety of explanations made under the sociological, psychological and criminological theories of crime. Sociologists, criminologists and psychologists have been trying to explain criminal conduct for a long time. The lines dividing their explanations are difficult to establish because these three disciplines are interrelated. Sociology looks at social classes, culture and organization, attempts to identify causes of criminality in social structures and cultural factors. However, this can be done through psychological explanations of personality and psychological process at the individual level (Blackburn, 1983, p. 87). It is known that if singled out, the explanations proposed by the above theories may be exposed to limitations. To study white-collar crime with a specific criminological theory is to reduce significantly the level of understanding of the problem. White -collar crime includes some hidden elements which limit the understanding of the cause. What is known to general public, the cases which have been publicised - may be just the tip of the iceberg: just a small proportion of the crimes committed. The methodology of studying such types of crime as white-collar crime presents some serious issues. For a long time, researchers focused on the offenders known to authorities, and rarely made an attempt to research the causes of the "socially advantaged" crimes.

From the macro perspective, the social schools attempting to study deviant behaviour can be divided into the classical, neo classical, positivist, and anti-positivism schools. Positivism dominated views on crime and criminals in the 20th century. Positivists believe in methods employed by natural sciences, in the so-called "unity of scientific methods" (Taylor, Walton, and Young, 1973, p. 11). They argue that it is necessary to focus on the individual offender, rather than on the criminal act. According to the

positivists, low social class position necessarily leads to poverty and inequality. That is why they argue that the low social class's position is one of the major social sources of criminality. This perspective explains criminality amongst the poor, but says little about criminality among privileged class. Opposing the positivists, the classical school of criminology focuses on offenders' conduct and considers it the conduct of free will (Beccaria, 1963). According to the classical school, all men are liable to commit crime, so it is important to focus on the seriousness of the crime and determine punishment proportionally. Critical criminologists criticised positivists for their attempt to exclude the social arrangement and the environment from the study, and for treating people as passive agents (Taylor, Walton, and Young, 1973). Gottfredson and Hirschi argued that invention of the concept of white-collar crime had two desirable consequences: it falsified poverty-pathology theory, and it revealed the criminality of the privileged classes and their impunity to the law (Gottfredson and Hirschi, 1990, p.181).

2.2 The general theory of crime and white-collar offenders

It has always been tempting to create a general theory of crime, to be able to explain all sorts of criminal conduct employing one theory. Gottfredson and Hirschi (1990) introduced a self-control theory as an attempt to consider the main causes of criminal behaviour, suggesting that low self-control in interaction with criminal opportunity is the major cause of criminality. They argued that those people with a lack of self control do not have an understanding of guilt, so they hurt people. They describe criminals as people lacking normal abilities to regulate themselves and who sustain opportunities to commit crimes. So, white-collar criminals are people with low self-control and inclined to follow momentary impulse without consideration of the long-term costs of such behaviour (Gottfredson and Hirschi, 1990, p.190-191). This may happen due to the unsuccessful socialization and the failure to learn self-control. Studies conducted in different countries found that about 25% of the variation in self-reported delinquency and crime could be explained by lack of self-esteem (Ellis and Walsh, 2000, p.323). Such variables as attachment to the family, school performance, strong belief in conventional values and religious belief, and employment are among the variables employed to explain criminality. For Gottfredson and Hirschi there is no distinction between the offender perpetrating a "crime in a suit" and a "crime in the

street" as the offenders in both cases are likely to have similar characteristics (Gottfredson and Hirschi, 1990, p.200).

The general crime theory has received wide attention and criticism. Grasmick, Tittle, Bursik, and Arneklev critically assessed the core elements of the proposed theory, by conducting a study which measured self-control and opportunity for crime. The authors supported the idea that fraud can be predicted by using a combination of both low self- esteem and opportunity for crime. However, regardless of the level of self-control, the opportunity to commit crime was a significant factor (Grasmick, Tittle, Bursik and Arneklev, 1993, p.24). The absence of effective crime-prevention situational factors had been named as one of the disadvantages of the theory (Krambia-Kaparadis, 2001, p. 22). It has been argued that general crime theory employed a number of explanatory elements which are utilised to explain how crimes are possible, namely, "opportunity, a suitable target, a free-thinking but basically self-interested hedonistic individual lacking self-control and making free-choice" (Krambia-Kaparadis, 2001, p. 22). However, the theory's explanatory power had been described as moderate and in case of serious criminality, even incomplete (Ellis and Walsh, 2000, p. 326).

2.3 The psychological theory of crime

Traditionally, psychology has been concerned with the individual aspects of crime, attempting to answer such questions as who becomes a criminal and why. Blackburn noticed that most of the early psychological research on criminals was conducted by prison physicians (Blackburn, 1983, p. 32). In the USA at the beginning of the 20th century, researchers mainly focused on the causes of juvenile delinquency, correlation between intelligence and crime, and psycho-dynamic theory (Ibid., p. 32). Blackburn considers three general psychological theories from psychoanalysis (Blackburn, 1983, p. 136). Psychoanalysis claims that failure to create the following conditions can cause criminality : first, successful socialization which depends on the success of social values transmitted through childhood; second, a developed parent-child relationship; third, a normal family relationship avoiding unconscious conflicts (Blackburn, 1983, p. 116). The theory of personality created by Eysenck (1977) considered three sets of propositions. First, the descriptive model of personality, which relates to three dimensions, Neurotic -Stability, Psychoticism-Superego, and Extraversion-Introversion. On the basis of these three models, Eysenck argues about

the biological basis of personality. The third element is a socialisation theory. Eysenck's theory predicts different levels of criminality depending on which characteristics are the best suited to the individual (extroverts, individuals who are high on neuroticism and psychoticism tend to show high levels of criminal behaviour). Cognitive -development theories deal with socialisation and moral development. Children construct moral judgements through their experiences of social interaction and these may later affect their judgement on what is right and wrong. Reckless (1967) suggested that good concept of self is an obstacle to deviant acts, "the self factor can explain selective resistance to deviant patterns or veering away from the street corner and delinquency" (Reckless, 1961, p.446). The impact of positive concept of self was mainly studied in cases involving juvenile delinquency. Cressey conducted a study of criminal violation of financial trust, interviewing those convicted on financial fraud charges (Cressey, 1953). Cressey's theory suggested consideration of three self-factors: a concept of self, awareness and rationalisation. Rationalisation has a special place in this theory. According to Cressey, it is necessary and essential to criminal violation of trust. People do not invent rationalisation techniques, but use those available in their culture. The way people rationalise their activity may be linked to the manner in which trust is violated and the socio-economic position of violators (Cressey, 1953, p. 137).

> "Trusted persons become trust violators when they conceive of themselves as having a financial problem which may is non-shareable, are aware that this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalisations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property" (Cressey, 1953, p.30).

Cressey's findings are considered to be controversial because of the methodology he had chosen. The respondents selected for the interview were in prison, the place where white-collar criminals were less likely to be.

Kaplan (1980) considered the importance of self-esteem to prevent criminality. The self-esteem motive is defined as the personal need to maximise the experience of positive self-attitudes and to minimize the experience of negative attitudes (Kaplan, 1980, p.8). It is suggested that self-esteem derives from competence and confidence

in achievements, and acceptance in social relationships. Failures in these areas may lead to self deregulation and subsequent criminality (Blackburn, 1983, p.199). Social psychologists consider a number of self-factors, such as self-concept, image, understanding of limited opportunities, norm erosion and neutralisation (or rationalisation). All these factors are named as possible determinants of a tendency towards or away from criminal behaviour (Reckless, 1967). For example, Rose-Ackerman stressed the importance of the self-control factor. "There is one human motivator that is both universal and central to explaining the divergent experiences of different countries. That motivator is self-interest, including an interest in the well-being of one's family and peer group. Critics call it greed. Economists call it utility maximisation" (Rose-Ackerman, 1999, p.2). Criminologists call it corruption and grand corruption.

2.4 The sociological theory of crime

Most sociological theories of crime focus on criminality and attempts to find social and cultural factors which predetermine criminality. The social environment and sub-cultural theories are represented by the "differential association", "social learning", "strain", "labelling", and "disorganisation" theories.

The term 'white- collar crime' was introduced into social science by Edwin Sutherland more than half a century ago. His primary concern was 'crime in relation to business' (Sutherland, 1940, p.,38). Sutherland examined the criminal behaviour of 70 of the largest US companies and 15 public utility corporations (Sutherland, 1949). He felt there was a lack of an integrated approach between sociology and economics. "The economists are well acquainted with business methods but not accustomed to consider them from the point of view of crime; many sociologists are well acquainted with crime but not accustomed to consider it as expressed in business" (ibid., p.38). According to Sutherland, white- collar crime in business mainly focuses on "the form of misrepresentation in financial statements of corporations, manipulation in the stock exchange, commercial bribery, bribery of public officials directly or indirectly in order to secure favourable contracts and legislation, misrepresentation in advertising and salesmanship, embezzlement and misapplication of funds, short weight and measures and misreading of commodities, tax frauds, misapplication of funds in receivership and bankruptcies" (ibid., p.40).

Sutherland was also among the first sociologists to stress the financial cost of white-collar crime, "the damages this type of crime imposed on social institutions, the creation of distrust and social disorganisation on a large scale" (ibid., p.42). He applied the definition to those ' respected ', 'socially' accepted and 'approved' and 'looked up to'. Sutherland also stressed the importance of such an issue as the implementation of the criminal law that apply to the lower and upper class criminals. "The crimes of the lower class are handled by policemen, prosecutors, and judges with penal sanctions in the form of fines, imprisonment, and death. The crimes of the upper class either result in no official action at all, or result in suits for damages in civil courts, or are handled by inspectors and by administrative boards or commissions with penal sanctions in the form of warnings, orders to cease and desist, occasionally the loss of a license, and only in extreme cases by fines or prison sentences. Thus, the white- collar criminals are segregated administratively from other criminals and largely as a consequences of this, are not regarded as real criminals by themselves, the general public, or the criminologists" (ibid., p. 45). Sutherland wrote this in 1940 and his major concern was the moral one, namely the inequality of those people from privileged and disadvantaged backgrounds, those who represent the low and the upper classes. He noted that "although the concept of 'status' is not entirely clear, it seems to be based principally upon power" (Sutherland, 1949, p., 224).

The differential association theory proposed by Sutherland can be summarised in the following propositions. First, that criminal behaviour is learned, similar to any other types of social behaviour, and it is not inherited. Second, criminal behaviour is learned through the internalisation and acceptance of "definitions favourable to violations of law relative to definitions unfavourable to law violations (Ellis and Walsh, 2000, pp. 340). Third, the more the individual has contact with others who violate the law, the more chances that the individual will adopt the law violations shown by others to himself/herself. The principle of differential association lies in fact that an individual becomes delinquent because of "an excess of definitions favourable to violation of law over definitions unfavourable to violation of law (Sutherland and Cressey, 1969, p.430). According to this theory, social disorganisation can lead to high crime rates. This learning theory had been criticised for the extensive use of vague psychological assumptions about human learning (Blackburn, 1983, p.90) . However, some authors suggest that this theory may be

useful in explaining the white-collar offences (Krambia-Kapardis, 2001). For example, differential association theory is useful in understanding such misconduct as an intentional victimisation a company by someone who illegally obtained a position of trust within the company. In this case, the association with other criminals helps to acquire necessary skills in committing fraud (Ibid., p.37).

2.5 Neutralisation technique theory

One reason why offender who has conventional values fail to prevent deviant conduct may be found in what Sykes and Matza called techniques of neutralisation (Sykes and Matza, 1957). There are five techniques of neutralisation: the denial of responsibility, the denial of injury, the denial of the victim, condemnation of the condemners, and appeal to high loyalties. An illustration of neutralisation is provided by the beliefs that some businessmen in transition countries described as association with their tax evasion, such as "everybody does it", or "it's not a major crime compared to what our officials do".

2.6 Control theory

In the context of this theory, control is a restraining factor, presented in the individual in the form of norms, such as authority of social institutions, like family and schools (Blackburn, 1983, p. 91). Hirschi suggested that the following four correlated elements of the bond are essential to "grow" the law-obedient citizens: attachment to others, commitment to conventional goals, involvement in conventional pursuits, belief in the moral validity of conventional values (Balckburn, 1983, p.91). The theory suggested by Hirschi was concerned with general criminality, and not with specific offences. There is a disagreement among the criminologists as to whether it is possible to explain grand scale economic crime by employing this theory (Krambia-Kapardis, 2001, p.39).

2.7 Situational crime prevention

Clarke (1980) argues that when considering criminal conduct emphasis should be made on choices and decisions made by the offenders. This would allow change of the preventative options, for example, to increase the risk of being caught. "It would be better for the burden of crime reduction to be gradually shifted away from the criminal justice system, which may be inherently selective and punitive in its

operation, to preventative measures , whose social cost may be more equitably distributed among all members of society" (Clarke, 1980, p.144). Applying this theory to the understanding of white-collar criminals conduct, one could argue that the creation of severe penal sanctions and peoples understanding of these sanctions could work as a crime reduction mechanism.

2.8 Examples of empirical research on white-collar crime

Gibbons (1979) noted that "in many areas of sociology it is possible to list a considerable number of important contributors..., but in criminology, Sutherland stands virtually alone" (1979, p., 65). The majority of social science researchers agree that Sutherland opened a new research area for social science, however he "did not establish a 'school' or research tradition" (Punch, 1996, p.,51). Sutherland's study was followed by only a few scientific investigations. Among them being a study of business violation of price (Clinard, 1952), the study of the wholesale meat industry (Hartung, 1950), interviewing embezzlers incarcerated in federal prisons (Cressey, 1953).

In the mid 50-s and 60-s researchers focused less on the moral concern and the attention shifted towards the consideration of 'occupational crime', the study of crime in industries. It was suggested that general culture can be a cause of crime. Taff and England (1964) argued that firstly, "our society involves the relative tolerance, acceptance , and even the approval of explorative behaviour of either the white-collar crime type, or that of the non-criminal exploiter"; secondly, "organised businessmen are not inclined to be specific in defining the right ways to conduct business"; thirdly, "socially dangerous people (causers of the causes)- these dangerous people are those who, not necessarily technically criminal themselves, nevertheless create conditions which result in crime or serve as examples consciously or unconsciously imitated by the potential criminal" (Ibid., p., 17).

Leonard and Weber (1977) studied criminogenic market forces in the area of auto-makers and dealers and suggested that "insufficient attention has been focused by sociologists on the extent to which market structure- that is, the economic power available to certain corporations in concentrated industries- may generate criminal conduct"(1977, p., 134). According to the economic literature market structure involves such aspects as:

1. "seller concentration, or market share of the leading producers;

2. buyer concentration, or market share of principal buyers;

3. product differentiation, or extent to which the product can be distinguished in the customer's mind through refinements, advertising, and so forth;

4. entry barriers- e.g., costs of capital, patents, economics of sale, advertising expenses;

5. price elasticity demand;

6. growth rate of demand." (Ibid., p.134)

Leonard and Weber argued that 1, 3, and 4 are the most important issues. Their concern was the concentrated market structure which could generate 'excessive power in the hands of a few corporations' leading to engagement in 'unethical activity against the public'. They suggested that 'competitive forces rather than government [should] do the regulations'. The term 'conditioned crime' was introduced to identify 'a crime stimulated by conditions over which the dealer has little control'.

The classical definition of white-collar crime suggested by Sutherland had been the subject of discussion and criticism for almost half a century. Sutherland definition had been considered as very restrictive in terms of offender class. "The requirement that a crime cannot be a white-collar crime unless perpetrated by a person of 'high social status' is an unfortunate mixing of definition and explanation" (Braithwaite, 1985, p., 3). One of the major developments in the white-collar crime study was the shift of the focus from the characteristics of offenders to the characteristics of offences. Edelhertz (1970) formulated the alternative definition of white-collar crime. He defined it as "an illegal act or series of illegal acts committed by non-physical means and by concealment or guile, to obtain money or property, or to obtain business or personal advantage" (1970, p., 7). According to some authors (Edelhertz, 1970, Edelhertz and Rogovin (1980), Braithwaite, (1985)) this neutral to social standing definition is a crucial point for public policy. Braithwaite argued that "it is unacceptable for the state to target enforcement that is contingent on the status of the offender" (Braithwaite, 1985, p.,18).

Reiss and Biderman (1980) avoided the use of the word 'crime' and introduced the definition of white- collar law violations. "White- collar law violations are those violations of law to which penalties are attached and that involve the use of a violator's position of significant power, influence, or trust in the legitimate economic or political institutional order for the purpose of illegal gain, or to commit an illegal act for personal or organisational gain" (Reiss and Biderman, 1980, p., 4). Punch

(1986) argues that such a definition has a few advantages over the previous ones. It helps to open up the area of private law, takes into consideration acts committed on behalf of the organisation and not only for personal gain (Punch, 1986, p., 55).
The research conducted by Clinard and Yeager (1980) studied illegal corporate behaviour and difficulties involved in attempts to control such behaviour. The study involved 582 of the largest publicly owned corporations in the USA and examined legal violations brought by twenty-four federal agencies. Clinard and Yeager observed that 'corporate violations are exceedingly difficult to discover, to investigate, or to develop successfully as legal cases because of their extreme complexity and intricacy' (1980, p., 6). They define corporate crime as 'any act committed by corporations that is punished by the state, regardless of whether it is punished under administrative, civil, or criminal law' (1980, p., 16).
Braithwaite (1985) discussed the advantages of white-collar crime division into occupational and corporate crime. "Occupational crime consists of offences committed by individuals for themselves in the course of their occupations and the offences of employees against their employers...Corporate crime, in contrast defined as "the offences committed by corporate officials for the corporation and the offences of the corporation itself" (Braithwaite, 1985, p., 19). Braithwaite argued that "while useful theories of white-collar crime have proved elusive, influential corporate or organisational crime theory is a possibility" (Braithwaite, 1985, p., 19). Tonry and Reiss (1993) argued that organisations 'are central offenders in many violations of law', organisations are responsible for creating climates 'where collective deviance is an acceptable answer to perceived institutional dilemmas (Tonry and Reiss, 1993, p.,1-5).
Clinard and Yeager (1980) study of illegal corporate behaviour showed the difficulties related to the disclosure of illegal conduct. Clarke (1990) examined the characteristics of business crime and identified its major factors, which again proved the complexity of the phenomenon. Among such factors are: a) business crime takes place in the business environment and hence in a private context; b) business offenders are legitimately present at the scene; c) business offences are political because of their essentially contested character' and this can lead to protracted struggles in the public realm involving the mobilisation of considerable and powerful resources by the contending parties; d) there is fundamental ambiguity about business crime which is 'profound and pervasive'; e) it raises in acute form debate about the

balance between the 'private interest' and the 'public good'; 'the danger of unfettered private enterprise is that it generates into greed, ruthlessness, and deceit to the oppression of those insufficiently cunning, skilled, wealthy or powerful to protect themselves, and so polarises the haves from the have-nots' (Clarke 1990, p., 20-31). The list can be continued. It is possible to add such factors as the complexity of evidence and the location of offences.

2.9 Red-collar crime: an application of the known theories to the realities of post-soviet countries

The term "red-collar" crime was introduced by American researchers in the beginning of the 80-s to refer to crimes committed by those who occupy important positions in Soviet countries (Los, 1986). Party members, top-level state officials, ruling elite were among those who could potentially constitute the group of 'red-collar' criminals. Despite the fact that large scale bribery and embezzlement of state property were punishable by death in Soviet Union, these types of crimes were well practised in different republics.

The majority of corruption cases reported involved officials and politicians from the Caucasian and Central Asian republics. For example, "in 1979, only a few years after the thorough reorganisation of the hierarchy of the Azerbaidzhan Republic, heads of three ministries were dismissed from their posts" (Los, 1986, p.4). In 1984 , a plenary session of the Uzbekistan party pointed out that favouritism, personal loyalty and mercenary motives are present among some party members (Ibid., p. 5).

The reason to prosecute corruption in a few selected republics was rather political. It gave high officials chance from one side to at least claim that corruption is tackled, and from the other side, it would not uncover the prevalence of corruption throughout the USSR.

A widespread corruption was described by Simis, a former defense lawyer in Moscow for underground business (Simis, 1982). He writes that in the 1970s the Soviet Judicial system had been ravaged by two parallel scourges: dependence on Party and State authority and corruption. The author traced these roots of corruption in the judicial system from the end of the Second World War, when "a people's judge's monthly salary would just about cover the cost of dinner in a commercial restaurant" (p.69). According to Simis, at that time the prosecutor's offices and the judges were all trading in justice simply to obtain additional sources of income to live a decent

life. At the beginning of the 1960s, when the "anti-bribe raid" began, there were some courts in Moscow where not a single former people's judge or public prosecutor remained, since it had been necessary to replace whole corrupt groups with a completely new group (Simis, 1982).

Los identified three types of red-collar crime, such as top-level corruption, crime against the central plan, and crimes against the principles of state production (Los, 1986, p.4). The Soviet type of economy was characterised by the lack of incentives, and ineffective organisation of production processes. These had been considered as opportunities for the introduction of illegal incentives and increased productivity (Los, 1986, p. 14). Sometimes greater productivity was achieved by simply improvements introduced to the organisation of production process. Surplus goods could be sold privately at a big profit due to the use of free state resources and black market prices. Los considered illegal parallel enterprises as "the most feasible solution to the profit -seeking habits of many executives in communist countries" (Ibid., p.15). Widespread use of the double record keeping was named as one of the socio-economic factors which makes such operations possible. To survive in a Soviet system enterprises were inevitable involved in illegal efforts to 'neutralise' control agencies, and to use them as a tool to cover parallel economy.

The decade of the 80-s witnessed two different approaches to tackle corruption and criminalisation of officials in the country. One was introduced by Andropov in early 80-s, as more stress on discipline, responsibility and organisational improvements. This was done with the help of KGB files on corrupt state officials. In the middle 80-s Gorbachev proclaimed that it was a right time for 'perestroyka' and 'glasnost'. His method of tackling corruption mainly consisted in replacing 'old' political mode. Los notes that "the official reason for many of the publicised dismissal are vague and seem to be applied quite mechanically. They include nepotism; mismanagement; carelessness; lack of vigilance, principles or modesty; political immaturity; and violations of socialist legality , norms of party life, or Leninist norms" (Los, 1986, p.18). It is clear that in the system where corruption is endemic, any officials may be charged with such violations. Los named Gorbachev approach as "wholesale" approach (Ibid., p.18). It was clear, that without the system restructuring the simple replacement of people is meaningless.

Kurkchiyan (2000) analysis the 'second economy' in the USSR and argues that "by taking part in the second economy people grew accustomed to the practice of

informal problem-solving. They cultivated a tradition of bypassing officialdom...a psychological condition of general alienation from the state became widespread" (Kurkchiyan, 2000, p., 88).

With the collapse of the Soviet Union, all the newly born independent countries started their own way towards the development of the democratic societies. This period is known as 'transition', meaning transition from the socialist-communist towards liberal capitalism forms of social organisation. Kurkchiyan writes "the move to the new system was not gradual, but sudden in its velocity and revolutionary in its impact" (Kurkchiyan, 2000, p.,88). The transition experience varies dramatically from country to country. Research on political, social and economic indicators suggest that in Central Europe reforms have been conducted in an 'orderly and clean manner', while in other countries, such as countries of the former Soviet Union (with the exception of Baltic countries), transition had the form of 'chaos and disintegration' (Fatic, 1997, p.2).

Part of the explanation of this chaotic and disintegrative transition can be found in the following facts. As it has been said, in communist countries, and especially, those of the former USSR, members of the communist party, the so-called elite and their supporters enjoyed a number of privileges. This group was able to use the system to collect benefits which were almost prohibited to the ordinary people. This inequality in the distribution of benefits and goods created the special group of population, namely the ruling elite or oligarchy. It must be said that this group lived under their own strict rules. For example, the distribution of privileges was conducted according to the job position, if you are a member of the district council you would get only a certain amount of the privileges, and the senior your position the more benefits you get (from extra food provision at the very low level to the state paid car with the driver and luxury apartments). After the collapse of the USSR, the official ideology had changed. But what did it mean in practice?

Fatic (1997) writes:

> "Liberalism requires initial equality and respect for the privacy of individuals. Liberal political economy does not call for any redistribution of resources on the basis of their origin and the circumstances of their acquisition (as long as this was legal), but rather for the respect of existing differences, equalisation of the terms of competition, and a gradual redistribution, according to the principles of economic efficiency. This means that those who had the resources from the beginning - and they were very few compared to the mainstream population, which was impoverished and politically victimised

under communism- are free to use their resources in accordance with the newly discovered and established rules of the market..." (Fatic, 1997, p.156).

Based on the above presented theories, there are at least three components which should be addressed to provide the theoretical framework to understand the rise of white-collar crimes in transitional society. First is the existence of a group of crime prone individuals. At the beginning of the 90-s this group was presented by two subgroups: those, whom Los named 'red-collar' criminals, namely party officials, politicians, directors of big state enterprises, who kept their jobs after the regime change; and those businessmen who were unable to operate legally under the previous regime. The second, and the major component is opportunity. Lack of general knowledge of the financial market mechanisms, lack of legislative framework to operate in a new business environment, all these factors have opened a new horizons for a big scale 'criminal projects, like banking, privatisation, certain areas of entrepreneurial activity (see chapter 4). Neutralisation of the criminal action, or rationalisation is the third component: 'If everyone does it why not me'. While this technique justifies the spread of the economic crime amongst the general population, it can also be employed when addressing the grand scale financial crime. As the Ukrainian expert interviews suggest (Chapter 4), every level of the official hierarchy blames the level above in gaining more from illegal conduct.

During the chaotic early years of transition former communist elite and their supporters acquire control of large companies. This may be seen as the classical example of the abuse of the job position, neglect of the rule of law, and intentional deterioration of the economic situation in the country. It may be argued that the previous ideology allowing the redistribution of the privileges according to your plaice in the hierarchy had been changed by the ideology of the 'absolute power', and may be summarised in the proverb 'what the power is for if it is not to be abused'. The case study on corruption presented in Chapter 4 provides more detailed answers to the question raised.

The ruling elite and those who conduct illegal business had (and still have) a 'big cover' which is the judiciary system. Simis (1982) argues that the judges in the USSR created a very special legal tradition of 'dependent judgement'- judgement according to the standards imposed by the government. Fatic argues that "when the over regulated communist system gave way to liberal and capitalist societal arrangements, the judicial institutions found themselves in the position of not being able to cope

with the new duties, especially with their independence acquired overnight" (Fatic, 1997, p.151).

How could all these facts be helpful in our understanding of the causes of the current rise of economic/white-collar crime in Ukraine? First of all, it has to be understood, that white-collar crime is not a new phenomenon in the country. For a long time party officials abused the system and enriched themselves using illegal means. This philosophy of 'absolute power' had survived the transition and became a slogan for a modern day politicians or a state official. They socialise and 'grow up' politically to become 'old faces' under the new masks. Control theory suggests that to become a law obedient citizen, among the other factors, one need to have commitment to conventional goals, belief in moral validity of conventional norms. Obviously, transition from the communist ideology to the liberal-democratic is a difficult time. Norms and values can not be changed just overnight, especially when one could never be sure who is right and who is wrong, and what constitutes the illegal conduct. Second, high level of economic crime amongst the senior officials can not be kept in secret from the ordinary citizens. So, that for general population there are two ways to resolve the moral problem: revolution or 'peaceful rebellion'. In a peaceful rebellion approach, ordinary citizens separate themselves from the 'state' and live their own lives, not counting on the help of the government, but rather trying to avoid its obligations and regulations. By creating this cover known in criminology as the neutralisation techniques, like denial of responsibility, the denial of injury, ordinary citizens adopt their own approach as to how to avoid regulations imposed by those whom they seen as corrupt and irresponsible. A very simple example is the denial of the responsibilities for tax evasion. In the system which does not care for ordinary citizens and creates unjustifiably complex regulation, business people at any level do not feel guilty by breaching the taxation regulations. They would know, that those at the top do the same on the bigger scale, and do not care, so why should they, ordinary businessman be committed to what has to be conventional norm. As suggested by Fatis (1997) "only by accepting a certain moral and cultural order, constituted by a certain order of values, the law becomes possible as a normative framework within which the relationships of legitimate mutual expectations between members of society are constituted, and which gives meaning to what is these days increasingly called "the social capital of trust" in the institutions (Fatis, 1997, p.1).

Social trust is a very important concept, which reflects the advances in different areas of life. Economists consider trust as a carefully calculated long-term interest , which brings different groups of people together and results in the voluntary contracts. The efficient functioning of the modern economies is dependent on social trust. It has been argued that the level of development of economy reflects the level of trust in the society. Fukuyama finds a possible explanation of corruption in a system with narrow radius of social trust, where different standards of behaviour would apply to different groups of people (Fukuyama, 2001). In such system, the 'transaction cost', the cost of legal agreement, can be substantial. Transition societies, such as Russia and Ukraine have 'weak voluntary associations' because people do not trust one another. The primary form of kinship has substituted the voluntary associations of people.
What are the differences between the class of white-collar criminals in transition and developed economies. The author suggests that the major difference is in the probability of being shamed and punished for what you have done. It means less fear to abuse the system, especially then the system is under-regulated in such fundamental areas as business law, protection of contracts, trade practices regulation.

2.10 A brief summary of the development of the theoretical framework

To clarify the development of white- collar crime theory let us summarise the findings according to the historical perspective. It all started in the beginning of the 20th century with the Marxist focus on class structure and neglect of the ruling class crime. Late 1930s- 40s may be identified as the decade of the Sutherland white -collar crime theory. 1940-70s domination of American studies, attachment to "who" and "why" questions and a weak public interest to the problem of white-collar crime. 1970s- early 80s a new string of publications as a reaction to Watergate scandal and foreign officials bribery (USA). Mid 70s -mid 80s were observed as the 'Theoretical Reorientation' and focus on organisational and corporate crime. The mid 80-s British and Australian studies of white-collar crime had their emphasis on "how" question. The mid 80-s also experienced the establishment of the international treaties and organisations aiming to study and prevent white- collar crime.
Although economic crime has been considered as an important element in white-collar crime it is only after the so-called theoretical reorientation had taken place, and the focus of attention had been redirected from the social characteristic of offender to

the characteristic of offence, that the economic crime phenomenon had actually started to be defined as the major component in white-collar crime.
The white-collar offending includes a broad range of criminal conducts. There are many factors that may contribute to white-collar offending. The explanations presented by one single theory is not the answer. The environment, socio-cultural aspects of the society where the crime is committed should always be taken into the consideration. Such factors as weak society's values, advances in technology used by criminals, socio-economic instability named by many as reasons in increased number of economic crimes (Krambia-Kapardis, 2001, p. 41). It is rather impossible to single out one factor which can cause the white-collar criminality. In explaining it, one should take into consideration, the personality, environment, and situational factor.

The next chapter considers economic development and its relationship to financial institutions in the country. It starts by elaborating on the advantages found in white-collar type of crime, and continues with the financial market and economic development of advanced and transition counties, and the modern day type of white-collar crime.

Chapter 3. White-collar crime and financial market

3.1 The white-collar crime advantages

Why does white-collar crime present such a danger to the society? Based on the Sutherland's concept of white-collar crime, there are three basic factors to explain the different treatment of white-collar and street criminals. First, is that judges view white-collar offenders "as offenders whose social standing is similar to their own", and that is why they are reluctant to prosecute them. Second, white-collar criminals have more resources to invest in legal defences. Third, for a long time laws have been formulated in such a way as to exclude white-collar crime (Calavita, Pontell, Tillman, 1997, p.149). Recent studies addressed these problems in an attempt to find the best possible solution to the problem (Shapiro, 1984; Posner, 1981; Gurney, 1985). Shapiro studies securities violations in the USA, writes that "upper status offenders are less vulnerable to criminal prosecution, but must defend themselves frequently in civil and administrative proceedings. Lower statues wrongdoers who collaborate with their bosses are treated more like the bosses than like lower status perpetrators acting alone. The data suggest that any apparent discrimination against lower status offender in prosecutorial discretion is more readily explained by greater access to legal options than by social standing" (Shapiro, 1984, pp. 361-362). The study suggest that misrepresentation of the numbers of white-collar ranks offenders occur because of the existence of 'other' legal options, which divert this group from criminal process. This is exactly the same problem that Sutherland stated more than half a century ago. Shapiro suggests that "arguments that attribute the leniency accorded white-collar offenders to class bias misunderstand the structural source of leniency" (Ibid., pp. 361-362).

Posner argues that the best way to punish the white-collar criminals is to fine them. "In a social cost-benefit analysis of the choice between fining and imprisoning the white-collar criminal, the cost side analysis favours fining because, as we shall see, the cost of collecting a fine from one who can pay it is lower than the cost of imprisonment. On the benefit side, there is no difference in principle between the sanctions (Posner, 1981, p. 409). Coffee criticised this point of view and argues that "the threat counts more than penalty" (Coffee, 1980, p. 468). According to Coffee, imprisonment is a best deterrent, while fines would generally lack the deterrent value. The important issue in regard to the fining white-collar crime is to keep the criminal

justice system in balance. Meaning, "a system that fines the rich and jails the poor risks the appearance of institutionalising bias" (Ibid., p. 469).

Some studies suggest that there are factors which distinguish cases selected for enforcement (Gurney, 1985, p. 622). Gurney named three factors- type of defendant, type of victim, and number of victims (Ibid., p. 622). It tends to be that both offence and offender characteristics are related to the decision to prosecute cases of white-collar crime. On the contrary, Calavita, Pontell, Tillman suggest that the resulted leniency toward white-collar offenders can be attributed to the "neutral" systemic features of the crimes themselves and the criminal justice process (Calavita, Pontell, Tillman, 1997, p. 150).

To summarise, one of the biggest advantages of the white-collar offenders is the knowledge of inside information, which enables them to 'hide' their offences within the organisation, and to be engaged in the cover up activity at the minimum degree. It would make the investigation difficult if not impossible. This advantage together with the ability to hire the best possible legal aid makes this types of crime extremely complex for the criminal justice system.

3.2 White-collar crime and financial market

The early development of the City of London registered many cases of frauds, including insider dealing. White -collar criminals regard financial markets as a low risk high reward activity (Rider, 1996). Nowadays, most financially advanced countries have developed legal systems that regulate different forms of manipulation and fraud in their markets. However, as it has been discussed in the previous part, the reality is that the vast majority of wrongdoers in the financial market will never be prosecuted, much less sent to prison (Calavita, Pontell, and Tillman, 1997; Rider, 1996). Despite the measures undertaken, last decade has experienced an increase in the number of crimes committed in different financial sectors. "...it is clear that in recent years both traditional and other forms of organised crime have increasingly moved into "white-collar crime" and in particular securities fraud and other related activities" (Rider, 1996, p., 378). The activities may range from false statements and inducement to deal to sophisticated schemes and market manipulations. For example, bankers can permit overdrafts or provide unsecured loans at low interest rate to friends or family members; pension funds or investment companies can invest in

business in which they have financial interest; government officials can direct business to firms with which they are connected (Shapiro, 1984).

The savings and loan crisis of the 1980s in America was named as one of the worst financial disaster of the 20th century (Calavita, Pontell, and Tillman, 1997) "The estimated cost to taxpayers, not counting the interest payments on government bonds sold to finance the industry's bailout, is $150 to 175 billion" (Ibid., p.1). It is suggested that such large scale fraud was possible due to a series of white-collar crimes and political influence as a critical ingredient (Calavita, Pontell, and Tillman, 1997). In the research conducted to study the savings and loan crisis in America, Calavita, Pontell, and Tillman identify three basic types of insider abuse: hot deals, looting, and covering up. According to the authors, hot deals provide "both the cash flow from which to siphon off funds and the transactional medium within which to distinguish it...."Looting" refers to the more direct siphoning off of funds by thrift insiders and is thus more like traditional forms of crime than are the business transactions involved in hot deals... The most straightforward, but probably least common way to loot was simply to remove deposits from the thrift and stash them away...In some cases the cover-up came in form of deals ...where the primary purpose of the transaction was to produce a misleading picture of the institution's state of health" (Calavita, Pontell, and Tillman, 1997, pp.48-65).

The collapse of the Bank of Credit and Commerce International (BCCI) in the early 90-s underlined the importance of strong regulatory framework to tackle money laundering in banking. BCCI was a Luxembourg based bank operating in over 72 countries, at one time was the seventh largest private bank in the world, with stated capital of $ 1.5 billion and stated assets worth over $ 20 billion.

Among the specific offences admitted by BCCI were such as: "seeking deposits of drug proceeds and laundering drug money; seeking deposits from persons attempting to evade US income taxes; using 'straws' and nominees to acquire control of US financial institutions; lying to regulators and falsifying regulatory documents; and creating false bank records and engaging in sham transactions to deceive regulators" (Performance and Innovative Unit, 2000, p. 25). Bhala (1994) considers the implication of the BCCI scandal on the international banking and gives the following examples of the illegal conduct by the BCCI. BCCI covered up a loss of $633 million resulting from poor trading in the foreign exchange and derivative products markets. Bhala noticed that it occurred in the London office of BCCI (Bhala, 1994, p.8). BCCI

manipulated its account to cover up loans to one of its principal customers, that amounted to 60% of BCCI's capital during 1977-81 (Ibid., p8).

The BCCI scandal stimulated the discussion and the actual legal initiatives to cover the existing loopholes in legislation and regulatory practices. In response to the BCCI scandal the US regulatory authority adopted The Foreign Bank Supervision Enhancement Act (FBSEA) of 1991, aiming to strengthen the rules according to which foreign banks must play.

More recent example, is the Bank of New York case, where between 1995 and 1999, some $ 7 billion was transmitted via an illegal banking network through accounts at the Bank of New York. Most of funds came from Russia from persons attempting to evade Russian state customs duties and taxes (Performance and Innovative Unit, 2000).

It is difficult not to mention the current war against white-collar crime in America, involving the world biggest multi-national companies- Enron and WorldCom.

> A national team of 230 prosecutors is responsible for WorldCom, "which allegedly disguised deteriorating results through massive accounting fraud; the important bits of Adelphia, a publicly owned firm whose founding family helped itself to riches; and ImClone, a biotechnology start-up run by a Manhattan socialite whose alleged insider trading ensnared Martha Stewart, America's doyenne of soft furnishing. More cases may follow, including Sunbeam, a bankrupt home-appliance company whose former boss, Al "Chainsaw" Dunlap, has been accused of cooking the books (The Economist, 2002, p.67).

As on September 2002 the list of the indictments published by The Economist (The Economist, 2002, p.68) includes the following. In August 2002 a senior executive in Enron's finance department pleaded guilty to money laundering and conspiracy to commit wire fraud. A former chief financial officer of WorldCom charged with one count of conspiracy to commit securities fraud, one count of securities fraud, and five counts of making false fillings. In June 2002 a former chief executive of Tyco was charged with evading sales taxes on six paintings worth about US$ 13.2 million. In August 2002 a former chief executive of ImClone Systems was indicted on charges of insider trading, bank fraud, forging a signature and destroying records to obstruct a federal investigation. The list can be continued.

3.3 White collar crime and countries in transition

As it has been said, white-collar crime exists in different forms, from simple bank fraud to the cases involved corruption and insider dealing. The newly-born financial market systems in transition countries have presented the 'new business world' with a variety of opportunities to misconduct. Rapid political an economic changes have provided those who are in search for the loopholes in legislation with an excellent opportunity to expand illegal business, and, for example, to conduct illegal money transfers. The widespread corruption in some of the transition countries in Eastern Europe has been a helpful tool to create "a friendly environment" for money -launders (Adamoli, 1999; Osyka, 2001). For example, Shelley (1999, p. 1) writes that:

> After nearly six years of independence, total foreign investment in Ukraine is a paltry $1.4 billion, and some $15–$20 billion is believed to have left the country illegally, at least partly in response to corruption and organised crime.

As reported by BBC News World (2000):

> Former Ukrainian Prime Minister Pavlo Lazarenko has been indicted in the United States on charges of laundering $114m he allegedly stole while in office. Mr Lazarenko is being held in a US federal prison pending resolution of a Swiss extradition request.
>
> The US Attorney's Office for Northern California said a federal grand jury had indicted Mr Lazarenko, 47, on one count of conspiracy to commit money laundering, seven counts of money laundering and 23 counts of transporting stolen property.
>
> If convicted on all counts, he could face a sentence of up to 370 years in prison. Mr Lazarenko, previously a close associate of Ukrainian President Leonid Kuchma, once paid $6.7m in cash for a California estate.
>
> The Ukrainian authorities accuse Mr Lazarenko of having profited by buying and selling natural gas contracts when he was Ukraine's energy minister, and of having siphoned off millions of dollars from state programs as prime minister in 1996-97.

Research on transition countries suggests that a large proportion of economic crime is committed by or with the help of high-level public officials and politicians (International Bank for Reconstruction and Development & The World Bank, 2001; Shelley, 2000). This has detrimental effects on a developing free-marked economy (Jain, 1998; Mauro, 1995; Tanzi, 1998) and undermines the integrity of legal, political, and economic institutions within the nation (Coulloudon, 1997; Johnson, McMillan, and Woodruff, 1999; Radaev, 2000), thereby threatening the healthy development of newly born states. Corruption decreases trust and confidence in government institutions, and recent studies suggest that this directly undermines economic growth within a state (Raiser, 1999; Rose-Ackerman, 1999). Research conducted on the economics of corruption shows that countries experiencing high

levels of corruption have a lower Gross Domestic Product and rate of Foreign Direct Investment than less corrupt nations (Mauro, 1995; Tanzi and Davoodi, 1997). Tanzi and Davoodi (1997) found that corruption motivates government leaders to increase public investments, which does not necessarily add to economic welfare. This is a special case in countries where governments play a large role in the economy. Researchers also found out that public investment as a ratio of GDP is strongly related to a corruption index. There is also a link between the quality of investment and corruption. "Corruption reduces growth by increasing public investment while reducing its productivity"(Ibid., p.20).

Mauro (1995) linked macro-economic performance to an index of corruption. The researcher examined indices developed by Business International to measure the institutional efficiency. The results of the study proved that corruption significantly lowers the levels of investment in an economy. Corruption may affect the collection of taxes in some countries. The author suggested that corruption of tax officials might result in decline of total revenues and grants of the government.

Further, the economic costs of the corrupt privatization process in the transitional countries have been tremendous. Describing Russia, Fituni (2000) states that "The money our oligarchs paid at the auctions was, more often than not, interest-free credits from Central Bank, i.e. they were buying expensive enterprises virtually for a song" Fituni (2000, p. 25).

Till the beginning of the 1990s insider dealing was not illegal in most European countries. Bhattacharya and Daouk (2000) considered insider dealing and stock markets around the world. To measure insider dealing on the stock market Bhattacharya and Daouk examined the cost of equities and its variation using different approaches. They concluded that it is not the introduction of insider dealing laws what matters, but the enforcement and the first successful prosecution.

The impact of corruption and especially grand corruption on the economic development of the country has been a subject for discussion since the mid-90s. The World Bank provides comprehensive recommendations as to how to prevent corruption inside the banking sector in developing economies, especially in regard to the World Bank projects countries. Aguilar, Gill and Pino (2000) stated that corruption affects macroeconomic stability, it discourages investment, including foreign direct investment. As a consequence it raises the cost of doing business; reduces competitiveness of domestic enterprises in the international market.

Corruption by foreign officials is the focus of the study conducted by The Society of Advanced Legal Studies Anti-Corruption Working Group. According to the report, the scale of the wealth reported to have been acquired in cases of grand corruption is staggering and can even threaten economic development and stability of the whole country. The World Bank estimated that the sums distributed world -wide each year in 'pay-offs' or 'bribes' total US$ 80 billion. The negative influence corrupt foreign officials may pose on the development of the country has been studied from such perspectives as: impact on economy or private business relationships (when the business environment is too risky and the level of corruption is high, so that unless the bribe is offered there is no reason to compete for contracts); negative impact on the country's relationships with other country (illegal immigrants); negative impact on public safety (illegal drug trafficking , fraudulent immigration) (MacLaren, 2000, p.3). Based on the Canadian experience, MacLaren suggested, that it is essential to develop an ethical position in relationship with other countries and international organisations.

It is recognised that white-collar crimes present a danger to the developed and financially advanced countries. In case of transition countries where the legal system is under the constant development, financial institutions are in new born stage, and political is unstable, white-collar crime has found a fertile soil to grow.

3.4 Financial markets and economic development

The central question addressed in this research is the impact of economic crime on the development of financial markets in transitional countries. First of all, we need to answer why the financial market plays such an important role in the economic development of modern countries.

The relationship between economic prosperity and the development of financial intermediaries can be considered from two perspectives: traditional and new. The neo-classical or traditional view paid little attention to the role of financial intermediaries in long-term economic growth. The traditional view was that financial markets are simply the "handmaiden of history" (King and Levine, 1992, p.156). Financial intermediaries were considered simple channels to direct household savings into business investment. However, in the 1960s, researchers acknowledged the importance of effective resource allocation and the role the financial intermediaries could play (Roubini, 1996, p. 194).

The new view discusses the primary importance of the financial intermediaries in the development of economic growth in a country (King and Levine, 1992). The main idea of the new view is to show a relationship between the efficiency of the financial system, the quantity and efficiency of the allocation of resources to entrepreneurs and the amount of productivity-enhancing investment in intangible capital (Roubini, 1996, p. 194). To show the importance of financial intermediaries, King and Levine established the following model representing sustained economic development. Sustained economic development involves at least three parameters: entrepreneurship, intangible capital investment, and financial intermediation. At the centre of their theory is an entrepreneur willing to undertake some innovative economic activity (Ibid., p.158-160). King and Levine interpret the innovative economic activity very broadly.

"The key aspects of our view are as follows:

1. There is an entrepreneur who seeks to undertake an innovation, which requires finance of investment.
2. Entrepreneurs are heterogeneous: some ideas that are efficient for society to undertake, others do not. Evaluating the desirability of ideas is feasible at some cost, but it is essential that the process of evaluation not reveal too much information about the nature and character of the ideas. Otherwise the ideas might be appropriated by competitors.
3. Much of productivity-enchanting investment involves construction of an intangible capital good. By the nature of this asset, (i) it is difficult for a third party to evaluate the efficacy of the investments; and (ii) it serves as poor collateral, because it is embodied in an entrepreneur and a team of managers and production workers.
4. The returns to intangible capital good are quasi rents that are determined by (i) the size of the market; (ii) the rates of innovation of competitors; (iii) taxation and public regulation" (King and Levine, 1996, p.159).

In such a system, financial intermediaries play an essential role as a tester to distinguish the creditworthy of entrepreneurs. In other words, quality evaluation of entrepreneurs' innovations depends strongly on advances in financial services. Efficient resource allocation would be followed by increased productivity and growth by means of "physical capital accumulation, improvements in the types of intangible capital, and human capital development" (Ibid., p.160). The difference between rich and poor countries may be presented in the following three propositions: rich

countries have more savings in liquid assets per dollar of GDP, they do more lending per dollar of GDP, and they tend to allocate their lending to private companies (Ibid., p.170).

By employing a multivariate regression analysis, the above mentioned authors showed the importance of well developed financial institutions to the economic prosperity of a country. King and Levine examined the empirical importance of the different measures of financial intermediation to the rate of per capita GDP growth, and the effect of financial indicators on physical capital accumulation and proxy for productivity growth. The results suggest that by measuring the financial intermediary services it is possible to predict economic growth (King and Levine, 1996, p.182).

A cross-country study conducted by Eschenbach, Francois, and Schuknecht (2000) examined a sample of 93 countries found out that there is a strong positive relationship between financial sector openness, and between growth and financial sector competition. The researchers paid specific attention to the role of international trade in services, 'a causal chain linking financial sector openness, financial sector performance , and growth performance' (Ibid., p.106). Eschenbach, Francois, and Schuknecht (2000, p.104) writes

> "Our results suggest that moving from a closed to a relatively open financial services regime is correlated with significant pro-competitiveness pressures, and ultimately with large differences in growth rates (0.7 percent for a typical developing country). Because it is the developing countries in our sample that tend to be closed, this points to a significant potential growth bonus for developing countries who move from closed regimes towards regimes comparable (in terms of openness) to those of the OECD countries".

What are the implications of these findings for the development of transitional countries? It has been suggested that countries with well-developed banking systems, which allocate substantial resources to the private sector experience better economic growth over the future decades. In this case the development of the financial market is essential: it increases the rate of capital accumulation and the efficiency of resource allocation. For transitional economies it is important to generate growth. The most efficient way to achieve this goal is by establishing financial market institutions. Understanding the difficulty of transition King and Levine write "a major policy challenge will be to encourage the development of healthy, private-sector oriented financial institutions, uncontaminated by the bad debts of deteriorating state-owned enterprises, while political pressure force some financial institutions temporarily to

finance loss-making enterprises during the transition" (King and Levine, 1996, p.186).

To improve resourse allocation, transitional countries should make the difficult choice between emphasis on the development of stock market or banks. Stock market- and bank-oriented systems have existed for many years, however different countries have different experience and priorities. History knows examples of different modes, such as 'Anglo-Saxon', 'Franco-German-Japanese' and 'market socialist'. During the Industrial Revolution in the UK in the nineteenth century, new industries were mainly financed through the London Stock Exchange. While almost at the same time, Germany favoured bank finance. Allen suggests that countries in which stock market financing was prevalent reacted to progress and changes more rapidly (Allen, 1996, p. 102). "Banks will be a good way to provide financing in traditional industries such as agriculture where the technology is well known and there is a wide consensus on how things should be done.... Countries that will have a significant stock market will be those with a significant amount of technological innovation in the sense of developing entirely new industries and those industries with a significant amount of concentration" (Allen, 1996, p.102).

Transitional literature discusses the advantages and disadvantages of the policy choices made by countries with emerging markets. Coffee underlines the importance of the securities market development in transitional countries. Among the arguments in defence of the development of a strong securities market are "companies in economies without strong securities markets necessarily become more dependent on bank financing,...[companies] become more vulnerable to a downturn in the business cycle", stock market development is an essential element in building corporate governance mechanisms, gaining experience in firms' investment and management (Coffee, 2001, p.7). However, experience shows that not all transitional countries are able to develop stock markets. In some small countries, the development of stock markets will be very costly. Claesssens, Djankov, and Klingebiel argue that such countries should start the development of their financial system with the banking industry. By concentrating on the expansion of the banking system, the country would promote the development of the small and medium-size enterprises and, in the long term, the economic growth of the country (Allen, 1996; Claessens, 1996; Claesssens, Djankov, and Klingebiel, 2000).

All transitional countries strive to achieve sustained economic development. For the purpose of present study it is essential to recognise the importance of the advances in financial institutions development. Transitional countries such as Ukraine are in bad need for the quality investments into the economy. It tends to be that one of the best way to achieve sustained economic development lies in establishing transparent financial institutions able to allocate resources and provide productivity enhancing investments.

Next section will briefly consider the development of financial institutions in transition countries.

3.5 Financial market and countries in transition

Since the beginning of the 1990s, the focus of attention has been centred on the development of financial markets in transitional countries. First of all, because the development of financial market is essential for economies in transitional countries. Well functioning market unable companies to raise money for investment quicker and with low cost involved. Second, well functioning financial market, with transparent structure and access to information, is one of the indicators to measure the development of corporate governance, and to some extent, even democracy. There are three basic measures to analyse the development of financial market in transition countries: market capitalisation, market turnover and the existence of institutional investors (Claessens, Djankov, Klingebiel, 2000; Coffee, 2001).

3.5.1 Market capitalisation

The most typical indicator used to measure securities market's development maturity is "the ratio of market capitalisation to Gross Domestic Product" (Coffee, 2001, p.10).

Table 4. Market capitalisation in transition countries and comparator economies, 1994-2000.

Market Capitalization in Transition Countries and Comparator Economies, 1994-2000
Percentage of GDP, mid period

Country	1994	1995	1996	1997	1998	1999	March 2000
Armenia	0	1	1	1	1	1	1
Azerbaijan	0	0	0	0	0	1	1
Bulgaria	0	1	0	1	8	6	5
Croatia	3	3	15	21	15	11	13
Czech Republic	14	30	31	24	21	19	25
Estonia	0	2	10	11	28	31	36
Hungary	3	5	12	33	29	31	34
Kazakhstan	0	0	0	1	1	2	5
Kyrg Republic	0	0	1	5	7	3	3
Latvia	0	1	3	6	6	6	8
Lithuania	1	2	11	18	10	12	11
Macedonia	0	0	0	0	0	1	1
Moldova	0	0	0	2	6	22	19
Poland	3	4	6	8	13	18	21
Romania	0	0	0	2	3	2	2
Russia	2	5	9	8	7	25	19
Slovak Republic	8	7	12	9	5	4	3
Slovenia	4	2	4	9	13	11	12
Ukraine	0	0	0	0	2	3	4
Uzbekistan	0	0	0	0	1	6	6
Brazil	27	24	24	30	27		
Egypt	8	10	16	23	28		
Germany	23	22	27	36	45		
Korea, Rep.of	44	42	34	22	24		
Mexico	45	39	31	33	29		
Portugal	15	17	24	34	57		
Thailand	92	82	66	44	29		
Turkey	19	14	15	25	17		
UK	116	119	137	146	161		
USA	74	82	101	122	151		

Source: S. Claessens, S. Djankov, and D. Klingebiel, "Stock Market in Transition Economies, World Bank Financial Sector Discussion Paper 2000 No. 4, 21.

As Table 4 shows market capitalisation is low in almost all transition countries. Only a small numbers of countries had managed to achieve market capitalisation 25% or more (Estonia and Hungary). Most of the transition countries have a market capitalisation to GDP ratio of 11%, with Armenia and Azerbadijan at the bottom of the list and Estonia, Hungary, Poland and Czech Republic on top of the list.

3.5.2 Market turnover

Market turnover defined as the value of trading over market capitalisation (Coffee, 2001, p.10), is an important indicator to measure the effect of stock markets on growth (Claessens, Djankov and Klingebiel, 2000, p. 3).

Table 5. Market turnover in transition countries and comparator economies, 1994-2000.

Market Turnover in Transition Countries and Comparator Economies, 1994-2000

Percentage of market capitalisation, mid-period

Country	1994	1995	1996	1997	1998	1999	March 2000
Armenia	0	2	2	7	5	15	8
Azerbaijan	0	0	4	12	2	13	10
Bulgaria	0	8	1	1	2	4	6
Croatia	8	8	13	10	5	5	7
Czech Republic	26	33	50	47	37	61	81
Estonia	0	0	59	78	108	44	21
Hungary	22	17	42	76	112	103	93
Kazakhstan	0	0	0	2	2	2	3
Kyrg Republic	0	2	8	2	6	2	2
Latvia	8	12	15	35	24	21	19
Lithuania	0	37.3	9	18	16	13	7
Macedonia	0	0	3	24	41	45	36
Moldova	0	0	12	81	173	81	62
Poland	177	72	85	78	54	62	69
Romania	2	7	2	73	66	58	45
Russia	367	7	11	20	11	27	40
Slovak Republic	96	69	134	109	74	48	25
Slovenia	68	71	82	31	35	28	22
Ukraine	0	5	11	6	4	12	19
Uzbekistan	0	3	19	12	3	2	4
Brazil	76	47	61	85	70	64	54
Egypt	19	11	22	33	22	38	47
Germany	98	109	123	137	145	152	167
Korea, Rep.of	72	97	109	171	183	223	288
Mexico	44	31	42	40	28	32	35
Portugal	36	48	59	57	96	114	127
Thailand	60	41	36	39	70	86	89
Turkey	87	221	139	128	141	167	193
UK	78	78	37	44	53	62	73
USA	70	85	92	104	106	117	141

Source: S. Claessens, S. Djankov, and D. Klingebiel, "StockMarket in TrnsitionEconomies, World Bank Financial Sector Discussion Paper 2000 No. 4, 21

As the Table 5 shows, market turnover is highest in Hungary (93%), CzechRepublic (81%), and Poland (69%). Market turnover is less than 5% in most ransition markets of Central Asia (Kazakhstan, Kyrgy Republic and Uzbekistan). Claessens, Djankov, and Klingebiel, comment that stock markets in transition economies are dominated by a small number of firms. In a lot of countries turnover concentrations are above 80% (Claessens, Djankov, and Klingebiel, 2000, p.3).

3.5.3 Institutional investors

"The development and particularly the liquidity of a stock market depend on the development of a class of well-governed institutional investors" (Claessens, Djankov,

and Klingebiel, 2000, p.10).There are three types of institutional investors: investment fund and mutual funds, pension funds, insurance.

Table 6. Assets held by institutional investors in transitional and comparator economies (June 2000).

Assets Held by Institutional Investors in Transitional and Comparator Economies (June 2000)
Percentage of GDP

Country	Investment funds	Pensions funds	Insurance	Total
Armenia	4	0	0	4
Azerbaijan	0	0	0	0
Bulgaria	5	0	1	6
Croatia	2	0	2	4
Czech Republic	8	2	9	19
Estonia	5	0	3	8
Hungary	12	4	3	19
Kazakhstan	2	3	1	6
Kyrg Republic	2	0	0	2
Latvia	5	0	1	6
Lithuania	6	0	0	6
Macedonia	4	0	0	4
Moldova	4	0	2	6
Poland	8	2	5	15
Romania	8	0	0	8
Russia	2	1	1	4
Slovak Republic	6	0	4	10
Slovenia	5	0	4	9
Ukraine	0	1	0	1
Uzbekistan	0	0	0	0
Brazil	16	10	1	27
Chile	5	40	13	58
Germany	28	13	32	73
Korea, Rep.	20	2	16	38
Mexico	4	3	2	9
Portugal	21	11	10	42
Turkey	3	1	1	5
UK	60	101	89	250
USA	129	90	43	262

Source: S. Claessens, S. Djankov, and D. Klingebiel, "Stock Market in Transition Economies, World Bank Financial Sector Discussion Paper 2000 No. 4, 21.

As Table 6 shows institutional investors are small in transitional countries. Only Czech Republic, Hungary and Poland have institutional investors assets at average 18% of GDP. In most of the countries the institutional investors assets account only for 7% of GDP.

The analysis conducted by Claessens, Djankov, and Klingebiel shows that such factors as low inflation, good shareholder protection, and the size of institutional investor assets are important in explaining high rate of market capitalization share to GDP. Opposite to this, the underdeveloped stock markets in transition economies can

be explained by such variables as "unstable macroeconomic environment, weak minority shareholders rights, and limited asset based of institutional investors" (Claessens, Djankov, and Klingebiel, 2000, p. 12). "Market capitalisation is positively correlated with ratios of private credit to GDP in transition economies. Low ratios of private credit to GDP indicate that basic financial sector infrastructure is lacking in transition economies" (Ibid., p. 12).

3.5.4 Banking in transition

Table 7. Structure of banking system in transition and comparator economies, 1995

Data on Structure of Banking System in transition and comparator economies, 1995

Country	No of banks	No of State Owned Commercial Bank	Share of assets of top five banks (%)	Recapitalizations	Employment 100.000	M2/GDP (%)	Currency M2 (%)
Albania	8	3	100	y	838	45	37
Armenia	37	5	85	n	227	23	42
Azerbaijan	197	4		n	140	26	64
Belarus	52	7	75	n	323	11	25
Bulgaria	34	10	90	y	624	65	14
Croatia	47	19	70	y	854	21	24
Czech Republic	58	1	69	y	316	74	10
Estonia	16	1	70	y	1940	20	44
Hungary	41	3	63	y	176	43	26
Kazakhstan	167	4	90	n	317	11	58
Kyrg. Republic	17	3	90	n	189	11	78
Latvia	40	3	55	y	207	30	43
Lithuania	27	3	70	n	890	17	42
Macedonia	40	3	97	y	571	25	22
Moldova	27	4	85	n	223	8	51
Poland	73	5	66	y	614	31	26
Romania	28	7	74	y	1349	15	30
Russia	2561	1	33	n	392	15	42
SlovakRepubli	3	2	79	y	2085	67	13
Slovenia	34	2	70	y	1678	37	10
Ukraine	217	2	70	n	254	16	37
Uzbekistan	35	29	95	n	128	79	26
United Kingdom	530		29		4140	90	3
France	419		43		3211	63	6

Source: Claessens, 1996, Banking in transition countries, Washington, DC: The World Bank.

(As explained by Claessens, re-capitalization refer to formal re-capitalization programs; employment is the number of employees in the whole financial sector, M2/GDP is domestic currency component of broad money (M2) only ; Currency/M2 (%) cash holdings as a share of domestic currency broad money (M2) (Claessens, 1996)).

The existing number of banks in one country reflects the choice of the policy toward the banking reforms. Researchers distinguished two different approaches to banking in transition: new entry and rehabilitation (Claessens, 1996). The new-entry approach can be characterised by the liberal entry of new banks. The approach can be illustrated by Russia and Ukraine where it resulted in a rapid grow in the number of banks, in Ukraine from 5 in 1989 to 217 in 1995 and 194 banks in 2000. Claessens suggests that the choice of policy was not always deliberate (Claessens, 1996). For

example, after the collapse of the Soviet Union the political and economic instability created a very liberal environment for the entry of the new banks. On the opposite to the new entry approach, rehabilitation is associated with more limited entry, re-capitalization and institutional development of existing state banks (Claessens, 1996, p.2). It is also suggested that banking reforms in transition countries are related to initial conditions and macro-economic development (Ibid.). Legal and enterprise reforms play an essential role in progress in banking reform (Ibid., p.3). Established legal system is an essential component of the strong banking system. Bad loan problems and absence of new lending opportunities prevent the advances in the banking sector (Ibid., p.5).

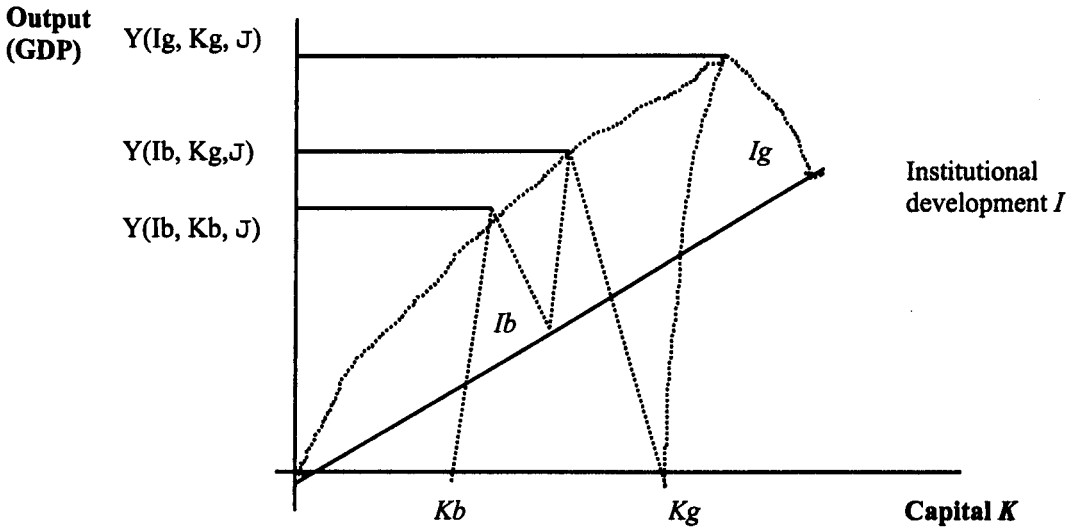
3.5.5 Analysis

The benefits of the well-functioning stock market should first of all be considered as companies ability to raise capital at lower costs. Companies are also less dependant on bank financing, they operate in a less risky environment. Uncertainty and 'bad' environment result in failure to raise necessary capital. Haque, Hauswald and Senbet (1999) proposed the following explanations to understand the lack of recourses in transition countries. Graph 1 presents their theory on institutional failure and under investment (Haque, Hauswald and Senbet,1999, p., 6). If we consider three inputs in economy: labor J, institutions I to deal with the resolution of conflicts of interest, and capital K. Then asymmetric information enter the picture through uncertainty about the state of legal, economic and financial institutions in this economy. It leads to the fact, that outsiders, who are in this case foreign investors can not assess the state of institutional reforms, or institutional development, which can be , as presented on the graph as high as *(Ig)* and as low as *(Ib)*.

In order to see how failure to provide institutional reforms may lead to the lack of the capital mobility, the authors add 'inference problem (non-observability)' in the form of external shocks ε (Ibid., p.6). As a result potential investors unable to comprehend if the country under consideration has sufficient institutional infrastructure. So, that willing to invest the amount *Ka* for institutional development *Ia* (as in perfect economic environment) the investors fear that output realization $Ybg = Y(Ib, Kg, J) + \varepsilon$ would lead to insufficient returns on capital. In the absence of legal guarantees and political instability such investors would come to the pessimistic assessment of

the return potential. So that if investment opportunities which would lead to the output level *Y(Ig, Kg, J)* exist somewhere else investors would rather look for that opportunity. This would be resulted in investors willing to supply funds *Kb*, which is estimated to be failure to raise sufficient capital. Haque, Hauswald and Senbet (1999) argue that the capital shortage is not "a cause of underdevelopment , but a symptom for deeper structural problems that revolve around failed institutions and malfunctioning financial system. Indeed, it is precisely an environment characterized by uncertainty, informational imperfections, and incentive problems among contracting parties that requires the financial system to perform tasks beyond mere capital mobilization" (Haque, Hauswald and Senbet, 1999, p., 7)

Graph 1. Institutional failure and underinvestment.



The difficulties emerging with the creation of financial market in transition countries are most often associated with weak law and regulations, slow progress on private sector development, a limited supply of institutional development, as well as macroeconomic uncertainty (Claessens, Djankov, and Klingebiel, 2000).

It is suggested that "before considering equity markets, transition economies should focus on improving and enforcing creditor rights to foster their banking system development. This will also be the most effective way to foster the development of small and medium-size enterprises, a key source of economic growth" (Claessens, Djankov and Klingebiel. 2001, p.12-13).

Coffee suggested that one should start establishing capital market with creation of a strong legal protection to minority shareholders. It is important to create "a strong

system of securities regulation that can both provide essential information and deter the common forms of fraud and misappropriation that appear to have caused market crashes in Russia, Czech Republic, and other transitional economies (Coffee, 2001, p.9). Among the factors that can explain the underdevelopment of the financial sector Coffee named such factors as macroeconomic and political instability, legal underdevelopment. The effectiveness of legal institutions makes a big difference in a creation of effective market. "...even if "legal effectiveness" is a subjective and largely non-quantifiable variable, because financial economists have found that the overall effectiveness of legal institutions has a much higher correlation with both equity and credit market development than does the quality of law on the books. Ultimately, it is far easier to specify legal protections that should be adopted to protect shareholders and creditors than to recommend means by which to make a disreputable judiciary or governmental agency honest, credible and effective" (Coffee, 2001, pp. 14). To prevent the criminalization of the capital market, and securities market in particular, Coffee suggested introduction of the three principal reputational intermediaries. These intermediaries are independent auditors, underwriter and "outside directors who stand to profit very little from corporate fraud, but who may have liability if they fail to exercise adequate care" (Coffee, 2001, p.22). Coffee also argue that it does not really matter if the country managed to develop securities market, the need to establish the securities statute still remains. "One obvious reason is that investor fraud and the mass marketing of irresponsible investment scheme can produce real social unrest" (Coffee, 2001, p.27).

Krkoska (2001) analysed foreign direct investments in transition countries as an important source to finance capital formation. It is suggested that "improvements in the investment climate helping to attract higher FDI inflows will translate into higher gross fixed capital formation, which in turn leads to greater economic growth" (Krkoska, 2001, p.18).

Pistor, Raiser and Gelfer developed and analysed two groups of indices. The first group was designed to analyse shareholders and creditor rights in transition economies, and the second group consisted of the measures of the effectiveness of legal institutions in transition economies. The three variables were used to identify the effectiveness of legal institutions: rule of law, effectiveness of corporate and bankruptcy law, and the enforcement index (Pistor, Raiser and Gelfer, 2000). The study concluded that the obstacle for the successful reform is seen in 'legality', or the

absence of effective legal regulations (Pistor, Raiser and Gelfer, 2000, p. 25).The regression analyses conducted by these authors show that "legality has overall much higher explanatory power for the level of equity and credit market development than the quality of law on the books" (Ibid., p.25) The transition toward the market reforms requires changing of the role of government, reducing the direct level of government involvement in economic activity, and creating the fundamentals for the rule of law system. "The lack of confidence in the rule of law reflects the extent to which this transformation has remained partial, as governments continue to play to vested interests, often those that have benefited from asset redistribution during the initial transition" (Ibid., p. 25).

To summarise, the analysis of transitional countries experience indicate the importance of a carefully thought out decision making process. However important the development of stock market is, in some small countries it could be very costly, and thus unjustifiable money and time spent. These countries should concentrate on the development of banking industry to start with financing the basic industry in the country. Once the economic development choice has been made, political will is necessary to continue the chosen way to reform the system. The literature on transition studies the role of the initial condition and the economic policies the country chooses to implement the reforms (de Melo, Denizer, Gelb, Tenev, 1997). Studies support the fact that initial conditions transition countries had at the starting point are not that significant as the devotion to the political reforms. Researchers argue that political reform emerges as "the most important single determinant of the speed and comprehensiveness of economic liberalisation" (Ibid.,p.41). Further in the study we will be examining the experience of Ukraine in creating the environment for the reforms.

Chapter 4. White-collar crime phenomenon and financial market development in Ukraine

4.1 Ukraine: initial level of development, resources and growth

Studies show that the experience of countries during transition from a planned economy to a market economy has been different (Claessens, 1996;Claessens, Oks, Polastri, 1998; Grigorian, Manole, 2002). While some countries experience deep depression and significant decrease of their GDP, the performance of the others are growing. What are the major factors which determine the outcome of the transition? The answers are different. Some researchers concentrate their analysis on the inherited economic conditions, and natural resources (Fisher and Gelb, 1991; Foglesong and Solomon, 2001). The other stress the importance of the economic policies the country chooses to implement. Political transition was named as a key factor in shaping the reform process and economic outcome. The World Bank studies suggest that the link between political reforms and economic reforms is very close (World Bank, 2000). It is known that economic reforms are easier in countries where political changes are fundamental and rapid.

Table 8 presents the data on the initial level of development, resources and growth in Ukraine.

Table 8. Initial level of development, resources and growth in Ukraine.

Country	Per cap GNP at PPP US$ 1989	Urbanization (% of population) 1990	Industry	Distrib of GDP 1990 cur prices		Redicted share of industry	Average % growth 1985-89	Natural resources	Location
				Agriculture	Services				
Ukraine	680	67	44	21	35	40	4	moderate	0

Source: De Melo, Denizer, Gelb and Tenev, 1997.

Table 8 presents a number of important indicators. Income levels, measured in 1989 was US$ $5680 in Ukraine, that is about the same level as Poland US$ 5150, and Croatia $US 6171. As on 1989 among the Soviet Union Republics the lowest income was in Uzbekistan US$ 2740, and the highest income was in Estonia US$ 8900. Industrial shares were high in Ukraine, as it was typical for almost all socialist countries. The richness of natural resources differs from country to country. Ukraine, Poland, Georgia are among those countries named as moderate in resources; Hungary, Czech Republic are among the poor once; and Russia, Kazakhstan and Turkmenistan named as rich in natural resources. Location means geographical situation and the proximity to the developed market economies. Such countries as Hungary, Czech Republic, Baltic countries have benefited from better access to developed markets.

The geographical location of Ukraine has not been considered as beneficial by the above authors.

De Melo, Denizer, Gelb and Tenev analyse the role of initial conditions and their interaction with policy choice and economic performance during the transition in 28 countries (De Melo, Denizer, Gelb and Tenev, 1997). Researchers suggest that initial conditions for transition countries can be summed up in two principal components such as "market distortion" and "overindustrialization" (Ibid., p. 38). Results suggest that the effectiveness of the reform does not depend on the initial conditions, "unfavourable initial conditions discourage reforms but effectiveness of reforms is not reduced once they are implemented" (Ibid., p.40). Political reforms are named as the most important determinant of the speed and the character of economic reforms (Ibid., p.41).

Following is the discussion consisted of a few parts, which was designed to specifically examine transition period in Ukraine, the role of the initial conditions and the chosen policies. It will lead us to the consideration of the impact of some specific factors, such as economic crime and corruption on the development of the financial market in the country.

4.2 Macroeconomic situation

In the beginning of the 90-s Deutsche Bank named Ukraine as the most advanced and promising post - Soviet economy. However, since 1991 a great majority of the researchers identified Ukraine as a financial disaster (Foglesong and Solomon, 2001, p. 7).

"In 1996, the World Bank categorised Ukraine as among the group 4, or slow reform, countries. In 1997, the World Economic Forum ranked Ukraine as the 52d of 53 countries in overall competitiveness in its Global Competitiveness Report. And in 1998, the Heritage Foundation - Wall Street Journal Index of Economic Freedom ranked Ukraine as the 125 of 156 countries, labelling Ukraine as the "mostly unfree" economies of the world. Industrial investment (both domestically and abroad) remains low, despite lower inflation and a more stable currency. Since 1995, Ukraine has become dependent on massive infusions of capital from multilateral lending institutions, particularly the International Monetary Fund (IMF), to prop up its economy" (Foglesong and Solomon, 2001, p. 8).

Ukraine was considered as the most developed Soviet Republic. The country had advanced military and industrial complex, metallurgy, and chemical industry. Thousands of people were employed at large enterprises. However, what appeared as an advantage proved to be a 'disadvantage' during the first years of independence, when an attempt had been made to restructure these enterprises. The Ukrainian government directly subsidised non-profitable enterprises, and introduced tax concessions. These decisions were often political rather than economic. So that many managers of the enterprises made large illegal profit during the so-called restructuring (see below for the details of the crimes committed).

From 1991-1994 Ukrainian economy had experienced hyperinflation with the annual rate about 2.000 % in 1992 and 10.000% at its peak in 1993. The sharp expansion in the money supply in the first half of the 90-s was named as the main cause of hyperinflation.

During 7 years since 1991-1998 the Gross Domestic Product declined dramatically. Different sources name different figures, usually with variation from 48 % to 100%. Almost all sectors of economy had deep depression. A new currency (the Hryvnia) was introduced in 1996 as one of the aspect of macroeconomic stabilisation.

There are a lot of arguments about the causes of economic collapse. Foglesong and Solomon named three areas of economic decay in Ukraine (Foglesong and Solomon, 2001, p. 9). Firstly, the natural resources in Ukraine. Though Ukraine is rich in natural recourses, most of these were depleted during the Soviet period. Extraction cost in many cases exceeds the prospective sales prices. Secondly, the economic base of Ukraine is not marketable. This is mainly due to the industry in eastern part of Ukraine, in particular, unprofitable mining and metallurgy concerns. Thirdly, Ukraine is highly dependent on Russia for its energy. "Ukrainians with connections to Russian exporters have taken advantage of the price differentials and their administrative authority to reap huge illegal profits from import business" (Foglesong and Solomon, 2001, p. 9). Robinson named such causes of economic collapse as the breakdown in intra-CIS trade after independence, enterprise's slow progress in finding the new markets, the effects of paying for energy at market prices, the very slow emergence of market structure, hyperinflation (Robinson, 1998, p. 38).

Unstable legislation in economic sphere has complicated the economic reforms in the country. Research suggests that this situation has been very well explored by criminals (Kamlukand Nevmerzhickiy, 1998). Slow reforms and the role of

government in it have been one of the main reason for the current economic problems. It tends to be very difficult to break through the old bureaucratic habits of doing business, and the transition towards the responsible decision making is still in process.

4.3 Legal framework to tackle economic crime and corruption

4.3.1 General Provisions

Ukraine has signed and ratified the Vienna Convention and the Council of Europe Convention. Ukraine has joined the CIS Council of Ministers, the particular goal of which is to combat crime in the former Soviet Union countries. Ukraine has also signed the counter-narcotics agreements with the United Nations Drug Control Program. In 1995 with the assistance of this program, Ukrainian Parliament passed drug-control laws. In 1994 a draft of the Anti-Money laundering law was introduced to the Ukrainian Parliament. In December 1997 Ukraine has signed and ratified Strasbourg Convention on Laundering, Search, Seizure, and Confiscation of the proceeds from crime. A new Criminal Code was adopted in Autumn 2001, introducing new articles punishing financial fraud and money laundering.
Specific offences (New Criminal Code of Ukraine, adopted in Autumn 2001)

- Crimes committed in relation to property and connected to fraud (Criminal Code, Part VI, art. 185-198). For example, Article 191 punishes the abuse of the office power followed by embezzlement of state or collective property, its appropriation, and waste;
- Crimes committed in the sphere of the state budget fulfilment (Criminal Code, Part VII, article 210-211): Ukrainian budget legislation violation (Article 210); The adoption of the decrees potentially confusing the legal income-expenditure structure of the state budget (Article 211);
- Crimes committed in the financial sectors (Criminal Code, Part VII, Art. 199-235). For example, Manufacture, sale and circulation of the forged non-state securities (Article 224); Foreign currency earning concealment (Article 207); Tax evasion, failure to fulfil the obligatory payments (Article 212); Securities issue and circulation rules violation (Article 223); Forged mail or travel documents (Article 215); Legalization (laundering) of money or other property illegally acquired (Article 209).

- Crime committed in the entrepreneurial sphere (Criminal Code Part VII): Involvement into the legally forbidden entrepreneurial activity (Article 203); The entrepreneurs activity rules violation (Article 202); Fictions enterprises (Article 205); Financial Fraud (Article 222); Bankruptcy concealment (Article 220); Fictive bankruptcy (Article 218);
- Crimes related to the anti-monopoly rules violation and dishonest competition: Illegal obtaining of commercial secrets (Article 231); Commercial secrets disclosure (Article 232); Agreement to fix the price (Article 228);
- Crimes committed in the sphere of public service: Production and sale of poor quality goods (Article 227); Deceive of customers (Article 225); Breach of trade regulations (art. 155, p.3);
- Crimes committed in the sphere of the custom regulation: Contraband (Article 201);
- Crimes committed with the aim to destroy or to use illegally the work of the automatic system (art. Criminal code Part XVI, Articles 361-363). For example, computer crimes, such as illegal obtaining of some information by misuse of official posts (Article 362);
- Crimes related to business practices and misuse of official position (Criminal Code, Part XVII, Articles 364-370), for example, Article 364 punishes the abuse of authority or business duties, Articles 366 and 367 deal with counterfeiting of official documents and unscrupulous or careless official activity, Articles 368, 369 and 370 punish bribery of public officials as well as officials in corporation disregarding the forms of ownership.
- Crimes related to the privatisation process (Articles 233-235), for example, illegal privatisation of the state property (Article 233).
- Ukraine has adopted a series of presidential decrees, including Decree No 1199/2001 (10 December 2001) "On the measures Aimed at Elimination of Legalisation of the Profits Obtained by Illegal Ways", Resolution No.35 (10 January 2002) "On Establishment of the State Department of Financial Monitoring", and Resolution No.194 (18 February 2002). Regulation No.700 29 May 2002 provides guidance to what kinds of transactions financial institutions should consider as 'doubtful and uncommon'.

4.4 The political elite in Ukraine

To understand the problems Ukraine has experienced since the declaration of independence, there is a need to address the issue of the political elite formation in the country. After the collapse of the Soviet Union, Ukraine had being left with almost no central authority. None of the following institutions was present in Ukraine: central government, political elite, effective democratic institutions, including parties, civic movements and non-governmental organisations. The presence of the above mentioned institutions generates political process and can guarantee the foundation of the democratic political regime. The paradox of the Ukrainian situation was the coexistence of two phenomenon: the so-called vacuum of the political centre from one side and the presence of an old administrative mechanisms of the Soviet type of politics.

During the first years of independence and democratisation, the state apparatus was formed and reinforced due to the migration of many political leaders from different regions of Ukraine, but mainly from Western part of the country. Karasev describes at least three waves of such migration (2002). The first wave of the migration is the so-called 'familiarization' of those who came to the capital with the characteristics of the central authority in the country. The majority of those who came during the first years were representatives from the Western part of Ukraine. These politicians formed a first coalition of national democrats and post-communist political elite. The second wave occurred as a result of dissatisfaction expressed by the political/business elite from the Eastern Ukraine. The elite in Eastern Ukraine did not support the national oriented presidency of Leonid Kravchuk (1991- 1993). Under the influence of East Ukrainian lobby, Ukrainian political elite was reinforced with a number of new political figures from the Eastern part of the country. Leonid Kuchma from Dnepropetrovsk became a Prime Minister in 1992. The third wave in the year 1993 saw a rise of Doneck region and their mining lobby. Zvyagilky was then chosen as a prime-Minister. In 1994, Dnepropetrovsk elite had recovered its 'lost' influence, then Leonid Kuchma became a President, Lazarenko became a Prime-Minister, and a number of new people from the Dnepropetrovsk region were included in a new presidents command (including Julia Timoshenko, Tigipko, etc.).

The so-called vacuum of political elite allowed the formation of a new type of elite-people, those who made an unbelievably fast careers in politics in a short period of time. The central political arena of the country has now comprised a number of

political and business leaders representing different regions in the country. By the end of 90-s the centre of the political power in Ukraine was formed. This centre has an interesting feature. Despite a big number of political parties and the presence of a number of groups in the Parliament, the centre of Ukrainian political elite is formed on the basis of an alliance between the representatives of the resourceful regions and representatives of central power. All the 'pure' party activists were pushed to the periphery of the political life. The result is an absence of a united administrative management of the country and the fight between these 'resourceful regions' groups. The basis of the state is formed not on the united cultural and political platform, but rather on the administrative pressure, regional sabotage and those who have enough resources to influence most.

Karasev (2002) discusses two pillars of post-soviet political regime in Ukraine. The first one is the presidency, the administrative pillar, with the president at the top and 'his people' all the way down to the bottom (regional authority, administrative and military structures). These people ensure the control of different regions and local self-governance. They also made an alliance with the regional authority and business elite to control recourses in the regions. In a number of regions such allies created a cultures of 'fathers' ('fathers'- regional leaders). Regional elite can be very powerful if it consolidates administrative and financial resources, and a number of powerful people. Such consolidation is very important during the electoral campaign. The second pillar of the post-soviet Ukrainian economy units is the three systems, namely: financial, budget and tax regulation. The post-soviet economy still depends on a number of different privileges, such as privilege to reallocate the budget money. In this system the loyalty towards the central authority would mean more privileges while planning the regional budget, more business privileges, including tax reduction. To summarise what has been said, the Ukrainian politics these days is the politics of the fight between the resourceful regions, and fight for more privileges.

4.5 Case study 1: Economic crime and financial market: the results of the expert study in Ukraine

The purpose of this study is twofold. First, we need to know the opinion of knowledgeable experts regarding the state of economic crime in different sectors of financial market in the country. Second, we need to identify the most affected by the economic crime sector of financial market in the country to conduct further analysis.

We will examine the existing regulatory norms and enforcement to understand whether the existing regulatory framework is adequate for the development of emerging market.

The total number of the respondents questioned is twenty four. Among the experts interviewed were eight representatives from official government agencies (e.g., Verhovna Rada and the Ministry of Economics), and sixteen experts from the private sector. Experts from the private sector included those working in insurance companies, banking, money markets and the foreign currency exchange market, the stock exchange, trust companies, and investment funds.

The introductory part of the questionnaire includes the political platform question. We want to know whether our respondents consider themselves as being politically active or not. Only 20% of the "business" respondents identified themselves as a party member or a party supporter. The majority is out of politics or pretend have neutral political views. Generally, ordinarily Ukrainian citizens tend to stay out of politics, blaming the corrupt activity of some ex-politicians and absence of constructive thoughts from the side of the new political elite. What is interesting, is that although economics and politics are tied together in Ukraine, only a small proportion of respondents representing financial market players has expressed strong support for certain political party.

Three types of financial crime were identified in the questionnaire: money laundering, tax evasion and corruption. The respondents were to select the most popular. We did not limit the choice of options in the answer. 30% of respondents named all three types of economic crime as being widely practised in Ukraine. Sometimes it is impossible to distinguish which type of economic crime is primary and which is secondary. For example, tax evasion and corruption are at least two 'necessary' types of crime to gain the resources to launder money. Experts who singled out some of the types of crime as the most popular chose tax evasion (30%) and corruption (5%). Our results support the belief that a great proportion of economic crime has been provoked by unstable and repressive tax system in the country. According to the State Tax Administration, in the middle 90-s there had been a tendency to register fictitious companies to cover illegal activity, in particular tax evasion. According to some sources, in 1996, 33,4% of all registered private companies did not pay taxes (Kamluk and Nevmerzhickuy, 1998).

One of the intriguing topics in the study is experts involvement in the illegal economic activity in the course of their ordinary business. The question about personal involvement in economic crime is a very sensitive issue. However, in the case of Ukrainian reality the neutralisation techniques proved to overcome the so-called 'sensitivity barrier'. The most widely used statement was 'everyone does the same'. Only 20% of the respondents answered that they have never encountered criminal activity in their business career. The majority (80%) answered that in one way or another they have been subjected to economic crime. Some respondents told that the involvement in the criminal activity in economic area occurs on a regular basis and does not constitute exceptional cases. By providing the alternatives to answer this question, we actually directed our respondents to think about corruption in the country. The answers proved the fact that corruption is widespread in Ukraine, especially among the high level state officials, involved in regulatory and economic activities. The limitation of government involvement in the nation's economic activity is one of the main issues. A number of international organisations have warned the Ukrainian Government about the danger of the state being so closely related to the economic activity (Transparency International, 2001; International Bank for Reconstruction and Development and World Bank, 2001).

We asked our respondents to identify the most affected by economic crime financial sectors. The answers may be summarised in the following table. The level of criminalization is very high at number 1 and is low in number 7.

Table 9. The impact of economic crime on financial market in Ukraine.

Most affected

1. Money market/foreign exchange market;
2. Commercial banks/savings banks;
3. Trust companies and investment funds;
4. Insurance companies;
5. Stock Exchange;
6. Central bank.

Less affected

Insurance companies and stock exchange shared the fourth place in the table. Let us now consider each sector separately:

1. Commercial and savings bank sector. According to the responses given, money laundering and corruption are the most popular crimes in this sector. 50% of the respondents identified the necessity to pay bribes in order to obtain the loan. The soundness of the projects would not be questioned then. Siegelbaum (1997) discusses

a form of "relationship" banking in the transition economies and suggests that borrowers face little risk given the creditors lack of effective remedies or bankruptcy procedures. This is why bribing bank officials or lobbying politicians to influence bank officials will help even unsound projects obtain loans. This situation prevents banks from having the most creditworthy customers. This highly politicised process of issuing loans has also been described in a report by the International Bank for Reconstruction and Development & World Bank (2001). Further, and OECD report stated that the system of government guarantees for credits obtained in hard currency from foreign lenders by Ukrainian companies needs to be eliminated as soon as possible. According to the OECD experts, this system encourages large-scale corruption and has resulted in enormous losses to the state treasury (OECD, 2001, p.25).

2. Insurance companies. Money laundering through insurance companies received the biggest score. 40% of those who answered the question named insurance companies as the helpful tool to escape taxes and legalize money. 30% of respondents named the breach of the insurance obligations and insurance payment evasion as the typical crime in this sphere. 15% of respondent named corruption and bribery needed to insure the state companies and 15% named insurance of the high risk activities as the popular offence.

3. Trust companies and investment funds. Involvement into the high risk activities named by 50% of the respondents. Bribing to escape penalties for the failure to return credit received 25% of responses. Financial fraud was named by 25 % of the respondents.

4. Money market and foreign exchange market. 'Black exchange' was named by 50% of the respondents. Meaning tax evasion then exchanging currencies. Financial fraud named by 35% of the experts and money laundering received 15% of the answers.

5. Stock and bond market. This sector is equally affected by tax evasion, breach of the securities issue regulations and insider trading. Although, only 30 % of the respondents identified this sector being exposed to economic crime.

6. Central bank. One respondents told, this is "a sort of forbidden area for the discussion". None of the respondents named illegal activities connected to this sector. Let us now have a look at what our respondents think about the impact each specific crime has on the identified financial sector. 60% of "business" respondents

(representing the financial market players) think that illegal acts committed in the banking area have a positive impact and promote the development of the sector, and only 40% think that it prevents further development. However, considering the responses on the question about the general impact economic crime has, it tends to be that corruption in the banking sector goes to the first place and considered to be one of the factors which prevent the development of the whole financial market. Such a controversial data may be explained by a fact that in reality in Ukraine, bribing bank officials would give you the chance to receive a short term credit, but as one respondent answered 'it is almost impossible to get a long -term credit'. Almost the same tendency is observed when analysing the responses in regard to insurance companies. 55% of "business" respondents consider the activity of this sector as positive, 20% believe that it prevents the development and 25% answered that it does not have an essential impact. Those who believe in a positive impact have very good grounds to think so. They actually named money laundering as the most popular crime committed in this sector. Some businesses in Ukraine use the services provided by insurance companies to avoid high taxes and to legitimise money, which otherwise would be 'burdened by taxes'. Those who identified the negative impact economic crime has on the sector have previously noted the high rate of crime in regard to breaching the insurance obligations. Trust companies and investment funds activities prevent the development of the sector according to 40% of respondents and 60% of experts think that illegal activities do not have any impact at all. Money market and foreign exchange market as well as stock exchange suffered the 'normal' development according to 50% of all the experts questioned.

A regulatory base for the existing financial market is also a very serious issue. Eighty percent of respondents involved in business activity think that the regulatory framework needs major restructuring and that it does not correspond with the needs of the emerging market. However, the majority of those representing official governmental bodies believe that the legislative framework has been properly developed or is currently in the process of development and revision. They believe the reasons why the existing legislation has not resulted in a positive outcome are seen in such issues as political pressure and corruption in the enforcement and control agencies. Seventy percent of the respondents believe that there is a lack of political will to enforce the regulations because of corruption inside the regulatory bodies. In

the meantime, the growth and development of financial markets in the country is stunted.

These findings are in line with recent reports by such international organisations as Transparency International (2001) and the International Bank for Reconstruction and Development and World Bank (2001). The development of financial institutions and improvement of the financial market services in a country can be described as indicators of the effectiveness of the economic, political, and legal reforms and the dedication of the government to these reforms (Claessens, Djankov and Klingebiel, 2000). Weak financial institutions, then, are vulnerable agents in a corrupt system (International Bank for Reconstruction and Development and World Bank, 2001).

The results of the study suggest that the financial sectors under consideration have not been acting as agents to promote the development of the financial system as a whole, but rather serving as mediators to provide cover for political mistakes and/or those earning "easy money," as well as being a tool to avoid regulatory obligations. A few respondents in the pilot study, for example, argued that the insurance companies in the country exist for one main purpose, laundering money in order to avoid paying high taxes. Stock exchange suffered the lack of regulations and slow privatisation process, as well as mismanagement inside the privatised companies.

The respondents were asked to summarise the impact of economic crime on the development of the financial sector in general, and 85% agreed that the impact is negative, is preventing development, and is spreading corruption even deeper into society.

The majority of experts agreed that the regulatory system is over-constrained and needs to be liberalised. The following are the proposed steps toward the liberalisation of the system:

- The majority believes in changing tax legislation, as well as in stabilisation of legislation.
- The development of the normative bases for the trust companies to work efficiently and the fulfilment of the existing rules as in case of the stock exchange formation.
- 70% of respondents believe that introducing criminal responsibilities for breaching the credit obligations also followed by a few successful cases and conviction would only improve the investment environment in the country.

- Improving the joint-stock companies regulations was named by 40% of the respondents.
- Simplifying the system of accountability of financial sector to the state establishments was named as one of the possible ways how to tackle corruption and to bring transparency in the sector.

The emerging markets tend to experience a lot of difficulties on the way. In case of Ukraine, it has been burdened with complex and not stable regulatory bases, incredibly high tax rates and wide-spread of corruption. Unfortunately, the reality is that we can not speak about the development of the financial sectors to serve the economy as it is known in the West. At the moment, financial sectors, willingly or sometimes, because of the high political influence just serve immediate needs of the customers, which is either to avoid taxes or to invest in non-sound project.

4.6 Shadow economy in Ukraine

Shadow economy is not a new or recent phenomenon in Ukraine[1]. Some researchers believe that the actual "commencement" of the shadow economy occurred in the mid-80s, with the beginning of "perestroyka" (Popovich, 1997) the other suggest, that shadow economy had been a feature of the Soviet economic system for a long time (Simis, 1982). The World Bank named three types of activities which together create the shadow economic activity:

> "Illegal activities such as drug dealing, prostitution, protection rackets, and theft from state enterprises; marginal subsistence activities of micro enterprises that employ individuals and their family members; legal activities that are hidden from taxation, regulation, or other public scrutiny and official records" (World Bank, 1999, p. 25)

The third type of activity is the largest and most developed in the country. It is explained by the existence of economic restrictions adopted by the central government during the Soviet time. "Few efforts were made to minimise production costs, including transportation....draconian restrictions on trade , currency transactions, and private property and business made people reluctant to obey legislation and trust the government to protect their savings, investment and property" (World Bank, 1999, p. 25). The formal sector which was created during the Soviet

[1] See the discussion of red-collar crime in Chapter 2, part 2.9.

time, and later inherited by the Independent Ukraine, is not efficient and does not promote the idea of being a good citizen. "In Ukraine the costs of being formal are excessively high, and the benefits doubtful" (World Bank, 1999, p.25).

> "Low benefits and high costs induce businesses to operate informally, reducing revenues to the state and undermining its ability to provide services that might attract businesses into the formal economy. The key cost encouraging shadow activity is the burden of regulations and taxes as they are implemented. If rules look fine on paper but officials have considerable discretion in implementing them - as in Ukraine - the result is a higher effective burden on business, more corruption, and a stronger incentive to move to the unofficial economy"(World Bank, 1999, p. 25).

Excessive state intervention and tax system are named among the factors that have stimulated the growth of the shadow economy in Ukraine. Enterprises are heavily taxed in Ukraine. Appendix 1 shows the example of the ordinary taxation requirement for an enterprise in Ukraine.

In 1997 Global Competitiveness Report rated the tax burden from the firm's standpoint, using scale of 1 to 7, the high score indicates that the tax system enhance competitiveness. Ukraine was one of the worst countries evaluated, with the score at 1.58. According to the researchers, a one point increase in this index reduces the share of unofficial economy by 6.5 % (World Bank, 1999, p.26).

"The high cost and small benefits of participating in the formal economy create an enormous informal sector. The World Bank estimates that half of Ukraine's economy is in the shadow. Much of this shadow activity is happening in mainstream enterprises. For example, a 1997 survey by the IFC found that 69% of Ukrainian small businesses fail to report at least 30% of their profits. Thus Ukraine's malfunctioning tax, regulatory, legal, and service delivery systems have driven mainstream businessmen to commit illegal acts in order to survive"(World Bank 1999, p. 27).

Studies suggest three methods of estimating the real size of shadow economy in Ukraine (Borodiuk and Turchinov, 1997). These methods are electricity consumption method, monetary method, and cash in circulation and taxation. The first method calculates a real GDP based on GDP of a known date in the past and changes in electricity-consumption since that date. It is assumed that electricity consumption will reflect changes in real GDP. The result is then compared with official data on GDP

and with estimated share of GDP in the shadow economy. On this basis Borodiuk and Turchinov estimated the shadow economy at 38.1%, 50.5% and 56.4 of the official GDP in 1993, 1994, 1995, respectively (World Bank, 1999, p.118).

Monetary method suggests that the size of shadow economy depends on the amount of cash in circulation outside the banks. So that by examining changes in the key monetary aggregates, such as cash in circulation, and cash in hands, the size of shadow economy is estimated (World Bank, 1999, p. 118). Using this method Borodiuk and Turchinov estimated that the size of the shadow economy was 101%, 32%, and 158% of the official Ukrainian GDP in 1993, 1994, 1995 respectively.

Cash in circulation method focuses on measuring influence of cash in hands and size of taxation on the size of shadow economy. The formula puts the size of shadow economy in direct proportion to the amount of cash in hands and inverse proportion to the size of taxation (World Bank, 1999, p.119). The size of shadow economy was estimated at 30%, 55% and 77.3% of the official GDP in 1993, 1994 and 1995.

4.7 Financial market development in Ukraine

As it has been discussed in previous chapters almost all transition economies have underdeveloped financial market mechanisms and institutions. Ukraine is not an exception. The typical financial development in most countries can be observed as a number of different indicators such as market capitalisation, market turnover, foreign financing and the existence of a strong group of institutional investors.

4.7.1 Market capitalisation

Market capitalisation is very low in Ukraine. As Table 4 shows the figure was 2 % in 1998, 3% in 1999 and 4% as on March 2000. This is significantly lower than the average 11% of market capitalisation figure in transition economy.

Table 10. The development of stock market in Ukraine (Bhattacharya & Daouk, 2000).

Country	Establishment of Main Exchange	Company listing in Main Exchange (end.1997)	Market capitalisation of Main Exchange (USD billion in end-1997)	Dollar volume in Main Exchange (USD billion in 1997)	Turnover in Main Exchange	Insider Trading Laws Enforcement
Ukraine	1992	6	0.212	n/a	n/a	No

It is believed that such good fundamentals as strong macroeconomic policy, advanced law system and disclosure requirements (Claessens, Djankov, Klingebiel, 2000, p. 3) are the preconditions to the large stock market in the country.

Stock exchange had been open for more then 50 years before the Soviet power closed Kyiv exchange in 1930. Nowadays, there are three stock exchanges in Ukraine: The Ukrainian Stock Exchange (USE), the Kyiv International Stock Exchange (KISE) and the Donetsk Stock Exchange (DSE). Shares are also traded on the Ukrainian Interbank Currency Exchange (UICE) and, over the counter, on the PFTS (Ukrainian OTC Stock Trading System Association) electronic trading system. The stock exchange account for only 5% of equity turnover in Ukraine (Robinson, 1998, p.130).

The stock exchange regulations are based on the following statutes: The Law of Ukraine "On securities and stock exchange", adopted in 18 June 1991, The Law of Ukraine "On the state regulation of the securities market", adopted in 30 September 1996. In September 1995 Ukrainian Parliament adopted the Concept of the development and functioning of the stock exchange in Ukraine. In 1997 the President of Ukraine issued a decree "On the state commission on the securities and stock exchange". According to this decree it is the responsibilities of the state commission to control securities issue and circulation (except the privatisation voucher). The Law "On the state regulation of the securities market" identifies the fines and legal responsibilities of those who breach the regulations (including high level state officials).

According to Article 3 of the Law of Ukraine "On securities and stock exchange", the following types of securities may be issued and traded:

- shares, defined as securities that do not have defined flotation period and serve to prove the ownership of the statutory fund of a joint stock company and give the right to receive the part of the company's profit, as well as the portion of assets should the company cease to exist;
- bonds issued by central and local authorities, defined as securities that serve as proof of payments made by their owner and assurance to repay the owner the nominal value of a bond as well as accrued interest at a specified date;
- shares of companies;

- savings certificates, defined as the written bank's statement to prove the right of the account owner to withdraw the deposited funds as well as accrued interest;
- promissory notes, defined as obligation to pay a specified amount of money at a specified date to the issuer of a promissory note;
- privatisation certificates;
- investment certificates issued by the investment funds and investment companies.

Pursuant to the law described above, the following operations may be carried out on the securities market:

- securities trade, defined as operations that involve buying the security either as authorised by a client (broker activity), for own benefit, or for the purpose of reselling the security to third parties (dealer activity);
- depository activity, defined as providing services of securities safekeeping, keeping track of securities ownership and servicing the operations with securities;
- clearing activity, defined as establishing mutual obligations under operations with securities;
- managing securities, defined as authorisation to manage securities during specified period of time;
- keeping track of owners of personal securities;
- organisation of trade on the securities market, defined as provision of services to assist entering the contracts related to securities trade.

The illegal activities on stock market are specified in article 223 of the Criminal Code of Ukraine. These articles, respectively are 'On false money and securities issue and trade', and 'On the breach of procedures of securities issue and circulation'. According to these provisions there are two types of offences. The first one relates to false securities issue and trade and the second type considers the breach of established procedures of securities issue, including the breach of registration procedures. There is no law on insider trading, however articles 231 and 232 of the Criminal Code proscribe the criminal liabilities in case of intentional disclosure of false information which may lead to the damage of someone's reputation and the commercial secrets disclosure with the aim to damage someone's reputation. According to article 51 of the Law 'On Prevention of Corruption', civil servants should not be a member of a

directorate or management team of the financial establishments. Civil servants must not use their official business to assist in economic, credit and business activities. This can be applied to the stock market as well.

4.7.2 Market turnover

Most transition markets are illiquid (Claessens, Djankov, Klingebiel, 2000, p. 3), the exceptions are Hungary, Czech Republic and Poland. The average market turnover in transition economies is 30 %. Market turnover in Ukraine in 1999 was 12%, and as of March 1999, 19%. Ukraine is also among the list of countries with the high turnover concentration, which is above 80%. A few companies in Ukraine account for more than 95 % of the market turnover (Claessens, Djankov, Klingebiel, 2000, p. 3).

4.7.3 Institutional investors

This is the least developed part of the financial market in Ukraine. The three groups of the institutional investors: investment and mutual funds, pension funds and insurance present the least developed part of the Ukrainian financial market. Only pension funds amounted to 1% of GDP. As Table 6 shows most of the transition countries have the pension funds assets underdeveloped and amounted at 1% of GDP. The insurance funds and investment funds are in an embryonic state in Ukraine and the legal provisions needed to develop these sectors.

There are a number of reasons why the financial market development is in such a infant state in Ukraine. Among these reasons are such as macroeconomic and political instability in the country, inefficient law enforcement, cultural issues, such as low level of law obedient behaviour and political ethics.

4.7.4 Foreign exchange market

Foreign exchange market is one of the important components of money market in the Ukrainian financial system. The National Bank of Ukraine established the foreign exchange market in 1992, then the Cabinet of Ministers adopted the decree 'On the system of foreign currency exchange regulation and control'. According to this decree the National Bank of Ukraine is the only structure in the country which is responsible for the development and control of the foreign currency regulation. In July 1993 the Decree adopted by the National Bank of Ukraine directorate transformed the Ukrainian Foreign Exchange Market into the Ukrainian Inter-

Banking Foreign Exchange Market. The new decree stated the aim of the foreign exchange market as to regulate the trade and to determine the actual exchange rate policy in the country. At the beginning the foreign exchange market operated as a structure within the National Bank of Ukraine, and later it was registered as a joint-stock company with 40 commercial banks being among the founders (each bank has 2.5% of shares). 31 banks have been involved as the working operators and 106 banks registered as a member of foreign exchange market. The foreign exchange market has three sectors: foreign currency, stock and temporary contracts (Ushenko, etc., 1999). Only two currencies, USA dollars and Belorusia rubles, had operated in the beginning. In 1993 Russian rubles and deutschemarks were introduced, and in 1995 French francs, sterling and Italian lira started to operate in the market.

The Ukrainian Inter-Banking Foreign Exchange Market has four branches (in Dnepropetrovsk, Kharkiv, L'viv and Donezk).The Crimean Foreign Exchange Market was opened in 1994.

Table 11. The Ukrainian Inter-Banking Foreign Exchange Market.

Branch	1994 (%)	1995(%)	1996(%)	1997(%)	1998(3 months) (%)
Kyiv (centr)	997	89.2	87.1	91.8	89.7
L'viv	0.0	1.5	1.1	0.8	0.3
Kharkiv	0.0	1.1	0.9	1.4	3.0
Dneprop	0.3	8.2	11.0	6.1	7.0
Donezk	0.0	0.1	0.0	0.0	0.0

Source: Ushenko & Mishenko, 1999.

To become a member of the Ukrainian Inter-Banking Foreign Exchange Market the following conditions of entry should be satisfied. The bank should have no less than 50 clients and the total of the balance in foreign accounts should be more than 500,000 USA dollars. There are also some conditions as to the correspondent banks accounts.

Article 6 of the Cabinet of Ministers Decree 'On the system of foreign exchange regulation and control' (19.02.1993, No.15-93) proscribes the responsibilities for breaching the regulations of foreign exchange. Articles 207 and 208 of the New Criminal Code of Ukraine punish illegal activity with foreign currencies, such as the abuse of regulation in regard to income obtained in foreign currency and illegal opening and using the bank accounts outside of Ukraine.

4.8 Case study 2: Banking in Ukraine

4.8.1 The starting points

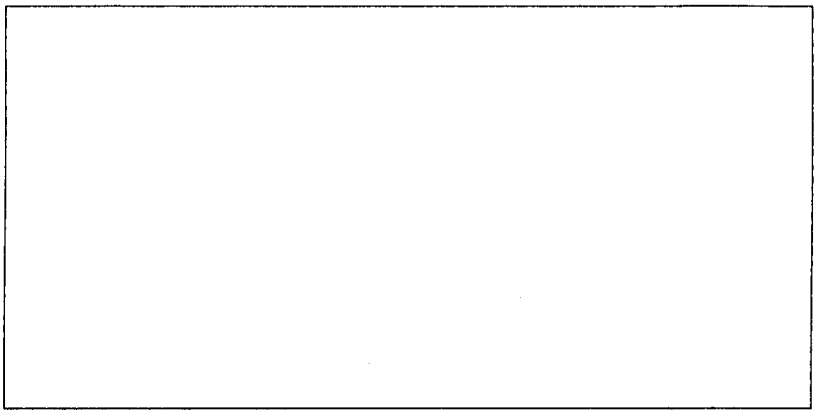
During the Soviet times savings were allocated through a government's budget and largely passive banking system. Financial decisions and assessments were made by the special planning department in accordance to an agreed budget. Banking system served as so-called "supplementary system" to maintain the industry. Krotuk defined the banking system in the USSR as a primitive structure (Krotuk, 2000). There was no such function as management of banking activity. Ukraine, as all of the Soviet Union Republics inherited the mono-bank system of the USSR. Almost all financial and credit operations were conducted in one bank, the Derzhbank and its two branches servicing specific areas of economy, Budbank and Zovnishstorg Bank. Derzhbank worked with short-term crediting, Budbank had a set of functions dealing with the long-term customers, and Zovnishtorg Bank operated with foreign clients (Krotuk, 2000, pp. 12). As Robinson stated "by the time Ukraine achieved independence, the

country had no real banking system, just buildings. The capital was in Moscow" (Robinson, 1998, p. 142).

Three stages of the development of Ukrainian banking system can be identified: from 1991 to the 1994, from 1994 to 2000, and the third stage from the year 2000 to present. The first stage began in 1991, when Ukraine had to decide what to do with its remnant of the Soviet Union banking. In 1991 the Law of Ukraine On Banks and Banking (20.03.1991) was adopted. This law proclaimed the Ukrainian Republic branch of the Derzhbank as a property of Ukraine, and provided a legal background to establish the Central Bank- the National Bank of Ukraine (NBU).

In the previous chapter we discussed different approaches towards banking reforms. We identified the new entry and rehabilitation approaches as the possible choice to transform old banking system. Ukraine adopted the new entry approach and in 1992, 130 banks were organized. This number had almost doubled in 1993, about 207 banks were registered in the country. By the end of 1997, 224 banks were registered in Ukraine. However, far less were actually functioning as banks. Chart 1 presents the data on the number of banks in Ukraine. For less than a year since Ukraine obtained independence in 1991, the number of banks had increased from less then ten to more than hundred.

Chart 1. The number of banks in Ukraine, 1989-2001



In summer 1991 NBU introduced a first set of instructions, addressing such issues as the interrelationship between NBU as a central bank and commercial banks. In summer 1992 NBU started introducing the system of licensing for those banks operating with foreign currency. In January 1994 the electronic payment system was introduced in all Ukrainian banks. In autumn 1991 NBU made first attempt to

introduce compulsory requirements to the minimum capital required to establish bank. However, minimum capital was set at a very low level.

Table 12. Statutory capital paid by banks, 1992-2001 in mln. Hrv.

Year	1989	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of banks/Year		30	11	28	30	29	27	14	03	95	92
Statutory capital paid, mln. Hrv	/a	.5	5	7	41	098	560	107	914	666	028
Mean statutory capital paid by one bank, mln. Hrv	/a	.004	.07	.4	.4	.8	.9	.8	4.4	8.8	1.0

As Table 12 shows mean statutory capital paid by one bank is very low in the early 90-s. It was increased in 1996 and 1997 due to the changes in the banking regulation and rising level of the minimum statutory capital to be paid. According to the data of the National Bank of Ukraine, in the year 2000 the total capital of all Ukrainian banks was about 1.1 billion $US.

The first stage is characterised by the extremely liberal policy adopted by NBU toward the licensing of new commercial banks. Many new private banks were established by enterprises and functioned as pocket banks. Ukraine was not an exceptional case, and the majority of newly independent countries had experienced the same problem (see Fleming, Chu, Bakker, 1996 for the examples of Baltic countries experience). The majority of commercial banks established between 1993-94 could not function properly. Economic crises and high level of inflation were the obvious reasons which caused troubles for a lot of banks. However, this was not the only reason. Lack of educated staff and a very close connections a lot of banks had with the Ukrainian industry were named as negative causes. Four out of five banks had their statutory capital formed with the state enterprises finances. This lead to the high dependency on clients, representing state enterprises and almost lost interest in the independent clients. The Degree of the Cabinet of Minister of Ukraine from 31 December 1992 prohibited involvement of state enterprises in any type of business activity, to avoid further disruption of the banking sector.

The second stage began at the end of 1994, characterised by the introduction of a number of regulations related to the supervision of the commercial banks activity. Although, new regulations were introduced, this period was characterised by

deepening economic crises, poor bank management and poor risk assessment in lending. During the year 1995-96, 65 banks went bankrupt (Krotuk, 2000, p. 17).

Table 13. Number of banks breaching the banking regulations, 1992-2000.

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000
N of banks liquidated due to the breach of banking regulations	3	6	11	1	11	10	16	11	9
N of banks with recalled licenses due to the breach of the foreign currency operations	3	1	0	7	26	5	9	0	9

According to the data presented in Table 13 in 1996, 26 banks lost their license to operate with the foreign currency because of the breach of the banking regulation (the total number of banks holding the licenses was 146 as of 1996). With the adoption of the Constitution of Ukraine, the National Bank of Ukraine had received the legal foundation to operate. Article 99 of the Constitution of Ukraine states that the National Bank of Ukraine (NBU) is a state central bank, whose main function is to provide currency stability (see Eremenko for the critic of this choice)[2]. By the end of the 90s, with more than 200 banks registered in the country, the National Bank had finally realised the importance of a managerial function, and such issue as commercial banks' supervision became of particular importance. Since 1999 the National Bank has prioritised such functions as regulatory and supervisory functions. NBU stresses the importance of reforms in the state credit policy, introduction of the world best experience in inter-banks payments

The third stage began in 2000. As we mentioned already, financial sector reforms involved transformation of a virtually passive banking structure of a centrally planned economy into an active financial sector supporting the development of the real sector. Introduction of the market reforms changed the monopolistic system. Two banking systems were created with central and commercial banks functioning separately. One

[2]To be in line with the IMF policies, Ukraine, as many CEE countries, had followed the IMF recommendations to single out monetary stabilisation as a top priority for the central bank. Many experts argue that such a narrow policy does not create the right environment for the development of the financial institutions in transitional countries (Eremenko, 2000). For example, Eremenko (2000) writes, "Setting money stability as the only main target of the central bank is certainly the right thing to do in the case of hyperinflation. There is no evidence, however, that this stability should be the main or only target in an environment of moderate inflation. Moreover, such a narrow targeting enables the authorities to intervene more easily in the financial sector in order to finance budget deficit or to siphon off funds to selected enterprises or individuals" (Eremenko, 2000, p.55.).

of the reasons for such separation was the autonomy the newly created banks would obtain in the area of credit allocation.

During the years 2000-2001 the State policy was centred on banking sector improvements, and, also on stressing the importance of the role of banks in economic transition. The main priority for the year 2001 was an increase of the investments into the real economy. Changes to two major legal acts related to banking were adopted during that two years: The Law of Ukraine "On Banks and Banking", from 7 of December 2000, and The Degree of the President of Ukraine "On measures to improve banking system in Ukraine and on improvement of the role of banks in the processes of economic transformation" N 891, from 14 July 2000. These normative acts set up the main directions to develop the systemic program on the development of banking in Ukraine in 2001-2003.

Table 14. Banks in Ukraine, as on April 2001.

Total number of registered banks	194
Total number of banks with foreign capital	31
Total number of banks holding licenses to operate with foreign currency	150
Total number of banks liquidated during 1991-1999	76
Total number of banks which are currently in the process of liquidation	37
Total number of banks with the assets more than 100 million hryvnia (less than $US 18mln)	47
Number of banks with 100% of foreign capital	7
Total statutory capital of registered banks	3.86 billion Hrv (approximately $US 700mln)

Source: The International Bank for Reconstruction and Development/ The World Bank Report, 2001, p. 32.

Simple calculation of the data presented in this table shows that excluding banks with the assets more than Hrv.100 million, the mean average assets for the rest, 147 banks, would be about Hrv. 5.7 million (about $US 1 million). In general, the main indicators of bank performances improved . The banking system had about 30 million Hrv lost in the year 2000, and it started to make a recovery in the first part of 2001, making 187 million Hrv in profit. Balance capital grew by 8.3 %. There was a positive sign in recovery of the general population interest to long-term bank deposits. The banks credit portfolio increased

on 14.4 %. However the problems remained to be the same: low level of bank capitalisation, low quality of assets, substantial number of unrecoverable loans, not sufficient interest to reorganise and restructure banks, weak development of the property market, which unable banks to develop a system of risk covering, like mortgages.

4.8.2 The crises

During the mid-90-s a lot of Former Soviet Union republics experienced crises in banking. For example, banking crises in Estonia in 1992, in Latvia in early 1995, and in Lithuania in late 1995[3].

While the Ukrainian banking sector had escaped serious crises, at least two events had shaken the stability of emerging banking: crises in Russia in 1998, and bankruptcy of two big banks, "Ukraine" Bank and Slovyanskiy Bank. Three factors mitigated the danger of systemic crises in Ukraine: (i) slow progress on privatisation and other structural reforms, (ii) high inflation 'minimised' the effect of bad loans, and (iii) ongoing distortion in the economy, and ongoing volatility of many key prices, including that of foreign exchange (Roe, Siegelbaum, King, 1998, p.,14).

In Ukraine some deeply insolvent banks were still considered to be 'safe', due to the state subsidies allowing to cover losses. While these banks could be safe for some time, they were very unsafe from the perspective of taxpayers, who somewhere in the future would be liable to cover bank's losses.

Ukrainian banking system had substantial losses after two big banks collapsed. Here, we present a brief history of the "Ukraine" Bank.

The "Ukraine" Bank was established in September 1990. This period would later be characterised by the absence of adequate bank supervision and control, aggravated by macro-economic instability (like hyperinflation). All these irregularities created a safe environment for suspicious practices in banking (the interest rate reached 700% a year at some stage). Experts argue that during these years a lot of banks had created a portfolio of 'hopeless' credits. However, a lot of big banks, such as OshadBank and UkrsocBank, had managed to recover. These banks had better management and strong control from the side of the management. The "Ukraine" Bank had the

[3] For the detailed study of banking crises in the Baltic countries see Fleming, Chu, and Bakker (1996) The Baltics- banking crises observed, The World Bank Policy Research Working Paper 1647.

disadvantage of a constantly changing management, which would often abuse bank information and act against the bank's interest.

As in April 2001, the balance was about 4.5 billion Hrv, the credit portfolio was 1.37 billion Hrv, of which more than 70 % were credits allocated to enterprises working in agriculture. The structure of the "Ukraine" Bank consisted of the main office, 26 regional directorates and more than 1100 branches. More than 1.7 million people, and around 200,000 legal entities were bank depositors. The Bank had around 337,000 shareholders.

As a result of activity in the year 2000, the Bank had losses of 91,152 million Hrv. About forty foreign banks and companies extended credit to the bank, and the total credit allocated to the bank was $70 million Hrv. As on July 2001 deposits of physical entities accounted for 271 million Hrv ($50.4million), and the bank's liquid assets were estimated to be around 290 million Hrv ($53.9 million).

The Parliament supported the idea of creating a special commission to investigate the financial activity of the "Ukraine" Bank. According to some sources, as of 1 May 2001, the credit portfolio of the Bank had 800 million Hrv in delayed credit payments. The court received the cases on the Bank's failure to pay $30 million and 150 million Hrv credit payments. Its losses accounted for about 353.6 million Hrv, and during January - April 2001 this amount increased by 37.2 million Hrv. The Bank owed 0.5 billion Hrv to other banks. It received 320 million Hrv as credit from the National Bank of Ukraine. In total, the bank spent 137.2 million Hrv to buy credit from other banks. One of the conditions upon which the International Monetary Fund would re-open the credit line in Ukraine was the end to the long saga of the financial problems of the "Ukraine" Bank.

On 16 August 2001, the Attorney General's Department requested 160 credit files from the Bank. One of its former managers was accused of illegal activity which led to losses of more than 1 million Hrv. During 1997- 2000, bank officials authorised almost irrevocable loans to some commercial structures. The total sum of the loans issued was 330 million Hrv. The Attorney General's Department accused these bank officials of simply stealing 3.5 million Hrv from the Bank.

Results of the year 2000 showed that the majority of Ukrainian banks came to the end of the financial year with good results. Losses were reported only in 12 banks. However, the amount of losses in these banks was sufficient to make total banks profit negative. In total banks lost 30 million Hrv. One of the reason for this is

financial trouble in three banks: Oshadbank and "Ukraine" Bank losses accounted for nearly 124 million Hrv, and Slovyanskiy Bank losses accounted for 325 million Hrv. Criminal investigation followed the official announcement of financial troubles in Slovyanskiy Bank and "Ukraine" Bank.

Five years, from 1996 to 2000, showed a sharp increase in the number of crime committed in banking sector. In 1995, 362 offences were registered. Among them 92 were committed by organised groups. In 1996 the number of crimes registered in banking sphere had risen to 3721, and 244 were committed by organised groups. The number is almost doubled in 1997, 6227 crimes were registered, and among them 361 crimes were committed by organised groups (Kamluk and Nevmerzhickiy, 1998, p. 99).

4.8.3 The underlying causes

It is difficult to uncover the complex web of causes which led to the criminalization of the banking industry in Ukraine. However, we can discuss a number of systemic factors involved in the criminalization process. These factors pressured the solvency of banks and created incentives for unsound banking practices.

Transitional literature categorises these systemic factors under the following broad headings: 'poor regulation and supervision, poor accounting and excessive taxation, an inadequate legal infrastructure for bank lending, and pervasive corrupt practices coupled with weak banking skills and mismanagement on a significant scale' (Fleming, Chu, Bakker, 1996, p.26). The above-mentioned factors are interrelated. For example, poor regulation and supervision could be considered a result of negligence and corruption of government officials. At the same time, the lack of adequate bank supervision created a safe environment for corrupt practices.

4.8.3a Banking regulation and supervision

Banking supervision is a difficult subject in developed and financially advanced countries, and it presents a lot of problems for transitional countries. However, whereas Western banking considers supervision a necessary mechanism to reduce individual and systemic risks, transitional countries consider supervision to be another form of political pressure. Transitional countries should start with establishing independent regulatory mechanisms, free from political pressure.

As discussed earlier, during the first years of independence, in the early 90s, the National Bank of Ukraine had a very liberal policy towards the entry of new banks. Even in the mid 90s, when the problems were identified, the implementation of regulations remained a serious issue. A good example of the supervisors inability to impose new regulations is the issue of a minimum authorised capital requirement for new and existing banks. A few years after this requirement was introduced, some Ukrainian banks still struggle to meet minimum capital requirements (Caprio, Hunter, Kaufman, and Leipziger, 1998).

It is important to understand the problem of banking regulation in the context of the economic and financial development of the country. The old Soviet system of regulation was very repressive, the emphasis was on almost literal obedience. The new market-oriented system brought a different concept of relationship between the state and financial institutions. The main idea of this concept is co-operation. The problem is how to adopt this new system to the reality faced by transitional countries. To some extent, we may argue that, in general, transitional countries experience wide spread ignorance of existing rules. This may negatively influence the financial institution's environment. It may be argued that strong and transparent supervision of the banking sector could positively influence the development of a safe economic environment in general, and a safe environment for financial institutions in particular. In Ukraine, as in many other transitional countries, currency stability was chosen as a prime objective of central bank policy. IMF considered monetary stabilisation as a top priority for the newly developed countries.

As Eremenko (2000, p. 60) writes, "In politically unstable countries with a high level of corruption, and particularly in ex-USSR countries, price stability as the sole target on monetary policy provides the authorities with greater freedom to achieve short-term objectives and pursue personal interests. It also enables a government to justify financial repression and to subsidise enterprises favoured by particular officials. Moreover, there is no evidence of gains from very low inflation, especially in transition economies. In fact the opposite seems to be the case. A policy enforcing "artificial" stability, not supported by economic and institutional fundamentals, could result in missed opportunities to pursue other goals, while gaining little from stable prices. After all, in transition economies, price stability is not the main factor in investment decision-making: there are other, much more serious problems related to the tax system, contract enforcement, corruption, etc.".

The following regulatory inefficiencies complicate banking in Ukraine: the absence of an independent body to supervise banks and other financial institutions; indecisive action from the NBU towards bad banks, fast privatisation of state banks, problems with implementation of adequate regulations to control bank secrecy and disclosure of information; inadequate regulation, which allows excessive use of barter operations and delayed credit payments; involvement of commercial banks in the NBU's monetary problems; and transfer of state regulatory functions , such as foreign currency control, to the commercial banks. The last, but definitely not the least, is the lack of transparency in the regulatory practice of the NBU and the absence of clear rules applicable to all banks. This has resulted in the different treatment which the NBU provides to different banks (the NBU may choose a bank to help cover debts, to provide some financial assistance, or contrary to the financial help, the NBU can fine the bank and refuse to provide financial assistance). The other loophole in supervision is the absence of a 'bad' enterprises official register (those with the 'bad' borrowers' records). Such enterprises should not be eligible to borrow unless the previous debt payment is made.

4.8.3b Accounting and taxation

As in many countries of the former Soviet Union, banks in Ukraine continued to use the old Soviet chart account. The introduction of accounting and reporting requirements began in 1994-1995. In Ukraine, as in other former Soviet Union countries, the distinction between supervisory and tax accounting was initially an unknown concept. Almost common practice for the FSU countries was explained in those days as better banks using profit and loss data after hypothetical provisioning to determine dividends payouts, while corrupt banks were using this loophole to drain funds out of their banks through large dividends payouts out of non-existent profits (Fleming, Chu, Bakker, 1996, p.27). As a result of such regime many 'good' and 'bad' banks were taxed on the basis of fictitious profits. In Ukraine, this problem has been addressed only recently. The level of the taxes imposed on banks is very high in Ukraine, and in total is about 70%. It has been argued that in a system where the taxation of bank profits is punitive, substantial negative consequences may flow from introducing transparency through Western accounting and loan loss provisioning techniques (Roe, Siegelbaum, King, 1998). The authors write that "complex prudential regulations and discretionary principles of bank supervision can present

new and lucrative opportunities for rent-seeking on the part of politicians and bureaucrats, especially where social and legal controls on corrupt behaviour have been weakened in the transition" (Ibid. p.7).

4.8.3c Legal infrastructure for bank lending

Financial system development in transitional countries is difficult without advances in the legal system. In many FSU countries, a legal framework supporting bank lending was missing at an early stage. For example, the development of the banking industry strongly depends on such procedures as bankruptcy and collateral recovery. Both procedures had been underdeveloped in Ukraine[4].

As we write, the following areas of banking in Ukraine are underdeveloped: the circulation of securities bills, the management of state budget allocations, liquidity provisions, insurance of deposits and bankruptcy legislation. From the early years of independence, appropriate corporate governance and accountability provisions for banks were missing. This led to a lack of information and regulation on such issues as the duties and responsibilities of bank shareholders and the supervision of board members and managers. Lack of knowledge or negligence from the side of the NBU, led to the fact that a number of bad banks were given subsidies, which never helped the recovery process, and on the contrary, only worsened the financial situation of that bank. The bankruptcy of the "Ukraine" Bank, one of the eight biggest banks in the country, has been named as a supervisory fault. The problems with the "Ukraine" Bank began in 1998. Since then, through the intercession of the National Bank of Ukraine, the "Ukraine" Bank has received substantial help from state budget money. By summer 2001, it became obvious that it was no longer possible to cover the activity of the bankrupted bank. In total, the "Ukraine" Banks's debt to depositors was around Hrv 270m (around US$ 50m). In July 2001, authorities opened the investigation into the reasons of the bankruptcy of the "Ukraine" Bank. The Ukrainian Prime Minister, Mr Kinah, said that it is necessary to find those responsible for the bankruptcy of one of the biggest banks in the country (Ukrainian News, 2001).

4.8.3d Corrupt practices

[4] However, many bankers realised that in a weak and corrupt judicial system the collateral recovery is not an effective risk control device.

There are a number of factors which determine the scale of corrupt practices inside the banking industry. First of all, in a society where corruption is systemic, corrupt practices inside financial institutions constitute alternative forms of management. For example, bad supervision can be a product of corrupt exchange or corrupt agreement. Second, corruption or the threat of politically-influenced supervision leads to inequality in the treatment of banks. Third, a weak judiciary system leaves almost no chance for successful prosecution of corrupt practices.

Corrupt practices in banking include the following examples: allocation of 'cheap' state-budget money into banks with 'special' connections; inequality of banks; different activities of 'pocket' banks (banks created as funding mechanisms by groups of entrepreneurs).

4.8.3e The policy response

The fact that the majority of banks had positive results at the end of financial year 2000 should be considered as the positive outcome of the state policy aiming on strengthening banking sector in the country.

The Law of Ukraine "On the banks and banking activity" is the basis for the regulation of the credit and banking practices. In 1998 NBU adopted a number of instructions with the aim to supervise and strengthen the banking system. These instructions increase the minimum authorized capital requirement for new and existing banks (to one million ECU), the solvency ratio limited the ratio of a bank's total capital to total risk-weighted assets to 8%; set up standards to single borrower exposure (maximum is 25%); identifies maximum amount of large credits (limited by the ratio of total loans exceeding 10 % to 8 times the bank's capital) and maximum investment in shares, as well as maximum insider lending (to be reduced from 100% of capital to 25%) and maximum borrowing from the interbank market and the NBU (should not exceed 300 % of a bank's capital). In 1998, after the registered banks submitted the information to NBU, it became clear that among 189 banks submitted information, 127 violated some of these norms (Robinson, 1998, p. 146).

Unfortunately, these regulations are not always satisfied. There have been a lot of cases reported involving banks failing to fulfil the minimum capital requirements. The Old Criminal Code prohibited such activities as tax evasion, fictitious entrepreneurial activity, financial fraud, concealment of bankruptcy and fictitious bankruptcy. Matysovskiy (1999) considers the importance of the financial fraud

article in the Old Criminal Code. It prescribed criminal responsibility for the provision of false documentation and information to the state organisations, banks or credit institutions with the aim to obtain tax relief, credit or subsidies.

To avoid further criminalization of financial establishments the New Criminal Code introduced article 209 that punishes laundering of the illegally acquired gains, article 200 punishes illegal activity in banking sphere, such as illegal electronic money transfer.

The Criminal Code of Ukraine specified the responsibility for opening up and use of the accounts in foreign currency out of the Ukraine without the prior consent of the with National Bank of Ukraine. The object of this type of crime is the profit in foreign currency, enterprise accounts opened without the agreement with the National Bank of Ukraine. However, the problem is to define 'the profit'. For example, the illegal foreign currency flow is possible in the form of fictitious enterprises or agreement between the company in Ukraine and abroad. These fraudulent companies are called 'one day' companies, because they are established with the only aim which is "to transfer bearer bonds into local cash and then to transfer this into foreign currency with the aim to bring it abroad and use it in some overseas shadow economy" (Osyka, 2001, p. 122). According to some sources, the Nauru island has about 35 branches of Ukrainian banks and more than 200 trade accounts. This bring us to the problem of money laundering control in the country.

The introduction of the system to control, prevent and counteract the legalisation of proceeds of crime has only started in the year 2000. It has been a very difficult political issue to discuss at a high level. The draft of the Law of Ukraine, 'On prevention and Counteraction of Legalisation of the Proceeds of Crime' was prepared in the year 2000. The draft law includes five section: general provisions (articles 1 and 2), the state control of financial transaction to prevent legalisation of the proceeds of crime (articles 3-12), counteraction to legalisation of the proceeds of crime (articles 13-18), international co-operation for the prevention and counteraction of legalisation of the proceeds of crime (articles 19-21), and section five on final provisions. The draft law regulates relations in the area of prevention and counteraction of the proceeds of crime being put into legal turnover, as well as their seizure and liability for legalisation of such proceeds (article 1). The Law may apply to actions committed outside Ukraine by Ukrainian citizens and aimed at legalisation of the proceeds of crime (article 1). Proceeds of crime is identified as any criminally acquired money or

securities, movable and immovable property, property rights, items of intellectual property, or any other items covered by property rights (article 2). Financial transactions include the following: bank account transactions, cash transaction, international money transfer, crediting transactions, movable and immovable property transaction (article 2). Legalisation of the proceeds of crime means any action taken to make legal the proceeds of crime by means of: concealment or wilful distortion of information on their origin, source or location, or making modifications in the rights to them; as well as use of such proceeds as legal in any financial transaction or other agreement or in business or any other economic activities (article 2). A financial transaction is subject to control if its amount exceeds 5,000 Euro (article 4). Tree major controlling agencies discussed in the draft: financial operators, i.e. commercial banks, finance and credit institutions; special governmental agencies authorised to monitor financial operations; and special units set up in the state tax services (article 5). To control financial transaction the following measures are considered: identification of the initiator of a financial transaction, detection and registration of any doubtful transaction, reporting the doubtful transaction to a special unit of state tax service, and record making and verification of the reported doubtful transaction by the special unit of state tax service (article 6). Criminal Code punishes the legalisation of money or property illegally acquired (article 209).

The draft program of preliminary measures on introduction of the system to control, prevent and counteract the legalisation of proceeds of crime includes the following spheres: legislative regulation; organisation, management, information, scientific-methodological, staff, and material support; international co-operation. In the sphere of legislative regulation the following topics are considered: elimination of contradictions in regulating the grounds and procedures of restricting the scopes of commercial and banking secrets, giving the information on movement of money by the organisations, conducting financial operations; enlarging the sphere of grounds and mechanism of civil liability for actions, connected with obtaining and using the money and other assets, gained in an illegal way; improvement of the normative regulation of operations, conducted by residents or non-residents through the correspondent accounts type LORO and NOSTRO, as well as the control over the movement of money being on correspondent accounts with the aim to eliminate the possibility of their use for laundering of proceeds of crime, or tax evasion. In the sphere of organisation, management, information, scientific-methodological, staff,

and material support the following issued considered: introduction of a system to communicate information on financial transactions (for example, establishing a department as a part of the state taxation service, to combat non-paying taxes and laundering the proceeds of crime); and creation of an integrated bank of data on unfair subjects of financial-crediting and banking activity. In the sphere of international co-operation the aims include bringing the current national legislation in line with international regulations preventing and counteracting the legalisation of proceeds of crime, establishing co-operation with information-analytical centres (groups) of other countries to monitor and prevent financial crimes as well as to obtain relevant information (see Appendix 1).

4.8.4 Efficiency analysis in banking: methodological problems

The intensity of the European financial integration, and the increasing number of emerging transition banking system, have brought the topic of efficiency analysis of the banking systems in different countries. While there are certain rules regarding how to measure the efficiency of banking system in Western economies, the analyses of the banking industry in transition economies has to employ some specific characteristics that are likely to influence bank behaviour and safety.

To begin the evaluation of financial institutions performance researchers need to identify those production unites that by some standard perform well from those that perform poorly. This can be done with the help of non-parametric or parametric frontier analysis. Berger and Humphrey identify three ways how the obtained information can be used: "(1) to inform government policy by assessing the effects of deregulation, mergers, or market structure on efficiency; (2) to address research issues by describing the efficiency of an industry, ranking its firms, or checking how measured efficiency may be related to the different efficiency techniques employed; or (3) to improve managerial performance by identifying 'best practices' and 'worst practices' associated with high and low measured efficiency, respectively, and encouraging the former practices while discouraging the latter" (Berger, Humphrey, 1997, p.175).

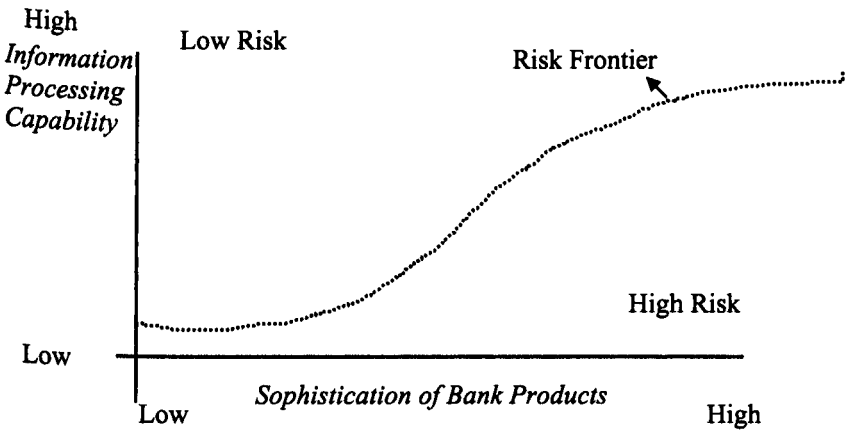
Frontier analysis had been described as 'a sophisticated way to 'benchmark' the relative performance of production units' (Ibid., p.175). Berger and Humphrey argue that frontier analysis "permits individuals with very little institutional knowledge or experience to select 'best practices' firms within the industry, assign numerical

efficiency values, broadly identify areas of input overuse and/or output underproduction, and relate these results to questions of government policy or academic research interest" (Ibid., p.175). Frontier analysis provides "an overall, objectively determined, numerical efficiency value and ranking of firms (also called X-efficiency in the economic literature) that is not otherwise available" (Ibid., p.176). Researchers indicate the need to analyse productivity, efficiency and differences in technology in one given country and to be able to compare the obtained results with the similar findings from different country (Pastor, Perez, Quesada, 1997). Computed efficiency indicators are usually based on the use of production, cost or profit frontiers. Experts describe the production frontier as the maximum attainable level of output, given a level of inputs, or the minimum level of inputs required to produce a given output. The profit frontier studies maximum level of profits that can be obtained given a set of output and input prices (Ibid., p. 396). Optimality was named as the common characteristic of these three frontiers (Ibid., p.396). The above mentioned frontiers derived from a maximum or minimum condition under given conditions on technology and prices describing a frontier or a boundary (Ibid., p.396). The estimation of the distance from each observation to such frontier would provide efficiency level data.

The study of the Spanish banking system Pastor et al (1997) employed a production frontier analysis. The productive change was estimated through the use of Malmquist indexes. "These indexes use the notion of distance function, so that a previous estimation of the corresponding frontier is required. Such estimation is carried out by using data envelopment analysis (DEA), a non-parametric deterministic frontier method based on mathematical linear programming" (Pastor, et al, p.396).

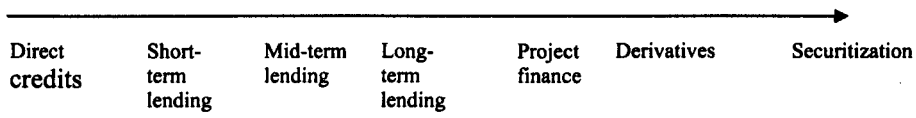
Roe, Siegelbaum, and King (1998) employed the risk frontier technique to analyse banking problems in transitional countries. The framework based on the analytical approach of asymmetric information, which discusses adverse risk selection when riskier borrowers could pay more for credit, and moral hazard, with riskier borrowers involving in greater risk in the deployment of funds to generate better returns. Information Processing Capability is "a function of the individual's bank's ability to collect and process information about the economy in general and specific enterprises in a way that generates valid conclusions of relevance to the banks profitability and risk profile" (Roe, Siegelbaum, King, 1998, p.,9).

Graph 2. Banking sector risk frontier (Roe, Siegelbaum, King, 1998, p. 9).



Sophistication of Bank Products represents "a continuum of commercial banking activities and products with the operational complexity increasing cumulatively with moves to the right along the axis" (Ibid., p., 9). So that, for example, direct credits to state enterprises would appear at the far left of the axis, and sophisticated activities such as project finance and derivatives fall to the far right of the axis. The horizontal axis, representing the sophistication of commercial banks activities may be presented as following:

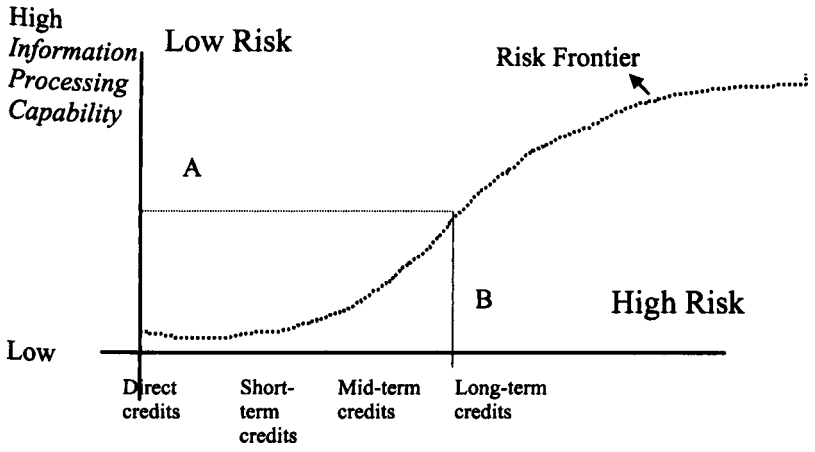
Figure1. The sophistication of bank products.



Banking sector risk frontier identifies that "level of information processing capability required to engage in an activity having a given level of sophistication without incurring an unreasonable level of risk" (Ibid., p.10). The authors agree that the precise shape of the Risk Frontier may be a subject for discussion, and to justify the proposed frontier the assumption is made, that in order to progress the development of financial institutions in the country which used to be deeply involved into the government directions into lending the significant increase in banking skills and information processing infrastructure is necessary. Also, the operating environment, such as legal infrastructure, macro-economic conditions, structural reforms, and reform in banking regulation would contribute to the quality, and risk taking in particular in banking. One additional factor should be considered, which is very important to the country experiencing changes in social values and norms. This factor is trust. Trust is important when we consider the attitudes of general public to the financial institution, or the relationship between commercial counterparts. Social trust is closely related to the issue of asymmetric information (Greenwald and Stiglitz, 1987), a situation where one side of market has better information than the other on options and incentives, an the less informed side is aware of its informational disadvantage (Bossone, 2002). Incomplete trust, or awareness that others may seek to pursue inappropriate gains either through deliberately reneging on obligations due to earlier commitments, or by hiding information relevant to transactions, has been considered as the core of the asymmetric information (Bossone, 2002).

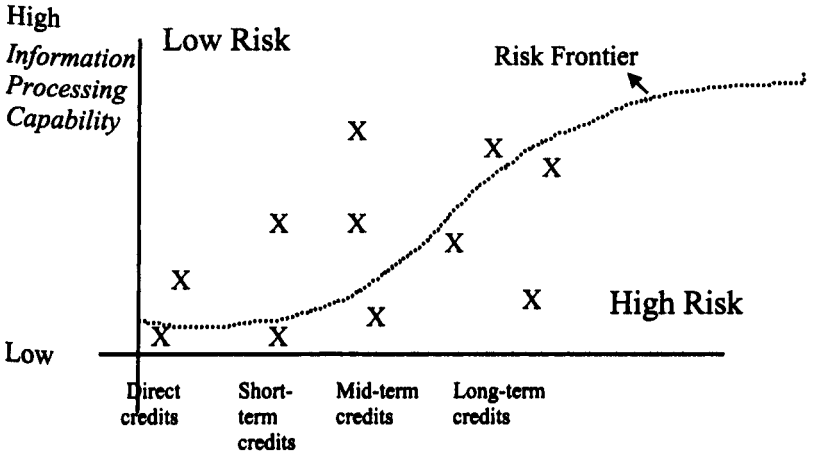
The analysis of individual bank in transitional country according to the above presented theory would lead to the following picture. The majority of banks in transition countries provide very simple services, such as directed credits, short and long- term credits. So, that the axis presenting the sophistication of bank procedures is very simple.

Graph 3. Risk profile of a specific bank (Ibid., p., 12).



According to the theory, the point there a bank's level of information processing capability (A) intersects with the Risk Frontier is the actual limit of the bank activity, "the maximum product sophistication a Bank can deliver at that stage without incurring undue risk" (Roe, Siegelbaum, King, 1998, p.11). The relationship of the high risk area to the corresponding low risk area would give some indication of the overall risk profile of a given bank in a given environment (Ibid., p.11). Roe, Siegelbaum, King apply this approach to the entire banking sector and receive the following picture (Ibid., p.,12). Each "X" represents one bank.

Graph 4. Banking sector risk profile (Ibid., p.,13).



According to the theory presented, "the overall riskiness of the sector depicted is a function of: (i) the number of banks in the "High Risk" zone, (ii) how far below the

Risk Frontier each of those banks is, and (iii) the relative share of banking activity represented by those banks" (Ibid., p.12). In the next part we are going to undertake the analysis of the banking system in Ukraine. We will make an attempt to understand how safe is the banking system in the country and what roles do banks play to improve the economic performance of the country.

4.8.5 Analysing banking sector in Ukraine

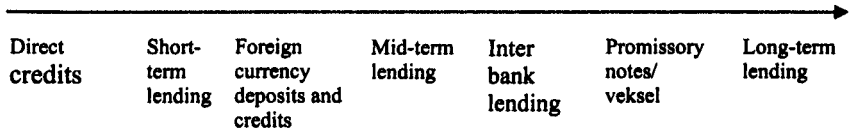
What is the application of the risk frontier theory to the analysis of banking sector in Ukraine? There are at least three factors which can influence banking in transition: (i) the information processing capabilities of one bank; (ii) the sophistication of banking products; (iii) the external operating environment (Roe, Siegelbaum, King, 1998). In one way or another each of these factors were considered in this study.

How innovative and how risky is (was) the banking sector in Ukraine?

At least three innovations are considered in the literature: mobilising deposits in a foreign currency, inter-bank borrowing, and introduction of promissory notes (Claessens, 1998; Roe, Siegelbaum, King, 1998). These innovative products added the extra risk to the banking system in Ukraine.

The axis representing the sophistication of banking products in Ukraine can be presented as following:

Figure 2. The sophistication of banking products in Ukraine.



In the mid-90s foreign currency activity was the source of a substantial profit in Ukrainian banks. Because of the large excess demand, the margins on these resources were very high. Introduction of the veksel (promissory notes) system supported a non-cash payments, because once in circulation veksel' can be used as 'a substitute for cash payment by any enterprise or organisation which happens to become the temporary owner' (Roe, Siegelbaum, King, 1998, p.19). Inter bank lending was reported as a cause for mini-crises in a couple of banks in Ukraine (Ibid., p.19). The major borrowers in the inter bank lending market were the newly emerging

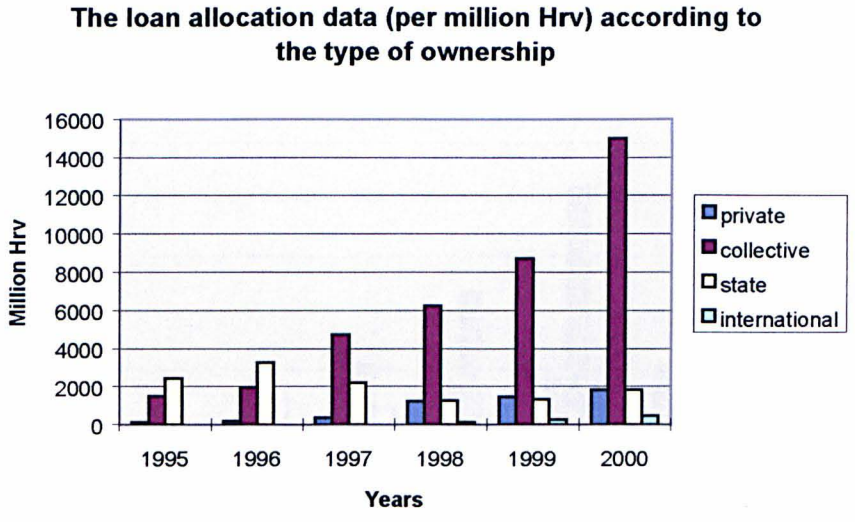
private banks, unable to get a sufficient number of household deposits, or subsidies from the state budget funds.

It is rather difficult to estimate the risk of such services, because many banks were integrated with the state system. So, that cheap state subsidies would not lead the bank to be bankrupted. The majority of Ukrainian banks would be in a far left corner of a figure presented above. The next question we address is how would this position of Ukrainian banks affect the development of the economy?

4.8.6 Banking system and resource allocation in Ukraine: achievements and obstacles

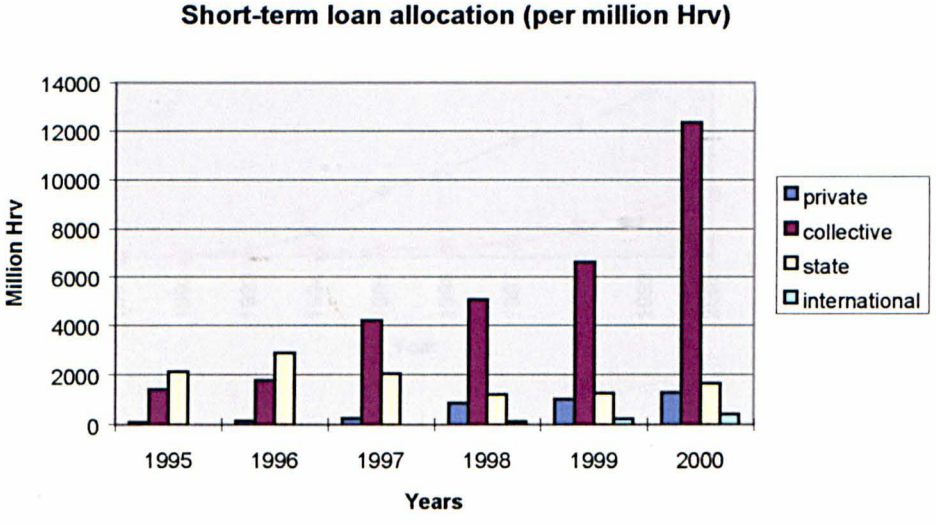
Findings suggest that the richest countries allocate about 1/3 of their loans to the private borrowers, while the poorest countries have less than half of such loans (King and Levine, 1996). According to the data published by the National Bank of Ukraine, only a small proportion of loans is allocated to the private sector, and the most substantial number of loans are made to finance the former state or types of collective enterprises. Graph 1 presents the loan allocation data (per million Hrv). Private means private ownership, collective ownership is when the group of employees is the owner (in Ukraine, a number of former state owned enterprises have become collective property during the privatisation process), state enterprises are owned by the state, and international enterprises are those with foreign capital and owned by non-residents.

Chart 2. The loan allocation, 1995-2000.



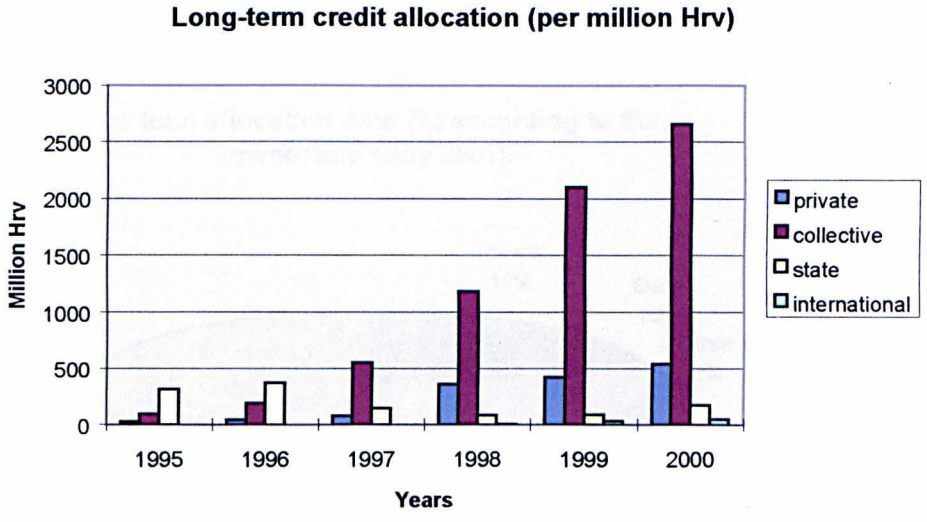
As Chart 2 shows a substantial number of loans have been allocated to support collective ownership. With privatisation under way from the mid 90s, a lot of state enterprises became collectively-owned enterprises. However, as we noticed earlier in this paper, there have only been some nominal changes (see p. for the discussion of privatisation in Ukraine). This means that the management has remained the same at these enterprises. In some ways, this is a new name given to the old structure. The following graphs present the short and long term credit allocation data.

Chart 3. Short term credit allocation, 1995-2000 (per million Hrv).



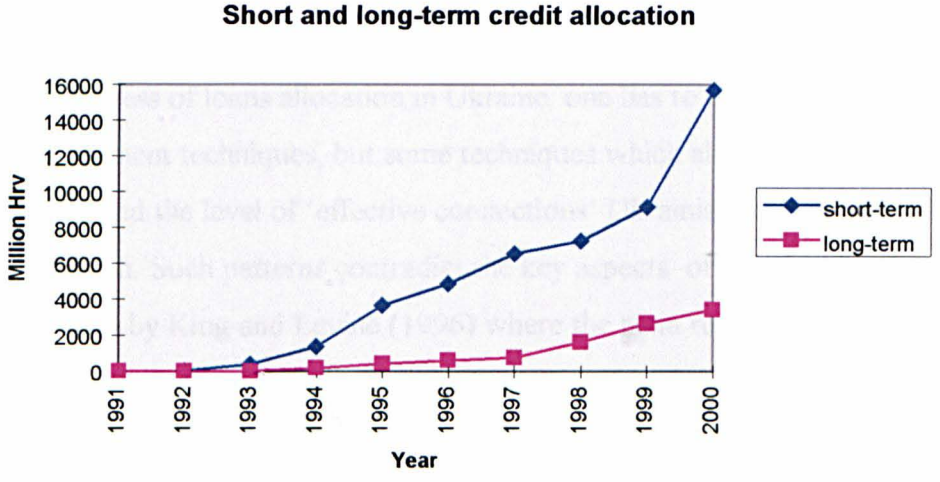
As Charts 2 and 3 show collective form of ownership attracts the major part of both, short and long term loan allocation.

Chart 4. Long term credit allocation, 1995-2000 (per million Hrv).



The amount banks lend to private companies could be substantially reduced if the choice of activity to invest were considered. The majority of loans have been allocated to finance current activity and not to invest in long-term projects. About 75% of the credit portfolio of Ukrainian banks comprised of 3-6 month loans. Chart 5 presents the choice of activities in which to invest (per million Hrv).

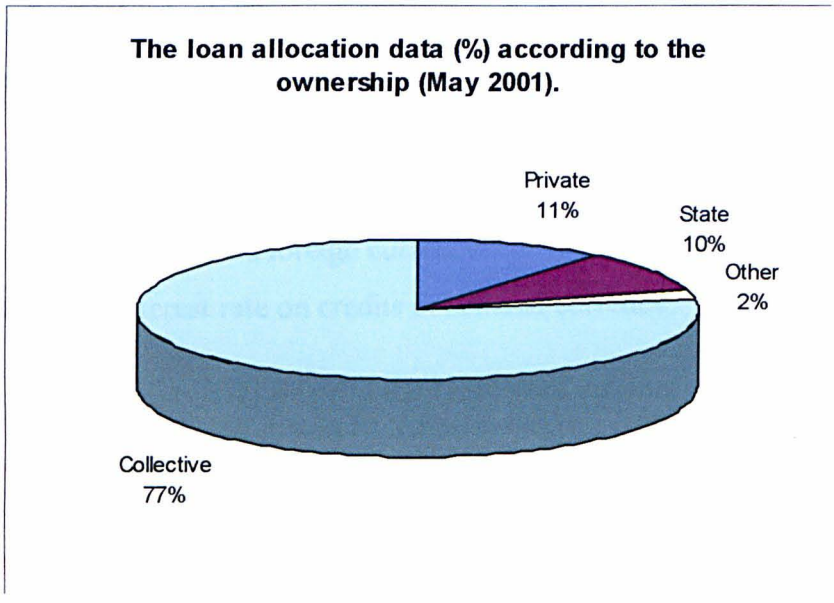
Chart 5. Investment preferences, 1991-2000.



As Chart 5 showed the substantial number of credits were issued as short-term credits. As of May 2001, 82 % of credits issued, were short-term credits. The unpaid debts on these credits accounted for 19 billion Hrv, and increased on 21% during the first six months of the year 2001. In the first part of the year 2001 there was a positive tendency towards increase of the level of long-term credits, from 17.9% in the

beginning of the year 2001 to 18.2% in May 2001. However, as Chart 6 shows the domination the collective type of ownership credit allocation is still substantial.

Chart 6. The loan allocation.

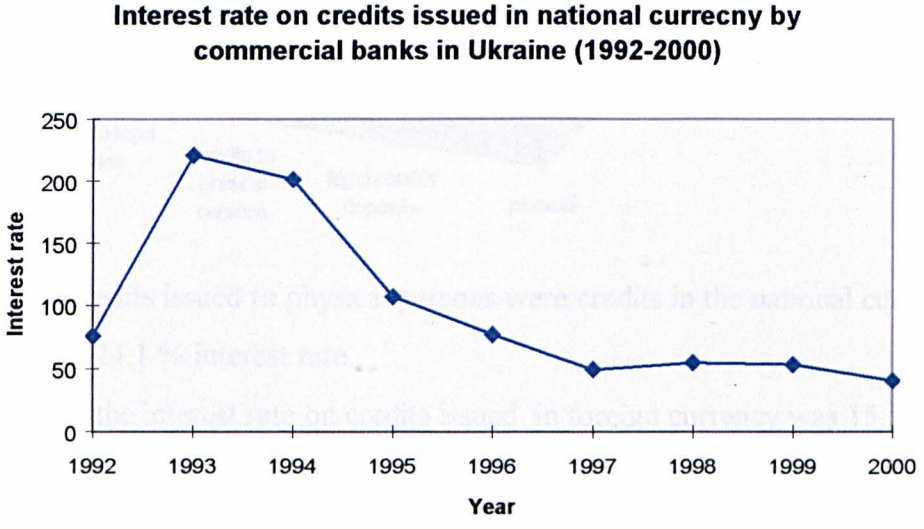


A study conducted by a German agency and reported by The International Bank for Reconstruction and Development analysed the activity of about 1000 Ukrainian enterprises (International Bank for Reconstruction and Development, 2001). The results show that credit allocation is high even among the enterprises experiencing considerable losses. Moreover, the level of creditors' debt has a statistically positive impact on the usage of all forms of bank finances. It tends to be that, in order to understand the process of loans allocation in Ukraine, one has to employ not only the banking risk assessment techniques, but some techniques which allow measurement of political influence and the level of 'effective connections' Ukrainian entrepreneurs have managed to establish. Such patterns contradict the key aspects of sustainable development theory by King and Levine (1996) where the main role of financial institutions is to identify the creditworthiness of entrepreneurs in society by means of transparent methods.

To summarise what has been said, unfortunately the Ukrainian banking system has been unable to allocate sufficient resources to the economy. During the decade of the 90-s the percentage of the bank credits to the GDP has varied from 10 to 20 %. This situation leads to the creation of the alternative forms of loans allocation and debt re-payment system, which increased the risks of financial services in the country.

Now that we have identified the difficulties a company may experience when searching for the necessary resources, we can consider the disadvantages of the loans issued by commercial banks in Ukraine. The major one is the high operational cost and high credit rates. Ukrainian banks are known for their high operational cost and high interest rates. One part of explanation lies in unstable economic environment in the country, including high level of inflation in the mid-90s. As of May 2000, the official interest rate of the National Bank of Ukraine was 21%. Chart 7 presents data on the credit issued in national and foreign currency.

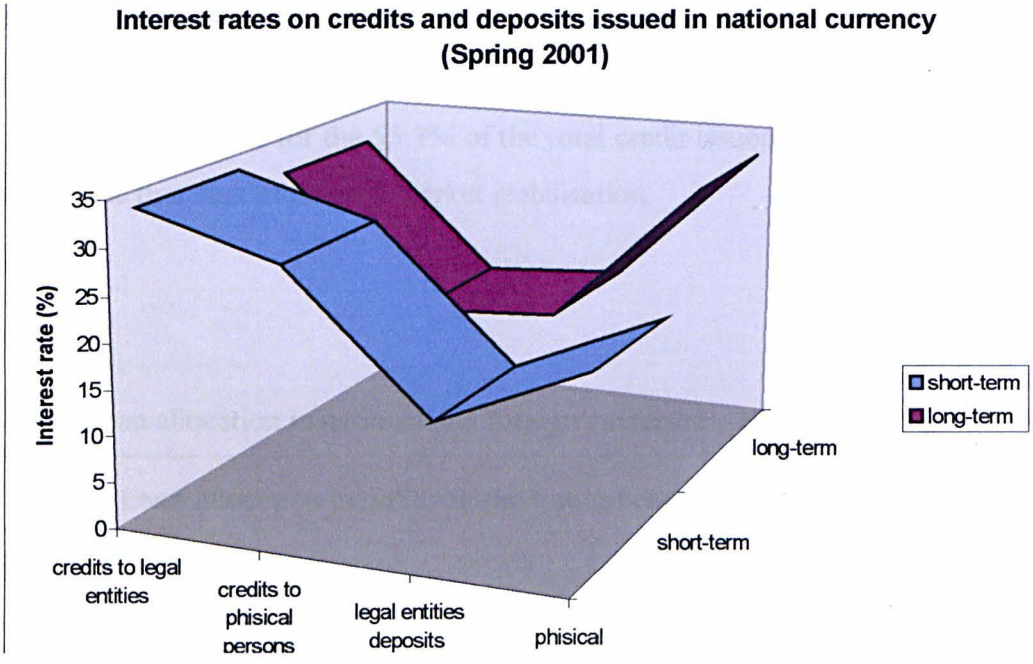
Chart 7. Interest rate on credits in national currency.



The inflation reached its peak during 1993-94, but then fell gradually, and since 1997 the interest rate varied from 30 to 45 %. In 1993 Ukrainian banks started mobilising the deposits in foreign currency. By 1994 the deposits in foreign currency were equivalent of 8.5% of GDP. Involvement in foreign currency deposit mobilisation, as well as foreign currency credit issue were considered as extra risk activity.

There has been reported a tendency towards the lowering interest rate on credits issued in national currency. For example, in May 2001the medium weighted interest rate on credits in national currency was 31.7%, which is 5.7% less then in the beginning of the year.

Chart 8. Interest rates on credits and deposits issued in national currency as on April 2001.

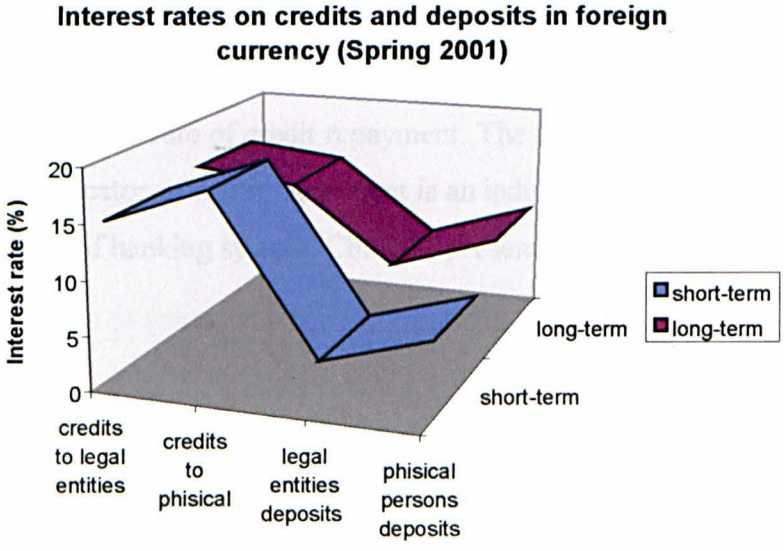


About 80% of credits issued to physical persons were credits in the national currency, issued under the 24.1 % interest rate.

In the year 2001 the interest rate on credits issued in foreign currency was 15.5%. Credits issued in foreign currency for the period from 3-12 month, were the most expensive, with the interest rate reaching 15.7% a year.

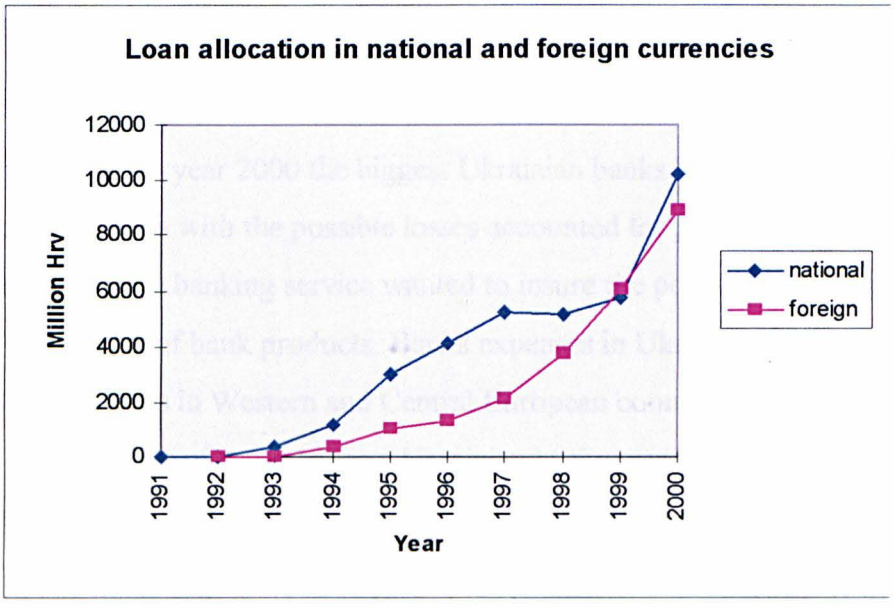
Chart 9 presents data on credits issued in foreign currency, as of April 2001.

Chart 9. Credits issued in foreign currency.



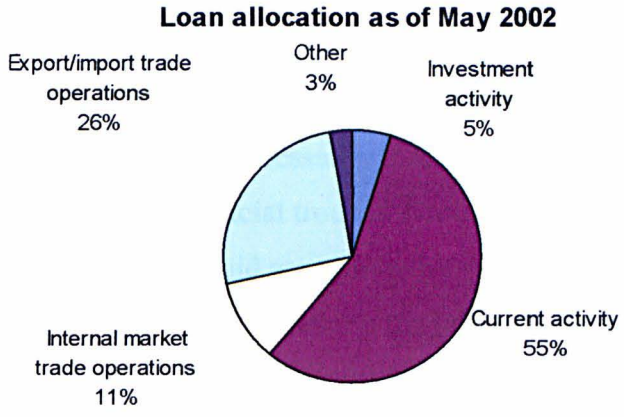
From the beginning of the year 2000, there has been a tendency towards increasing the total amount of loans issued in national currency (see Chart 10 below). In May 2001 the total amount of loans issued in national currency increased on 4.5% , and on 3 % in loans issued in foreign currency foreign currency. As of May 2001, credits issued in national currency accounted for the 55.7% of the total credit issued. This can be considered as the first sign of internal market stabilisation.

Chart 10. The loan allocation in national and foreign currencies, 1991-2000.



The analyses of credit allocation can not be complete without knowing the structure of credit allocation and the rate of credit repayment. The last one is a special concern for us, because the indicator of credit repayment is an indirect indicators of how to measure the abuse of banking system. Chart 11 presents data on loan allocation as of May 2000.

Chart 11. The loan allocation, 2001.



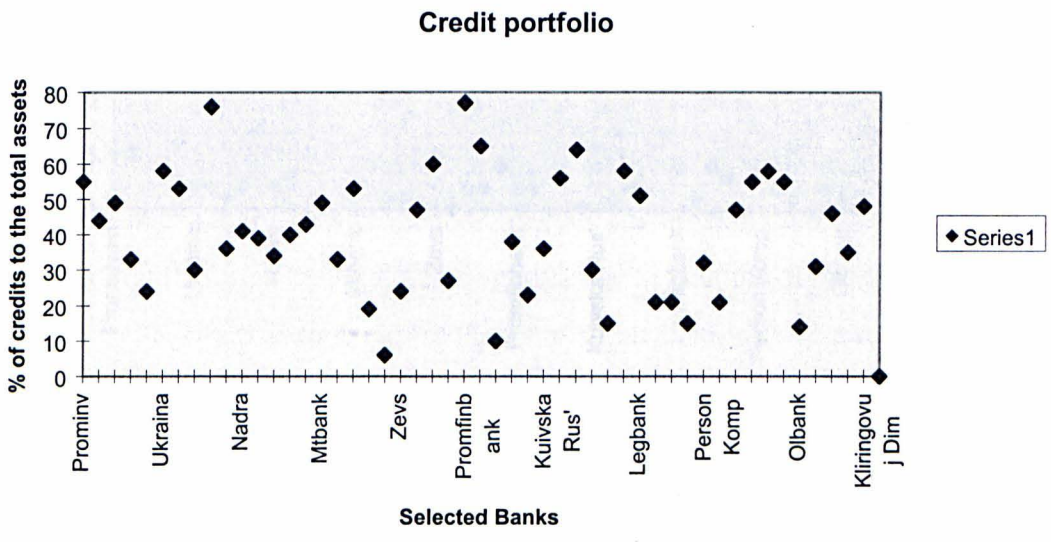
As of the end of the year 2000 the biggest Ukrainian banks had around 24% of their credits as suspicious with the possible losses accounted for 2.5 billion Hrv. Understandably, the banking service wanted to insure the possible losses and increasing the cost of bank products. Banks expenses in Ukraine differs dramatically from those expenses in Western and Central European countries. In 1998-99 the operational expenses of seven biggest Ukrainian banks were in between 8% as the lowest and 37% at the highest. Western experts suggest that 2-3% is a recommendable figure. The report conducted by the International Bank for Reconstruction and Development blames political influence as the major distracting element: direct credits due to the political decisions, political interference with such issues as bank profit and liquidity management after the crises in 1998, banks expenses when performing role of tax inspectors, which is the result of political decision. Apart from political influence such issues as expenses on premises and branches, as well as unjustified high number of bank staff.

How efficient is bank management in the country? Is it possible to obtain a realistic picture by simply studying the statistics presented by the National Bank of Ukraine? To understand that we need to employ a variety of indicators, we present the calculation of two main indicators, which would be helpful in understanding the problem. On the bases of the statistics submitted by the majority of Ukrainian banks

to the Central Bank it is possible to calculate proportion of credit portfolio to the total assets, and proportion of other assets to the total assets (see Appendix 4).

Proportion of credit portfolio in the total assets tends to be the main evidence of the preferences of bank activity, which is to provide loans to the banks' customers or invest in securities, inter-banking credits. If the proportion of the credits in the total assets is substantial it is not necessarily that a bank prefers investment activities. It may also be a result of financial trouble. For example, if the number of suspicious/or bad loans is big, then all liquid assets may be spend on the fulfilment of the client requirements. Chart 12 presents data on the selected banks as of 01.01.2001.

Chart 12. Credit portfolio in selected banks.

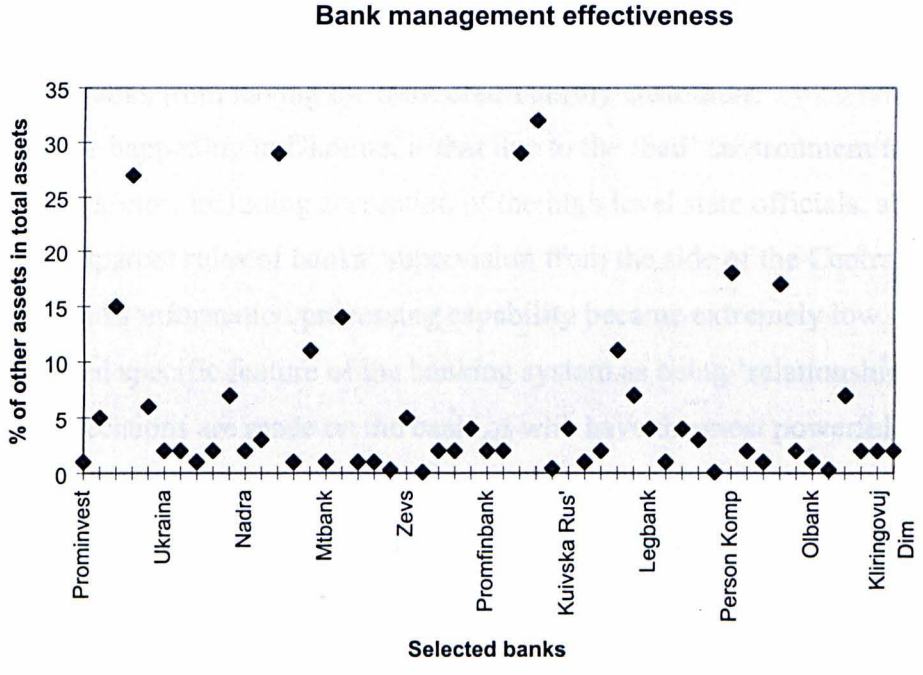


As the above Figure shows, the majority of Ukrainian banks has a substantial proportion of credit portfolio in the total assets. Knowing that the problem of bad loans is a very serious issue in Ukraine, our suggestion is that a great number of banks with the proportion of credits to the total assets more than 30% has experienced financial troubles.

Proportion of 'other assets' in the 'total assets' can be a helpful tool in understanding the level of management effectiveness. The term 'other assets' referred to the assets which are not profitable to bank, and can not be added to any other categories. For example, delayed debtors payments, not fiscal assets, and premises and equipment. When conducting the analysis of the bank assets, it is believed that the proportion of credit portfolio in the total assets should be the biggest one. While the proportion of other assets should be the smallest one. Why? There are several explanations to this

fact. First of all 'other assets' are not profitable. Second, is that for some time some Ukrainian banks tended to 'hide' low quality assets, which in fact were the bank's losses, under the 'other assets' category. Chart 13 below presents data on the selected banks as of 01.01.2001.

Chart 13. Bank management indicator in selected banks.



As Chart 13 shows, for the majority of banks the proportion is low, but there are still some banks where the 'other assets' accounted for the more than 20% of the total assets. The interpretation of this data is very difficult (it is important to remember that the majority of banks window-dress their statistics to show better results). However, this analysis can give a hope that the implemented in the year 2000 regulations have started to work and the bank management system has being improved. It is too early to judge the success or failure of the current reforms in banking.

At the beginning of the study, we discussed the key aspects of sustainable development. Now we would like to critically analyse the presence of such aspects in Ukraine and discuss the impact of corruption. The first point is the existence of an entrepreneur who wants to invest in a business. The results of our expert study suggest that in Ukraine there are at least two groups of entrepreneurs, with useful connections and without. The representatives of the first group would have better access to the resources than those from the second group. The majority of Ukrainian

enterprises finance themselves not with the help of short or long term investments but by employing their own funds, e.g. delaying or not paying wages to employees (International Bank for Reconstruction and Development, 2001). A study conducted by the International Bank for Reconstruction and Development suggests that only 5% of the active (not fictitious) enterprises succeeds in obtaining loans from the financial sector (Ibid.). When we discussed the result of our experts study we cited Siegelbaum (1997) definition of the banking in transitional economies- "relationship" banking, which prevents banks from having the most creditworthy customers.

What seems to be happening in Ukraine, is that due to the 'bad' environment to develop banking sector, including corruption of the high level state officials, absence of clear and transparent rules of banks' supervision from the side of the Central bank, the Ukrainian banks information processing capability became extremely low. In fact, already mentioned specific feature of the banking system as being 'relationship' banking, when decisions are made on the basis of who have the most powerful friend, led to the minimisation of the bank's ability to assess, and what is more importantly to implement decision on the basis of their risk assessment measurements. Although, knowing that a lot of banks were created as 'pocket' banks, one may argue, if the risk assessment could really change the situation in such banks.

Not only the customers of banks need to have a sort of special protection, but banks themselves need to be protected. In case of pocket banks it is easy-the customers and 'guards' come in one 'package', but in case of banks operating as 'normal' that would be a question. Those banks without protection (if there are any), would be the ones to establish their own risk assessment techniques, and increase the information processing capabilities.

4.8.7 Social trust

In a system where corruption is endemic, to conduct a serious business, such as banking, one has to be connected to the high-level officials. It may be some kinship ties, friendship, or an exchange of favours among the colleagues. It reminds the major characteristics of traditional system, where the business relations are based on informal contacts and trust in 'spoken' agreements. Western countries experienced this type of relationship long time ago, and contract form of socio-economic relations has been in place for many decades now. One of the main tasks for transitional

countries is to establish the contract system of relationship based on a rule of law. Trust is an important concept in these changes. Economists consider trust as carefully calculated long-term interest, which brings different groups of people together and results in the voluntary contracts. It has been argued that the level of development of the economy reflects the level of trust in the society. Fukuyama finds a possible explanation of corruption in a system with narrow radius of trust, where different standards of behaviour would apply to different groups of people (Fukuama, 2001a). In such system, the "transaction cost" the cost of legal agreement, can be substantial. Transition societies such as Russia and Ukraine have 'weak voluntary associations' because people do not trust one another. The primary forms of kinship have substituted the voluntary associations of people (Markovskaya et al 2002).

Modern societies consist of many different groups interacting with each other to provide the wide radius of social trust and, therefore substantial economic and political benefits. The economic function of social capital has been seen as the reduction of the transaction costs associated with formal co-ordination mechanisms such as contracts and bureaucratic rules (Fukuyama, 2001).The political benefits stem from the ability of people to organise themselves, to form associations in order to participate in political life and to form the foundation of civil society. If the level of social trust is low, the ability of people to co-operate is reduced, and the danger of state interference in all sector of public life , and in economic in particular, is high. Social trust is closely related to the issue of asymmetric information (Greenwald and Stiglitz, 1987), a situation where one side of market has better information that the other on options and incentives, and less informed side is aware of its informational disadvantage (Bossone, 2002). Incomplete trust, or awareness that other may seek to pursue inappropriate gains either through deliberately reneging on obligations due to earlier commitments, or by hiding information relevant to transactions, has been considered as the core of asymmetric information (Bossone, 2002).

Trust in traditional societies is based on trust in relationships, connections. While trust in a contract society is based on trust in law and legal system. It tends to be that in transitional countries trust has a very low credibility. For example, general population tend not to trust banks and keep their savings literally under their own pillows. One of the way to restore the trust is seen in coming from the top of the society. So, that for example, imposing strict laws and regulations on banking, as well as transparent mechanism of controls would insure the general public that their

deposits safety comes first. Globalisation is widely perceived as creating external impulses for the advancement of social capital in transition countries. Globalisation is capable of breaking apart dysfunctional traditional and social groups and bringing the horizons of modernity closer (Fukuyama, 2001).

Here is the place where the problems had started. The restoration of trust, as we suggested, need to come from the high level officials, those, who in Ukraine, were named as the most distrustful category. In the beginning of the study we discussed the red-collar crime phenomenon, as crimes committed by officials during the time of the USSR. At that time, the belief in government and official policy, as well as the concept of social trust were a part of the ideological propaganda. In transitional Ukraine the official propaganda is far away to be publicly recognised as the icon to believe in, moreover, there has not been a ground on which to build this belief.

To understand the Ukrainian government's devotion to reform we must also understand the human factor at the individual level. We must consider changing attitudes and perceptions of what is good and what is bad and what are inappropriate acts for a state official. One of the respondents suggested that the inappropriate behaviour goes to the very top of the government, arguing that the new ruling elite who recently came to power are unable to think globally, but are instead concerned with enriching themselves in the immediate situation. During the Soviet era, those who ruled the country had at least some basic understanding of the political process and management of the country. With the collapse of the Soviet Union and the Communist Party, Ukraine lost its system of educating future public leaders in the prerequisites for their difficult positions.

Today, those who five years ago were members of criminal groups or who were low-level directors in collective farms, and who gained enough money during the transition to run for office or to gain the ear of politicians, are able to actively participate in high level political and official life. As one of our respondents suggested, "the racket came to the power." The majority of these people appear to be more concerned with their immediate personal and monetary interests. There appears to be a great danger of losing the educated official and political elite. Of course, there is little desire to return to Soviet ways, but there is a need to establish a sort of 'filter' for those who come to rule the country.

Building trust and confidence in government institutions is essential for the transition countries, and Ukraine in particular (Popovich, 1998). The President of the Ukrainian

Legal Foundation, Sergey Holovaty, addresses the problem of weak governance that enables corruption to grow. It has resulted, he says, in "the emergence of the present machinery of government, where responsibilities overlap and accountabilities are diffuse, as well as in ministerial ownership of commercial activities and associated conflict of interest, in low pay and poor supervision of civil servants and in the lack of a public service ethos in the civil service" (Holovaty, 2000, p.271) A number of reports (for example, see Foglesong and Solomon, 2001) suggest that there is a need to increase the responsibilities of high-level state officials. But this can only be achieved if there is a strong political will present in the country, and unfortunately it appears as if Ukraine is a country where political will has been replaced by the will and financial resources of the oligarchs. Power in Ukraine is divided among different clans or groups of oligarchs (Panchenko, 2000), and the major groups of political and economic interest have been reported recently in the Ukrainian magazines (International Bank for Reconstruction and Development and World Bank, 2001; Panchenko, 2000). These groups have divided the country according to their spheres of interest, such as the electric and energy sector (which is recognised as the most lucrative, and thus most corrupt, sector of the Ukrainian economy), metallurgy, the oil and gas sector, and export-import operations. The existence of such groups, at least at such a high level and with such control, is only possible with the support of ranking state officials. Each group has representatives in the Parliament and in the political parties to support its interests, and often also control mass media sources (Panchenko, 2000).

According to the information gathered during the experts study and the literature study it is possible to discuss the hypothesis suggested in Chapter 1. It tends to be that the majority of cases of grand scale economic crime in Ukraine is associated with corrupt involvement of high level state officials or politicians. On a bigger scale it proved to be the obstacle to the successful reforms in transforming the financial system of the country, adopting the internationally recognised standards of transparency and corporate governance. It is reasonable to suggest that the development of the financial institutions in transitional economies can be considered as one of the indicators of the successful democratic reforms. Going back to the micro level, and considering the quality of law with regard to the financial institutions, transitional countries, and Ukraine is a good example, proved the fact that establishing the legal framework for the financial institutions to operate is an essential

starting position. Absence of legal provisions to cover bankruptcy enabled some interested parties to be involved in illegal conduct. Banking is a good example of the area where regulations do matters. Total neglect of the banking supervision in the first years of the independence lead to the establishment of a great number of banks unable or unwilling to operate legally, working essentially to cover financial manipulations of a small group of business or political elite. Introduction of the simple requirements proved to be a very helpful tool in regulating the number of new banks, and the quality of work of those banks established during the first years of the independence. For example, the National Bank of Ukraine recommendations on the consolidation of banks can potentially improve the banking performance, and reduce the number of 'problematic' banks.

4.8.8 European banking liberalisation and integration: lessons Ukraine can learn

The problems the Ukrainian banking system has been experiencing for over a decade now is not new or unique to the financial world. In the previous chapter the examples of financial crime conducted in different economically advanced jurisdiction developed, such as the USA, prove the fact that Ukraine is not alone in experiencing the spread of illegal conduct in the financial service. However, after 1985, only four major banking failures can be identified: BCCI in 1991, Banesto in 1994, Baring in 1995 and problems with Credit Lyonnais (Vives, 2000). Among the factors stimulated banking crises in Spain in the first part of the 1980s were inadequate enforcement of the capital requirements, poor supervision, close links between banks and the industry, and bad management (Ibid.). These factors are no different from what we have just discussed in regard to the Ukrainian experience. How Spain had managed to overcome its banking crises? Vives (2000) suggests that Spain is an example of the successful transformation of the deeply disturbed banking system through the improved mechanisms of institutional settings, strengthened supervision by the Bank of Spain, establishment of a rule of law framework, although far from perfect, as Vives noted.

Vives (2000) considers two cases of bank failures, Credit Lyonnais and Banesto and stresses the importance of a timely response to the bank problems. However simple it may seem the timely response is a very complex issue, involving financial and political issues. As, for example, in case of the Credit Lyonnais, "political

interference and lack of transparency characterised successive attempts to rescue the bank" (Ibid., p.188). This is exactly the problem Ukraine is experiencing, the close links of supervisors and managers of the banks , as in case of Ukraine Bank. To resolve the problem of the Credit Lyonnais the European Commission had to be involved to limit the public aid to the bank.

There is a need to identify the level of problems: is it individual banking problem or a systemic problem? It tends to be that the individual banking crises is a consequence of ineffective corporate governance system, not able to control managers and, as Vives (2000) suggests, facilitate the exit of badly managed institutions. The biggest obstacle to the creation of the system of corporate governance is seen in political interference. The systemic crisis is more difficult to overcome as it not only involves the creation of a safe environment inside the financial institutions, but also strengthening the system of national regulation, establishment of the rule of law.

There are at least two lessons that can be learned from the experience of the European countries. First, is that banking supervision is a very important issue, and second is that political interference with banking regulation should be eliminated, and to achieve this the external regulatory structure can be established. In case of the European Union countries the importance of the role of external supranational regulatory institutions have to be stated (Vives, 2000).

What is the prospect of these lessons being learned in Ukraine? Next part will examine the rule of law and the enforcement problems in Ukraine.

4.9 Ukraine: Present economic crime situation and the rule of law

The researchers argue that criminals in Ukraine can be divided into two groups: the one which is actually a syndicate of businessmen and corrupt officials, and the other is criminal groups, involved in petty crimes (Transcrime, 2000). In the year 2000, in the annual report to the Ukrainian Parliament the President identified the major ways to prevent corruption in society. It has been stated that the most profitable sectors of the Ukrainian economy have been divided between criminal groups. The report conducted by Transcrime cited one of the state officials in Ukraine who pointed out that "criminal groups are dividing spheres of influence in Ukraine among themselves" (Transcrime, 2000, p. 57). According to some Ukrainian state officials the main areas affected by economic crime (as of 1997) were "the transfer of hard currency funds to

foreign bank accounts, money laundering through investments in real estate, securities, hard currency and legal commercial activities (Transcrime, 2000, p. 57). Organised criminality can be explained with the help of a "pyramid" structure (Kamluk and Nevmerzhickiy, 1998). Where the corrupt state officials are at the peak of the pyramid, businessmen working in shadow are in the middle, and criminals are at the bottom of the pyramid. These three groups have developed very close relationships. A number of mutual tasks, such as issuing of licenses, credits and loan obtaining, lobbying certain types of legislative acts, have improved this 'alliance'. Studies suggest that businessmen who work in shadow economy present the biggest group in this structure (Koshuy, 1996; Kamluk and Nevmerzhickiy, 1998).
Studies suggest that there are at least two groups of financial crimes in Ukraine, which generate illegal profits (Transcrime, 2000, p. 58) . The first is mainly represented by fraud, drug trafficking, embezzlement of state property, theft, forgery of documents, corruption, unfaithful management, extortion and racket. The second includes the smuggling of consumer goods, alcohol and cigarettes, tax evasion and tax fraud, arms trafficking and small-scale trafficking of nuclear materials (Ibid., p. 58).
Studies suggest that corrupt state officials have negatively affected at least three spheres of economic activity in Ukraine (Kamluk and Nevmerzhickiy, 1998). These spheres are entrepreneurial activity, banking, and privatisation.

4.9.1 Entrepreneurial activity

Due to the very close state supervision of business and entrepreneurial activities, a number of 'bad' practices have almost been institutionalised in the country. Among them are such issues as state control over issuing licenses to different types of services, high taxes and almost inevitable will to 'neutralise' state agencies who collect taxes, and bad management.
The previous part discussed the general macroeconomic situation in the country and mentioned the difficulties the large state enterprises have experienced during the transition. Many state enterprises received large state credits and tax concessions to improve the business. However, due to the management fraud and in some cases political influence, these measures rarely improved the situation at the enterprises. Many managers at these enterprises made huge illegal profits by establishing private companies to buy and sell goods to state enterprises at artificially high prices

(Kamluk and Nevmerzhickiy, 1998, pp. 91-118). Such operations allowed the relocation of profit from state-enterprises to private ones. Moreover, later, state enterprises could apply to the government credits or subsidies to cover the losses. The involvement of high level state officials was necessary to allow such transfer at the first place and to prevent the competitive market solutions to the problems. The box below presents some well known examples of the corrupt practices of the high level officials.

Box 1.1.

Example 1.

A former Prime Minister Lazarenko allowed privatization of a number of large enterprises who where 'customers ' and 'buyers' of each other. The owners were 'people' of Lazarenko. Being owned by the same groups, these enterprises were forced to buy supplies, including energy (gas) by artificially high prices and sell their products for artificially low prices. This scheme resulted in a very rapid money earned on the one hand and in almost bankruptcy if enterprises. After the money were safely transferred to the off-shore and foreign accounts, the 'financially sucked' enterprises were transferred back to the state. The owners argued about 'unsuccessful' privatization and reform attempts.

Example 2.

Indirect bad influence of Lazarenko manipulation with energy sector. Lazarenko bought gas from Russia and sold it through the number of 'his' companies. His famous 'say' was 'you either do business with me, or you do no business at all'. Apart from huge kickbacks, there was another negative effect: the selling price of gas was about three times larger than that bought from Russia. Say a gas provider sells gas to lamp- producing company ('Iskra' in Lviv, the largest producer in Ukraine). He knows that 'Iskra' will not be able to pay gas bill and takes lamps as in -kind payment (barter). The lamps are sold in large quantities by very low prices, the gas -provider makes lots of money quickly, but 'Iskra' suffers since it can not sell lamps on its normal price. A lot of companies use energy and gas, which represent vast proportion of their production costs. Thus, they suffer the same problem as Iskra with marketing and selling their products.

The role of the enterprises in transition to market economy are paradoxical in Ukraine (Kamluk and Nevmerzhickiy, 1998, pp. 94-95). Instead of becoming the main tool to advance economy, the Ukrainian enterprises have become unproductive force which only worsen the economic crisis in the country. One of the reason for deterioration of the enterprise's strengths is seen in the corrupt activity of some high level state officials. These people made it possible to transfer the economic system of the country into the "arena to trade privileges and redistribute property between the most influential groups" (Ibid., p. 94).

According to some sources (Osyka, 2001) 9 out of 10 Ukrainian companies use illegal transfer of money mainly to avoid taxes.

4.9.2 Banking

The use of 'loro', or overseas accounts have been employed by criminals to transfer huge funds. According to the National Bank of Ukraine data, in 1996 only 25 % of the transactions used to transfer money abroad were results of the export-import operations. The rest is the result of the financial transactions of non-resident banks with Ukrainian currency (Kamluk and Nevmerzhickiy, 1998, p. 100).
In 1996, $81 millions was discovered as been illegally transferred by using this type of personal accounts.

> "One of the main methods used for laundering illicit proceeds is the commingling of licit with illicit money. Among the most frequently employed instruments for laundering are electronic payments, traveler's cheques, credit cards, wire transfers and cheques" (Transcrime, 2000, p. 58).

Criminal practices in banking in regard to credit/loan can be classified on the following ground: different illegal methods the loan applicant uses to obtain financial sources; the credit institution officials methods to defraud their clients; the illegal agreement between the client and the bank officials. The mechanism of obtaining illegal credit seemed to be very simple. The 'ingredients' are false enterprise, false project and a bank willing to credit such project. Kamluk and Nevmerzhickiy (1998) give an example of one bank in the city Odessa which credited such false enterprises with $500 thousands. $10 thousands for the enterprise, $240 thousands to the 'authors' of the project, and $250 thousands was left in the bank (Ibid., p.102). Kamluk and Nevmerzhickiy (1998) argue that organised groups of corrupt state officials have developed a system to illegally transfer state foreign currency to the foreign bank accounts (Kamluk and Nevmerzhickiy, 1998, p.100). Transcrime found out that "because of loopholes and lack of legislation, considerable amounts of non-cash money are systematically transferred into cash and used in the criminal turnover (Transcrime, 2000, p. 58). Special companies are established with the only aim to transfer non-cash money into cash and vice-versa. In 1996, 210 such companies were identified by the authorities (Kamluk and Nevmerzhickiy, 1998). The 'life-expectancy' of such companies is very low, usually from 3 to 6 months.

The new Criminal Code adopted in autumn 2001 has addressed the issue of money laundering. The problem now is to find the experienced agents to prosecute financial crimes. As Transcrime report suggests, "Ukrainian law enforcement agencies have little experience in prosecuting offences relating to money laundering and other financial crimes, especially in cases that involve more technical aspects of financial investigation such as tracing of funds transferred abroad" (Transcrime, 2000, p.61). As for providing information or assistance to another country, for freezing bank-accounts, seizing and forfeiting assets, the authorities may only act on the basis of bilateral agreements existing between countries" (Transcrime, 2000, p. 61).

4.9.3 Privatisation

In the mid-90s about 120 billion Hrv earned due to the sale of state property, but only 1 billion ended up in the state budget. Privatisation process had witnessed such crimes as late or unqualified consideration of the buyers applications, breach of the rights of people who work at the enterprise to be involved in the decision making as to the choice of ownership and type of privatisation, intentional decrease of the actual cost of the enterprise. During 9 months of the 1997, there were about 1500 enterprises privatised. The estimated cost of these enterprises were 4.2 billion of Hrv, but the state budget received only 48 million Hrv. It is certain that illegal acts with such huge profit were supervised at the very high level.

The causes of such widespread criminalization of the privatisation process are seen in firstly, the absence of the actual supervision from different state agency, and State Property Department in particular; secondly, corruption among state officials, who were authorised to control privatisation, and thirdly, the low level of management.

To summarise what has been said, there are at least three areas in which the impact of corrupt state officials can be seen. These areas are entrepreneurial activity, banking, and privatisation.

One of the preconditions for economic crime to rise is the ineffectiveness of legal institutions in the state and the poor quality of the law on the books.

4.9.4 Legal institutions in Ukraine

Pistor, Raiser and Gelfer use three variables to measure the effectiveness of legal institutions in transition economies: rule of law, an index of the effectiveness of corporate and bankruptcy law, and the enforcement index (Pistor, Raiser, Gelfer,

2000, p. 13). The rule of law (for which the researchers use the Central European Economic Review Index), an index representing the effectiveness of corporate and bankruptcy law in transition economies (which was previously constructed by the European Bank for Reconstruction and Development in Transition Report), and an enforcement index (which was constructed on the basis of the Business Environment and Enterprise Performance Survey and which reports the percentage of firms studied in the survey that agree that the legal system will protect their property rights and enforce their contracts). Table 15 below shows the data from three countries.

Table 15. Rule of law, legal effectiveness and law enforcement in Ukraine, Russia and Poland.

Country	Rule of law	Legal effectiveness	Enforcement	
			now	3 years ago
Ukraine	3.4	2	0.26	0.30
Russia	3.7	2	0.27	0.25
Poland	8.7	4	0.75	0.70

Studies conducted in this area suggest the difference between transition countries, and existence of at least two groups. The one with the high scores of legal effectiveness, represented by Central European countries (Poland, Czech Republic), and the other group, with the lower scores unites almost all the countries of the former Soviet Union, except the Baltic countries (Latvia, Lithuania, Estonia). The problem which has been studied for a few years now, is if there are any correlation between the quality of law on books and the improvements in the development of the financial market. The results tend to be twofold. Ukraine, for example, received legal technical assistance from the West, and today some of the areas of the legislation are very well developed. However, the development of the law has not yet matched the development of the financial sector.

The following section is addressing the issue of the rule of law and law enforcement in Ukraine and presents the results of the case study conducted in Ukraine.

4.10 Case study 3. Corruption and law enforcement in Ukraine

The following case study examines the existing legislation on corruption in Ukraine and attempts to identify the impact of corruption on different sectors of financial market.

According to a Transparency International Survey, the Corruption Perception Index[2] in Ukraine is 2.2, and the World Bank estimates that the annual sum of bribes in Ukraine is equal to the country's trade turnover for a two-month period (Haran, 2000). The high level of official illegality portrayed by the Corruption Perception Index help to reveal the high levels of corruption in Ukraine makes it easy to assume that there is an absence of legislative measures designed to combat corruption in the country. This is not the case, however. Beginning in the mid-1990s, the Ukrainian President, parliament, and law enforcement agencies began introducing a number of decrees and laws that constitute the Ukrainian anti-corruption framework.

4.10.1 Corrupt exchange in Ukraine

The Ukrainian-Polish cross-border trade is a good business. Due to price differentials between Ukraine and Poland, entrepreneurs from Ukraine go to Poland to buy goods, which they later sell for a profit in Ukraine. Thousand of people use this opportunity to make money. Bribes are not uncommon along the way, and to ensure quick and safe procedures at customs, the entrepreneurs often offer bribes to border guards. The price is well known, as are the people to bribe.

During an expert study of corruption in Ukraine, one respondent described the following process, which helped expedite a particular border crossing. At Christmas time many people bring holiday items from Poland to sell in Ukraine. Due to the necessity of selling these goods before Christmas, sellers need to cross the border quickly. While approaching the customs checkpoint to enter Ukraine, someone who was heavily loaded with Christmas items to sell in Ukraine realised that the queue was extraordinarily long. In fact, there were hundreds of cars waiting in line. The reason for this situation was that an inspector from Kiev had come to "check the work of the crew" at this border crossing. The majority of those in the queue possessed Christmas items to sell in Ukraine and knew that they did not have the time to wait at customs. After discussing their options, the sellers decided to collect money and bribe the high-level inspector from the capital. About US $60,000 was collected and the sellers' representatives went to see the inspector to discuss the chances of quick entry. The inspector laughed at their offer. He informed them that this amount did not offset the bribe he had given to officials in Kiev in the first place in order to come to this particular checkpoint (ostensibly to check on the work of those at the border, but in truth to collect bribes from these entrepreneurs).

The final decision might be considered extraordinary in other places, but not uncommon in this setting. Since the inspector had paid more in cash to Kiev officials than the bribe offered to him by the sellers, the local customs officials decided to raise the additional funds among themselves that was necessary to make up the deficit. The result was that everyone was happy: The inspector went back to capital with a 'good' report about the work of the crew at the customs point, the local customs officials kept their jobs, and these entrepreneurs were allowed to rush back and sell their Christmas presents.

4.10.2 General provisions

There are more than 52 legal provisions relating to the fight against corruption in Ukraine. The three main pillars are (1) "The Law of Ukraine Against Corruption," adopted on 5 October 1995, N 356/ 95-BP, (2) "The Decree of the President of Ukraine 'Concerning the Concept to Fight Corruption,'" Strategic Plan for 1998-2005, adopted on 24 April 1998, N 367/98, and (3) "The Decision of the Plenary Meeting of the Supreme Court of Ukraine 'About the Court Procedures Related to Corrupt Practices,'" introduced on 25 May 1998, N 13, and amended on 3 March 2000, N 5. These were very recently supplemented by the new Ukrainian Criminal Code, which was adopted in 2001.

The fight against corruption officially began in 1995, with the introduction of the Law of Ukraine Against Corruption. According to this law, corruption is any activity by those authorised to fulfil state functions that is designed to misuse authority in order to obtain financial resources, services, privileges, or other advantages. The law divides corrupt activities into subgroups. The first is the *quid pro quo* of illegally obtaining financial resources, services, or privileges in return for services provided. The second subgroup consists of receiving credits securities or property by using the advantages and privileges provided to them as part of their position. Civil servants, People's Deputies of Ukraine and the Republic of Crimea, governors, and deputies of the regional Union of People's Deputies are subject to this law. Both administrative and criminal punishments may be imposed on those guilty of violating these laws, and the criminal punishments shall meet the requirements of the corresponding statutes in the Criminal Code of Ukraine.

The Law of Ukraine Against Corruption is rather general and covers mainly administrative norms. The old Criminal Code of Ukraine (see discussion of new

Criminal Code below) did not have a legal definition of corruption. Some legal scholars (see Gultay, 2000) believe there is no need to introduce a definition, since corrupt practices will usually fall under the illegal activities already outlined in the Criminal Code (e.g., Article 84 on embezzlement of state property or Article 165 on abuse of power). The Criminal Code applies to the criminal activities of the entire population and is not limited in its power to civil servants or public officials, and Gultay argues that such an approach is sufficient to ensure an effective response to corruption.

On the other hand, the lack of clarity in the law was viewed by many as a problem. For example, since there is no clear boundary between criminal and administrative responsibilities for corrupt practices, it is up to the courts to make final decisions on charges. The generality of the former Criminal Code of Ukraine was believed by some to be obsolete in its treatment of corruption. These issues are dealt with explicitly in the new Criminal Code adopted in 2001, however, and this is outlined below.

The Law of Ukraine Against Corruption has been the target of criticism from a number of other legal researchers and practitioners. This criticism consists generally of two main groups of problems. The first is the lack of clarity in the written statutes in terms of what constitutes an infraction of the law, and the second is the unrealistic time-frame for bringing legal proceedings. Critics propose (1) to prolong the time given to prosecute corrupt practices to at least a year (only two months are currently allowed for prosecutors to bring corruption cases to court), (2) outlining regulations for the mechanisms and procedures of evidence collection in order to reduce bureaucracy, (3) to introduce procedures of preliminary investigation and a system of appeal, and (4) to introduce specialised courts to handle these cases. These measures would substantially ease the work of the enforcement agencies and may be regarded as a step toward strengthening responsibilities of high level state officials (Gultay, 2000).

The need to increase the responsibility of high-level state officials is a pressing issue in the country. The Constitution of Ukraine has granted immunity to People's Deputies who may be subjected to the Law Against Corruption. In order to deprive a member of immunity, Parliament must organise a special meeting and vote. The complicated system of immunity deprivation makes it nearly impossible to prosecute People's Deputies for corruption. According to the Ministry of Internal Affairs

statistics, in 1997, in Ukraine 947 applications were made by attorneys to receive the permission to administratively prosecute people's deputies. However, only 183 permissions were given. 374 applications were rejected and 417 applications were left without any response.

Finally, most of these problems pale in comparison to the most important one: the absence of an independent judiciary system. "[I]n practice, the judiciary is subject to considerable political interference from the executive branch and also suffers from corruption and inefficiency. The courts are funded through the Ministry of Justice, which allows the Government to influence judicial proceedings" (Holovaty, 2000, p. 271)[3].

A study conducted by the Supreme Court of Ukraine and cited by Foglesong and Solomon (2001, pp.78-79) reported that many corruption related cases are poorly prepared. In 1998, total number of cases sent to trial was 6,656 (civil servants and deputies). However, in only 246 cases were the permissions to proceed with charges requested, and only in 48 cases was such permission granted. Foglesong and Solomon suggest that in some cases corruption may be the answer to the fact that "many charges fail to stand up to evidentiary scrutiny at trial," or the fact that some judges assign penalties lower than the statutory minimum suggest. The Decree of the President of Ukraine 'Concerning the Concept to Fight Corruption,' Strategic Plan for 1998-2005, was adopted on 24 April 1998. The general statement of the concept includes a list of the negative effects of corruption on society, including the promotion of organised criminal activity in the economic sphere and the provision of illegal privileges to the corrupt groups and clans, which undermines the integrity of the state (Kushnarev, 2000). The Decree discusses the social causes of corruption in Ukraine and suggests political, economic, legal, managerial, and social-psychological ways to prevent the further spread of corruption in Ukrainian society. Many of the respondents in the pilot study outlined in the next section view this Decree as an important achievement, since it was one of the first official documents that publicly recognised the problems of corruption and suggested ways to fight it.

The Decision of the Plenary Meeting of the Supreme Court of Ukraine 'Concerning the Court Procedures Related to Corrupt Practices' was originally introduced on May 25th, 1998, and was later amended in March 2000. It considers courts' responses in regard to battling corruption and suggests ways to interpret the law and to improve practices. For example, one of the possible loopholes of the law is that the

responsibilities of those subjected to it could only be imposed in case of direct financial advantages and privileges. The law does not clarify so-called third party involvement. On 3 March 2000, the Supreme Court of Ukraine recommended that the courts should implement the law in a way that would not allow avoidance of responsibilities in cases where family members or other relatives are involved in obtaining corrupt proceeds.

Several scholars have argued that since there was no new criminal code in place, it was difficult to combat corrupt behaviour with these decrees, since with the Ukrainian legal system decrees carry considerably less weight than law. Further, there was deliberate stonewalling of the necessary legislation by corrupt officials and those otherwise connected with the government.

Finally, the new Criminal Code adopted in 2001 also introduces provisions designed to control corrupt practices. Part XVII considers crimes related to business practices and activities and consists of seven articles. Abuse of authority or business duties is punishable under Article 364. This article relates not only to government officials or civil servants, but to private employees as well. To be precise it does not differentiate the forms of ownership. Abuse of power is defined as the use of official post against the official interest, causing substantial injury to the rights, freedom and interests of certain citizens or state or citizens interest, or interest of the legal entity. Types of sanctions vary depending on the severity of offences or 'seriousness' of consequences. In the case of considerable consequences, the punishment may be corrective labour up to five years, imprisonment up to six months, or sentencing up to three years and a court-imposed ban on the defendant occupying a particular post or working in a given field for up to three years.

Article 365 provides punishment for exceeding authority or official duties. Punishment depends on the severity of consequences and the use of offensive weapons or physical threat. The maximum punishment is ten years imprisonment and a court-imposed ban on the defendant occupying a particular post or working in a given field for up to three years. Articles 366 and 367 deal with counterfeiting of official documents and unscrupulous or careless official activity. Articles 368, 369 and 370 punish bribery of public officials as well as officials in corporation disregarding the forms of ownership.

An official who takes a bribe can be punished by up to five years of imprisonment or be fined 750 or more times the pre-taxed minimum salary and face a court-imposed

ban to occupy certain posts. The punishment is also dependent on the size of the bribe. Article 368, parts 2 and 3, distinguish the sizes of bribes as "large" and "very large." Large is an amount 200-499 times larger than the monthly minimum wage, and very large is 500 or more times larger than monthly minimum wages. In both cases, the confiscation of property is provided as a penalty. Part 2 of Article 368 also considers repeated offenders. Those who bribe can get up to five years imprisonment or be subjected to a fine of between 200 and 500 times the monthly minimum wages. Repeated bribing can be punished by up to eight years of imprisonment, sometimes with property confiscation. Article 370 punishes those who provoke the bribe giving behaviour.

The new Code has also introduced an article that prohibits laundering of money or other property illegally acquired. Article 209 makes it a crime to conduct financial transactions with money or other property illegally acquired, as well as to use illegally acquired money or other property in business or other activity, or to establish organised groups in Ukraine or abroad with the purpose of legalising money or property that was unlawfully acquired. Article 209 imposes penalties such as fines from 500 to 3,000 times the pre-taxed minimum salary, or up to five years of imprisonment with confiscation of the property and money illegally acquired.

The old Code was believed to be obsolete in its treatment of corruption and did not differentiate offences depending on the size of bribe, duration and severity of criminal practices. The new Criminal Code provides an attempt to measure the illegal conduct. In the new Code, an attempt has been made to increase the financial penalties. The old code was criticised due to the very mild financial penalties, which were between 25 and 50 times the minimum monthly wages, or approximately $250 to $500 (Foglesong and Solomon, 2001).

Discussions among experts concerning the weak points of the legislation regarding corruption in Ukraine continue. One point that must be addressed is if those cases where the substance of the corruption laws may interfere with the primary legislation. Another fact that must be considered is that now that Ukraine has constructed a framework for anti-corruption legislation, the true question that must be addressed is how well these legal acts are implemented and enforced and if cases can successfully prosecuted. Recent studies assessing the legal environment in transition tend to conclude that the quality of law enforcement is at least as important as the presence and coverage of the law (Pistor, Raiser, Gelfer, 2000).

Pistor, Raiser, and Gelfer argue that legality would have been higher in transition countries if the legal transfer were "smoothed by cultural proximity, legal adaptation and ability of lawyers trained in application of the new laws" (Pistor, Raiser, Gelfer, 2000, p.15).

Thus, lack of enforcement appears to present one of the major problem for the Ukrainian system. This weakness creates a lack of confidence in the rule of law and leads to resistance on the part of the government to give up or transform its role as a major co-ordinator of economic activity.

Earlier in the chapter the hypothesis was proved that the high quality law on books brings the quality financial services, and guarantees the development of the financial services even in transitional countries. The quality laws on corruption tends to have bigger problems with regard to the enforcement issues. Generally, the equation better law better policies does not work if applied to corruption. There can be certain hidden elements to explain the situation. For example, the irregularities in financial institutions, such as banks can be solved by employing corruptive means, so while it does not affect researchers' attitude to how law affects financial sphere, it brings more light on the effectiveness of the law on corruption. The most obvious explanation, however is the complexity of corruption as a social phenomenon, so that fighting it by only legal means is not enough.

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Chapter 5: **Developed economies in fighting white-collar crime: the lessons Ukraine can learn.**

The evolution of the international responses to the white-collar crime problems in emerging countries can be explained through the evolution of international financial regulations in developed countries. Chapter 3 considered some specific examples of white-collar crime in financial market, and mentioned the fact that the major financial regulation initiatives came after big financial or political scandals. For example, Bhala (1994) discusses the US government response to the BCCI scandal, and critically considers the Foreign Bank Supervision Enhancement Act of 1991. According to Bhala, the Act did not address the issues raised by the scandal, but makes the international banking system very complicated.

Following recent events in the US and continuing threat of international terrorism, the global financial community has become increasingly worried about the effectiveness of financial supervision and financial policing.

This chapter briefly discusses the evolution of the financial regulation with the specific attention paid to the financial crime problems. It addresses the problems of financial regulation in transition countries and discusses possible ways to improve financial environment in transition Ukraine. The main argument of this chapter is that the international community represented by a number of international organisations can and should address the issue of financial crime problems in transitional society. However, the help and assistance provided should be relevant to the country's social, cultural and legal traditions, and should not be centred on punitive sanctions only.

5.1 Multilateral initiatives

Over the last two decades a substantial number of international organisations have been established to address the issues of financial regulation. Generally, these organisations can be divided into two groups. The first group is presented by the organisations designed with the specific task, such as the Basle Committee on Banking Supervision, the International Accounting Standards Committee (IASC), and many others concerned with the harmonisation of certain standards of financial services. The second group represented by the established international organisations such as European Union, and Council of Europe, dealing with the issues of international political co-operation in different areas, including the one of financial

services. Empel and Morner (2000) discuss the General Agreement on Trade and Services (GATS) as an example of an international agreement focused primarily on 'the political commitment to liberalisation' (Empel and Morner, 2000, p.39). However, it is understandable, that to make a strict dividing line in a complex web of the organisations dealing with the issues of financial regulations and supervision is almost impossible. Following is the discussion of the initiatives undertaken by different organisations and states (the examples of USA and UK initiatives) to harmonise technical rules in the financial market area, and to stress the importance of the financial crime phenomenon.

In the early 80-s then the Council of Europe Committee on Crime Problems considered the growth of criminal offences in the economic area as the consequences of the growth of economic activity in Europe and the development of international economic activity. The list of economic crime consisted of 16 offences. Among such offences were fraudulent practices and abuse of economic situation by multinational companies, computer crime, faking of company balance sheets and book-keeping offences, offences concerning money and currency regulations, stock exchange and bank offences (Council of Europe, 1981, p., 1-12 p.). It was stated that economic crime "causes loss to a large number of people (partners, employees, creditors), to the community as a whole and even to the state, which has to bear a heavy financial burden or suffer a considerable loss of revenue; it also causes a certain loss of confidence in the economic system itself" (Ibid., p.10). It was recommended for "governments of members states to take steps to facilitate the detection of economic offences, ensure swift and efficient criminal justice in the field of economic crime, review the legislation on criminal penalties for economic offences" (Ibid., p.9-10).

By the end of the 1980-s the international community had recognised the danger of economic crime and large illegal financial profit derived not only from drug trafficking but also from other criminal activities such as tax evasion, financial fraud and corruption.

Since the mid- 80-s economic crime problems have become a focus of attention for a number of international organisations, such as the Council of Europe, the Committee on Crime problems (European Ministries of Justice), the United Nations, the Basle Committee on Banking Regulation and Supervisory Practices, the Financial Action Task Force (FATF), the Interpol.

The study of international response to economic crime problems would necessarily bring us to the study of international measures to combat the laundering of illicit proceeds. Savona (1999) writes:

> "The initial impetus for co-ordinated international action against money laundering arose in the 1980s within the context of efforts to combat the problem of drug trafficking, when a high priority was afforded to law enforcement strategies designed to disrupt the organisation and management and break the economic power of major trafficking organisations" (Savona, 1999, p.,19).

The main international initiatives to prevent the laundering of illicit proceeds are: the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, adopted in Vienna in December 1988 (UN Convention, 1988); the Statement of Principles concerning money laundering, issued in December 1988 by the Committee on Banking Regulation and Supervisory Practices (Basle Committee); the Forty Recommendations issued by the Financial Action Task Force in April 1990; and the Convention on Laundering, Search, Seizure and Confiscation of Proceeds of Crime, adopted by the Committee of Ministers of the Council of Europe on September 8, 1990 (Strasbourg Convention, 1990). The international anti-money - laundering regime is an example of non-binding principles and recommendations. Alexander (2000) explains: "The international anti-money laundering regime includes a variety of soft law (non-binding) principles and rules that involve voluntary co-operative arrangements amongst states that have hardened to a certain degree into a specific legal framework that binds the major states of the international system" (p., 9). Alexander also suggests that "the international anti- money laundering regime may serve as a model of how a high degree of international co-operation and co-ordination amongst national and regional regulators may result in an effective legal framework to combat transnational crime" (Ibid., p.,21).

Following is a list of well-known multinational initiatives to combat corruption and money laundering:

Council of Europe[1]:

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[1] Council of Europe web-site: http://www.coe.int/portalt.asp

Council of Europe instruments on combating terrorism and money laundering include the following conventions: European Convention on the Suppression of Terrorism, ETS No.090 (1978); European Convention on Mutual assistance in Criminal Matters, ETS. No.030 (1959); Convention of Laundering, Search, Seizure and Confiscation of the Proceeds from Crime ETS No. 141 (1990); European Convention on the Transfer of Proceeds from Crime, ETS No,141 (1990).

Council of Europe adopted several anti-corruption conventions, including Criminal and Civil Law Conventions on Corruption, opened for signature in 1999. The Criminal Law Convention on Corruption demands parties to criminalise bribery of public officials and private persons, domestic and foreign. The implementation of the Criminal Law Convention on Corruption is monitored by the group of states against corruption.

United Nations[2]:

One of the United Nations recent initiatives is the UN Convention against Transnational Organized Crime has been considered as a result of the 25 years efforts of the United Nations to strengthen international co-operation to combat organized crime. The Convention extends beyond the sphere of co-operation on drug trafficking. It strengthens the power of governments in combating serious crimes. The new convention provides the basis for stronger common action against money-laundering, greater ease of extradition, and measures on the protection of witnesses and enhanced judicial co-operation. Article 5 of the convention deals with the criminalisation of participation in an organised criminal group, Articles 6 and 7 consider criminalisation of money laundering and measures states parties shall consider to effectively implement anti-money laundering regimes. Articles 8 and 9 deal with the corruption and measures against corruption. Articles 12 to 31 consider the issues of conficscature and seizure, extradition and international co-operation, mutual legal assistance and investigative techniques. The Convention seeks to establish a funding mechanism as well as technical assistance to help countries implement the Convention. An important issue which the convention raised is the synchronisation of the national laws, to avoid uncertainty as to whether a crime in one country is also a crime in another. As on 15 December 2000 124 states signed the Treaty.

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[2] United Nations web-site: http://www.un.org/law/

World Trade Organisation (WTO)[3]:

In 1996 the WTO Ministerial Conference established a working group on transparency in government procurement. All 140 members of the WTO agreed to make binding international conventions to guarantee transparency and predictability in their government procurement procedures.

The Basle Committee[4]:

Established in 1975, the Basle Committee comprised of the governors of the central banks from the G-10 countries and Switzerland. Its purpose is to co-ordinate international bank regulatory activities, specifically to develop standards of good practice in international bank regulation. The work of the Basle Committee has been especially influential in the area of capital adequacy standards. The recommendations on the minimum capital adequacy standards do not have legal force but have been successfully adopted by many countries.

In 1983 The Basle Committee agreed to four principles: first is that bank regulators cannot be satisfied with the soundness of individual banks unless they are able to examine all aspects of a bank's world-wide business on a consolidated basis; second, no foreign bank establishment of an international bank should escape supervision; third, supervision should be adequate; fourth bank regulators in different countries should co-operate with each other. Revised Basle principles includes the issues of mutual critical assessments, comprehensive, extraterritorial supervision, and co-operation. In 1988, the Basle Committee published a set of minimal capital requirements for banks. These requirements became law in G-10 countries in 1992. The requirements have come to be known as the 1988 Basle Accord. In 1992 the Basle Committee published a paper entitled "Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments".

In 1997, The Basle Committee prepared a list of 25 basic principles, which should constitute the framework for the banking supervisory policies and structures. The 25 Core Principles structured in seven sections: preconditions for effective banking supervisions, licensing and structure, prudential regulations and requirements,

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[3] WTO web-site: http://www.wto.org

[4] The information on the Basle Committee can be downloaded from:

methods of ongoing banking supervisions, information requirements, formal powers of supervisors, and cross-border banking (Basle Core Principles, 1997).
This list of basic principles known as the 1998 Basel Accord, formed a single international model for prudential regulation. More than 100 countries have implemented the Basel Accord in some form. Today, the Basle Committee is working on a replacement for the 1988 Accord. The three pillars of the New Accord are: minimum capital requirements, supervisory review and disclosure. As on January 2003, the 1998 Basel Accord is being wholly rewritten. The Basel Committee hopes to finalise the New Accord by the end of the year 2003.

The Organisation for Economic Co-operation and Development's (OECD) Convention[5]:
According to the Convention on Combating Bribery of Foreign Public Officials in International Business Transaction (adopted by the Negotiating Conference on 21 November 1997), it is a crime to offer, promise or give a bribe to foreign public official in order to obtain or retain international business deal. 34 countries have signed convention and more than half has changed their domestic laws in accordance with the Convention.
In 1999 OECD launched the Global Corporate Governance Forum. The Forum provides a framework for international co-operation, aims to improve corporate governance world-wide.

International Chamber of Commerce (ICC):
The International Chamber of Commerce is a business organisation that supports and promotes high level standards in such areas as international trade and investments. In 1977, the ICC published "Rules of Conduct to Combat Extortion and Bribery", which were revised in 1996.To provide a guidance to comply with the OECD Bribery Convention the ICC issued a manual of best corporate practices.

The World Bank and The International Monetary Fund (IMF)[6]:

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http://www.bis.org/index.htm
[5] OECD web-site: http://www.oecd.org

[6] The World Bank web-site is: http://www.worldbank.org/

The World Bank and IMF consider economic cost of corruption and adopt measures to prevent corruption and fraud in bank-financed projects. These international financial institutions have agreed that corruption is a serious obstacle to economic growth. The World Bank advises countries on economic policy reforms, stresses the importance of the institutional reforms. The IMF policy restricts financial assistance in cases where corruption and fraud reached the level threaten to undermine the economic recovery programs. In some cases both institutions denied or suspended assistance to countries where corruption affected the way the recovery policy goes and governments are not ready to tackle the problem of corruption and fraud.

Transparency International (TI)[7]:
TI is a non-profit organisation working to prevent corruption in international business transactions, encourages national and local governments to implement effective anti-corruption laws, policies and programs. TI publishes annual Corruption Perception Index, which reflects perceived levels of corruption in 90 countries.

Financial Action Task Force (FATF):
FATF was established by the G7 Heads of State in 1989 at the G7 Summit. It is the international organisation established to fight financial crime, and in particular, money laundering. In 1990, FATF issued a list of Forty Recommendations on money laundering counter-measures. These recommendations are not legally binding under public international law. However, FATF may impose sanctions against non co-operative jurisdictions. In 2002 FATF group on Money Laundering produced a report on Money Laundering Typologies, which is a helpful tool in combating money laundering. Since June 2000 the FATF has started to conduct an annual review of the non-cooperative countries and territories by identifying the major deficiencies in the legislative systems and any developments.

Although the majority of the above mentioned initiatives represent the example of the 'soft laws'- which do not have a legally binding force, a great number of countries follow its rules. For example, more than 100 countries followed the Basel Accord and implemented it in some form. Ward (2002) identifies several possible explanations: to

[7] Transparency International web-site is: http://www.transparency.org/

cut the cost of legal drafting it is cheaper to borrow the rules; financial markets reward developing markets in case if, for example, a Basel regime is implemented; financial institutions from countries which do not complying with certain international standards, such as Basel standards, tend to find it difficult to enter financial centres in New York and London.

There are other organisations which work on more specific areas, such as accounting standards. A growing number of international organisations dealing with economic crime problems can be explained through a growing concern expressed by governments in some financially advanced countries over the financial security in emerging markets. An international agreement has been reached in regard to the policies a country needs to adopt to provide laws for the confiscature of the proceeds of serious crime (the major development was made in the area of confiscation of the proceeds of illicit drug trade). The investigation and interdiction of the proceeds of serious offences are of great importance to the international community. The criminalisation of money laundering, the reporting of suspicious transactions, the imposition of reporting and due diligence requirements on those most likely to confront money laundering and facilitation of international mutual assistance- all these problems are on today's international agenda.
Rose-Ackerman (1999) lists five broad arenas for international involvement in combating corruption. One of these is particularly important for transition countries such as Ukraine, the idea that international programs should control the flow of illicit funds in order to check corruption "by impeding the transfer of secret funds abroad where they cannot be traced" (p. 178). Further, the United States Department of State, for example, has listed several practices that have been developed and introduced by a number of international organisations in combating the problem. These include (US Department of State, 2001, pp. 36-42):

1. Adaptation of systems to promote transparency, such as through disclosing the financial circumstances of senior officials (promoted by Inter-American Convention Against Corruption; Council of Europe Committee of Ministers 20 Recommendations against Corruption, November 1997; United Nations Commission on Crime Prevention and Criminal Justice: Report of Expert Group on Action Against Corruption and Bribery, March 1997, others).

2. Development of the systems for swift and effective extradition so that corrupt public officials can face judicial process (OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions; Council of Europe Criminal Law Convention on Corruption; United Nations Convention Against Transnational Organised Crime, others).

3. Development of the systems to enhance international legal assistance to governments seeking to investigate and prosecute corruption violations (OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions; United Nations Convention Against Transnational Organised Crime, others).

4. Promoting efforts to educate the public about the dangers of corruption and the importance of general public involvement in government efforts to control corrupt activity (United Nations Secretariat Manual: practical Measures Against Corruption, July 1990; United Nations Commission on Crime Prevention and Criminal Justice: Report of Expert Group on Action Against Corruption and Bribery, March 1997).

Some of the most effective measures against corruption the international community can provide are those that come from outside a particular nation. This includes closing down the channels for international capital flight (as well as for the proceeds from corruption and money laundering) and tightening the international laws and financial market regulation. For example, the Transparency International "Global Report on Corruption" (2001, p. 122) stated that "the role the West can play in helping post-Soviet countries in their efforts to curb corruption must not be underestimated. One of the most important challenges facing the international community is to monitor more closely offshore banking activities and, in particular, to ensure that banks strictly follow 'know your customer' rules when dealing with money transfers from the region."

Next section explores certain recent initiatives undertaken by the US and the UK.

5.2 Individual country's initiatives: anti-corruption and money laundering control initiatives in the USA and the UK

5.2.1 The USA on corruption

The United States of America has to be named as the country which started the fight against money laundering and corruption at the international level. In 1977, the United States enacted the Foreign Corrupt Practices Act (FCPA), criminalising offer,

promise and payments by US firms to foreign officials, political parties, party officials and candidates made to secure business advantage. The United States played significant role in encouraging other countries to take similar steps. The real progress came in the late 90-s with the establishment of the Organisation for Economic Co-operation and Development's (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The OECD Bribery Convention entered into force in February 1999. Signed by 34 countries, the OECD Bribery Convention required parties to: "apply effective, proportionate and dissuasive criminal penalties" to those who bribe; establish liability of legal persons or impose comparable civil sanctions or fines; make bribery a predicate offence for money-laundering legislation; improve accounting procedures; prohibit off-the-books accounts; and provide mutual legal assistance and extradition in cases falling under the Convention" (United States Department of States, 2001, p.11-12).

The US recently amended the FCPA 1977 to provide for jurisdiction to prosecute US persons. "The US can prosecute for the payment of a bribe to a foreign government official or private party, even where that activity takes place solely outside the US, if the payment is made by a US person. Consequently, US companies must now assume greater responsibilities to ensure that their employees overseas do not attempt to secure a contract or close a business deal through the payment of improper commissions or bribes" (The Society for Advanced Legal Studies, 2000, p.201).

The United States Anti-Money Laundering Laws provide extra-territorial reach to prosecute illegal money transfer. "18 USC section 1956 (f) provides for extra-territorial jurisdiction over the substantive money laundering offences where the impugned conduct is by a US citizen, or otherwise if the conduct occurs in part in the US, and in either situation the transaction involved over US$ 10,000" (Ibid., p.202).

Almost for a decade the US had been ahead of all the industrialised counties in its legislative initiative to combat foreign bribery (Ibid., p.202). The report conducted by the Society for Advanced Legal Studies (2000) states that even among the democratically governed countries the issue of foreign bribery has being overlooked. For example, "the official UK position is that existing legislation criminalises transnational bribery, but legal opinions differ and there have been no prosecution to date (Ibid., p.203).

5.2.2 The USA on banking regulation

In the USA the Federal Reserve, the FDIC, the Comptroller of the Currency and the state banking regulators work closely together to establish the framework for banking supervision.

International Banking Act 1978 was the major piece of federal legislation regulating foreign banks until the BCCI scandal and the following changes in legislation such as the introduction of the Foreign Bank Supervision Enhancement Act (FBSEA).

FBSEA has five major topics. First is the entry requirements, the standards that a foreign bank must meet in order to enter and engage in banking in the USA; second is deposit insurance, mainly the circumstances under which foreign banks may receive deposit insurance; third topic is the issue of termination and enforcement; fourth is the examination of foreign banks operations in the USA; and fifth is the disclosure requirements (Bhala, 1994). Some authors suggested that the FBSEA did not address the core issue of the BCCI case, that is about lying to the government, but made it extremely difficult for foreign banks to gain entry into the US banking market (for the critique of the FBSEA see Bhala, 1994).

5.3 Financial market regulation in the UK: a brief overview

Historically, financial services in the UK have been regulated by different agencies, government bodies, laws, private association and self-regulatory organisations. For decades the English banking system was managed "as a small gentlemen's club of bankers through the practice of 'moral suasion'" (Norton, 2000, p.106). Regulatory consolidation was announced in 1997, and with the approval of the Financial Services and Markets Act 2000, the super regulator was established. The new UK system of financial regulation separates the job of prudential control - Financial Service Authority from the responsibility for financial stability and lender of last resort facility - Bank of England. The Financial Service Authority (FSA) has significant power. FSA has four regulatory objectives. The first is to maintain confidence in the financial system; the second is to promote public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment and other financial dealings and the provision of appropriate information and advice; the third objective is to secure the appropriate degree of protection for consumers; and objective number four is to reduce the extent to which it is possible for financial services businesses to be used for financial crime.

FSA is accountable to the Treasury. FSA is given the power and responsibility to require the provision of information and to conduct investigation in various cases (FSMA 2000, s165).

The Financial Services and Market Acts (2000) (FSMA 2000), creates a new civil offence of behaviour that may not have fallen into the criminal concept of 'insider dealing'. The new prohibition widen the group of individuals to whom this rule can be applied: "commodities firms who conspire with futures traders to distort prices in a market, associates or family members of market participants who might not previously have been caught by the insider dealing rules; and members of public, such as participants in a web chartroom who 'pump and dump' a stock for profit" (Blyth, 2001, p.414).

In the UK, HM Treasury works together with FSA and those responsible for the financial stability from the Bank of England.

In summer 2001 the FSA published "The Money Laundering Theme: Tackling our New Responsibilities", a document which specifies the issues of money laundering in the UK, and clarifies the methodological approach the FSA applies in dealing with money laundering. The FSA study suggests that compliance failures are common as regards to the major requirements of the Regulations and the FSA rules. Morris (2001) singles out the following failings: problems in the identification of customers who are based overseas or introduced by others and the beneficial owners of corporate customers; problems arising when there is a need to acquire source of wealth information from customers. Morris (2001) writes "knowing your customer means precisely that and should not be considered to be a matter of form filling, especially where large sums are at stake or unusual transactions are to be carried out" (Morris, 2001, p.399); insufficient attention is given to the geographical location of customers and the need to conduct additional due diligence for customers from jurisdictions designated as uncooperative by the Financial Action Task Force. The FSA identified six risk areas most vulnerable to money laundering: international banking involving high risk jurisdiction, independent financial advisers dealing with offshore funds, domestic banking involving large volumes of small scale deposits, online broking, credit unions, and spread betting.

5.3.1 The UK on corruption

The report conducted by the Society for Advanced Legal Studies which has already been mention here, focused its attention around the legal issues of corruption in the UK. The report concluded that "it is unclear whether bribery of foreign officials is an offence under UK's existing prevention of corruption legislation...No offence under the existing prevention of corruption legislation is committed if the offer and payment of the bribe takes place abroad...If the bribe is offered and paid abroad, it is tax deductible" (The Society for Advanced Legal Studies, 2000, p., 11). As of the year 2000, no -one has been convicted for bribing foreign officials under the present legislation in the UK (Ibid., p.19). Anti-corruption legislation in the UK based on the following three acts: Public Bodies Corrupt Practices Act 1889, Prevention of Corruption act 1906, and prevention of Corruption Act 1916.

5.3.2 The UK on money laundering

The UK's money laundering regime has three main directions: the UK has criminalised money laundering with penalties for offenders, obliged financial institutions to put system in place to detect and prevent money laundering, and encourage reporting of known or suspected money laundering to the authorities (Cabinet Office, 2000).

The Money Laundering Regulations 1993 oblige financial institutions to provide an adequate system of control to identify suspicious transactions. There are still some obstacles in the defendant's favour in case of money laundering offence. It is believed that the test for money laundering should be simplified (Cabinet Office, 2000).

The Financial Service and Market Act adopted in the United Kingdom in 2000 reflects the changes introduced by the globalization of financial markets. Financial Service and Market Act has significantly extended the responsibilities of the Financial Service Authority in the markets area. Among the four objectives stated in the act, one addresses the reduction of financial crime:

> "This involves reducing the extent to which it is possible for a business carried out by a regulated person or in contravention of the general prohibition to be used for a purpose connected with financial crime. The FSA must have regard to the desirability of regulated persons being aware of the risk of their business being used in connection with the commission of financial crime, and regulated persons taking appropriate measures to prevent financial crime, facilitate its detection and monitor its incidence, and regulated persons devoting adequate resources to these matters" (Financial Service and Market Act, Section 6).

According to the Act 'offence' includes an act or omission, which would be an offence if it had taken place in the UK. It means that the bankers can no longer turn a blind eye and say that it is not their major concern what happens in, for example Russia and Ukraine. Rather, the bankers must treat events in Russia and Ukraine as if they happened in the UK.

5.4 The Patriot Act: international response to terrorism and its implication to the financial service regulation.

The attack on the USA of 11th September had dramatically changed the international approach in dealing with terrorism and its financial aspects. The US Government has adopted extraterritorial financial controls on foreign banking and financial institutions that facilitate transactions with, or assist designated terrorist groups. In October 2001 the US Congress enacted legislation entitled 'the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism' (the Patriot Act 2001). Title III of the Patriot Act deals with the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. It considers US and foreign banks and financial institutions. Among the other provisions, Title III provides authority to take targeted action against countries, institutions, transactions, or types of accounts that the Secretary of the Treasury finds to be of prime money-laundering concern. It contains high standards of due diligence for inter-bank correspondent accounts and payable-through accounts opened at US financial institutions by foreign offshore banks and banks in jurisdictions that have failed to comply with international anti-money-laundering standards.

Provisions of US Executive Order 13224 on 24th September 2001, and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 impose extra-territorial jurisdiction on foreign banks, companies and individual who conduct, facilitate or assist transactions involving US-designated terrorist organisations and provides a framework to establish a set of new reporting requirements and due diligence standards for US and foreign financial institutions designed to combat international money laundering and to stop terrorist financing (Alexander, 2002).

Title III of the Patriot Act is entitled the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. It contains the major provisions addressing not only US banks and financial institutions, but foreign financial institutions as well.

Section 312 of the Patriot Act requires financial institutions to establish due diligence programs for correspondent accounts of foreign financial institutions and private banking accounts of "non-US persons".

With regard to correspondent accounts for foreign banks, the proposed regulation requires that a due diligence program must first, assess whether the foreign institution presents a significant risk of money laundering; second, consider information from US government agencies and multinational organisations with respect to supervision and regulation of the foreign institution; third, review guidance from the Treasury and federal regulators regarding risk associated with particular foreign institutions; and fourth review public information to decide whether the foreign institution has been the subject of any criminal or regulatory action relating to money laundering (Alexander, 2002). Special attention is given to certain foreign institutions that operate under licenses issued by countries regarded as non co-operative with international anti-money laundering principles (ie FATF).

With regard to due diligence programs for private accounts of non-US persons, the proposed regulation requires that such programs must: establish the identity of all nominal holders and beneficial holders of the accounts, including information on their lines of business or source of wealth; identify the source of funds deposited into the account, identify whether any holder may be a 'senior political figure' (if it is established that an account holder is a senior political official further due diligence is required), and report any known or suspected violation of law conducted through or involving the account (Alexander, 2002).

The due diligence regulation is believed to be the 'further-reaching' regulation issued under the Title III (Gimbert, 2002). In case if suspicious financial transaction have been discovered the institutions must report to federal law enforcement agencies and the Treasury. The reports then entered into a confidential database. The FBI uses this database to create the list of suspicious persons and entities, which is available to all financial institutions.

Section 313 (a) prohibits some financial institutions from establishing, maintaining, administering or managing correspondent accounts with foreign banks that have no physical presence in any jurisdiction (known as 'shell banks').

Section 315 entitled 'Inclusion of foreign corruption offences as money laundering crimes' recognises bribery and other foreign corruption offences as unlawful for purposes of the crime of money laundering.

The definition of financial institutions became wider and from now includes foreign banks or other financial institutions operating outside the USA (Alexander, 2002). The regulations issued by the Department of Treasury will determine financial institutions subject to anti-money-laundering laws. New regulations will apply to the concentration accounts to prevent the financial institution's customers from anonymously directing funds into or through these accounts.

Section 326, considers the issue f identity verification and sets up the following rules: "all financial institutions must have a Customer Identification Program detailing its Identity Verification Program; all new accounts need to be screened against the OFAC and other published lists of suspected terrorists and terrorist organisation; any documents used to identify the new account holder, such as, driver license, passport, social security card, etc, need to be verified against a third party database to determine that the identity is valid to extent reasonable and practicable; a database of all accounts needs to be maintained that includes the account name, date of account opening, identifying information presented, and the items used to verify the identity. This information needs to be time and date stamped and maintained for 5 years following the closure of the accounts" (Penley, 2002).

Section 311 entitled Special measures for jurisdictions, financial institutions, or international transactions of primary money laundering concern, considers a payable - through accounts as 'an account, including a transaction account, ...opened at a depository institution by a foreign financial institution by means of which the foreign financial institution permits its customers to engage, either directly or through a sub-account, in banking activities usual in connection with the business of banking in the United States'.

> "Payable -through accounts are offered by US banking entities to foreign banks. It involves the US banking entity opening a checking account for the foreign bank. The foreign bank then solicits customers that reside outside the USA who, for a fee, are provided with the means to conduct banking transactions in the US payment system through the foreign bank's account at the US banking entity. Ordinarily, the foreign bank will provide its customers, commonly referred to as sub-account holders, with checks that enable the sub-account holder to draw on the foreign bank's account at the US banking entity. The group of sub-account holders may become signatories on the foreign bank's account at the US banking entity" (Alexander, 2002, p.316).

A new obligation to identify the 'foreign beneficial owners' of accounts with US financial institutions may lead to conflicts between the secrecy law provision in some jurisdictions and these new US requirements.

5.5 International response to the USA initiative to strengthened anti-money laundering regime

The USA initiatives to strengthened anti-money laundering control has been regarded as highly controversial, but long awaited in terms of establishing world-wide understanding of the danger of the abuse of financial institutions. The Patriot Act 2000 received a wide international response. Following are just a few examples of the initiatives undertaken by two international organisations, such as United Nations and the FATF, and one country, the UK.

United Nations:

The UN adopted resolution 1373 requires some extra measures to be taken into account by countries to prevent future terrorist acts. Under the article 2 (c) states are required to prevent and suppress the financing of terrorist acts and to refrain from providing any type of support, active or passive, for terrorists and to deny safe haven to those who finance, plan or participate in terrorist acts.

FATF:

FATF issued "Special Recommendations" on terrorist financing to establish the basic framework for detecting, preventing and suppressing the financing of terrorism and terrorist acts. Special recommendation II asks each country to criminalise the financing of terrorism and associated money laundering.

Alexander writes that "The 'Special Recommendations' supplement and reinforce the measures already adopted by the UN and create a more comprehensive international regime for interdicting the financing and commercial support of terrorists and terrorist activities (Alexander, 2002, p.320).

Great Britain:

The UK Government adopted a number of measures to combat the financing of terrorism. Anti-Terrorism, Crime and Security Amendments to the Terrorism Act 2000 adopted in November 2001 creates new offences, including offences of international terrorism, offence for a person to solicit, or to receive, money or property on behalf of terrorists if the person knows or has reasonable cause to suspect that such money may be used for the purpose of terrorism.

It is difficult to discuss now the implication of this act to the developing nations. What is clear is that financially advanced countries such as USA and UK take the issue of the abuse of financial system very seriously and they are willing to impose a

set of strict regulations allowing the financial system to identify the terrorist finances at a very early stage. It is also important to remember that corruption of the foreign state officials is now considered as an offence by US legislators. For countries there corruption is endemic these changes can bring a lot difficulties.
Next section considers the issue of financial regulation in transition countries.

5.6 Financial stability in emerging financial markets: Ukraine at the international agenda

5.6.1 FATF black list: the image of Ukraine

On 7th of September 2001 FATF added Ukraine to the list of non-co-operative jurisdictions. Non-cooperative jurisdictions are those, which have not made adequate progress in addressing the serious deficiencies in anti-money laundering legislation identified by the FATF. As on September 2001 Ukraine met the following FATF criteria 4, 8, 10, 11, 14, 15, 16, 23, 24, and 25. These criteria described are: (4) existence of anonymous accounts or accounts in obviously fictitious names; (8) secrecy provisions which can be invoked against, but not lifted by competent administrative authorities in the context of enquires concerning money-laundering; (10) absence of an efficient mandatory system for reporting suspicious transactions to a competent authority, provided that such a system aims to detect and prosecute money laundering; (11) lack of monitoring and criminal or administrative sanctions in respect to the obligation to report suspicious or unusual transactions; (14) regulatory or other systems which allow financial institutions to carry out financial business where the beneficial owner(s) of transaction is unknown, or is represented by an intermediary who refuses to divulge that information, without informing the competent authorities; (15) laws or regulations prohibiting international exchange of information between administrative anti-money laundering authorities or not granting clear gateways or subjecting exchange of information to unduly restrictive conditions; (16) prohibiting relevant administrative authorities to conduct investigations or enquiries on behalf of, or for account of their foreign counterparts; (23) failure to provide the administrative and judicial authorities with the necessary financial, human or technical resources to exercise their functions or to conduct their investigations; (24) inadequate or corrupt professional staff in either governmental, judicial or supervisory authorities or among those responsible for anti-money laundering compliance in the financial services industry; (25) lack of centralised unit (i.e., a

financial intelligence unit) or of an equivalent mechanism for the collection, analysis and dissemination of suspicious transactions information to competent authorities (FATF, 2000).

Ukraine met FATF criteria 11, lack of monitoring and criminal or administrative sanctions in respect to the obligation to report suspicious or unusual transactions. Criteria 11 needs to be explained in more details. According to Article 64 of the Law on Banks and Banking Activities, banks are required to identify persons involved in substantial or suspicious transactions. Pursuant to the law the threshold for substantial transactions are transactions amounted more than Euro 50.000, and cash transactions Euro 10.000. As defined by the Law suspicious transactions have following characteristics: (1) transactions, which are carried out in an unusual or unjustifiably complicated conditions; (2) transactions are not economically justified or are against the legislation of Ukraine. According to some Ukrainian researchers (Neelov, 2001), to observe the law and other requirement, one has to report the major part of the transactions of legal and physical entities undertaking in Ukraine.
However, for FATF meeting these criteria were not enough not to list Ukraine as non-co-operative jurisdiction. Ukraine was given time until completion of the third round of the FATF's evaluation to work on serious deficiencies identified to be able to escape the FATF's counter measures.
The remaining deficiencies originate from different problematic areas: financial regulations, international co-operation, and recourses available to finance public and private sector. While the poor state of the economy, and state budget deficit can explain the last problem, which is the general lack of resources, the rest of the problems tend to be united by the lack of political will in the country. For example, the draft Anti-Money Laundering legislation has been at the discussion in the Parliament for almost a year since FATF identified the problem and warned Ukraine about possible sanctions.

5.6.2 Law of Ukraine on Prevention and Counteraction of Legalisation ("Laundering") of the Proceeds from Crime.

On December 7th 2002 Ukraine enacted the "Law of Ukraine on Prevention and Counteraction of Legalisation of the Proceeds from Crime". However, according to the FATF this legislation does not address the main deficiency identified by the FATF

earlier in the year 2001, during the anti-money laundering regime review in Ukraine. In the mid-December 2002 Members of the FATF decided to apply the counter measures to Ukraine. Although, as of the 14 of February 2003, the FATF informed: "FATF members have decided to withdraw the application of additional counter-measures with respect to Ukraine as the result of a recent enactment by Ukraine of comprehensive anti-money laundering legislation that addresses the main deficiencies identified by FATF in 2001 and reaffirmed in December 2002. Ukraine will remain on the list on NCCTS until it has implemented effectively its new anti-money laundering legislation" (FATF, 2003 downloaded from http://www1.oecd.org/fatf/ FATF withdraws counter measures with respect to Ukraine, 14 February, 2003).
As it has already been mentioned the draft law had been under consideration in Ukrainian Parliament for more than a year and it had been approved by the Parliament and signed by the President just a couple of weeks before the FATF's deadline in December 2002. This law consists of 16 articles, described under 6 sections. Section I: The General Provisions consists of three articles: Article 1 provides definitions, Article 2 gives an account of activities related to money laundering, and Article 3 describes the scope of the law. According to Article 1 the main definitions are: profit, illegal activity which lead to money laundering, money laundering, types of financial activity, compulsory financial monitoring, and local (inside financial monitoring). Profit is defined as any economic advantage criminally acquired and is followed by legalisation; profit shall mean money or securities, movable and immovable property, property rights, any other items covered by property rights. Illegal activity which is followed by money laundering shall mean activity which according to the Criminal Code will lead to three or more years imprisonment or activity which is considered to be criminal according to the criminal code of another country (and the same activity is prohibited under the Criminal Code of Ukraine), and as a result of which the profit is illegally obtained. Financial transaction shall mean any transaction aimed at making or assisting in transaction by means of: bank account transaction; foreign currency exchange; assisting in issuing, buying or selling of securities; giving or receiving a credit; insurance (reinsurance); giving or receiving financial guarantees; managing the securities portfolio; issuing, circulation of a state or other financial lottery; assisting in issuing, buying or selling of securities, payments, postal cash transaction or other means of payments; opening an account. Section II describes the system of financial monitoring in Ukraine. Article 4 of the Section II identifies two

levels of the financial monitoring in the country: primary and state. The primary financial monitoring units are: commercial banks, insurance and other financial institutions, agencies authorised to receive, pay and transfer money; commodity or stock or other exchanges; professional players at the securities market; investment trusts; commissions shops, gaming houses and organisations which hold lotteries of any kind; post offices telegraph offices and legal entities that provide, in conformity with the law, services of receiving, paying, conveying, transferring money or management of investment funds or non-state pension funds. The state financial monitoring units are represented by the governmental agencies and the National Bank of Ukraine and authorised under the law to regulate and monitor financial operations. Article 5 describes tasks and duties of the primary financial monitoring agencies. These duties include identification of the initiator of a financial transaction, detection and registration of any doubtful transactions, reporting financial transaction which is under the financial monitoring to a special unit (reporting shall occur not later than three days from the day of transaction registration); assisting the special financial monitoring units in the financial transaction analysis; on request of the financial monitoring agencies provide additional information regarding a particular financial transaction, even if this information constitutes banking and commercial secret (information shall be provided no later than three days after the request is received); keep the financial monitoring in secret from the client. The primary financial monitoring units shall keep the file of identification of the initiator of a financial transaction which is under the financial monitoring for five years. Article 6 states the details of the information necessary to obtain to identify the physical and legal entity, including residents and non-residents in Ukraine. According to Article 6 identification is not necessary in cases when financial transactions initiated by someone who has already been identified before. Article 7 gives a right to the financial institutions to refuse financial transaction. Article 10 identifies the duties of the state financial monitoring agencies, such as the National Bank of Ukraine and the authorised bodies, to control the compliance of the primary financial monitoring institutions with the obligations prescribed by the law, inform a special unit of discovered violations of this law by financial operators.

Section III describes the financial operations which are under compulsory and inside financial monitoring. Article 11states that a financial operation is subject to control if

its amount is equal or more than Hrv 300.000[8], or its amount in foreign currency is equal or more than Hrv 300.000, or in case of a cash transaction, if its amount is equal or more than Hrv 100.000, or its amount in foreign currency is equal or more than Hrv 100.000 and if the financial transaction has one of the following characteristics: payment is due to be made to the anonymous account abroad or is due to be received from the anonymous account abroad, and if a payment is due to be made to the financial institutions situated in countries listed by the Cabinet of Ministers as off-shore zones; buying or selling travel cheques or other means of payment; financial transactions conducted with the countries which do not co-operate with international organisations aimed to tackle money-laundering; transfer of the money abroad with the aim to receive money their in cash; opening account to the third person; foreign transfers conducted despite the absence of the foreign trade agreement between parties involved; cash payments for the securities purchased; lottery or casino payments; foreign currency exchange.

According to Article 12 financial operations shall be monitored if they are unnecessary complex, or the information obtained can not be checked (for example, changes made by one of the party in regard to the money re-allocation, etc.); if the financial operation does not correspond with the business activity of a client described in related documentation; if there is a reason to suspect that the client has conducted financial operations aimed to avoid financial monitoring. Section IV states the tasks, functions and duties of the authorised authority.

Section V of this law is of particular importance to this research because it aims to regulate the international co-operations in regard with the anti-money laundering measures. Article 15 identifies the grounds for and forms of international co-operation for the prevention and counteraction of legalisation (laundering) the proceeds of crime and terrorism financing. The article states that international co-operation for the prevention and counteraction of legalisation (laundering) of the proceeds from crime and terrorism finances shall be based on the grounds of the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (1990) and other international treaties of Ukraine, this Law and other Ukrainian laws and regulations. Refusal and postponement of co-operation shall be on

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[8] £1 equals Hrv 8, 45 as on December 15 2002, The National Bank of Ukraine exchange rates.

the grounds and in the manner prescribed by the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (1990).

Article 16 describes the agencies involved in international co-operation. According to the Article 16 the central agencies charged to carry out international co-operation for the prevention and counteraction of legalisation (laundering) of the proceeds from crimes shall be the Ministry of Justice of Ukraine with regard to judicial decisions and the Office of Prosecutor General of Ukraine with regard to investigations in criminal cases. The information or evidence provided by the said agencies within the framework of international co-operation for the prevention and counteraction of legalisation (laundering) of the proceeds from crime shall not be used by authorities of a foreign state for the purposes of investigations or judicial proceedings not mentioned in the judicial request, without a prior consent of the Ministry of Justice of Ukraine or the Office of prosecutors General of Ukraine. The authorised agency shall co-operate with appropriate authorities of foreign states for the purposes of exchange of information on legalisation (laundering) of the profits, shall co-operate with the Financial Action Task Force (FATF) and other international organisations aiming to prevent and counteract the legalisation (laundering) of the profits.

Section VI states the responsibility for breaching this law.

This law shall enter into force in six month from the date of its official publication (published in November 2002).

The above-described law can be considered as a victory of the international organisation, and FATF in particular. Without the pressure from the international community the adoption of this law in Ukraine would not be possible. However, there are still deficiencies to be addressed to 'clear' the country's name.

5.6.3 Financial regulation – the new perspective

It is obvious that functioning of any economy is hardly possible without efficient financial system. Norton (2000) names four issues necessary to take into consideration when speaking about the international strategy for the development of financial stability in emerging markets. The first issue is the development of an international consensus on the key elements of a sound financial and regulatory system by representatives of the G-10 and emerging market economies. The second is the formulation of sound principles and practices by international grouping of national authorities with relevant expertise and experience, such as the Basle

Committee on Banking Supervision, the International Accounting Standards Committee (IACS), the International Organisation of Securities Commission (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Joint Forum on Financial conglomerates. The third strategic issue is the use of market discipline and market access channels to provide incentives for the adoption of sound supervisory systems, better corporate governance and other key elements of a robust financial system. The last issue is the promotion of the adoption and implementation of sound principles and practices. The multilateral institutions such as the IMF, the World Bank and the regional development bank, such as the EBRD can play an essential role (Norton, 2000). Although it is important to consider international strategies, they can only achieve results if implemented in collaboration with the national governments and financial authorities initiatives in the countries concerned (Norton, 2000, Rose-Ackerman, 1999).

The responsibilities of the national government of the country concerned have been mentioned twice already in this chapter. What does it mean in practice and how feasible is it to expect the national government to react to the problems of financial crime accordingly? Chapter four analyses the experience of Ukraine with regard to establishing the sound financial system. The case study on banking showed the importance of timely introduced legal framework. It also shows that despite difficulties arising during the first years of transition, once the legislation is adopted the financial institutions can regulate themselves and follow the rule of law principles. The major problem is not in creating the 'specialised' legal framework, which is in our case the framework for the financial institutions to operate, but the creation of the system known as the rule of law. The case study on corruption showed that despite the number of legislative acts and decrees adopted, the problem of corruption and corrupt state officials involvement in the financial sphere remains to be acute. The specialised legal framework for the financial institutions needs to include adequate contract, corporate, bankruptcy and private property laws as a minimum requirement. However, even if these requirements are satisfied the development of the financial system is far away from being safe. The danger comes not necessarily from 'the inside' of the banking system, but from the 'outside' of the system. Enforcement of the above mentioned laws presents a biggest challenge, especially in Ukraine- a society characterised by the lack of the rule of law principles.

In January 2002 the President of Ukraine adopted a decree "On measures to prevent legalisation (laundering) illegally obtained income". This decree raised concern among the players in the financial market. According to the decree, banks or other financial institutions will carry out the primary control of the transactions defined by the law as substantial or suspicious. The Cabinet of Ministers is ordered to create a special state department inside the Ministry of Finance. The biggest worry of those representing the financial market industry is the highly politicised character of this new structure. The results of the expert study suggest that big financial scandals can be closely related to the high-level state officials. The question is how to insure that this new structure is free from being political or under the pressure of corrupt state official. Most developed economies have established their own system of control through years of experience and learning from their own mistakes. Unfortunately, Ukraine does not have time to choose the right policy by means of experimenting. With regard banking supervision, there are three alternatives to organising the banking supervision in the country: to separate banking supervision from the central bank, to conduct supervision as a part of central bank activities, to create a single regulator. Each alternative has arguments in favour or against it. In case of the separation of banking supervision from the central bank, the immediate concern is the conflict of interest between supervision and monetary policy objectives. As it has been discussed in Chapter 4, case study on banking, Ukraine had followed the IMF recommendations to single out monetary stabilisation as a top priority for the central bank. The danger of this situation is that the authorities and central bank can easily jeopardise their power and use it to provide assistance to a few selected banks. Norton (2000) considers examples of Mexico and Thailand, "where the central banks have been forced to abandon stability in the face of threats to the banking system" (Norton, 2000, p.102). The list of countries suffered from such a narrow policy approach assigned to the central banks can include Ukraine as well. What happened in Ukraine was not a separation of the central bank from banking supervision activities, but neglect of these supervisory activities for almost five years, from 1991 to 1996. Norton (2000) discusses three fundamental arguments against the separation of the central bank from banking supervision activities: "those relating to the central bank's lender of last resort function; those involving the payment systems; those advancing the need for consistency between monetary policy and banking supervision" (p.103).

Obviously, for the emerging economies it is essential to have consistency between monetary policy and banking supervision.

Early in this chapter we briefly discussed the financial regulation systems in the US and the UK. It is rather difficult to suggest what is the best choice for one jurisdiction. It is necessary to take into account not only the experience the country has gained in the financial services, but legal and social issues as well. Norton (2000) suggests that both system models are valid, if they are adequately structured. The Basle Core Principles state that the effectiveness of the banking supervision depends on how clearly the regulatory responsibilities and objectives are set.

It is essential to remember the certain characteristics of supervision (Ward, 2002). Supervisors tend to use a broad range of information, even of subjective nature. It is often the case that supervision depends on incentives of supervisors, and other professionals surrounding them, such as bakers, politicians, and auditors. These incentives may be affected not only by law, but also by culture and norms presented in the country. Ward (2002) writes: "It is easy to build incentive mechanisms that fail to achieve regulatory objectives, and difficult to build mechanisms that succeed. Organisational structures give even the most public-spirited supervisor reason to misbehave" (Ward, 2002, p.13).

Supervision of financial institutions is a very complex activity which amongst the other includes human relationship. It is a big issue for the advanced financial markets to monitor the relationship between supervisors and bankers, and to have a judgement free from superstition. However, as Ward (2002) notes: "whether supervisory actions are effective or entirely superstitious is not known" (Ward, 2002, p.13).

To understand the problem Ukraine is experiencing now, one has to imagine the establishment of the democracy and financial institutions in the economically advanced countries such as the UK and the USA. For decades, if not centuries, these countries have been involved in building the market systems, the efficient financial mechanisms, the operation of the rule of law principles in the society and the effective enforcement mechanisms. And yet, so many questions remain to be answered. For example, it took centuries to develop properly regulated securities market in the West, and yet, taking into consideration the poor example of Enron and others, it tends to be that even mature markets are not a hundred percent insured against abuse.

Understanding the spread of the corruption in Ukraine, it is argued that it is essential to develop a system of clear and simple rules to regulate the financial institutions. As

Ward (2002) stated, these rules should be easy to write, communicate, enforce and verify. The role of supervisory discretion in countries such as Ukraine should be minimised.

5.6.4. The new international framework and emerging markets: recommendations

Although the importance of the above-described international co-operation can not be underestimated, a concern expressed regarding the emerging markets involvement in the development of the international policy and the actual co-operation among countries. Some researchers (Porter, 2001; Ward, 2002) argue that a common tendency can be observed when considering the international organisation dealing with financial regulation. These organisations tend to represent a number of developed countries who get together and establish new regulatory arrangements, and they later spread these arrangements to emerging markets. A concern is also made over the democratic principles involved in an international attempt to regulate the globalised financial services. There is a tendency to exclude developing countries from the international collaboration. Porter argues that the Basle Committee's bank regulations do not match the needs of microfinance industry in developing country (Ibid., p. 110). Ward (2002) critically considers the new Basel Accord, stresses the difference among countries and argues that in case if the New Accord is implemented without major adjustments it is 'likely to fail in developing countries' (Ward, 2002, p.4). Wards provides three reasons for that: greater macroeconomic volatility, greater volatility of external flows and greater vulnerability to external stocks, weak institutions, and lack of skills in developing markets (Ibid., p.4).

The need to address the special character, social and cultural traditions in one country is important when attempting to impose the regulations or law simply borrowed from another country. Discussing this aspect of the international financial regulation Rider (2002) writes:

> "There is a real danger that the understandable desire on the part of leaders and politicians to come up with a 'solution' to the problem of organised crime, has rendered them too willing to seize upon, what is no doubt a good weapon- when used with others, but in no ways a solution... as in other areas, the laws and legal procedures of one jurisdiction are not always easily transported, without adaptation, to the legal system of another, with quite different traditions and structures. The need to establish a convincing and workable balance is all the more important in the context of small, developing and

> transitional economies. These highly vulnerable states may well find themselves effectively deprived of the advantages and services of those more developed and stable countries that are able to espouse the sort of measures found in legislation such as the Patriot Act. (p.32)

The danger of imposing the standards provided by the group of countries with advanced economies has been expressed before the attack on America and subsequent changes in legislation (Porter, 2001). It seems as if the critical discussion of the role of authoritative supranational decision-making has now been postponed until the more peaceful future. It is also difficult to provide one-sided answer to the question: will such strengthening of the measures lead to the quality-improved response of the Ukrainian government to the international standards of financial regulations? There are two possible scenarios: the first one is if the fear of being excluded from the international financial markets will preoccupy the thoughts of single-minded Ukrainian politicians, who will address the issues timely and with great care, when the new international requirements will prove to be workable. The second scenario, if the Ukrainian politicians would avoid taking this matter seriously, then not only the image of the country would be under attack, but the losses the financial services will have to overcome would devastate the financial industry in the country.

However critical the response to the current changes suggested by the USA authorities might be, one thing is obvious, for the country where corruption is endemic and where the financial institutions have not been supervised on the basis of transparent and equal rules, current changes in the international environment can provide the opportunity for reforms.

It is important to understand the complexity of international standards and regulations. Developing countries can face themselves with the dilemma, if they do not implement the international standards they experience the risk of being punished, but if they do, they can face the risk of wasting resources, and sometimes extend the roots of corruption. Following the international pressure Ukraine will shortly be introducing the new structure for the financial supervision, to stress the role of financial supervisors. However, as it has been discussed before, the danger is in abusing the supervisory power in a corrupt system.

There are two issues that need to be addressed as the possible policy recommendations[9]. The first one is the necessity to create effective regulation and

[9] It needs to be said that in one way or another Norton (2000) affecting discusses the similar issues as the policy choice of developing economies.

supervision of the financial system in the country (this subject has been briefly considered in the previous section). As the case study on banking has shown effective regulation is among the prevalent problems in Ukraine. We have already addressed the issues of legal development in the country, and the importance of the foundation of the legal framework. The case study on banking has shown the importance of timely introduced bankruptcy procedures. Again, this is where financial issues come close to political issues, as many banks in Ukraine remain under the 'roof' of state budget subsidies. A number of international organisations have advised Ukraine that the consolidation of banks technique should be introduced to overcome bank failures to fulfil the minimum requirements[10]. It is interesting to observe the negative reaction expressed by a number of bank directors who early in the year 2000 refused to consider the possibility of consolidation. To understand the thoughts behind this, one has to be aware of the changes of norms and values in the transitional society. Firstly, one has to remember the specific culture of those who are rich in a transitional society, it is 'cool' to have your own bank. Secondly, is that it has been known for a long time that "the best way to rob a bank is to own one" (Calavita, Pontell, Tillman, 1997, p.58). The role of national regulators should also be seen in changing the above-mentioned attitude towards banking. An internationally recognised norms and regulations should be a helpful tool in this difficult transformation.

National Bank of Ukraine as the main supervisory body of the country should create the supervisory practices that will be transparent and will guarantee the equal treatment to each financial institution. The Financial Service Intelligence Unit, the foundation of which was suggested by the President of Ukraine in January 2002, should be an independent body. There is a great danger of creating another corrupt unit inside already corrupted structure. If, as suggested, this unit will be created as an internal structure managed by the Ministry of Finance, there is potential for direct political influence and political supervision of this unit. In this case, the equality of treatment of the financial institutions in the country will remain problematic. It is essential to establish the Financial Intelligence Unit not as a punitive organisation, but

[10] It should be said, that contrary to this opinion, Mertens and Urga (2001) study of the Ukrainian banks argue that as on 1998 small banks operate more efficiently in cost terms, but less efficiently in profit terms, and the researchers suggested the existence of the monopoly power in Ukrainian financial sector (see the discussion in Chapter 4).

as a preventative and capable of providing examples of the best practices. This is a question of political will.

The second issue is the creation of the foundation for corporate governance, meaning the creation of transparent business environment. As Norton (2000) argues, policy makers must realise that the legal framework of business and finance relationships will determine the outcome of the economy's corporate governance. As the expert study suggested a lot of illegalities appeared in the financial sector in the 90-s have been closely related to the inadequate system of regulation of economic and financial life. This issue is closely related to what has already been suggested: the transition countries will only benefit from simple and easy to enforce rules. The system of taxation is an obvious example of a failure of an ever changing and complex rules, difficult to enforce and verify. The general public and the businesspeople have seen tax authority as a corrupt and punitive state organisation, often abusing its privileged position to the knowledge of the extremely complicated system of tax payment in the country. A lot of articles have been written to indicate that to conduct business and to pay all the necessary taxes means to be bankrupt the next day (International bank for Reconstruction and Development, 2000). So, to avoid the high rate of taxes a lot of companies have used the double bookkeeping system to evade money from the official turnover. The present official ideology created 'unreal' norms, and when framed them within a set of institutions to insure the 'fulfilment' of these norms by means of unofficial agreement, exchange of favours or simply to say, corrupt practices. Where do we go from here? To make sure the financial system operates under the transparent and equal treatment principles, we need to be sure that the norms and regulations are 'workable', that they have been understood by the general public and the consensus has been reached on such a simple issue such as what is the good and the bad practices, what is legal and what is illegal.

It was suggested earlier that the level of the democratic reforms could be judged according to the level of development of the financial institution. It may be argued that the concept of corporate governance is another essential step in the way towards democracy. A number of issues may arise regarding the introduction of the corporate governance practices. Among these issues are lack of transparency and wide spread-corruption. Both issues can be tackled as from the inside of the system, such as by increasing the enforcement standards, and from the outside of the system, as it was

suggested earlier, by obliging the country to comply with certain rules and standards (although the latter presents a lot of controversy).

To summarise, last two decades of the 20th century had witnessed an enormous advance in technology. This had influenced not only the way the financial market has developed, but also the way high profile criminals have conducted their business. Adamoli (2001) noticed "...just as legal businesses are expanding internationally in response to the globalisation of market, so are the crime enterprises seeking to develop both their structures and crime trade internationally in order to gain access to new markets, taking advantage of the discrepancies between the national legal system" (Adamoli, 2001, p.187-188).

If allowed to participate in a modern international financial market system, emerging financial markets can find themselves in an advantage position. It means financial and technological assistance will be provided by more mature financial markets. However, at the same time emerging markets can easily be abused by criminals. That is why the primary goal of the government in a country is to assure the transparency of the financial institutions and good supervision. Experience suggests this is not always the case. That is why it is important to establish international mechanisms to control financial institutions in emerging economies. A great number of international organisations have already been created and carry out these functions of supervisions, by issuing recommendations and warnings to non co-operative jurisdictions. An international agreement has been reached as to the policies each country needs to adopt to provide laws for the confiscature of the proceeds of serious crime, or at least those associated with the illicit trade in drugs, the investigation and interdiction of the proceeds of such offences, the criminalisation of money laundering, the reporting of suspicious transactions, the imposition of reporting and due diligence requirements on those most likely to confront money laundering and facilitation of international mutual assistance. What remains to be achieved is to identify the most suitable ways of imposing the new rules to the developing and emerging markets, that is, to make sure that these markets would not suffer from artificial rules and standards. Stating that it is also understood that international co-operation in such issues as financial regulations is very complex: by ignoring the problem there is a chance to create a financial monster inside the emerging financial system, but in the opposite, by putting too much pressure, it is possible not to let the system further develop. As it was discussed in case of Ukraine the pressure of international financial community is

necessary to put corrupt state officials out of business and to set the framework for the good practices.

Chapter 6: Conclusion

The study was carried out in an attempt to reduce the gap in our knowledge about the problems experienced by transitional countries during the transformation of their financial systems. The 1980s and 1990s have seen dramatic political, economic and social changes in all post-communist countries of Central and Eastern Europe. Many countries have been involved in the process of establishing the financial market structures. Transitional countries have recognised the importance of finance with regard to savings and effective resource allocation. This study has provided many examples of the recent empirical and analytical work to suggest that economic growth depends on the development of the financial sectors. Transitional countries are not alone in their way to build sound and effective financial markets. The almost parallel process to the transitional countries development is the process of the internationalisation of financial services, which is elimination of discrimination in treatment between foreign and domestic financial services providers, removal of barriers to the cross-border provision of financial services (Claessens and Jansen, 2000, p.,3). The benefits many transition countries could gain from this process are substantial. Transitional countries can be introduced to the system of international standards and practices, improve the quality of financial services, access more sources of funds. Unfortunately among at least 15 Eastern and Central European countries not many achieved success in building the sound and effective financial institutions. For some countries bad performances of the financial sectors can be justified by the small size of their economy and substantial costs involved to build up financial system, for some economic crises and political instability have become a serious obstacle.

This study examined the impact of the financial crime on the development of the effective financial system in transitional Ukraine. The 24 experts who participated in the interviews reported a regular encounter of the financial crime problems. Given the fact that among the experts interviewed were those involved into the legislative process and working at the high state officials level, the problems is very serious. Summing up the results of the expert study, as on the end of the 90-s the two most corrupt and prone to criminal activities sectors in Ukrainian financial market are foreign exchange market and commercial/ saving banks. The impact of the financial crime on the development of the Ukrainian banking industry has been profound: allocation of the cheap state subsidies to selected banks, the criminal use of the overseas accounts, different illegal methods the loan applicant uses to obtain financial

resources from bank, which is often the illegal agreement between the 'big' client of the bank and the bank officials. Unsound and not effective banking industry has been seen as a direct influence of the grand scale financial crimes.

The results of the pilot study suggest that Ukrainian financial sectors have not been acting as agents to promote the development of the financial system as a whole, but rather serving as mediators to provide cover for political mistakes and/or those earning 'easy money', as well as being a tool to avoid regulatory obligations

It has been said before, that the financial crime problems experienced by Ukraine are not new to the world, what is new is the immunity of perpetrators and the scale of their crimes.

The expert interviews and the literature study have proved the hypothesis that a grand scale financial crimes in the country are associated with the big political figures or high level state officials. It is clear now, that during the first years of independence, which is the early 90-s, lack of regulatory skills, and most certainly negligence and desire to make private profit lead to the foundation of the unsafe banking system which allowed substantial flow of the illegally gained capital. The "Ukraine" Bank scandal brings the question of the political interference in the financial issues, and as the Chairman of the Ukrainian Parliament Ivan Plush said,

> "What should the Parliament do in regard to "Ukraine" Bank?...The Parliament has nothing to do with the Bank...The National Bank of Ukraine and the Government have worked with the bank, including the state budget subsidies to the bank....I have been saying it more than once, to 'seriously' steal money one would need to 'employ' state budget resources..." (Business, 2001).

However difficult it is to tackle the issues of corruption at the macro level of the society, to tackle the financial crime problems at the micro level of banking tends to be feasible. One of the important finding of the expert study is the contrast of opinion of those involved into the legal drafting for the financial market and those players on financial market. Eighty percent of respondent involved into the business activity think that the regulatory framework needs major restructuring and does not correspond with the needs of the emerging markets. The majority of those representing official government bodies believed that the legislative framework has been developed or is in the process of development and revision. The representatives of this group see the major problem in the enforcement of the regulations, and connect enforcement problems to the problems of the lack of political will and wide-spread corruption.

The three stages of the development of Ukrainian banking system (chapter 4:case study on banking) suggest that with the introduction of the basic principles of the transparent banking and the strengthened role of the National Bank of Ukraine as a supervisory body, a tendency towards the improved bank performances have been observed. That is to suggest that domestic financial regulation and supervision play crucial role in the development of the effective banking system and financial system in general. Although, in case of Ukraine it may not necessarily means the transparency of banking, freedom form political pressure, and the equality in the treatment of banks by the main supervisory body. In this case, the international organisation, such as Financial Action Task Force can start actions to attract more attention to the problematic areas. Case study on corruption presented in Chapter 4 and Chapter 5 considered corruption and the different ways to tackle it. It is suggested that for the country where corruption is endemic neither the quality of law on corruption no the enforcement matters. The way forward has been seen in the international initiatives, including introduction of some strict regulations and even sanctions. At the same time doubts expressed as to the real possibilities of the Financial Intelligence Unit which will be created by the Ukrainian Ministry of Finance to effectively control and supervise financial organisations on the issues of financial crime. The main reason to doubt the possibilities is seen in the political pressure and corruption of those responsible at the ministerial level. The international response to the problems of corruption in Ukraine is also complex. While such initiatives as FATF black list of the non-co-operative jurisdictions stimulates the debates and provides the country named with the time and experts to tackle the problem, the measures proposed by the US Patriot Act can exclude the country from the whole spectrum of financial services without a chance to teach and assist the country.

Findings reported in Chapters 4 and 5 provide empirical support for the theoretical model explaining the rise of financial crime in Ukraine (Chapter2). The group of crime prone high level state officials have being given a historic chance to transform the system. However, a number of opportunities have arisen to abuse the fragile financial system and to use the temporary absence of the basic legal provisions to conduct illegal business. The choice to use these opportunities have been rational and supported by the neutralisation technique, which blames the other for doing the same.

To ensure the 'safe game' everyone should be in it. If someone is out or refuses to play according to the rules, than the new scandal for the press appears.

Giving the account to all what have been said we approach the general hypothesis that the level of the success of the democratic reforms in transition countries can be judged according to the advances in transformation of the financial institutions. It tends to be that the transformation of the Ukrainian financial system has double meaning. The first is that the country has really achieved a lot of progress in establishing the new financial institutions. Less than ten banks operated in 1991 just before the collapse of the USSR, and a few years later this number would be far more than a hundred. The second meaning is the abuse of the newly created financial system. At some stage in the mid-90s the numbers of banks in Ukraine reached 200. The case study on banking in Chapter 4 discussed the period of the middle 90-s in great details, and identifies the absence of the regulations in banking as the biggest problem for the development of the industry. As one American researcher said, the best way to rob a bank is to own one.

One of the important lessons learned can be summarised in the following statement: political will is a significant element in the establishment of independent financial institutions in transitional countries.

To conclude, it is necessary to stress the importance of studying certain economic and financial developments, such as, for example the establishment of the financial market, within the general context of the social and cultural traditions of the society. The study undertaken presents a first attempt to combine the sociological, criminological, economic, legal and even psychological thoughts to analyse the development of financial market in transitional countries. The present author believes that this combined approach has a great potential, not only in terms of understanding current developments, but also in terms of predicting future patterns and creating a framework for international collaboration.

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Appendices

Appendix1: Anti-Money Laundering situation in Ukraine[1].

1. Criminal law provisions related to money-laundering in Ukraine.

Criminalization of money laundering	Criminal code, part VII, Article 209
Criminal liability on corporations	NO
Provisions allowing the dissolution of companies by court order	NO
Existence of professional secrecy	YES
Provisions of abuse of company assets for non-company goals as criminal offense	Not directly
Provisions of abuse of company assets for non-company goals as criminal offense	Not directly
Difficulties with introducing anti-money laundering legislation	Lack of political will, and presence of personal interests.
Existence of legal provisions other than penal, to sanction money laundering	NO

2. Law enforcement structure in Ukraine with special attention to money laundering.

Specialized police forces	State tax police, Ministry of Internal Affairs departments on Organized Crime and Economic Crime, Security Service.
Special training for police forces	NO
Financial analysts available to assist police officers	scarce
Independence of the police	Under supervision of public prosecutor
Police right to start and /or stop their own investigation	Under supervision of public prosecutor
Special forms of cooperation between the police and the judiciary in investigations of economic and financial crime	YES

3. Criminal procedures and anti-money laundering measures.

Existence of the reversed burden of the	NO

[1] Designed on the basis of the study conducted by Transcrime (2000) "Feasibility study on anti-money laundering measures in Russia, Ukraine, and Moldova", Trento: Transcrime, obtained from Transcrime web-site (pp.12-20, synoptic table: the Anti-money laundering situation in Russia, Ukraine and Moldova, according to the findings of the study).

proof in money laundering cases	
Crime proceeds seizure	A part of tax authorities responsibilities
Existence of procedures to appeal a decision of seizing, issued in the investigation period	Appeal to the prosecutor
Protection for witnesses/ informants in money laundering cases	Witness protection
Anonymous report of information to the police	Possible, but the decision on what to do with the information is on the discretion of the police
Existence of sanctions for illegally obtained evidence	During trial evidence is excluded by the judge, before trial it can be excluded by prosecutor
Possibility of setting-up government - controlled companies/ banks to be used in undercover operations	Possible, but too little experience and financial means
Appointment of external/independent experts for assistance in investigation	Possible
Existence of criminal data base	At the Ministry of Internal Affairs

4. Judiciary structure

Authority dealing with financial crimes	Prosecutors
Presence of foreign law firms dealing with money laundering	NO
Existence of an ombudsman or similar official who can investigate financial crimes or money laundering cases among public officials	NO
Existence of particular protection for officials dealing with economic crimes	YES

5. Civil Law

Separate system of civil seizure and confiscation	YES
Relationship between criminal and administrative procedures in seizure and confiscation	YES
Necessity of criminal conviction before the confiscation	NO
Initiation of the civil seizure and confiscation	Judges
Documentation of transactions by public authorities	YES
Special control s on unjust enrichment of politicians	YES

6. Commercial Law

No. of companies registered and declared bankrupt in last five years	Statistics not available

Bankruptcy as criminal offense	YES
Most common types of companies	Commercial partnerships, joint stock companies, limited liability companies and accessorial liability companies, private enterprises
Existence of minimum share capital, debt/equity ratio, issue bearer shares	YES
Obligation to disclose the beneficial owner to tax or public authorities	YES
Existence of control/financial restraint imposed on companies	YES
Existence of registered office	YES
Who entitled to control the activities undertaken by the registered office?	Registration bodies
Lawyer or bank as registered office	YES
Existence of shareholder register	YES
Obligation to register financial statement in a public register	Auditors, securities and exchange commission
Obligation to appoint external financial auditors, obligation to deposit the annual balance by a designed authority	YES

Appendix 2: The Questionnaire. Impact of economic crime on financial markets: study of emerging markets

I. Background

Respondents:

The general sample consists of the following groups of knowledgeable experts:

- Association of Entrepreneurs;
- Corporations/ Private business;
- Enforcement agencies, including police, prosecutor's office, lawyers, concerned departments of the National Security Service;
- Representatives of local and national governments who sit on the committees on financial development or related to economic crime matters;
- Deputies of local and supreme councils who sit on the committees on financial development or related to economic crime matters;
- NGO concerned;
- To the extent possible, representatives from players in the financial sectors, including from commercial and savings banks, insurance companies, trust companies and investment funds, money market/ foreign currency exchange market, stock and bond market, and the central bank.

Sectors of financial market considered:

- commercial and savings banks,
- insurance companies,
- trust companies and investment funds,
- money market/ foreign exchange market,
- stock and bond market,
- central bank

Types of economic crime considered:

- tax evasion,
- corruption,
- money laundering

II. Profile of the interviewed

1. Please, identify yourself briefly, either among those listed above or other.

_____

2. Please specify your political platform, if any?

_____

3. Which of the following types of economic crime do you consider the most common in Ukraine?

3.1. Money laundering
3.2. Tax evasion
3.3. Corruption
3.4. Other_____

4. What is your involvement, if any, in the issues related to this study. How and in what capacity do you encounter cases of economic crime?

4.1. Illegal actions were suggested by high level officials
4.2. Illegal actions were suggested by low level officials
4.3. Other_____

III. Economic crime and financial market

1. Which of the following sectors of the economy do you consider to be most affected by economic crime?

1.1. energy/gas,
1.2. raw materials,
1.3. heavy industry,
1.4. food industry,
1.5. local/communal infrastructure,
1.6. public services,
1.7. other_____

2. Which sector of the financial market do you consider to be most affected by economic crime?

2.1. Commercial/savings banks;
2.2. Insurance companies;
2.3. Trust companies/investment funds;
2.4. Money market/foreign exchange market;
2.5. Stock and bond market;
2.6. Central bank
2.7. Other_____

3. Please specify the exact nature of economic crime that occur in the operations of the institutions below.

(Possible examples may include offences like bribing bank officials to get loans on projects that are not financially sound, criminalisation of insurance companies, wrong-doing in non-transparent trust companies that manage invested assets, unlawful speculations on money and currency exchange market and so forth.)

	Possible economic crime
1. Commercial/savings banks;	
2. Insurance companies	
3. Trust companies/investment funds	
4. Money market/foreign exchange market	
5. Stock and bond market;	
6. Central bank	
7. Other	

4. What is the impact of the identified economic crimes on each sector of financial market below?

Please use the following scale to estimate the impact:
1. Promote the development of the sector
2. Prevent the further development
3. No essential impact
4. Other (Please specify)

1. Commercial/savings banks;	
2. Insurance companies	
3. Trust companies/investment funds	

4. Money market/foreign exchange market	
5. Stock and bond market;	
6. Central bank	
7. Other	

5. Please, summarise the impact of the identified economic crime on the state of financial market.

_____

_____

IV. Regulation of financial market

1. Before we proceed to the issues related to the regulation of financial markets, please answer the following: In the cases of economic crime that you have encountered in the last five years which has been the underlying motivation what led the perpetrator to commit crime?

1.1. to make more profits;
1.2. to cover-up possible mistakes;
1.3. for political reason

2. Generally, is the existing regulatory framework adequate?

2.1 Yes (go to question 3)
2.2 No (go to question 4)

3. If yes, then what is the reason for existence/development of economic crime? (please, prioritise)

3.1. lack of resources to enforce the regulations;	
3.2. lack of political will;	
3.3. unwanted political and/or other pressure on enforcement agencies;	
3.4. corruption of enforcement agencies;	
3.5. other	

4. Generally, does the existing regulatory framework need major restructuring or can it be improved by relatively minor adjustments?

4.1. yes, the existing regulatory framework can be improved with minor adjustments;
4.2. no, the existing regulatory framework needs major restructuring.

5. Do you think that the existing regulatory framework is:

5.1. over-constrained (go to question 6)
5.2. under-constrained (go to question 7)
5.3. optimal
5.4. other

6. What relief/liberalisation needs to be implemented to improve the existing regulatory framework?

_____

7. What additional regulations/strengthening should be introduced into regulatory framework?

8. How will the adjustments that you suggested in 6-7 help combat the cases of economic crime and improve the operation of financial market? Please, refer to each particular type of economic crime and relevant part of financial market you specified in section III?

Tax evasion.

The object of this type of crime is defined as the taxation environment within more general economic environment, that is produced by the functioning of the state tax system.

According to the Article 6 of the Law of Ukraine "On the system of taxation", the object of taxation include revenues (profit), added value of product, services or works, value of product, assets of legal entities and natural persons and other objects, as defined by the applicable legislation of Ukraine.

Article 14 of the Law of Ukraine "On the system of taxation" defines central taxes, including value added tax, excise tax, enterprises profit tax, taxes on revenues of natural persons, land tax, tax for industrial use of natural resources and others.

TAXES

The Law of Ukraine "On the System of Taxation", No. 1251-12 of 25 June 1991 (Law on Taxation) sets "... the principles of the taxation system in Ukraine, taxes, levies and other required payments to budgets and payments to state special purpose funds, and the rights, duties and responsibilities of taxpayers."

Section 1 of the Law on Taxation states:

> "Establishment and cancellation of taxes, levies and other required payments to budgets and payments to state special purpose funds is done by the Supreme Council of Ukraine, ... local Councils of People's Deputies according to this Law and other legislative acts of Ukraine on taxation ... . Local Councils of People's Deputies may establish additional taxation benefits as to sums which are directed to their budgets."

According to Article 7 of the Law on Taxation, the rates of taxes and other required payments do not change during a fiscal year unless implied in the relevant Ukrainian legislation.

The procedure of payment of taxes and other required levies and the responsibility of taxpayers for violating the laws on taxation are described in Sections 17 and 11, respectively, of the Law on Taxation.

Sections 14 and 15 of the Law on Taxation list, respectively, State taxes and other required payments, and local taxes and levies. In addition, local taxes and duties are described in the Cabinet of Ministers Decree "On local taxes and levies", No. 56-93 of 20 May 1993. Of those taxes listed in Sections 14 and 15 of the Law on Taxation and in Decree No. 56-93, the following are paid by a state enterprise:

(i) Profit Tax;
(ii) Value Added Tax;
(iii) Land Tax;
(iv) Communal Tax;

(v) Geological Exploration Tax;
(vi) Transportation Tax;
(vii) Road Tax;
(viii) Chernobyl Tax;
(ix) Payments to:
    (a) Employment Fund;
    (b) Social Insurance Fund; and
    (c) Pension Fund;
(x) Innovation Tax; and
(xi) Labor Protection Tax.

All but the Communal Tax are defined as "General State Taxes", while the Communal Tax is a local tax. The Innovation Tax and the Labor Protection Tax are "non-budget taxes"; i.e., they are paid to separate Oblast funds (for more details, see this Section II(F), below). These taxes are set as follows:

(i) Profit Tax: According to Section 4 of the Law of Ukraine "On taxation of the profit of enterprises", No. 334/94-BP of 28 December 1994 , the rate of this tax is 30% of the enterprise's net profit.

(ii) Value Added Tax (VAT): The VAT is regulated by the Law of Ukraine "On Value Added Taxes", No. 2007-XII of 20 December 1991 . The amount of the tax is 20% of the enterprise's expenditures and is included in the cost of production. If the amount of VAT is larger than Krb. 1 billion per month, it is paid three times a month, of which two payments, on the 5th and the 25th of the month, are estimated, advance payments toward the current month's VAT. The third payment, on the 10th of the month, reconciles the previous month's estimated payments, based on actual expenditures for the previous month.

(iii) Land Tax; The Land Tax is paid according to norms set by the City Council and approved by the Oblast, depending on the location of facilities. Currently, these norms are set by the Decree of the City Council of 25 July 1995 . The Law of Ukraine "On the State Budget of Ukraine in 1995", No. 126/95-BP of 6 April 1995 required a 20-fold increase in the Land Tax in 1995.

(iv) Communal Tax: According to Article 18 of the Law "On local taxes and levies", it is within the competence of the local City Council to set local taxes and levies within approved limits.[2] The City Council has set the amount of this tax at 10% (the maximum percentage allowed by this Law) of the product of the number of employees and the minimum non-taxed salary (currently Krb. 1,400,000).

(v) Geological Exploration Tax: Equal to the amount of water supplied multiplied by the cost of one cubic meter (i.e. the "average tariff") divided by 1,000.

(vi) Transportation Tax: Based on the number of vehicles used and their power.

(vii) Road Tax: 1.2% of planned revenues.

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[2] According to the same Article, local City Councils have the authority to set reduced tax rates, to abolish some local taxes and levies, to make exemptions for some categories of taxpayers, and to permit payments to be postponed.

(viii) Chernobyl Tax: 12% of the Salary Fund.

(ix)(a) Employment Fund: 2% of the Salary Fund;

(ix)(b) and (ix)(c) Social Insurance Fund and Pension Fund: An amount equal to 37% of the Salary Fund is distributed between the Social Insurance Fund (12%) and the Pension Fund (88%).

(x) Innovation Tax: 1% of planned revenues, of which 30% goes to the Oblast Innovation Fund and 70% is retained by the enterprise;

(xi) Labor Protection Tax: 1% of planned revenues, of which 40% goes to the Oblast Labor Protection Fund and 60% is retained by the enterprise. The table below shows the taxes paid by the enterprise for the first half of 1995:

Category of Tax	Total Amount for Jan - Jun 1995[3]	% of total
VAT	Krb. 76,938,000,000	71.70%
Land Tax	10,650,000,000	9.92%
Innovation Tax	4,381,203,543	4.08%
Road Tax	4,248,138,140	3.96%
Geological Exploration Tax	3,157,735,407	2.94%
Pension Fund	2,847,703,805	2.65%
Profit Tax	1,573,000,000	1.47%
Labor Protection Tax	1,112,000,000	1.04%
Chernobyl Tax	932,941,526	0.87%
Communal Tax	568,000,000	0.53%
Social Insurance Fund	388,323,163	0.36%
Transportation Tax	359,000,000	0.33%
Employment Fund	150,827,546	0.14%
TOTAL	107,306,873,131	100.00%

Articles 11, 12, and 13 of the Law of Ukraine "On the budget system of Ukraine", No. 253/95-BP of 29 June 1995 (effective 1 January 1996) describe, respectively, how State, Oblast, Raion and City budgets are formed; i.e., what portion of each particular tax is allocated to the State, Oblast, City and Raion budgets. According to this law, some of the allocations of taxes to the State and the Oblast are set out in the budget law for the relevant year. The current allocations are set out in the Law "On the State Budget of Ukraine in 1995".

This law also describes the two types of taxes which form the City budget: "fixed" taxes, whose allocations to the City are determined by the State, and set out in the law, itself, and "regulated" taxes, whose allocations to the City are set by the Oblast (i.e. the State delegates authority to the Oblast to set the allocations). In 1995, 28% of City budget revenues came from "fixed" taxes and 72% from "regulated" taxes. Only 6% of total City budget revenues came from locally-controlled taxes.

[3] The amounts of each tax paid are based on the financial statement of the L'viv Water and Wastewater Enterprise, kindly provided by the World Bank Consultants.

Through the end of 1995, tax allocations among the budgets of different levels of government, and some current tax rates, were set out in the Law "On the budget system of the Ukrainian SSR" No. 512-12 of 5 December 1990 and differed from those set in the Law "On the budget system of Ukraine".

According to the Law "On the budget system of the Ukrainian SSR", which was in effect through 31 December 1995, and the Law of Ukraine "On the State Budget of Ukraine in 1995", the distribution of the major taxes paid by a State enterprise in 1995 was as follows:

	Allocation			
Category of Taxes	State	Oblast	City	Enterprise
VAT	6.1%	49.6%	44.3%	0.0%
Land Tax	30.0%	0.0%	70.0%	0.0%
Innovation Tax	0.0%	30.0%	0.0%	70.0%
Road Tax	0.0%	100.0%	0.0%	0.0%
Geological Exploration Tax	0.0%	0.0%	100.0%	0.0%
Pension Fund	0.0%	100.0%	0.0%	0.0%
Profit Tax	30.0%	30.0%	40.0%	0.0%
Labor Protection Tax	0.0%	40.0%	0.0%	60.0%
Chernobyl Tax	100.0%	0.0%	0.0%	0.0%
Communal Tax	0.0%	0.0%	100.0%	0.0%
Social Insurance Fund	0.0%	100.0%	0.0%	0.0%
Transportation Tax	0.0%	0.0%	100.0% (Raion)	0.0%
Employment Fund	0.0%	100.0%	0.0%	0.0%
TOTAL	17.0%	34.58%	47.42%	100%

Appendix 4: Banking statistics

Assets
01.01.2001.

In thousand HRV

				Bank assets		Securities					
	Total assets	Monetary assets	NBU resources	corresp accounts	deposits and credits	State securities	Other securities	Investment	Credit portfolio	Capital assets	Other assets
				Group 1. Largest banks							
Prominvest	3376995	126637	370170	322464	45391	0	6725	15537	2028885	442857	18330
Aval'	3233055	189486	1146887	83261	366699	98830	18634	7118	1085893	160761	75486
Privatbank	3129860	117870	283333	147388	463859	0	165646	4752	1610509	123476	213026
Ukreksimbank	2286688	44607	131366	361133	40665	6151	4154	5784	1013970	173872	504985
Oshadbank	2118852	82149	319941	245278	150682	154190	106639	23828	538958	301715	195472
Ukraina	1961823	46042	11	19238	20140	156748	80142	22045	1086251	492095	39111
Ukrsocbank	1705932	63863	111514	243237	136554	40675	22186	383	836724	216124	34673
PershijUMB	1265057	18503	130856	107109	227836	44977	559	2582	611316	108919	12400
Total	**19078262**	**680157**	**2494078**	**1529108**	**1451826**	**501571**	**404685**	**82029**	**8812506**	**2019819**	**1093483**
				Group 2. Assests more than 100 million HRV			total 52 banks, presented 27banks)				
Ukrsibbank	842522	9118	55883	24285	90361	0	51556	5580	554588	45841	5310
Brokbisnesbank	705742	5276	52277	120534	71133	0	83920	203	273510	50747	48142
Nadra	635847	14763	49021	50875	58163	49875	1957	1414	378266	15345	16168
Praveksbank	556748	23078	65669	15205	187716	651	130	3629	205428	43569	11673
Fin ta kredit	439892	14516	23479	54227	20362	0	12107	3260	235975	17476	58490
KrediLione Ukr	365341	2645	68161	8711	66375	0	95	0	211728	5866	1760
Vabank	333380	8978	24606	46619	41724	0	18863	13	153937	10231	28407
Mtbank	320551	5601	27437	68441	12489	68	473	50	177422	25858	2711
Ukrinbank	257621	17525	42985	24766	3655	6	4620	310	104815	54881	4057
Mriya	238505	6835	24464	4530	30327	0	6232	0	148248	13245	4623

Megabank	225455	3949	35290	106511	14680	0	1254	6335	44536	9932	2969
Ukrgazprombank	215013	550	16589	19619	125443	0	515	1070	46795	2428	2005
Zevs	214449	3456	28312	57613	2955	0	20491	2077	78511	16514	4519
Donmisbank	212782	694	11047	436	15385	0	2224	1301	169096	12412	186
Kuiv	204463	4469	12768	17000	2053	0	783	1616	144292	14571	6911
Ekspresbank	187868	6614	27055	42031	33693	0	6	0	64884	12620	966
Inko	160897	0	209	9203	9158	0	115	5534	127931	2020	6726
Promfinbank	154385	2487	3989	20346	16801	0	16099	75	85909	7670	1009
Real bank	141034	1556	15546	78919	16189	0	8646	0	17072	2151	954
Poltavabank	124201	3884	6358	4722	0	0	4223	2382	42708	11572	48352
Slovjanskij	119706	20	53	142	0	0	59708	185	40992	5324	13281
Nacionkredit	112518	6654	28698	5599	0	0	0	3	67740	3595	230
Kuivska Rus'	111892	5300	7879	5075	20141	0	2764	35	61756	5545	3396
Dnister	104089	1550	5910	3501	18032	0	1068	0	68135	5563	329
Metalyrg	103923	5130	9442	8662	0	2012	836	9	70594	6349	889
Sosiete Zhen Ukr	103262	0	46170	31660	22104	0	10	0	453	2242	440
				Group 3. Assets more than 50 mln. Hrv (total 44 banks presented 18 banks)							
Kuiv InvestBank	95873	2447	19515	12788	19438	0	15218	0	18009	5843	2615
Allonzh	92762	258	665	1347	18710	0	11552	3	49929	773	9526
Legbank	91241	3789	14766	2515	8380	0	2194	0	52770	3346	3480
Polikombank	87064	1205	11607	1399	12347	0	2651	7	43935	12261	1652
Bazis	84642	782	18642	17095	9293	0	2374	11	23691	8994	3760
Interbank	81454	754	3977	2961	29514	0	281	0	18636	1252	24079
Promekonbank	79478	809	2076	11413	22920	0	63	0	38122	1335	2739
Person Komp	78735	1087	4276	9533	1212	0	92	0	22083	22674	17777
Integral	73247	1736	4145	9602	17800	0	1910	52	35889	1791	322
Prikarpattya	68936	2355	10128	9717	7657	0	123	1	30007	8535	414
TK Kredit	67164	1232	4257	5092	8956	0	9026	0	36571	1678	351
Grant	65974	2175	7231	4072	5000	0	106	555	36217	10135	484
Olbank	64725	395	5872	21812	0	0	9380	114	24198	2006	950

Transbank	63184	1768	13097	2138	13612	0	218	0	28683	3382	286
Starokuivskuj	60269	3787	6764	2765	7851	1128	85	0	29947	3379	4564
Ukrainskuj kapital	57782	1369	9396	9705	5986	0	4	0	23402	7267	653
Prichornomorja	56837	1852	3764	1356	3977	0	162	0	44506	640	580
Kliringovuj Dim	55617	214	6055	1796	6350	0	10142	105	18616	2250	10089
				Group 4.Assets less than 50 mln.Hrv (total 50 banks,presented 23)							
Zoloti Vorota	47046	292	1243	2330	1100	0	0	0	40806	1140	135
ZemKapital	46643	1723	9738	4586	0	1858	3356	12	22659	895	1816
CreditSwisFBUkr	45024	0	102	3064	0	0	32260	0	0	1212	8386
KuivNarodBank	41983	996	686	972	15103	64	82	0	10763	10487	2830
ChornBankRtR	40506	629	3009	4132	2500	0	6840	54	6469	1190	15684
Garant	37340	1069	1781	252	4259	0	5444	330	19007	3975	1223
Slavutich	36655	523	2202	4882	13757	0	0	0	11013	1381	2897
Investbank	36093	588	1987	1159	3767	6	0	0	24226	2336	2025
Tehnobank	33261	361	579	2796	0	0	0	0	28598	851	76
L'viv	31932	644	981	706	5500	0	461	0	12351	11184	106
Morskij	31913	1260	1043	128	0	0	23	0	22415	6850	195
Aksi-Bank	30010	537	16033	1	0	0	70	10	2987	2808	7564
Ukoopspilka	28270	1570	6065	1287	3504	0	772	66	13580	1026	401
Radabank	21947	196	1411	2894	0	0	5058	0	11980	396	14
Finbank	21692	432	1235	547	2900	0	0	0	15569	250	760
OdessaBank	21380	1329	3689	83	2650	0	0	0	12566	833	230
Evropejskij	20768	2896	217	120	501	0	3497	156	12241	789	351
Al'yans	19416	763	3221	494	0	0	0	2	14609	281	47
KoralBank	18902	116	253	0	3000	0	0	0	14370	800	364
Bukovina	16763	52	2837	0	1490	22	0	0	10027	2300	37
Stolichnuy	14502	44	588	0	2450	0	1353	0	9636	411	20
Klasik	12638	259	1927	11	0	0	2185	0	6543	300	1413
FermZemBank	12592	10	1227	0	5048	0	0	0	5873	424	10

Liabilities
01.01.2001.

		Indebted to		Bank indebtedness		Client indebtedness			
	Total liabilities	Budgetary est	NBU	Bal on corr ac	Cred&dep	Legal pers	Physic pers	Own securities	Other liabilit
Prominvest	2651204	93119	7305	7503	10980	1645064	681909	118742	86583
Aval'	3057019	688648	20521	12188	66818	1667895	482291	63156	55503
Privatbank	2854301	7317	35128	71316	185739	794089	794303	107273	859136
Ukreksimbank	2005908	37343	658653	6650	176969	774068	267613	1500	83110
Oshadbank	1969268	13698	69351	437	92749	218240	1325986	8376	240430
Ukraina	1752465	103779	577988	4819	143438	404167	403401	2257	112616
Ukrsocbank	1372603	194253	9743	1652	90803	806767	244373	1669	23344
PershijUMB	969186	225	0	3676	263462	515958	148199	5363	32303
Total	**16631954**	**1138382**	**1378689**	**108241**	**1030958**	**6826248**	**4348075**	**308336**	**1493025**
Ukrsibbank	693143	4317	0	13856	114279	219825	101410	18218	222237
Brokbisnesbank	643508	5739	0	90225	95665	247905	51362	0	152611
Nadra	545659	12318	65442	14930	28136	106497	106976	88441	122918
Praveksbank	476942	5811	0	12	93456	131464	170782	1738	73680
Fin ta kredit	400300	5491	518	41102	27678	134180	150470	19962	20898
KrediLione Ukr	337249	0	0	163	106532	223475	2438	0	4641
Vabank	269083	871	53984	463	6100	109590	68289	10270	19516
Mtbank	216258	0	0	0	0	198086	12126	0	6046
Ukrinbank	241454	1374	0	1343	8933	109493	102987	0	17326
Mriya	206551	0	0	2568	52467	59933	59790	3367	28426
Megabank	182000	13512	0	0	0	156506	3162	0	8821
Ukrgazprombank	172361	0	0	147	71114	75904	15898	211	9087
Zevs	164194	0	0	1246	29752	77263	15728	32815	7389
Donmisbank	120490	455	0	1223	86562	27870	2042	0	2338
Kuiv	155724	7854	0	15165	3103	96617	20424	0	12562
Ekspresbank	137971	251	0	0	17506	107389	5478	0	7347
Inko	215346	0	0	0	19341	2	1274	0	194729
Promfinbank	122540	0	0	16311	17487	53700	15402	340	19300

Real bank	115949	0	0	3557	84218	12272	15295	0	606
Poltavabank	97503	1345	0	0	0	45300	45359	838	4661
Slovjanskij	212813	0	0	6336	4313	14058	91968	516	95622
Nacionkredit	90758	0	0	0	2310	64171	16376	0	7928
Kuivska Rus'	92261	0	0	0	11329	52782	20485	2076	5589
Dnister	85255	3957	0	2717	22401	14020	29567	3862	8731
Metalyrg	48559	0	0	8	0	21646	25649	0	1256
Sosiete Zhen Ukr	63573	0	0	61	0	59997	0	0	3516
Kuiv InvestBank	51128	0	0	7011	0	25675	5110	12408	924
Allonzh	48784	0	0	0	34981	8160	0	3454	2189
Legbank	80032	0	0	0	6524	34481	20475	1898	16655
Polikombank	58554	17797	0	0	5272	21956	13070	125	333
Bazis	69363	0	0	0	0	61728	799	18	6818
Interbank	55345	0	0	1	23142	14513	10111	7097	482
Promekonbank	56350	0	0	11296	17258	2346	6397	13225	5829
Person Komp	49853	0	0	120	10200	12022	26771	0	740
Integral	47651	0	0	10078	0	26977	9960	0	636
Prikarpattya	48101	24	0	0	7000	10716	28881	0	1480
TK Kredit	40238	0	0	0	9035	25904	5171	0	128
Grant	41553	1515	0	0	5000	19789	12489	1894	866
Olbank	44952	0	0	9	0	34757	8831	0	1356
Transbank	31649	2004	0	0	5435	19490	3530	0	1191
Starokuivskuj	47313	0	0	0	0	33182	12745	0	1386
Ukrainskuj kapital	39593	0	0	4112	500	26785	1763	0	6432
Prichornomorja	38593	0	0	6	3002	7609	15192	3381	9273
Kliringovuj Dim	30434	0	0	850	3014	18597	857	6650	467
Zoloti Vorota	26230	0	0	4652	6259	5459	8489	65	1307
ZemKapital	33915	17483	0	1003	0	4918	3603	0	6907
CreditSwisFBUkr	96	0	0	0	0	0	0	0	96
KuivNarodBank	15376	0	0	308	7000	6696	778	0	594
ChornBankRtR	23024	1237	0	0	9028	5822	224	11	6703

Garant	21646	0	0	0	9282	6421	5744	0	199
Slavutich	20729	0	0	0	4519	6652	2426	0	7132
Investbank	21360	0	0	0	3750	10012	3143	0	4455
Tehnobank	21576	0	0	2700	0	6920	3394	0	8562
L'viv	14840	1	0	0	5750	3746	4930	0	412
Morskij	9185	0	0	26	0	5891	2505	544	219
Aksi-Bank	18975	0	0	0	1700	6261	5	0	11009
Ukoopspilka	19814	0	0	0	0	12783	3629	0	3402
Radabank	7320	311	0	2700	0	1504	274	0	2531
Finbank	6251	0	0	0	2900	3184	1	0	166
OdessaBank	5690	0	0	0	2650	2807	108	0	124
Evropejskij	3237	0	0	0	600	1063	979	0	594
Al'yans	4393	0	0	0	0	3964	199	0	230
KoralBank	5608	0	0	0	3500	1220	0	0	888
Bukovina	7018	0	0	0	1000	1158	0	0	4861
Stolichnuy	7368	0	0	0	2500	1134	0	0	3734
Klasik	2527	0	0	0	0	1753	0	0	3019
FermZemBank	4772	0	0	0	0	1753	0	0	3019

Capital Thous HRV
01/01/2001

	Balance capital (total)	Statutory capital	Reserve funds	Prev years rests	Current year results	Other capital
Prominvest	725790	200113	37290	355628	58946	73814
Aval'	176035	104000	3880	56687	3641	7828
Privatbank	275559	140000	31414	48858	29430	25857
Ukreksimbank	280780	108000	27000	83604	32675	29501
Oshadbank	149583	100000	9197	33206	-26994	34174
Ukraina	209358	68895	15403	2952	-97152	219259
Ukrsocbank	333329	48522	14733	235998	4840	29238
PershijUMB	295871	112869	5411	121348	15912	40332
Total	**2446305**	**882399**	**144328**	**938281**	**21298**	**460003**
Ukrsibbank	148379	90000	3566	29129	7424	18260
Brokbisnesbank	62235	16826	2422	22250	5359	15378
Nadra	90188	50449	2940	22033	14363	403
Praveksbank	79806	60672	1818	9048	7881	386

Fin ta kredit	39592	20000	1400	13445	4748	0
KrediLione Ukr	28092	22261	2072	3328	430	0
Vabank	64297	40696	7502	8069	8030	0
Mtbank	104293	50150	23995	14552	15596	0
Ukrinbank	16167	19207	5000	-8390	-23135	23485
Mriya	31954	13565	3253	5498	8681	656
Megabank	43454	26392	960	11485	4593	25
Ukrgazprombank	42652	18200	1452	10143	12857	0
Zevs	50256	30168	5751	6290	7958	88
Donmisbank	92292	58132	4269	748	29143	0
Kuiv	48739	29404	6123	0	12918	293
Ekspresbank	49987	27621	1369	6190	14707	10
Inko	-54449	995	4596	-64756	10	4706
Promfinbank	31845	28209	747	0	2888	0
Real bank	25084	17602	1814	4353	1259	56
Poltavabank	26698	13112	268	3406	2769	7144
Slovjanskij	-93107	22500	6682	202891	-325441	261
Nacionkredit	21733	9964	572	3959	7239	0
Kuivska Rus'	19631	13030	2209	1559	672	2160
Dnister	18835	16657	47	902	1228	0
Metalyrg	55364	9611	2906	33645	8542	660
Sosiete Zhen Ukr	39688	23311	3254	7943	5180	0
Kuiv InvestBank	44745	44494	183	29	35	4
Allonzh	43978	43001	339	158	480	0
Legbank	11209	8000	500	2374	182	153
Polikombank	28510	12678	1386	2766	732	10947
Bazis	15279	7500	3781	1115	2802	81
Interbank	26109	22624	304	2391	403	386
Promekonbank	23128	20179	606	98	2244	0
Person Komp	28882	15000	2150	4083	552	7098
Integral	25595	22414	360	2614	207	0
Prikarpattya	20835	16000	295	889	1035	2616
TK Kredit	26925	21834	235	1841	3015	0
Grant	24421	9007	2893	4124	1095	7302

Olbank	19773	9174	642	9357	601	0
Transbank	31535	20135	2941	4439	3981	102
Starokuivskuj	12956	5603	1363	620	2809	2562
Ukrainskuj kapital	18189	14285	352	229	694	2629
Prichomomorja	18374	14667	1124	519	2048	16
Kliringovuj Dim	25183	24130	322	31	700	0
Zoloti Vorota	20871	19800	218	637	160	1
ZemKapital	12727	8150	432	1921	2224	1
CreditSwisFBUkr	44928	28275	958	15745	-49	0
KuivNarodBank	26607	20321	1920	266	157	3942
ChornBankRtR	17481	15332	164	1916	70	0
Garant	15694	12000	248	2253	87	1107
Slavutich	15926	13177	1806	715	228	0
Investbank	14733	12388	790	914	641	1
Tehnobank	11684	11026	212	241	174	31
L'viv	17092	7449	201	1213	302	7928
Morskij	22728	14852	265	1225	803	5583
Aksi-Bank	11035	9000	342	283	6	1404
Ukoopspilka	8457	8879	439	1744	-2606	0
Radabank	14627	13550	877	168	33	0
Finbank	15441	14547	318	360	216	0
OdessaBank	15690	15000	374	297	9	11
Evropejskij	17531	15307	326	1689	209	0
Al'yans	15023	14183	118	192	529	1
KoralBank	13294	7959	248	4437	83	567
Bukovina	9745	7500	1694	0	551	0
Stolichnuy	7134	6268	248	168	444	5
Klasik	10111	9404	372	334	1	0
FermZemBank	7820	7356	100	321	43	1

Return on assets

Thousan.

	Assets(01.01.2001)	Assets 01.07.2001	Average	net income 01 07.2001	Return on assets	ROA (%)
Prominvest	3376995	4008594	3692794,5	14201	0,384559715	0,77
Aval'	3233055	3903839	3568447	5458	0,001529517	0,31
Privatbank	3129860	4013939	3571899,5	15199	0,004255159	0,85
Ukreksimbank	2286688	2814342	2550515	4650	0,001823161	0,36
Oshadbank	2118852	2729108	2423980	835	3,44475E-04	0,07
Ukraina	1961823	1963411	1962617	-60933	-0,031046811	-6,21
Ukrsocbank	1705932	2173511	1939721,5	307	1,58270E-04	0,03
PershijUMB	1265057	1381554	1323305,5	20940	0,01582401	3,16
Total	**19078262**	**22988298**	21033280	**657**		
Ukrsibbank	842522	1090156	966339	4890	0,005060336	1,01
Brokbisnesbank	705742	860582	783162	722	9,21904E-04	0,18
Nadra	635847	831118	733482,5	3360	0,004580886	0,92
Praveksbank	556748	623571	590159,5	7021	0,011896784	2,38
Fin ta kredit	439892	574525	507208,5	4517	0,008905608	1,78
KrediLione Ukr	365341	332362	348851,5	817	0,002341971	0,47
Vabank	333380	396603	364991,5	1076	0,002948014	0,59
Mtbank	320551	347928	334239,5	15257	0,045646909	9,13
Ukrinbank	257621	342575	300098	1104	0,003678798	0,74
Mriya	238505	287910	263207,5	5813	0,022085237	4,42
Megabank	225455	213666	219560,5	780	0,003552552	0,71
Ukrgazprombank	215013	272374	243693,5	6079	0,024945269	4,99
Zevs	214449		214449	no data	no data	no data
Donmisbank	212782	276975	244878,5	18421	0,075225061	15,05
Kuiv	204463	274364	239413,5	428	0,001787702	0,36
Ekspresbank	187868	230994	209431	12522	0,059790575	11,96
Inko	160897	154196	157546,5	11	6,98207E-05	0,01
Promfinbank	154385	190504	172444,5	3276	0,018997417	3,80
Real bank	141034	150551	145792,5	811	0,0055627	1,11
Poltavabank	124201	178310	151255,5	2264	0,014968051	2,99

Slovjanskij	119706		119706	no data	no data	no data
Nacionkredit	112518	144461	128489,5	4299	0,033457987	6,69
Kuivska Rus'	111892	210838	161365	233	0,001443931	0,29
Dnister	104089	173402	138745,5	1231	0,00887236	1,77
Metalyrg	103923	151443	127683	3970	0,031092628	6,22
Sosiete Zhen Ukr	103262	27928	65595	-599	-0,009131794	-1,83
Kuiv InvestBank	95873		95873	no data	no data	no data
Allonzh	92762	129391	111076,5	2	1,80056E-05	0,00
Legbank	91241	115208	103224,5	16	1,55002E-04	0,03
Polikombank	87064	113338	100201	163	0,00162673	0,33
Bazis	84642	108480	96561	663	0,006866126	1,37
Interbank	81454	81348	81401	199	0,002444687	0,49
Promekonbank	79478	117144	98311	6	6,10308E-05	0,01
Person Komp	78735	83141	80938	353	0,004361363	0,87
Integral	73247	92399	82823	396	0,004781281	0,96
Prikarpattya	68936	71350	70143	284	0,004048872	0,81
TK Kredit	67164	96405	81784,5	745	0,009109306	1,82
Grant	65974	79429	72701,5	156	0,00214576	0,43
Olbank	64725	75268	69996,5	87	0,001242919	0,25
Transbank	63184	73239	68211,5	1915	0,028074445	5,61
Starokuivskuj	60269	54014	57141,5	2423	0,042403507	8,48
Ukrainskuj kapital	57782	61760	59771	836	0,013986716	2,80
Prichornomorja	56837	65340	61088,5	720	0,011786179	2,36
Kliringovuj Dim	55617	56672	56144,5	210	0,003740349	0,75
Zoloti Vorota	47046	53428	50237	100	0,001990565	0,40
ZemKapital	46643	50510	48576,5	494	0,010169526	2,03
CreditSwisFBUkr	45024	42187	43605,5	-2745	-0,062950775	-12,59
KuivNarodBank	41983	52161	47072	128	0,002719239	0,54
ChornBankRtR	40506	49583	45044,5	117	0,002597431	0,52
Garant	37340	40303	38821,5	48	0,001236428	0,25
Slavutich	36655	54269	45462	157	0,003453434	0,69

Investbank	36093	44152	40122,5	122	0,003040688	0,61
Tehnobank	33261	55991	44626	77	0,001725452	0,35
L'viv	31932	41912	36922	398	0,010779481	2,16
Morskij	31913	43219	37566	770	0,020497258	4,10
Aksi-Bank	30010	36931	33470,5	114	0,003405984	0,68
Ukoopspilka	28270	29987	29128,5	925	0,03175584	6,35
Radabank	21947	25519	23733	56	0,002359584	0,47
Finbank	21692	28333	25012,5	242	0,009675162	1,94
OdessaBank	21380	28068	24724	91	0,003680634	0,74
Evropejskij	20768	26189	23478,5	120	0,005111059	1,02
Al'yans	19416	24215	21815,5	341	0,015631088	3,13
KoralBank	18902	24395	21648,5	48	0,002217244	0,44
Bukovina	16763	24558	20660,5	683	0,033058251	6,61
Stolichnuy	14502	17361	15931,5	27	0,001694756	0,34
Klasik	12638	16631	14634,5	1	6,83317E-05	0,01
FermZemBank	12592	10007	11299,5	-920	-0,081419532	-16,28

Return on Equity 01.07 2001

ROE (%)

	Bal cap (total)01.01.2001	Bal cap 01.07 2001	Average	net income 01 07.2001	Return on Equity
Prominvest	725790	705919	715854,5	14201	3,97
Aval'	176035	237240	206637,5	5458	5,28
Privatbank	275559	290758	283158,5	15199	10,74
Ukreksimbank	280780	285430	283105	4650	3,29
Oshadbank	149583	237551	193567	835	0,86
Ukraina	209358	147197	178277,5	-60933	-68,36
Ukrsocbank	333329	333458	333393,5	307	0,18
PershijUMB	295871	316811	306341	20940	13,67
Total	**2446305**	2554364	2500334,5	**657**	
Ukrsibbank	148379	152796	150587,5	4890	6,49
Brokbisnesbank	62235	61361	61798	722	2,34
Nadra	90188	93463	91825,5	3360	7,32
Praveksbank	79806	86557	83181,5	7021	16,88
Fin ta kredit	39592	44110	41851	4517	21,59
KrediLione Ukr	28092	28908	28500	817	5,73
Vabank	64297	65368	64832,5	1076	3,32
Mtbank	104293	116668	110480,5	15257	27,62
Ukrinbank	16167	7946	12056,5	1104	18,31
Mriya	31954	32698	32326	5813	35,96
Megabank	43454	44422	43938	780	3,55
Ukrgazprombank	42652	46715	44683,5	6079	27,21
Zevs	50256	n/a	50256	no data	no data
Donmisbank	92292	110638	101465	18421	36,31
Kuiv	48739	n/aa	48739	428	1,76
Ekspresbank	49987	62457	56222	12522	44,54
Inko	-54449	54446	-1,5	11	-1466,67
Promfinbank	31845	35121	33483	3276	19,57
Real bank	25084	25937	25510,5	811	6,36
Poltavabank	26698	29392	28045	2264	16,15
Slovjanskij	-93107	n/a	-93107	no data	no data
Nacionkredit	21733	24219	22976	4299	37,42

Kuivska Rus'	19631	22864	21247,5	233	2,19
Dnister	18835	25409	22122	1231	11,13
Metalyrg	55364	61132	58248	3970	13,63
Sosiete Zhen Ukr	39688	26225	32956,5	-599	-3,64
Kuiv InvestBank	44745	n/a	44745	no data	no data
Allonzh	43978	43980	43979	2	0,01
Legbank	11209	21392	16300,5	16	0,20
Polikombank	28510	28407	28458,5	163	1,15
Bazis	15279	15942	15610,5	663	8,49
Interbank	26109	26351	26230	199	1,52
Promekonbank	23128	24036	23582	6	0,05
Person Komp	28882	29235	29058,5	353	2,43
Integral	25595	28074	26834,5	396	2,95
Prikarpattya	20835	12056	16445,5	284	3,45
TK Kredit	26925	26995	26960	745	5,53
Grant	24421	24577	24499	156	1,27
Olbank	19773	19860	19816,5	87	0,88
Transbank	31535	30976	31255,5	1915	12,25
Starokuivskuj	12956	15199	14077,5	2423	34,42
Ukrainskuj kapital	18189	18454	18321,5	836	9,13
Prichornomorja	18374	19094	18734	720	7,69
Kliringovuj Dim	25183	30943	28063	210	1,50
Zoloti Vorota	20871	23609	22240	100	0,90
ZemKapital	12727	13249	12988	494	7,61
CreditSwisFBUkr	44928	42183	43555,5	-2745	-12,60
KuivNarodBank	26607	26735	26671	128	0,96
ChornBankRtR	17481	17598	17539,5	117	1,33
Garant	15694	15742	15718	48	0,61
Slavutich	15926	15854	15890	157	1,98
Investbank	14733	14838	14785,5	122	1,65

Tehnobank	11684	20760	16222	77	0,95
L'viv	17092	17075	17083,5	398	4,66
Morskij	22728	23498	23113	770	6,66
Aksi-Bank	11035	25745	18390	114	1,24
Ukoopspilka	8457	9382	8919,5	925	20,74
Radabank	14627	15933	15280	56	0,73
Finbank	15441	16077	15759	242	3,07
OdessaBank	15690	15782	15736	91	1,16
Evropejskij	17531	18078	17804,5	120	1,35
Al'yans	15023	15754	15388,5	341	4,43
KoralBank	13294	13342	13318	48	0,72
Bukovina	9745	10428	10086,5	683	13,54
Stolichnuy	7134	7160	7147	27	0,76
Klasik	10111	12390	11250,5	1	0,02
FermZemBank	7820	6900	7360	-920	-25,00