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Banking fragility rooted in justice failures

Evidence from Ukraine

Maria Repko

No. 2019-08, May 2019

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Abstract

This paper investigates the links between the rule of law and sustainable economic growth, focusing on a specific aspect – namely how corruption and lack of the rule of law affect the functioning of the banking sector.

It draws on the experience of Ukraine amid the crises in the banking sector (which is most of the financial sector). The burst of a bubble in the banking sector after the 2008–09 crisis was never followed by a robust recovery, and the 2014–15 crisis[1] deepened the problem. It highlighted serious dysfunctions in the justice system, with issues of corruption and political interference. Much of the banking system's fragility and poor credit utilisation could be explained by a lack of the rule of law on different levels. When the losses materialised, flaws in the rule of law impeded a response and resulted in a massive burden falling on the state and on the economy at large.

At the same time, reforms to the rule of law and the financial sector are going along separate tracks – being implemented by different teams that contact each other randomly at best. If these efforts are combined, a strong synergistic effect might be achieved.

This paper recommends a cross-sectoral policy angle for EU–Ukraine cooperation towards financial and justice sector reforms. It suggests six steps that might be taken at the crossroads:

1) launch a special forensic bureau for financial crime;
2) create a database for insolvency and financial fraud cases to support court expertise;
3) streamline insolvency law and regulations;
4) empower the independent regulator;
5) improve the know your client and anti-money laundering procedures of EU banks internally; and
6) support reform of the state-owned banks.

[1] During 2014–15, after a civil uprising, part of the country was annexed by neighbouring Russia (the Crimean Peninsula) and armed conflict began in the industrial eastern regions, fuelled by Russian command, arms and manpower. Coupled with the fiscal and banking crisis, this led to an economic downturn. The country lost ~16% of GDP and the local currency (hryvnia, UAH) depreciated by ~68%.

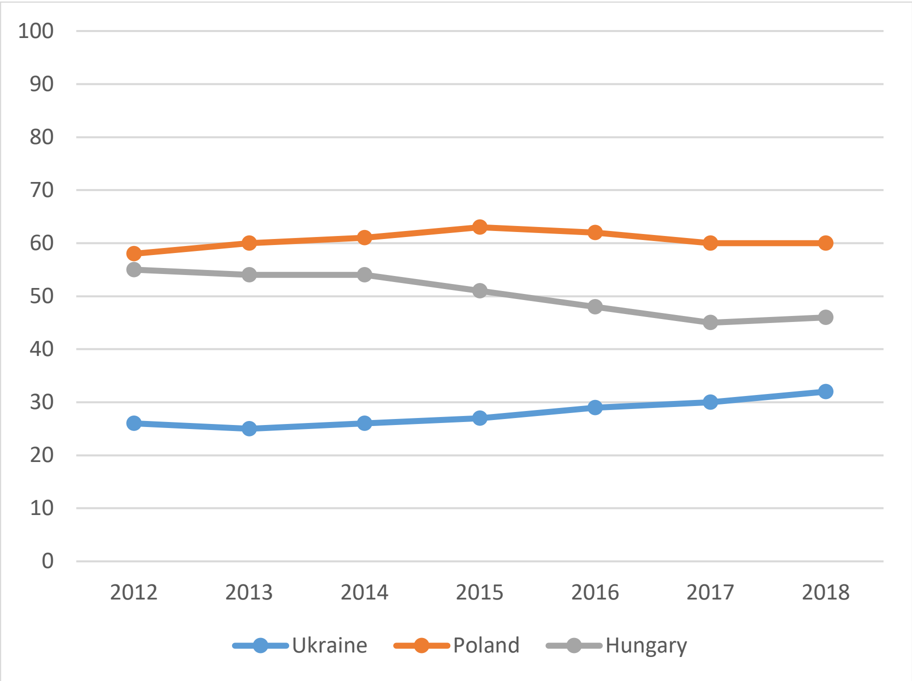
1. Introduction

1.1 Improving the rule of law in Ukraine: A never-ending story

Upholding the rule of law has long been a problem for Ukraine. Tensions had been building up gradually and then finally the Maidan[2] uprising occurred in 2013. It was inspired by European integration prospects and put civil rights and fighting corruption as cornerstone demands.

Corruption was the first area reforms sought to tackle after the immediate macroeconomic stabilisation. But this has not brought a breakthrough in corruption perceptions – Ukraine's score in the Corruption Perceptions Index has not improved dramatically. Progress, as shown by the indexes, has been sluggish at best – almost nothing has changed (see Figures 1 and 2).

Figure 1. Selected countries' score in the Corruption Perceptions Index

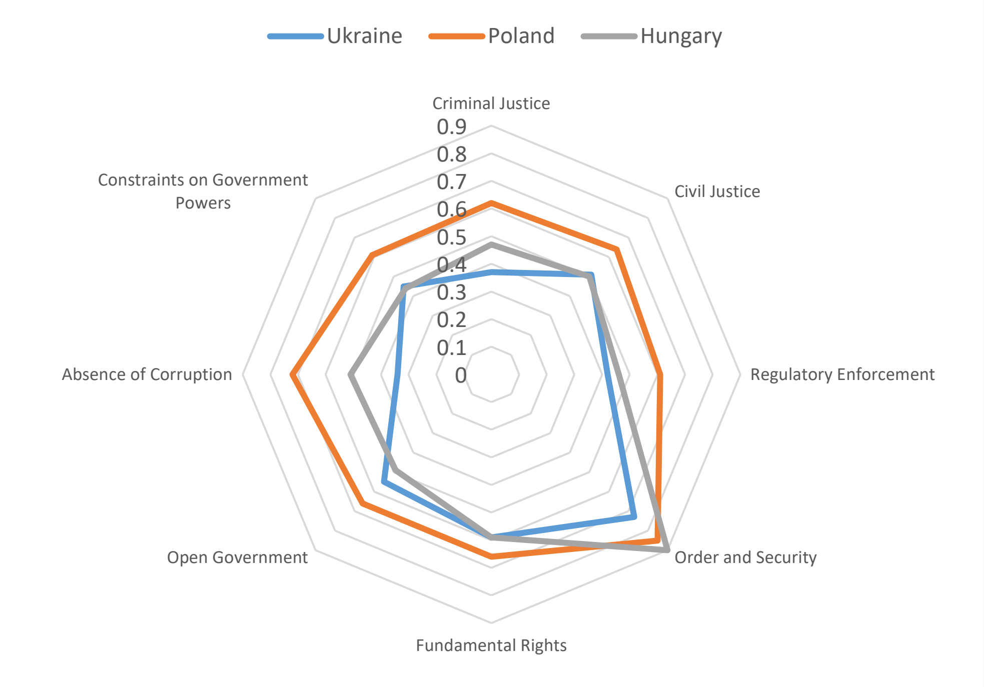


Source: Transparency International (the higher the index, the less corruption is observed, ranging from 0 to 100).

To meet the conditions posed by the International Monetary Fund and the European Commission for visa liberalisation, three anti-corruption bodies were created: the National Agency on Corruption Prevention (NACP), the National Anti-Corruption Bureau of Ukraine (NABU) and the Specialized Anti-Corruption Prosecutor's Office (SAPO). The final fourth element of the system – the Anti-Corruption Court – is to be fully launched in 2019.

[2] The massive civil uprising in winter 2013–14 (referred to as the 'Maidan' or 'Euromaidan' revolution) led to the corrupt president fleeing the country. The uprising started after the former president had failed to sign the EU–Ukraine Association Agreement (which had been prepared and was ready on the table) and had chosen instead to turn the country towards Russia.

Figure 2. Selected countries' score in the 2018 Rule of Law Index



Source: World Justice Project (the higher the index the better the situation, ranging from 0 to 1).

At the moment the results of anti-corruption reform are yet to be seen. Since its launch, NABU has unmasked 445 corrupted officials, but only 28 of them have been convicted after SAPO and the courts have stepped in. As of 2018, almost 2.8 million declarations by politicians and government officials had been submitted, yet NACP has performed full checks on only 447 of them (0.02%).

Box 1. Anti-corruption bodies and their activities

The **NACP's** main task is to develop regulations that facilitate law enforcement and reduce opportunities for corruption. It employs 311 people and its key function is to scrutinise the income and property declarations of politically exposed persons and determine whether they have a conflicts of interest or have gained illegally.

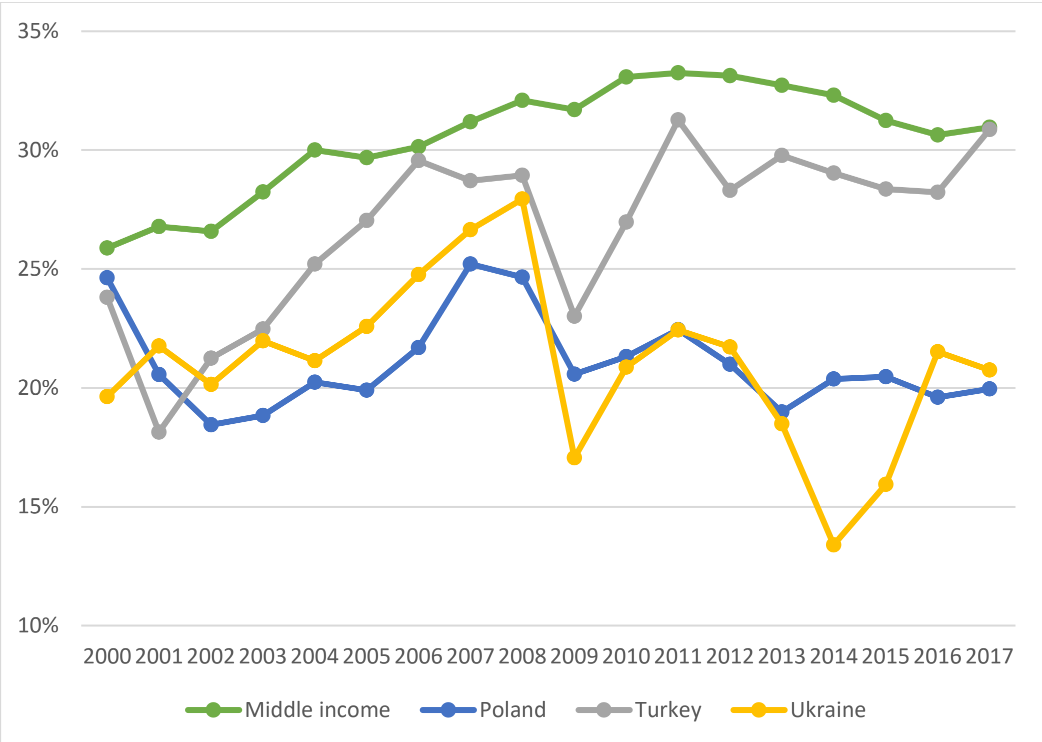
The key task of **NABU** as a special agency with 638 employees is to investigate top-level crime. Detectives start a pre-trial investigation when either the expected harm exceeds 500 times the minimum wage or a high official is involved. To supplement the work of NABU, **SAPO** was created as an independent branch of the Office of the Prosecutor General of Ukraine. It employs 45 prosecutors, supported by staff at the general office. Both NABU and SAPO were launched in 2015. Then in 2018, after years of hesitation and under heavy pressure from foreign partners, the president finally signed the law "On the High Anti-Corruption Court", which is to be launched this year.

Reforms of the courts, conducted with many halts and stumbles during 2015–18, have not increased trust in the judiciary by society. And even five years after the Maidan revolution, a free media often reveals cases of top-level corruption.

1.2 The banking sector in Ukraine: Clawing its way from the bottom

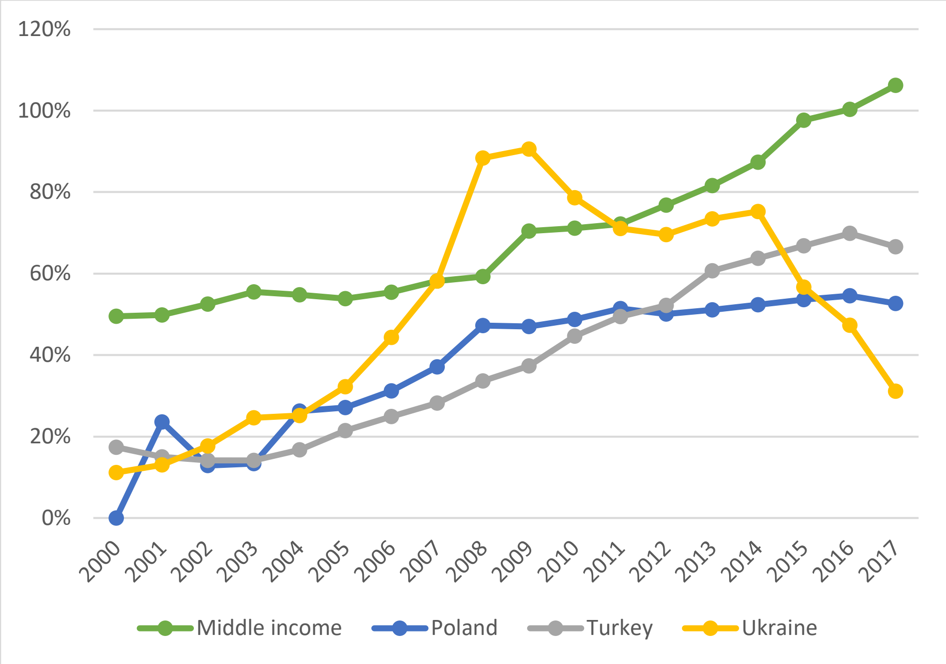
The Ukrainian economy receives less foreign investment compared with other middle-income countries. The recovery in capital formation is fragile and has repeatedly been crushed by economic downturns. The banking sector, which represents virtually all of the financial sector in Ukraine, has not yet recovered from two deep downturns. The banks have accumulated huge amounts of bad loans, and the credit history of many corporates and industrial groups has been damaged, as well as their creditworthiness. Therefore, interest rates are high, and corporate lending is stagnating. Capital investment in Ukraine funded via bank loans is only 7% of total investment, with the majority 71% made with private funding (see Figure 6). Without lending, the gross capital formation in Ukraine lags behind (see Figure 3) and curbs economic growth. As a result, Ukraine's economy has large investment potential on the mid-term horizon from bank lending: the current level of domestic credit now stands at ~30% of GDP, and within a decade it could potentially reach the middle-income country level (~100% of GDP) (see Figure 4). It is important that this growth does not turn into a new bubble – so the fundamentals for a healthy lending recovery should include solid changes in the risk-taking approach.

Figure 3. Gross capital formation (% of GDP)



Source: World Bank.

Figure 4. Domestic credit to the private sector (% of GDP)



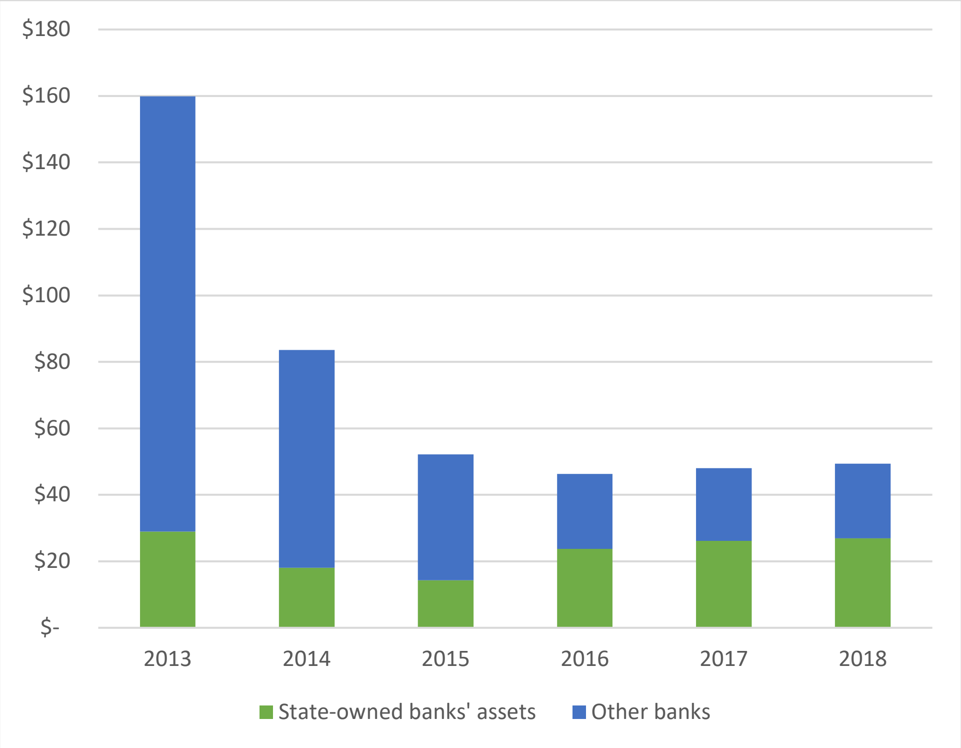
Source: World Bank.

The story behind the banking crisis of 2014–15 dates back to the 2000s. Back then the banking sector played a crucial role in gross capital formation and subsequent growth of the economy. Then the growth turned into a bubble with massive risk-taking by both banks and borrowers. Huge amounts of loans denominated in foreign currency and weak collateral policies against the background of skyrocketing loan portfolios were a norm. The crisis of 2008–09 put an end to the credit bubble and lending never recovered in full. The new crisis in 2014–15 disrupted even the fragile stability that had been achieved and unmasked the true quality of the loan portfolios, fake collateral and poor risk-monitoring procedures in general.

After 2014, the net banking system assets shrank from $160 bn to $50 bn (see Figure 5). This was an aftermath of three factors: currency devaluation, provisioning for bad debts and sector clean-up (99 out of 180 banks were liquidated). The non-performing loans on the balance sheets of the remaining banks and the Deposit Guarantee Fund,[3] which took over the bad assets of liquidated banks, exceeded 30% of GDP.

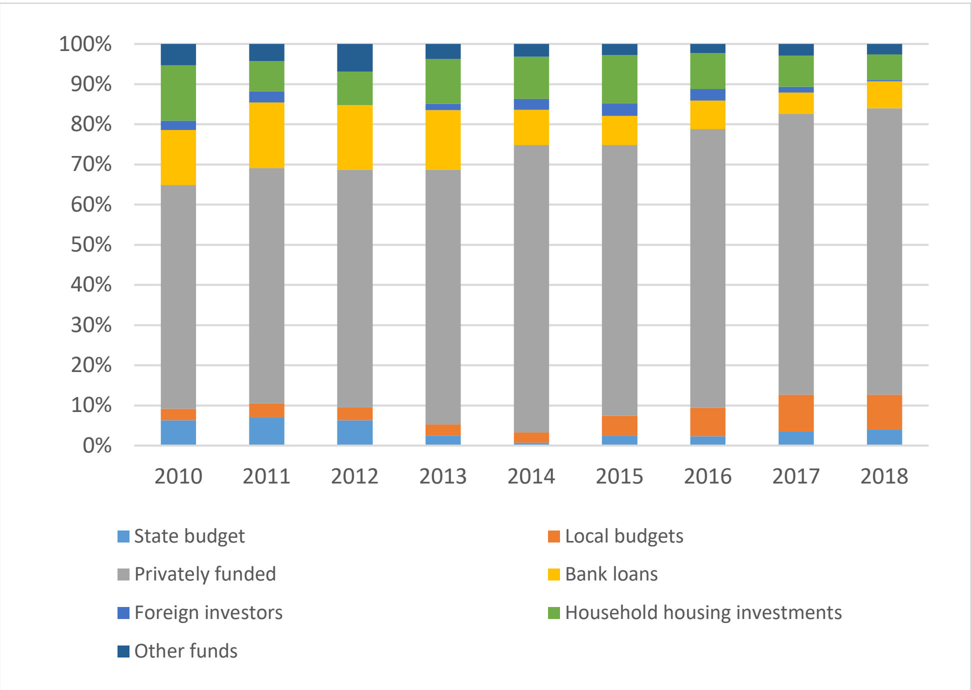
[3] The Ukrainian institution responsible for the liquidation of bankrupted banks and compensation of household deposits within the state-guaranteed limits. It is also involved in asset recovery – the assets from the balances of liquidated banks are either sold at auctions or via legal procedures.

Figure 5. Banking system net assets ($ bn)



Source: National Bank of Ukraine.

Figure 6. Capital investment structure (%)



Source: State Statistics Service of Ukraine.

After the 2014–15 crisis, the new team at the National Bank of Ukraine (NBU) transformed the institution, increased transparency of the banks' assets and ownership, changed approaches to loan and collateral quality assessment and reformed the banking supervisory function. New evidence has revealed the crucial role of rule of law shortcomings in the growth of the credit bubble, the subsequent crisis and the inability of the system to recover from losses.

The problems were widespread money laundering, window-dressing, top-level corruption and instructed lending, related-party lending on a massive scale, struggles with bankruptcy and collateral abuse. Out of over 5,000 financial fraud cases sent for investigation by the NBU or by the Deposit Guarantee Fund, no just punishment has been imposed, and only a few have actually made it to the courts.

Below this brief further investigates the link between the rule of law and banking sector problems and offers recommendations for cross-sectoral policies.

2. How the limited rule of law affects the banking sector: Channels and evidence from Ukraine

We examine the main channels through which the lack of rule of law,[4] elements of state capture and corruption practices affect the banking sector's sustainability and its resilience, by increasing the risk of losses for the sector. Based on expert interviews and statistical analysis, we come to the conclusion that this impact is material.

A bank's credit risk (and subsequently that of the banking system), namely the risk of facing losses associated with the extension of loans, is normally defined as a function of three variables:[5]

- **the probability of default** or the probability that the borrower becomes insolvent and cannot repay the loan;
- **the exposure at default** or the absolute size of the loan that might be at risk of default. It answers the question of how material for the bank's operations such a loss would be; and
- **the loss given default** or the relative amount of a bank's loss after all recovery procedures, such as acquiring the collateral and/or going through bankruptcy procedures.

Based on interviews with different stakeholders and through statistical analysis we have found evidence that the absence of the rule of law and widespread corruption negatively impact all three components of the credit risk and result in large losses, usually to be borne by the state or by the economy at large.

[4] For the purpose of this research, in the text below we often generalise 'the rule of law' to mean such phenomena as the courts' independence, prevention of corruption, officials not using their positions for personal gain, effective law enforcement and the absence of state capture.

[5] The approach can be found for example in papers of the European Central Bank: https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2165.en.pdf?176589bb4b7b020c3d3faffee9b982cd.

2.1 The probability of default

The rule of law problem in the context of the probability of default involves both general financial resilience as well as corporate and specific banking sector issues, especially when it comes to related parties' political interference in the lending of state-owned banks.

Rating agencies studying the probability of default pay attention to the operating environment. Fitch Ratings agency includes the governance of the respective country as one of the most important factors. The institutional framework and sector risk profile considers the legal, structural and regulatory environment as well as the macroeconomic factors that provide the backdrop against which the other key rating factors are evaluated.[6] Experts in the field tend to agree that the general level of the rule of law impacts on the probability of default.

> The connection between the probability of default and the level of the rule of law in the country exists and can be explained by the higher legal risks for an enterprise: e.g. getting permissions, competition barriers, having the contracts enforced properly. (European banking analyst)

For countries with a weak rule of law and widespread abuse of political powers there is also a specific angle: loans issued to political parties. The collateral on such loans is often misevaluated to avoid creating provisions. The anecdotal evidence suggests that the banks widely accepted such collateral as property rights for a share in a company whose only asset was an abandoned building in the countryside, or the waste left from iron ore production. The probability of default on such loans is higher in the event of a banking crisis, because the bank's owners usually have no intention of sacrificing their other assets for the depositors' sake, especially if the punishment seems perfectly avoidable.

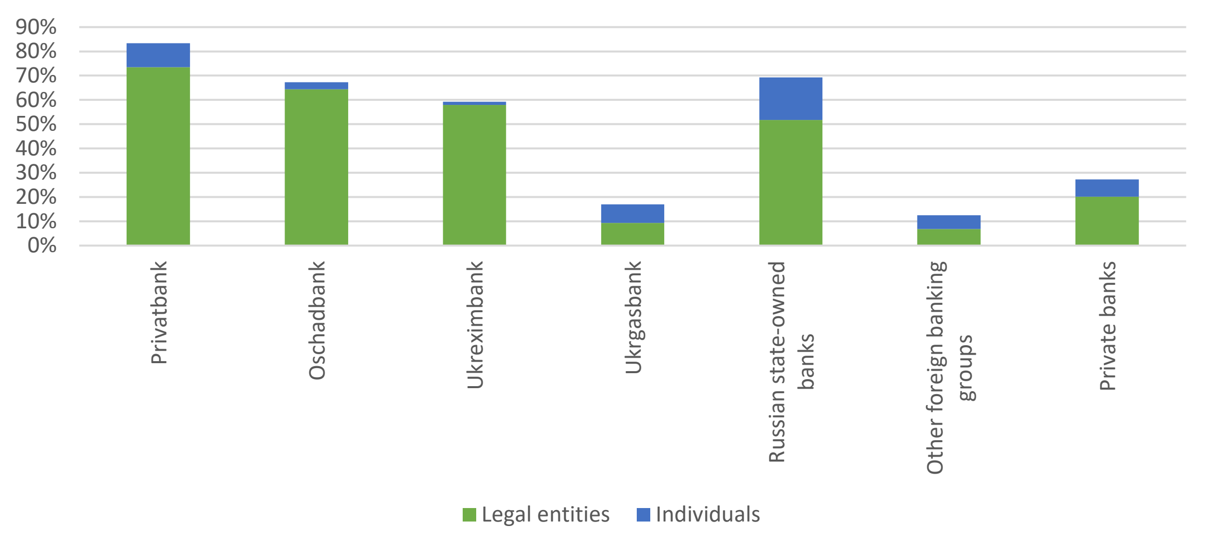
There is another problem valid for state-owned banks,[7] which represent over half of the banking system in Ukraine: so-called instructed lending. This involves the capture of state-owned banks by high-level officials and subsequent lending to politically exposed persons or their companies. The chairpersons at these banks are replaced as soon as each new political coalition acquires seats in the government. The bank secrecy laws protect such borrowers from the curiosity of the public, but some cases have nevertheless become widely known.[8] The probability of default on loans to politically exposed or politically connected persons is higher as such loans might undergo insufficient risk analysis by specific instruction. The level of non-performing loans in state-owned banks is twice as high as in privately owned banks (see Figure 7).

[6] "Procedures and Methodologies for Determining Credit Ratings", Fitch Ratings.

[7] There are four state-owned banks in Ukraine: Oschadbank and Ukreximbank are state creations, and Ukrgazbank and Privatbank were nationalised during the crises of 2008 and 2014 respectively.

[8] For example, the Bohdan automaker (close to former President Petro Poroshenko) has a loan from state-owned Ukreximbank, while previously (before 2014), Oschadbank issued a loan to Stirol and Activ Solar (the companies' owners, the Klyuevy brothers, were key people in the then ruling Party of Regions).

Figure 7. Non-performing loans in Ukrainian banks (% of gross loans)



Source: National Bank of Ukraine.

The other type of instructed lending is lending to state-owned enterprises, some of which in turn might be captured by vested interests. Such loans are usually reported as performing loans, but in reality they are rolled over on a constant basis because the actual loan redemption is highly questionable.

A **policy response** to the capture of state-owned banks was the initiative to introduce proper corporate governance and effective supervisory boards. At the moment only two of them (Privatbank and Ukrgazbank) have independent members on supervisory boards. The other two (Oschadbank and Ukreximbank) do not have a quorum on their boards; moreover, all members are appointed on the political quota principle. Legislative amendments have introduced new corporate governance rules that are yet to be implemented. But a number of experts are sceptical on how the supervisory boards will function in reality and if they will be effective in preventing instructed lending.

> A number of Members of Parliament enjoy an impact on financial–industrial groups and vice versa. They wish to reiterate their impact [on state-owned banks]. That is why some of them are against independent supervisory board members [in state-owned banks]. (Member of Parliament, Ukraine)
>
> I have Members of Parliament, whose companies are the actual borrowers, sitting in front of me and discussing with me the corporate governance in state-owned banks. (Top-level government official)

If the rule of law is not fixed in general, independent supervisory board members may come under pressure as 'white knights' within the captured institutions, up to the point of personal safety concerns.

2.2 Exposure at default

Exposure at default depends on two main factors: the internal credit risk procedures in banks and prudential regulations enforced by a central bank (the NBU). Regulatory capture[9] or just insufficient capacity in enforcing prudential regulation and bank supervision was a common problem for developing countries in the 1990s[10] and widespread in Ukraine before 2015. It meant that instead of controlling systemic risks by ensuring their portfolio quality and enforcing capital regulations, the central banks were constantly overlooking abuses and window-dressing. This 'state capture' or 'regulatory capture' occurs when the regulator acts in favour of vested interests rather than in the best interests of system stability. It is the reason why the banking sector may be exposed to more risk than it could possibly take.

For Ukraine this can be illustrated by anecdotal evidence of cases where collateral value and borrowers' credit quality were often misrepresented. The abuse, leading to higher than normal exposure at default, might for example be breaking the limits of lending to a single borrower or massive related-party lending. The owner of a private bank could happily syphon household deposits from the market for years, and under fake credit agreements channel the funds to his or her related companies either within the country or to offshore jurisdictions. A special market term appeared, calling such banks 'vacuum cleaners/dusters'.

> There were three types of supervision: the first is you describe everything as it is and then our boss makes you rewrite everything; second is you go for the on-site audit already informed of what you will have to write; and the third is you just describe everything as it is. (Former top-level manager of the regulator)

As a result, after the two downturns in 2008–09 and 2014–15 over half of the banks could not be saved and bankrupted, and the non-performing loans reached a peak of 58% of gross loans in the banking system.

The most infamous case was that of Privatbank, a Ukrainian too-big-too-fail bank that was nationalised in 2016. The international forensic audit bureau, Kroll, reported that 95% of the bank's loan portfolio was issued to related parties.[11] Some of the smaller banks following the same practices were not as lucky – they were liquidated. The Deposit Guarantee Fund reported over $3 bn of loans to related parties in its total legacy corporate portfolio[12] of $11 bn (28% on average).

Regulatory capture and the fight against it also have an important side effect: 'the witch hunt'. In an institutionally weak country, sluggish law enforcement against vested interests is often combined with over-enthusiastic investigation in politically-motivated cases. Political pressure

[9] https://en.wikipedia.org/wiki/Regulatory_capture.

[10] http://www1.worldbank.org/prem/lessons1990s/chaps/07-Ch07_kl.pdf.

[11] That is the NBU's interpretation, as the actual report has never been published https://bank.gov.ua/doccatalog/document?id=62483489.

[12] The sum of assets of the banks, which were liquidated under the Deposit Guarantee Fund procedure. Their loan portfolios were transferred to the Fund's balance sheet, while household deposits were repaid from the Fund's assets, mostly provided by the government at the taxpayers' cost.

in the form of prosecution could be used against any 'difficult' politician or official. This complicates the policy discussion and decision making.

> He used to have his favourite phrase for the board meetings: 'So, what will we be saying to Mr. Police Inspector when he comes for us?' Any policy decision is being stress-tested on the potential investigation outcome for the decision maker. Often non-optimal policy decisions won the floor because of 'the witch hunt' threat to officials. (A representative of the regulator)

The **policy response** to regulatory capture at the NBU was implemented after Euromaidan. Its management was replaced and the regulator adopted a new governance model, where each member of the board is responsible for one of six divisions and the decisions are made by committees rather than single-handedly. An internal audit was conducted. The regulator gained more independence, which put it in a better position to deal with crises. Regular stress-testing for each bank was implemented with new demands for capitalisation and loan portfolio restructuring where necessary. After the enforcement of related-party disclosure, the reported amount of related-party loans increased more than tenfold and the true amount of problem loans was revealed.

The NBU's transformation created a strong but very isolated independent institution against the background of an incapacitated and captured legal system. Despite a massive clean-up of the banking system, none of the banks' owners or managers were put in jail, for money-laundering or for fraud or illegal operations. What is also concerning is that there are still sporadic attacks on the NBU's independence. These will likely be more severe in times of political turbulence after elections and there is a risk that the NBU's independence might be compromised.

> Can the progress in bank supervision reform be reversed? – Yes definitely. It's very hard to build the institution, and it is very easy to break it down if you have enough resources and political will. (Top-level manager of the National bank of Ukraine)

2.3 The loss given default

When it comes to the last stage of the credit risk assessment – the insolvency resolution perspective – it appears that the recovery of bad loans is extremely limited. Corruption in investigation, prosecution and the judiciary is repeatedly named as a major bottleneck in a set of interviews conducted for this research as well as at numerous public events.

Since the 2014–15 crisis, Ukrainian banks have been able to collect only as much as 5–15 cents on the dollar of face value of a loan[13] on average. This is very far from the world average recovery rate of ~70%.[14] Recently, the Deposit Guarantee Fund sold several large asset pools

[13] Roughly 10% according to the World Bank's "Doing Business" estimation; during interviews, levels of 5-15% were identified as the most common for defaulted loan portfolios of different quality. There is not, however, any reliable official data on loan recoveries.

[14] https://www.researchpool.com/download/?report_id=1751185&show_pdf_data=true.

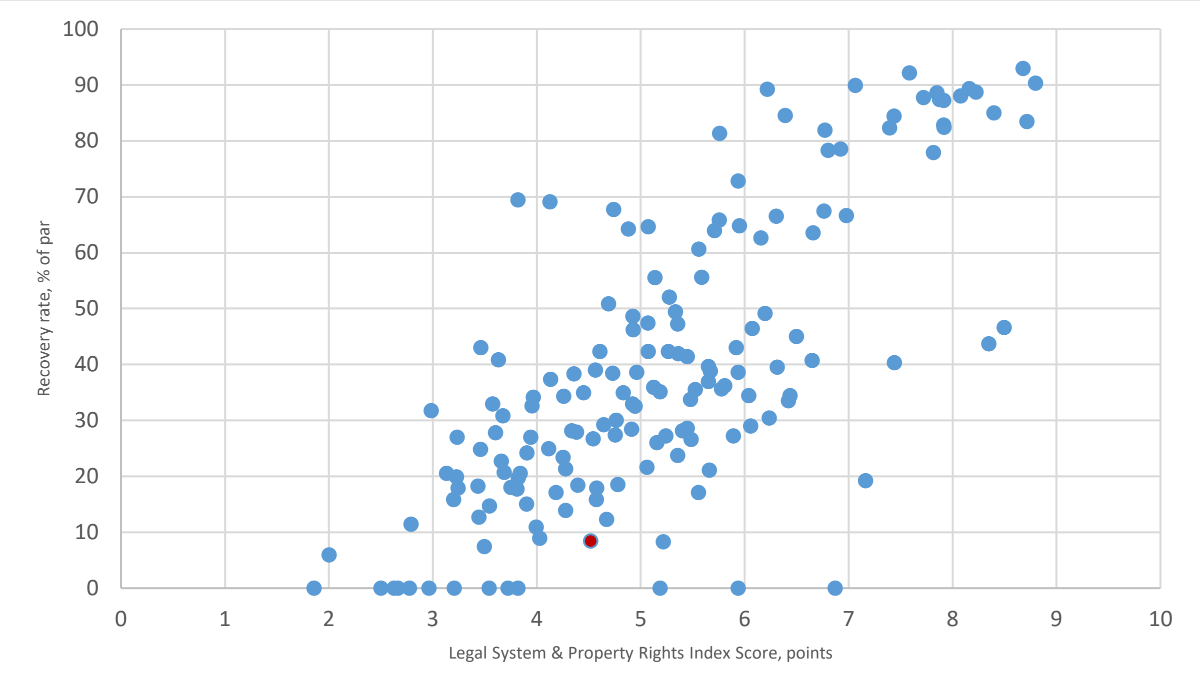
at a disgraceful 1–2 cents on the dollar of face value. The Deposit Guarantee Fund and the NBU also complain about problems with financial crime investigation: as noted above, of over 5,000 cases investigated during 2015–18, only a few have made it to the courts.

> When a corporate borrower has an opportunity to corrupt a judge, especially on a sizeable loan, it will definitely take the chance for it's much cheaper than repaying the debt. (International expert, former top-level Ukrainian official)

> The major bottleneck for effective resolution [is] definitely the courts. The banks simply could not get their collateral because the procedure is captured by vested interests in so many stages. Corporate borrowers widely use the loopholes and corruption. (Expert at the Ukrainian banking association)

The chart in Figure 8 shows the relation between the effectiveness of the legal system and the recovery rates on defaulted loans. There is also some evidence of such a correlation in the literature: Simeon Djankov et al. (2008)[15] argues that legal origins and per capita income are the most important cross-country determinants of insolvency resolution efficiency.

Figure 8. Correlation between the recovery rates on defaulted loans and the legal system's effectiveness (2016 data)



Notes: Red dot = Ukraine (y scale = the recovery rate, cents on the dollar, estimates by "Doing Business"; x scale = Legal system & property rights area in the Economic Freedom Index).

Sources: "Doing Business", Economic Freedom Index by the Fraser Institute and CES calculations.

[15] Simeon Djankov, Oliver Hart, Caralee McLiesh and Andrei Shleifer, "Debt enforcement around the world", *Journal of Political Economy*, 116(6), 2008, pp. 1105-1149.

Our findings suggest that the isolated impact of a 1-point improvement in the legal system and property rights (on a scale from 0 to 10) increases the recovery rate by 0.67 percentage points. An increase of GDP per capita by $1,000 (in 2010 prices) increases the recovery rate by 0.74 percentage points. (See Appendix 1 for model results.)

To summarise, the problem has at least three dimensions, which were mentioned during stakeholders' interviews: (i) corruption in the form of bribing or influencing the courts, police, prosecutors and/or levy officials; (ii) legislative loopholes, which make wrongful rulings possible; and (iii) a lack of capacity in the judiciary and investigative services to work on complex financial cases.

The **policy response,** up to now, has been very limited: a law on the protection of creditors' rights has been adopted and signed by parliament, as well as the law on the Anti-Corruption Court (not functioning yet). But judicial reform in general seems to have failed – this is the common opinion among Ukrainian independent experts and civil society actors. If the courts and enforcement system are not fixed, bad loans will continue to be written-off with very little recovery and the public loss will be huge. No specific, financial-sector-only solution like a devoted asset management company or a bad bank can save the day.

3. Conclusions and policy recommendations

The deep financial sector problems in Ukraine – namely a large amount of bad loans on banks' balance sheets, extremely low recovery levels and higher probability of default on 'instructed' loans, which have been issued without proper risk assessment – are associated with a weak rule of law environment. The corruption in the judicial and investigative branches, political interference, regulatory capture and capture of state-owned banks are either the sad reality or highly probable risks.

To deal with the bad-debt problem, to make the banking system more resilient and to fuel the country's sustainable growth, Ukraine needs to implement rule of law reforms with a specific objective of making the financial sector healthier.

This could realistically be done with help from foreign partners. The participation of the EU in fixing the legal system could be justified for two main reasons. The first is supposed financial market integration in the future. The Ukraine–EU Association Agreement gives a clear ultimate goal: the national treatment of the establishment and cross-border supply of financial services and market access, in line with standard principles of the World Trade Organization and the General Agreement on Trade in Services.[16] While the rule of law in industry remains compromised, this would work as a barrier. And the second reason is that the EU already has financial exposure to state-owned banks, which distribute institutional loans and manage financial aid projects.

[16] https://www.ceps.eu/system/files/RLI_Ukraine2_Master.pdf.

We believe that a special cross-sectoral (interdisciplinary) task force, involving EU and Ukrainian financial and legal professionals, should be created with the goal of improving the rule of law for the benefit of financial sector development. It needs to pick up the actions from the intersection of the rule of law and finance.

To address the low recovery of bad loans and ensure a credible threat of punishment, which will prevent some financial fraud from happening, three major steps could be taken:

- **Launch a special forensic bureau for financial crime.** Ukraine needs to import Western technologies and practices in fraud investigation and asset recovery. A special financial crime investigatory service – a forensic bureau – could be set up with technical support from the EU to take over the investigation responsibilities of the police and security services, which are currently incapacitated in terms of dealing with financial crime, banking fraud and money laundering. This bureau could cooperate with the European Public Prosecutor's Office and Eurojust. A very important effect of such reform should be a reduction of state capture in investigations, when decisions on who to scrutinise and who to spare are being politically and/or financially motivated, especially in big financial cases.
- **Create a database for insolvency and financial fraud cases to support court expertise.** The EU could help build the intellectual capacity, independence and integrity of courts with technical support for the establishment of a special database. This database could accumulate a sufficient number of financial cases of the Supreme Court, which then may be studied by other judges, advocates and prosecutors. It could specifically target insolvency and financial sector fraud. If the database is made public, it can bring to light high-level corruption, if MPs or public officials are involved. There is an alternative idea to allocate financial fraud cases to special 'financial' judges, but we do not view this as viable. A few judges may be easier to capture than all of the judges as a group, and judicial appointments to cases are random.
- **Streamline insolvency law and regulations.** Insolvency law and procedures should undergo a sanity check and be tested for loopholes at all stages and involving all aspects (including property valuation, audits and levies), ideally within the legislative approximation process with the EU. The tasks are to streamline the bankruptcy procedure and eliminate the possibility of conflict of interests (when, e.g. the borrower, via third parties, appraises the collateral or could affect the nomination of the bankruptcy liquidator). In addition is the need to promote preservation of the company as a going concern with the active participation of creditors and to ensure fast and effective enforcement when it comes to the realisation of collateral. The liquidation procedure for bankrupted banks also badly needs streamlining and loopholes closed. This could be done either separately or within the general insolvency framework.

On the prevention side, which might help to decrease exposure at default, several steps could be considered:

- **Empower the independent regulator**. Protecting independence, ensuring integrity and strengthening the institution of the national bank should become a religion in Ukraine and a continual point of attention of the EU. Progress (or regression) in this area should be closely monitored. Ukraine could adopt EU best practices in whistleblowing mechanisms on financial fraud.

- **Improve the know your client and anti-money laundering procedures of EU banks internally.** There have been cases, which have been made public, of European banks helping to launder assets from Ukraine on a massive scale. EU internal policies on strengthening know your client and anti-money laundering procedures in banks would be helpful, as well as mechanisms for returning the funds back to Ukraine.

- **Support reform of the state-owned banks.** State-owned banks should be privatised if possible – which is unfortunately not the case at the moment. Still, supervisory boards with independent directors should be established according to OECD corporate governance guidelines in the nearest future. The stock of bad loans in state-owned banks needs to be resolved; creating special departments for internal forensic investigations, reporting directly to the supervisory boards, could boost the recovery of these assets. We also believe that minority share ownership of Ukrainian banks by the European Bank for Reconstruction and Development or other institutions, and having their directors on the bank boards, would help avoid damage in future and be more effective in working towards the resolution of non-performing loans.

Appendix 1. Statistical analysis of the dependence of loan recovery on the rule of law and GDP per capita

In order to find out whether better rule of law increases recovery rates we conducted a random effect regression on the most recent panel data for 2011–16 for 164 countries. As a proxy for the rule of law, we used the "Legal system & property rights" pillar of the Economic Freedom Index, provided by the Fraser Institute. It includes three dimensions: property rights, government integrity and judicial effectiveness. We also included GDP per capita in real USD (2010) in the regression as a control variable, as wealthier countries usually have better property rights protection and rule of law in general.

Table A1 1. Regression table

Coefficients					
	Estimate	**Std. Error**	**t-value**	**Pr(>|t|)**	
(Intercept)	24.05600	1.84200	13.05950	< 2.2e-16	***
Legal system & property rights	0.66522	0.23497	2.83110	0.004739	**
GDP_per_capita2010	0.00074	0.00006	11.89150	< 2.2e-16	***

Signifigance codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1					
R^2	0.15127				
Unbalanced Panel: n = 164, T = 1-6, N = 941					

Source: CES calculations, based on the Economic Freedom Index, Fraser Institute, World Bank data.

Appendix 2. Description of expert interviews

For the project, 15 expert interviews were conducted during September–October 2018 by phone and in person with experts from Ukraine and Europe. The experts were top-level representatives of the banking sector, including state-owned banks, as well as academia, the regulator, international organisations, think tanks and financial consulting firms. Each interview was approximately 30 minutes long and included a discussion of the impact of corruption and the efficiency of law enforcement on the banking sector and how to quantify these impacts.

The questions initially proposed for the discussion were the following:

- Do you see the impacts of corruption and lack of the rule of law on banking sector development?
- How would you describe the main channels of these impacts?
- How would you quantify each of type of impact – what indicator would you choose?
- If you were a policy maker, how would you address the rule of law failures in the banking sector?

Engage II Fellowship Programme

The ENGAGE II Fellowship Programme is coordinated by CEPS with support by the Open Society Initiative for Europe (OSIFE). This one-year programme aims to involve academic, civil society and think tank actors from Central and Eastern Europe, the Western Balkans and Eastern Partnership countries in EU policy debates. It entails training, study visits, public events and the publication of policy papers. It culminates in the active participation of the selected fellows at the annual CEPS Ideas Lab.

The ENGAGE II Fellowship focuses on the significance of the rule of law in different policy domains, including rights and security, foreign and economic affairs.

The programme is coordinated by the CEPS Justice and Home Affairs (JHA) Unit. It is conducted under the supervision of CEPS Senior Research Fellows Sergio Carrera (Head of the JHA Unit), Cinzia Alcidi (Head of the Economic Policy Unit) and Steven Blockmans (Head of the Foreign Policy Unit).

For the period 2018–19, six highly-qualified Fellowship members were selected:

- Denis Cenușa, Researcher at the Institute for Political Science and PhD candidate at the Justus-Liebig University in Giessen, and Associated Expert at Expert-Grup, Chisinau
- Judit Bayer, Professor of Media Law and International Law at the Budapest Business School
- Simonida Kacarska, Director and co-founder of the European Policy Institute, Skopje
- Naim Rashiti, Executive Director and Senior Balkan Analyst, Balkans Policy Research Group, Pristina
- Maria Repko, Deputy Director at the Centre for Economic Strategy, Kiev
- Berat Thaqi, Policy Analyst at the GAP Institute, Pristina

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