

# RESOURCE POLICY OF BANKS WITH FOREIGN CAPITAL IN UKRAINE: PECULIARITIES AND PRIORITIES

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**Abstract.** *The goal of the research was to reveal the characteristic features of resource policy in banks with foreign capital during the period of the Ukrainian banking sector post-crisis recovery. Modern changes of the banking system's structure are described. The reasons for foreign capital outflow and foreign banks' withdrawal from the market are identified. The peculiarities and distinctions of resource policy implementation by Ukrainian and foreign banks are investigated. Changes of resource policy riskiness in the post-crisis period are estimated by using the loan-to-deposit ratio. The mechanisms of risk reduction are recommended.*

**Key words:** *bank, resource policy, deposit, loan, foreign capital*

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## Introduction

One of the important issues of the banking sector functioning in Ukraine over the last decade was the impact of foreign capital on the banking system. By 2005 the activities of banks with foreign capital in Ukraine had been characterized as being weak, which can be explained by the unstable economic and political situation, as well as low investment attractiveness of Ukrainian banks. Active entry of foreign banks into Ukrainian market, which started in 2005–2006, led to a rapid increase in the share of assets controlled by foreigners. Equity multiplier for most sales transactions of Ukrainian banks with foreign owners ranged within 3.7–6.4. Retail loans in 2005–2008 in Ukraine were increasing by 30–50% per year, and their profitability was much higher than in the EU: 10–16% against 3–4% in the EU. Therefore, the opportunity to receive extremely high revenues stimulated the European banking groups to actively enter the banking market of Ukraine and invest significant resources into their subsidiaries (such investments in the early 2009 accounted for about 40 billion euros). 2005–2008 saw that virtually none of the major foreign banks that came to the Ukrainian market had applied the strategy of buying a small bank and its further developing in order to transform it into a powerful

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financial institution. Foreign banks were interested in gaining control over banks owning a more or less significant share of the market and having an extensive network of branches.

During the crisis, the inflow of the foreign capital stopped, and in 2010–2013 the situation changed due to the gradual withdrawal of foreigners from the banking sector and changes in individual banks' ownership.

The financial crisis of 2008–2009 and the hard post-crisis recovery of the banking sector in Ukraine make it necessary to view the banks with foreign capital and their role in the market differently. Exit of foreign banks is a rare phenomenon in the world practice. To determine the reasons for this phenomenon, it is necessary to evaluate the main problems of banks in the post-crisis period, especially in the area of financial resources management and resource policy implementation.

Studies of the formation and implementation of bank resource policy make it possible to state that financial resources, are the main type of bank resources and due to their effective use banks can successfully implement their competitive strategy. Accordingly, bank resource policy is seen as a process associated not only with the formation of financial resources, but also with their use.

In the previous works (Рисін, 2012), the author substantiates the determination of bank resource policy as the measures taken by the bank to identify the most effective ways of forming and expanding its resource base, its optimal size and structure, placing the banking resources, balancing the processes of the formation and use of resources, and preventing money laundering.

Based on this interpretation, we will try to identify the peculiarities of the Ukrainian banks' resource policy and to characterize the differences in the policy implementation by banks with foreign capital in order to determine the reasons for reducing their activity in the Ukrainian banking market.

An effective research at the banking sector level is related with the application of various methods: a structural-functional comparison for evaluating the banking system's structure and foreign capital influence; statistical, analysis and synthesis methods for the description of banks' resource policy priorities; the ratio methods for assessing the riskiness of the banks' resource policy. The research is based on the official data of the National bank of Ukraine.

## **The modern structure of the Ukrainian banking system**

A structural analysis of the Ukrainian banking system shows a very uneven distribution of banks in the regions of the country. The vast majority of banks are concentrated in the Kyiv region, as well as in Dnipropetrovsk, Kharkiv, Donetsk, Odessa and Lviv (Table 1). At the end of 2012, only 16 banks operated in the other regions of the state; moreover,

11 regions did not have legally independent banks on their territory. This fact may be explained by the location of industrial potential, but its negative effect is actually the “washout” of resources from one district to benefit the others.

TABLE 1. Regional structure of the Ukrainian banking system in 2005–2012

	2005	2006	2007	2008	2009	2010	2011	2012
Number of banks, inc.	165	170	175	184	182	175	175	175
Kyiv and Kyiv region	97	100	105	112	113	110	114	115
Dnipropetrovsk region	11	13	14	14	13	13	13	14
Kharkiv region	12	12	11	11	10	9	9	7
Donetsk region	10	10	10	11	11	11	10	10
Odessa region	10	10	10	10	9	9	8	8
Lviv region	5	5	5	5	5	4	5	5
Other regions	20	20	20	21	21	19	16	16
Number of bank branches, inc.	1443	1413	1362	1308	1091	741	455	242
State banks	465	450	435	424	404	294	156	54
Private banks	978	963	927	884	688	447	299	188

Source: Національний банк України, 2013а.

Another trend that should be noted is the reduction in the number of bank branches in the recent years. The total number of branches from 2005 to 2012 reduced almost 6 times. This process is typical of both state and private banks. State banks, which in 2005–2008 included the Ukreximbank and the OshchadBank, and in 2009 were joined by three more banks nationalized by the government, had reduced their network more slowly by 2010.

However, during the following years, a sharp decrease in the number of branches started, which was caused by the state banks structure optimization and the reduction of administrative and economic costs; during three years, the number of banks branches decreased from 404 to 54. However, these processes didn't influence significantly the number of banks' staff, because a large-scale elimination of subsidiaries was a result of decision-making centralization in state-owned banks for which balance institutions were totally changed into non-balance ones. The OshchadBank in this context is a good example.

The process of private banks' branch network reduction contains elements of both institution consolidation and institution elimination, followed by staff lay-offs. The number of private banks' branches reduced from 884 to 188 in 2009–2012, and the average number of employees from 239.3 to 175.8 thousand. In general, it could be argued that in post-crisis period the vast majority of banks have optimized their network in order to reduce costs. This resulted in a sharp decrease in the number of bank branches.

## **The role of foreign capital in the banking sector**

Before the crisis, a lot of researchers believed that the benefits of foreign capital far outweighed the disadvantages (Claessens, 2001; Goldberg, 2004; 2002; Volz, 2004; Dabrowska, 2001, Levine, 1999). Foreign banks were considered to promote the competition and financial stability, facilitate access to loan resources and promote effectiveness of their borrowers (Смовженко, 2008). Active expansion of foreign banks in Ukraine, especially of Western European ones, started in 2005. The first of large Western banks investing in the Ukrainian banking sector was the Swedish financial group SEB and Austrian Raiffeisen Int., followed by the French BNP Paribas and Credit Agricole SA. The process grew rapidly up to the crisis in 2008 when the entire Ukrainian banking system felt serious liquidity problems due to the excessively risky banks policy in the previous years. The general decline in the living standard, loss of income by business entities, the crisis of confidence to banks due to deposit non-returns and often due to fraudulent actions of some institutions' management, as well as the spread of financial instability from abroad adversely influenced the results of operations of most banks with foreign capital in Ukraine. On top of it, this process was intensified by financial difficulties of the parent companies. It especially concerns West European banking groups.

In 2012–2013, the process of active outflow of foreign capital from the Ukrainian banking sector has started. According to the data of the National bank of Ukraine, the share of foreign capital in the authorized capital of the banking system declined from 41.9% in the early 2012 to 34% by 1 August 2013 (Hrebenuk, 2012). In July 2013, 31.6% of assets of the banking system of Ukraine were under the control of banks with foreign capital. The investors came from:

- Russian Federation – 11.6%;
- Austria – 9.3%;
- France – 3.4%;
- Cyprus – 1.8%;
- other EU countries – 4.4%;
- non EU Countries – 1% (Рисін, 2013).

Investigation of changes in the ownership revealed a tendency of leaving the Ukrainian market by Western European banks; this primarily concerns the German, Austrian, and Swedish banks. The share of assets controlled by German investors after the Commerzbank Group had sold the bank “Forum” decreased to 0.4%. The reasons for this phenomenon are the banks' negative financial results in 2010–2012, problems in the parent companies as a result of the financial crisis, and the high level of political risk as well as unacceptable conditions of doing business in Ukraine for banks from developed countries. In future, we expect a further decline of „real“ investments of European

banks and exit of these institutions from the market. In addition, this will be facilitated by the fact that some banks operating in Ukraine formally have the status of banks with foreign capital. However, it is a well known fact that their real owners are Ukrainian business groups which register their property through false companies in countries with a simplified tax regime trying to optimize taxes or to hide the real owner. In the recent years, Cyprus, Austria, Liechtenstein, etc. were popular places for such operations. With the emergence of problems in Cyprus, part of the owners had to shift to other offshore zones or to transfer their banks under possession of the controlled Ukrainian companies. Therefore, the actual share of the banking sector assets controlled by Western European banking groups is likely to be lower than the calculated figure.

The increasing role in the market of banks controlled by Russian investors should be noted. As of 01.07.2013, four banks (Prominvestbank, Sberbank, Alfa Bank and VTB Bank), by the classification of the National bank of Ukraine, belonged to the group of the largest banks. After acquisition of the Volksbank by the Sberbank of Russia, Russian owners controlled about 11.6% of the banking sector assets. Besides, there are all grounds for extending such expansion, because there regularly appears information about the plans to sell other banks controlled by Western European owners. At present, there is every reason to talk about the manifestations of the risk of dependent development in the context of the Russian banks' growing influence in Ukraine.

In 2012–2013, some Ukrainian financial groups have intensified their activity on the market through the acquisition of troubled banks and expanding their presence in the banking sector. Such activities may lead to the emergence of powerful players on the banking market and a significant restructuring of banks purchased from foreigners (changes may relate to the resource policy, network, and staff). However, long-term goals of such investments may totally differ from the declared ones and anticipate the further resale of the enlarged asset to the Russian banks which have significant financial resources. Moreover, the structure of the ownership and sources of the financial resources of Ukrainian groups are not transparent enough, which makes it impossible to make reliable conclusions about the real owners of a bank.

### **Comparison of resource policy priorities of Ukrainian and foreign banks in 2010–2012**

The National Bank of Ukraine classifies commercial banks into four groups by the size of assets: group I – the largest (15 banks as of 01.01.2014), group II – big (20 banks), group III – medium (25 banks), and group IV – small (115 banks). To study the peculiarities of resource policy, we have chosen four banks from each group. To determine certain institutions, at least three factors must be considered:

1. Regional – each group includes banks located in the capital and regions.

2. Presence of foreign capital – to identify the specific features of resource policy each group involved banks with foreign capital – Western European or Russian (because of strengthening its influence in 2012–2013).
3. Absence of serious financial problems – for the analysis, there have been picked up banks with a relatively stable financial position during the crisis and the post-crisis period, to which no restrictions of the NBU were applied (temporary administration, etc.). This approach helps to identify common trends of commercial banks' resource policy without taking into account the regulator's direct administrative pressure.

To fulfil these requirements, assessment of resource policy formation and implementation at the level of individual banks has been carried out by analyzing the performance of financial statements of 16 banks (Fig. 1). Next to the bank, the name of the group it belongs to is indicated.

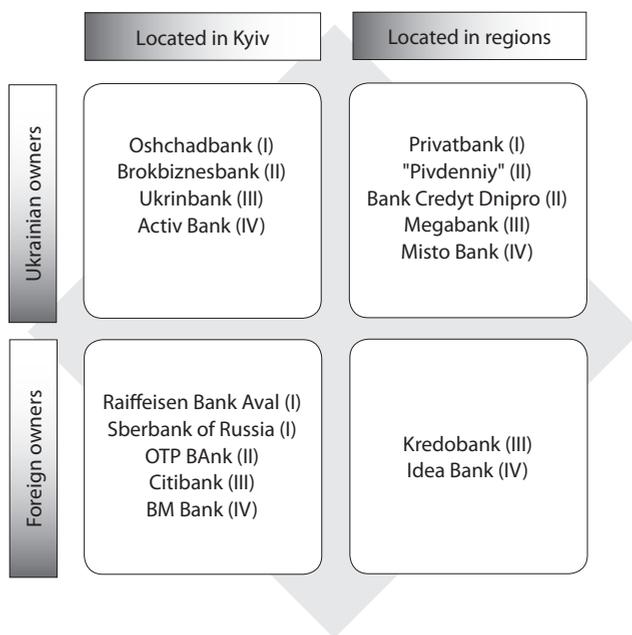


FIG.1. Bank institutions for research

Source: compiled by the author.

During the research, the dynamics of the main indicators characterizing the bank's resource policy have been analyzed:

1. Household's deposits.
2. Corporate deposits.
3. Loans to households.

4. Corporate loans.
5. Loan-to-deposit ratio (LTD).

The research timeframe is identified from 01.01.2010 till 01.01.2013 due to the need to characterize the peculiarities of some banks' resource policy during the banking sector recovery after the 2008–2009 financial crisis. Thus the data as of 01.01.2010 will show the state of bank resources during the crisis, and the following periods' data will reveal changes of this state under the influence of resource policy adjustments in the post-crisis period.

The crisis in the Ukrainian banking system led to a significant outflow of deposits from banks in 2008–2009, notably deposits of individuals. The ways of resource policy implementation in attracting deposits of individuals were similar for the analyzed banks.

During the period under consideration, three of the largest banks were actively increasing their deposit portfolio: the Oshchadbank increased it nearly two times, Privatbank 2.5 times, and the Sberbank of Russia almost nine times. Only the Raiffeisen Bank Aval slowed down the rate of attracting household deposits, this resulting in their volume declined by 3 bn UAH over four years (Fig. 2).

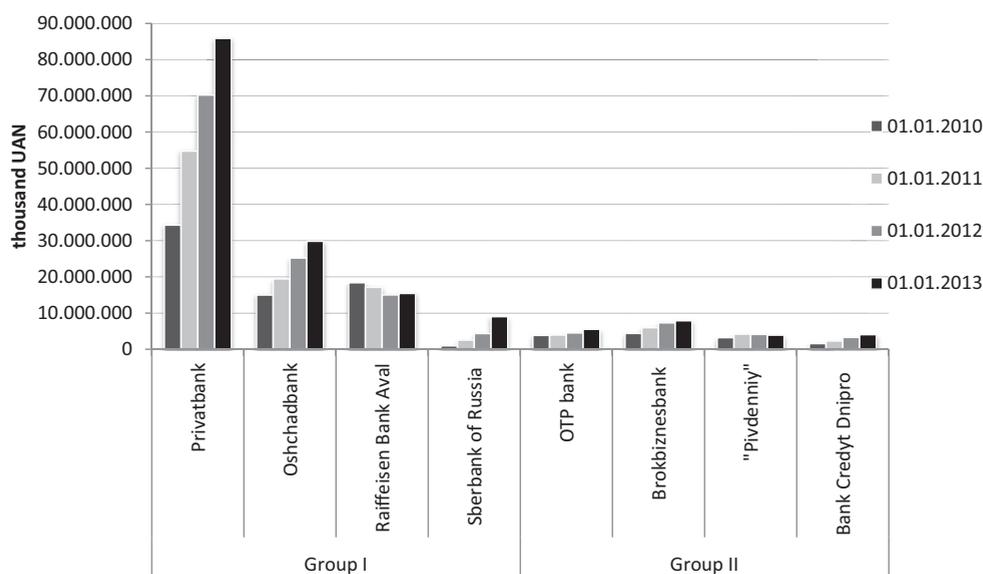


FIG. 2. Deposits of individuals in the banks of groups I and II

Source: data of the National Bank of Ukraine (Національний банк України, 2013b, 2012, 2011, 2010).

The second group of banks also tended to increase the deposits of individuals, but the rate of increase wasn't as high. On the contrary, in the post-crisis period, a significant part of banks in the third and fourth groups began to actively reorient their resource policy to attract funds of households, which allowed certain banks to replenish their

resource base significantly; the Ukrinbank and the Idea Bank were the leaders in this segment. In a rather unfavorable conditions, they could increase their deposit portfolio 6 and 9 times, respectively.

In general, we should admit that most of the banks preferred an aggressive resource policy in terms of households' deposits accumulation in the post-crisis period. The reasons for this situation were the inaccessibility of other sources of resources, inability to borrow on foreign markets, and the return of funds withdrawn during the crisis into the banking system. Attractive conditions offered by banks to individual depositors were also an important factor. Such measures were intended to compensate the loss of trust to banks and served as a kind of risk compensation for funds' placement. It is also necessary to note a trend of the cautious resource policy applied by banks to the foreign capital; as a result, two of them lost part of their deposit portfolio. The exception in this case is the Sberbank of Russia and the Idea Bank which used an extremely aggressive policy and were rapidly building up the volume of resources borrowed from the households. Moreover, this policy allowed these banks to strengthen significantly their market position.

The situation with foreign currency deposits wasn't fundamentally different, although it should be noted that the rate of increase was lower than the individuals' deposits portfolio as a whole. The sharp decline in foreign currency deposits was typical of the Kredobank and the Raiffeisen Bank Aval – banks with foreign capital. The policy of other banks involved an active use of this financial instrument, considering its significantly lower cost as compared to deposits in national currency. Foreign currency deposits were one of the ways for depositors to minimize currency risks in the post-crisis period, this providing explanation for their increasing volume attracted by some banks whose reputation did not suffer significantly during the financial crisis. We should state that no regional peculiarities of resource policy were considered in attracting the deposits of individuals. Banks located in regions as well as banks in Kiev worked actively with individuals and formed their resource base through their deposits in the post-crisis period. This is confirmed by the fact that in all the investigated banks (groups I and II) the portfolio of retail deposits significantly exceeded the portfolio of corporate deposits. Thus, retail deposits became one of the main objects of the resource policy of most large and medium-sized banks in 2010–2012.

Among the banks of groups I and II, only the Sberbank of Russia and the Brokbiznesbank saw a stable growth in corporate deposits during 2010–2012. Other banks in 2012 lost part of the corporate deposit portfolio despite an increase in liabilities to legal entities. These phenomena are unlikely to be related to changes in the priorities of resource policy towards this category of customers, because most of large banks have always been interested in attracting funds of businesses. To a greater extent this was the impact of general economic factors, including downturn in many areas of the economy, leading to a reduction in the financial resources of enterprises and thus reducing balances on their bank accounts.

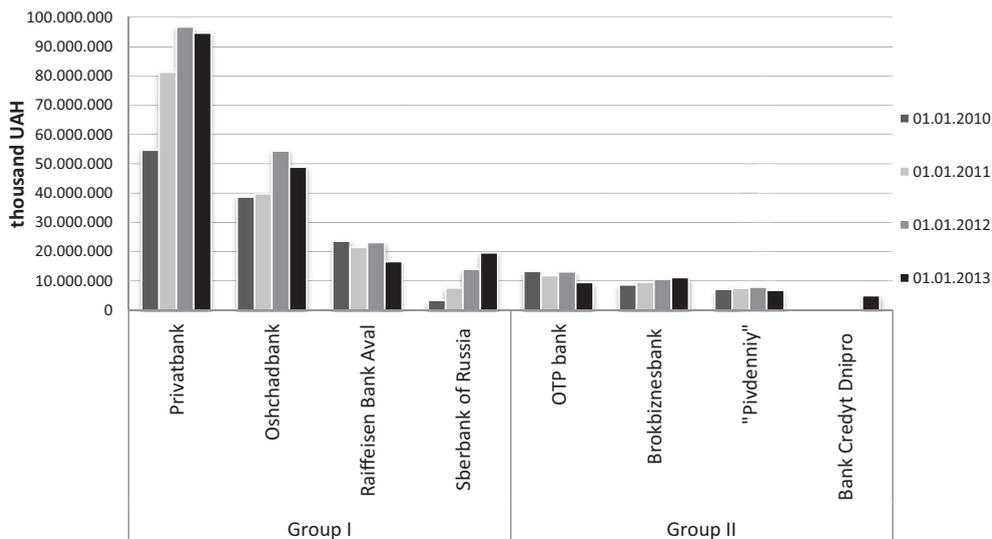


FIG.3. Corporate loans granted by banks of groups I and II

Source: data of the National bank of Ukraine (Національний банк України, 2013b, 2012, 2011, 2010).

Among the banks of groups III and IV, the situation is somewhat different: two banks (Kredobank, BM Bank) were unable to restore the volume of corporate deposits at the beginning of 2010, and another two (OTP Bank and Activ Bank) reduced their deposit portfolio in 2012. However, four banks were able to increase the amount of borrowed funds of legal entities over three years, and in some cases did it rather quickly. Thus, the corporate deposits' volume of the Ukrinbank increased 9.5 times, of the Idea Bank 4.5 times, the Misto Bank 3.3 times. This may be due to a better adaptation of medium and small banks' resource policy to changes in the business climate, making it possible to intercept customers of large banks by offering them more attractive conditions of service. At the same time, we cannot reject the version of a close integration of the mentioned banks into certain financial and industrial groups and the relevant concentration of their resource policy to manage the cash flows of such groups.

In the post-crisis period, the priorities of banks' resource policy shifted towards corporate lending. The largest and big banks have overcome the crisis and increased the volume of corporate lending (Fig. 3). The Sberbank of Russia became the leader in this field; within three years it has increased the corporate loan portfolio by 16.2 bn UAH, or 5.7 times. In the Privatbank and the Oshchadbank, the volume of loans is growing much slower, and in 2012 there was a decreasing tendency for these banks. The unusual situation for the Oshchadbank, which has a substantial portfolio of corporate loans with a total orientation of its activity to individuals, is explained by large loans that were granted by the bank to the Naftogaz of Ukraine. In general, this indicates an excessively risky

resource policy of the Oshchadbank in lending, which is associated with an extremely high concentration of the loan portfolio: as of 01/01/2013, 67% of loans were granted to 10 biggest borrowers. The Naftogaz was the largest among these borrowers; it accounts for 33% of the Oshchadbank's loan portfolio, or about 20 bn UAH. Moreover, these loans were granted at the rates lower than the fundraising market rates of the Oshchadbank itself, so in future it will inevitably affect the financial results.

Among the banks which reduced the volume of corporate lending are the banks with foreign capital – the Raiffeisen Bank Aval and the OTP Bank. In the first case, we can speak about general decline in the activity (reduction observed for all parameters), which subsequently can lead to financial problems at the bank. The OTP Bank is clearly reorienting its resource policy which became more cautious, this can be proved by the reduction of its corporate loan portfolio.

When it comes to the banks of groups III and IV, during 2010–2012 multi-vector trends were observed: along with the rapid growth in loans to legal entities in the Ukrinbank, Megabank and Misto Bank (owned by Ukrainian owners), a decline in lending by banks with foreign capital (Citibank, Kredobank, and BM Bank) took place. Thus, in the post-crisis period, banks controlled by the national capital have begun to conduct a more aggressive resource policy in corporate lending, which ultimately led to some redistribution of the spheres of influence in the market and the weakening of banks with foreign capital. Those banks have estimated the probability of potential risks in the formation of credit policy as significantly higher. That could eventually be considered as one of the reasons for foreign capital outflow from the Ukrainian banking system.

The resource policy of banks in lending to individuals in 2010–2012 was being conducted with the consideration of mistakes revealed during the financial crisis. As a result, the vast majority of banks revised their approach to consumer lending as well as to risk assessment systems. This resulted in a significant reduction in lending to individuals. This tendency was especially typical of banks of groups I and II. Even traditional leaders in this segment (Privatbank, Oshchadbank, Raiffeisen Bank Aval and OTP Bank) have reduced the portfolio of loans to individuals, this especially concerns the last two banks. The Sberbank of Russia, which during the period under consideration showed a rapid increase by all the indicators, didn't consider increasing the volume of lending to individuals as a priority of its resource policy. Among large banks, only the Brokbiznesbank managed to keep the volume of lending to households more or less stable for three years. No abrupt changes in lending to individuals by medium and small banks were observed. A decrease in the volume of the Ukrinbank, Megabank, and Misto Bank loans was caused by the reorientation of their resource policy to corporate lending; a sharp decline in granted loans has been fixed in the Kredobank, which can be explained by the general deterioration of the bank's activity and its inefficient resource policy during the analyzed period. At the same time, banks with foreign capital (the Citibank, BM Bank,

Idea Bank) have increased their loan portfolio by developing effective measures to make individuals interested in obtaining borrowed funds, attractive interest rates and terms of consumer loans repayment playing the leading role.

When it comes to currency loans to individuals, which became one of the factors of the financial crisis in the banking sector in 2008–2009, all the banks without exception have stopped making foreign currency loans since 2010. The result of such policy changes was a dramatic decline in the volume of currency loans. It especially concerns the banks with foreign capital, which in pre-crisis period actively made foreign currency loans to individuals because of cheap resources' availability from the parent companies. The Raiffeisen Bank Aval and the OTP Bank had the largest volume of such loans among the analyzed banks as of 01.01.2010, but in three years it reduced 3.9 and 4.6 times, respectively.

An assessment of riskiness for the analyzed banks' resource policy can be carried out using the loans / deposits (LTD) indicator. Since the goal in this case is to determine only the direction of resource policy changes and not the relevance of these parameters in any normative value, the calculation LTD value was done using the main components of assets and liabilities. The indicator's calculation was made by the formula:

$$LTD = \frac{(\text{Corporate loans} + \text{Loans to individuals})}{(\text{Corporate deposits} + \text{Individuals deposits})} \times 100\% \quad (1)$$

Figure 4 shows the dynamics of the LTD indicator in 2010–2012.

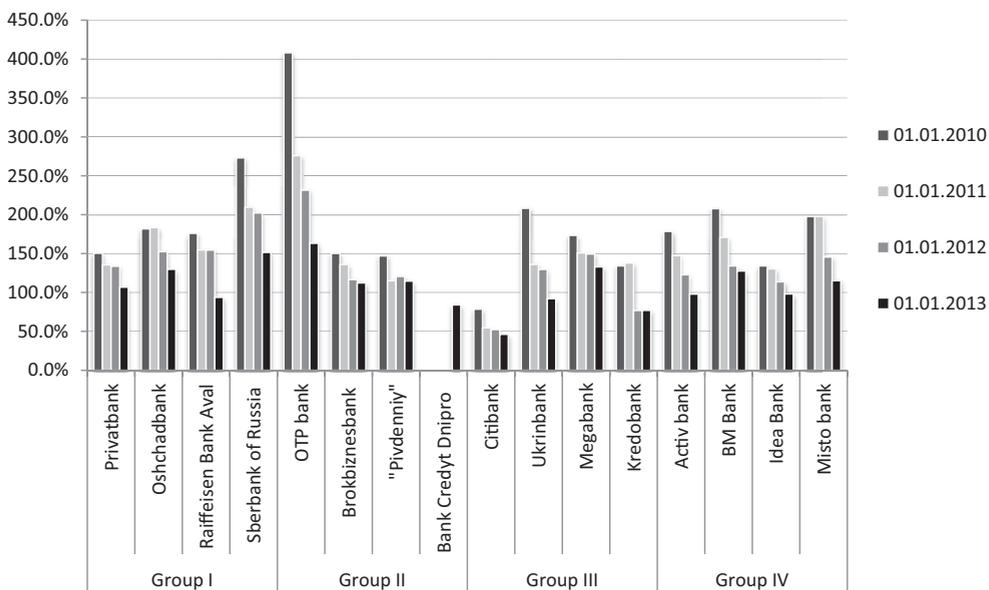


FIG. 4. LTD ratio for analyzed banks in 2010–2012

Source: the author's own calculation according to the data of the National bank of Ukraine (Національний банк України, 2013b, 2012, 2011, 2010).

The excessively risky policy of banks in the pre-crisis period resulted in an extremely high value of LTD. As of 01.01.2010, only in one bank (the Citibank) the ratio was less than 100% (which in theory is considered to be safe); two small banks with foreign capital kept it at 134%. The highest values were observed in the OTP Bank (408%), Sberbank of Russia (273%), and the BM Bank (208%). This situation suggests that the resource policies of the major banks with foreign capital were aimed at increasing the volume of the loan portfolio not by attracting deposits in the internal market, but by attracting resources from abroad, mostly in the form of interbank loans. Among small banks, the situation was quite opposite – it was banks with Ukrainian capital that took more risks in their activity, this resulting in the highest LTD value for the Ukinbank, the Misto Bank, and the Activ Bank.

The tendency to decrease the LTD ratio appeared in 2010 when the process of granting new loans actually stopped due to the crisis, but accelerated in 2011–2012. During this period, banks with foreign capital lost their ability to obtain cheap significant resources from parent companies; this forced them to review their interest rate policy and limited the possibilities of lending. Most of the banks began to conduct a more balanced resource policy, to more thoroughly evaluate the creditworthiness of borrowers, which also halted the growth of their loan portfolios. As a result, at the end of 2012, the average LTD value for the group of the biggest and big banks declined by almost 93% to 119.2%, and for groups of small and medium banks it dropped by 65% to 98.4 % as compared with the beginning of 2010.

In general, despite a significant decrease in the LTD value, the resource policy of large banks during the analyzed period is of a riskier nature. The value for the OTP Bank, the Sberbank of Russia and the Oshchadbank (taking into account the character of its resource formation and the importance of maintaining stability and confidence in the whole banking sector) remained rather high. For the first two of these banks, borrowing from parent companies remained the priority in their resource policy.

Most of medium and small banks in the post-crisis period began to conduct a more careful resource policy, resulting in a decrease of the LTD value to a level of 100% at the end of 2012. In this context, the Megabank and the BM Bank tried to conduct a more aggressive policy, although in the latter case we can talk about the use of parent bank resources.

## **Conclusions**

In general, structural changes in the sector of banks with foreign capital in Ukraine are going to have negative consequences caused by a significant deterioration in the financial market situation and investment climate. The exit of the European banks could reduce

the competition and the quality of banking services, which does not contribute to a successful integration of the Ukrainian banking system into the European financial area.

A comparison of resource policy peculiarities in 2010–2012 allowed to identify the main priorities of Ukrainian and foreign banks' activity on the domestic financial market:

- most of large and small banks implemented an aggressive and growth-oriented deposit policy to increase their retail deposits' portfolio. A more cautious policy was provided by banks with foreign capital. Banks-members of large industrial and financial groups were more active in attracting corporate deposits;
- the credit policy of banks with the Ukrainian capital was active in the sphere of corporate lending, while banks with foreign capital somewhat curtailed their activities in this direction. As for lending to individuals, more careful lending policies were started by large banks, which ultimately led to a decline in loans volume. This trend was less pronounced for small and medium-sized banks.

Banks controlled by foreigners during 2010–2012 conducted a more prudent resource policy in lending, the main reasons being difficulties in attracting medium and long-term resources, the high cost of resources, and a decline in income, suspension of funding from European banks for their subsidiaries in Ukraine due to the problems on the European financial market, and the high level of political risk, which makes it difficult to forecast the activities of banks over the medium term.

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