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# LEGAL FRAMEWORK OF THE BANKING SECURITY IN THE CONTEXT OF EUROPEAN INTEGRATION OF UKRAINE

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## ABSTRACT

*The article is devoted to the research of the banking security's, its main components and levels of development. The purpose of this work was to develop theoretical and methodological provisions on the legal principles of Ukrainian banking safety in the context of current European integration processes. Taking into account the formal division into the level of individual banking institutions, the level of the banking system and the macro level (the state), it is necessary to have a legal basis in case of negative factors' leveling up necessity. This is necessary in view of the fact that banking security is one of the main components of the national security of the state. The authors identified and systematized current problems of the Ukraine's*

*banking system. It is determined that at the current stage of Ukraine's development, the priorities and interests of domestic representatives of the banking system and foreign banking structures do not always coincide. In particular, in the European Union countries, banks are primarily focused on addressing liquidity-related issues, including through the cessation of funding by foreign affiliates and subsidiaries, withdrawals from less developed countries. The priority task of the banking system of Ukraine is not only to preserve the stability of the banking sector, but also to expand lending to the real sector of the economy. The authors summarized the processes of current Ukrainian legislation's necessary adaptation to the requirements of the EU. The main problems that slow down the implementation of adaptation measures are systematized; specific issues that require harmonization with the norms of the EU Directives are identified. The conclusion about the need for constant public reporting by the responsible bodies on the current state of adaptation measures' implementation and taking into account the comments, recommendations and proposals of European institutions, conducting a thorough analysis of their content and possible consequences was made.*

**Key words:** Banking security, Banking activity, Adaptation of legislation, Eurointegration

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## 1. INTRODUCTION

Globalization is an undeniable reality today. Whatever the sphere of public life we have taken, today's challenges require unification with the requirements of international standards. The national banking sector cannot function in isolation from the global system. Today, the Ukrainian banking sector requires a lot of improvements, especially in view of the European integration processes. The need for attracting additional capital, re-profiling the sphere of interests from the domestic market to the external, increasing the capitalization of banking institutions, reducing the risks of banking activities, preventing crisis situations and other measures should be introduced to improve the efficiency of the sector as a whole. Banking institutions should work according to world-recognized standards and in compliance with internationally recognized principles. The National Banking System has a certain development strategy; it is declared in the Integrated Program of the Financial Sector Development of Ukraine till 2020. According to this document, the regulatory approximation of financial services to the EU's rules and norms, the acquisition of internal market's regime with the EU in the context of the active realization of integration is envisaged [1].

The current Agreement between Ukraine and the European Union on an association that has replaced the Partnership and Cooperation Agreement between the European Communities and Ukraine has enabled a real transition from partnership and cooperation to real economic integration and political association. The process of entry into force of this Agreement stipulates the need of adaptation measures in all Ukrainian law's branches. Integration of Ukrainian banking sector into the European Union implies realization of concrete measures in such areas as ensuring stability, increasing competitiveness (especially in the area of banking services), preventing and reducing the possibilities of risky situations' occurrence, structural reorganization, etc. Any changes can cause uncertainty and instability, which encourages the

emergence of hazardous situations. Under such conditions, especially important is the question of determining the legal principles of the banking security of Ukraine.

## 2. METHODS

Theoretical and methodological basics of the research are general scientific and special methods of certain jurisprudence phenomena and processes' cognition. Dialectical method was used in the synthesis of theoretical and methodological foundations of banking activity in the European Union and Ukraine, as well as formulating conclusions. Thus, we used a common dialectic method that allowed us to reveal the content and security of banking activity in the context of the domestic and foreign scholars' experience. This method has established the place of the problem under consideration in the general context of the functioning Ukrainian banking system as well as its adaptation to the EU's requirements.

We also have used abstract and logical investigation methods of law process in the field of banking activity. Thus, the analysis and synthesis were used to identify current processes in the system of international relations' development that indicated a reduction in the weight of each individual country as a "player" in the world market. Analytical tools were used to find out the basic benchmarks for the implementation of Basel III. The application of the induction method made it possible to formulate a general conclusion based on specific issues. So, it was revealed that banking security should be based on a reasonable mechanism for overcoming the current and long-term problems of the banking system, as well as for adequate regulation of risks arising in the banking sector. Statistical methods were used for comparing the level of banking activity's developments in the European Union and Ukraine during last years. In these contexts the positive dynamics observed in the statistics of the National Bank of Ukraine indicated a certain stabilization of the sector by 2017. As a result of applying the method of generalization it was held the systematization of Ukrainian banking system's modern problems. Particular attention should be paid to the prognostic method that allowed us to draw a picture concerning the reforming requirements for banks in the framework of the European integration of Ukraine based on Basel III. It was found that the Ukrainian side should not only take into account the comments, recommendations and proposals of European institutions in this case, but also carry out a thorough analysis of their content and possible consequences. The results of the above mentioned investigations' methods can be a key part of the future research of banking activity.

Problems of banking security were investigated by such Ukrainian scientists as O. Baranovsky, R. Vovchenko, M. Zubok, O. Kirichenko, V. Kralich, I. Krupka, L. Paterykina, N. Prokopenko, A. Plastun, A. Sushko, O. Steyer, S. Yaremenko. The works examined the essence of banking security, its components and factors of influence, some ways to improve the legislative framework, etc. The question of the adaptation of the legal framework of Ukraine in the aspect of European integration was considered in the works of N. Hnidyuk, A. Dovgert, V. Zabigaila, O Zadorozhnyi, Yu. Kapitsy, A. Zaytsy, L. Luts, V. Marmazov, V. Muraveyov, V. Opryshka and others. However, in our opinion, it would be expedient to accumulate the results of current research in these spheres and to make a comprehensive and general analysis of the state of the legal framework of banking security in the context of European integration of Ukraine. Problems of the Basel Committee recommendations' implementation are associated with the researches in the spheres of finance, economics, jurisprudence, state management etc. Scientists have developed the main ways of reforms, the mechanisms for implementing changes, as well as their possible consequences. A significant contribution to the study of the problem was made by M. Diba, I. Dyakonova, O. Zarutskaya, M. Zvyeryakov, V. Mishchenko, S. Naomenko, L. Primosta, O. Habiuk, O. Chub, V. Shpachuk and others. However, further elaboration is important for Basel III implementation benchmarks' establishment and reforms of the requirements for banks' activities within the

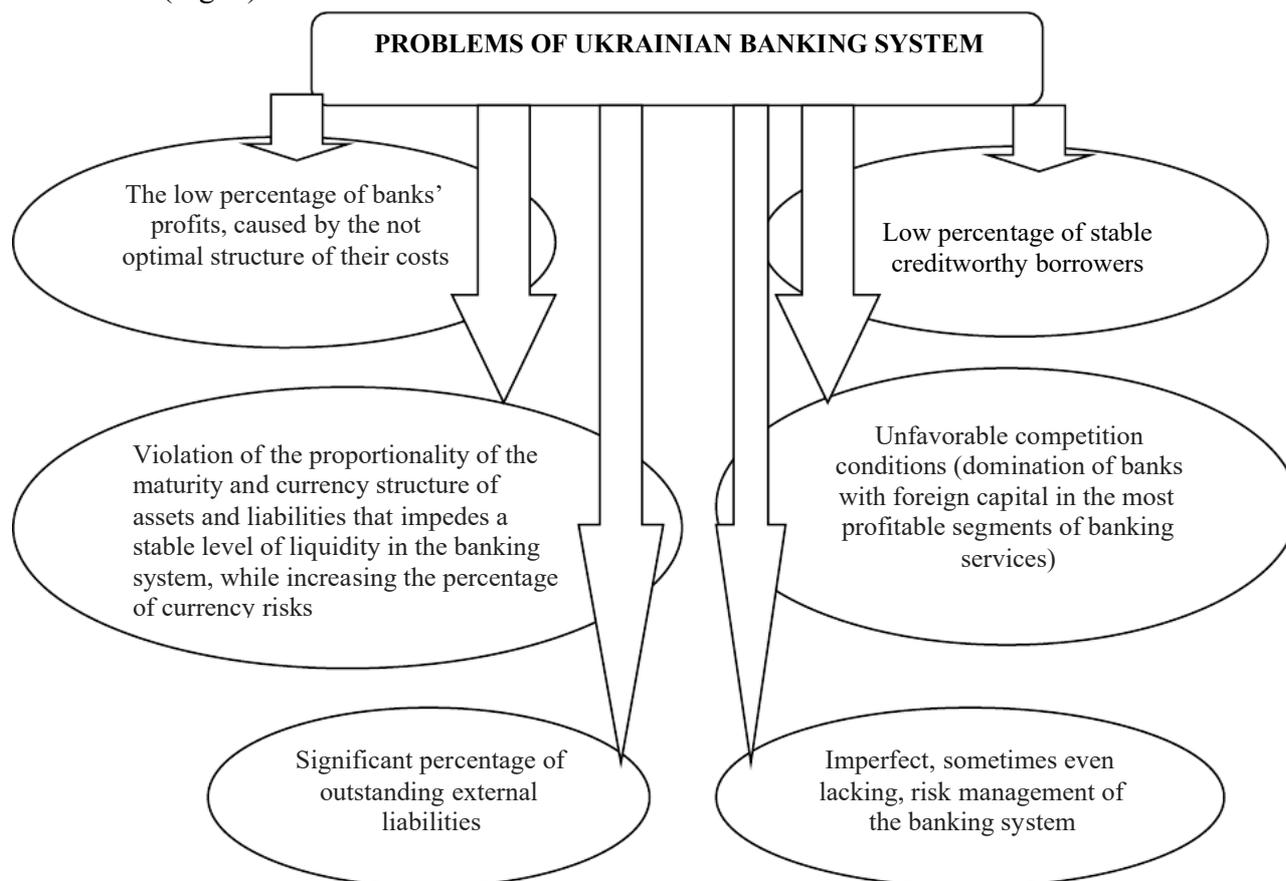
framework of European integration of Ukraine. The purpose of this work is to develop theoretical and methodological provisions on the legal grounds of Ukrainian banking security in the context of current European integration processes. In order to achieve this goal, the following tasks need to be solved: to formulate theoretical positions regarding banking security, its components and factors of influence, to analyze the current situation of Ukrainian legislation's adaptation according to requirements of the EU, to identify problem issues and to propose ways to eliminate them.

### 3. RESULTS

Banks often play a decisive role in the economic system of Ukraine. Confirmation of this statement may be a fact of bank-oriented financial system of the country. O. Baranovsky [2] determines that such a role, first and foremost, is due to the simultaneous functionality of banks as a monetary institution, financial intermediary and intermediary of the securities market. Moreover, banks participate in the activity of foreign exchange markets and work in the field of international settlements. Permanent or sudden negative effects that arise in any area of activity may affect the final result of the bank's activity. The danger, as a negative feature of banking activity, may be of different origin and can cause damage both to the banking institution itself and to all entities with which it is associated. Crimes in the sphere of banking covers various types of damage to the protected legal interests of the both legal and natural persons [3]. Consequently, for the work of individual banks, as well as the whole banking system, it is necessary to ensure such conditions, in which the action of external and internal factors will not lead to negative processes. These conditions constitute a complex concept of banking security, which leads to a large number of diverse approaches to its definition. Scientists state the comprehensiveness and contradiction of approaches to the formulation of bank's security essence. Thus, S. Vasilchak determines that the security of the bank is a state of sustainable existence, which ensures the implementation of the main interests and priorities of the bank, protection from external and internal destabilizing factors [4]. In the works of N. Prokopenko banking security is explained as a qualitative attribute and characterizes its state as such, in which there are no dangers [5]. The above mentioned definitions focus on the banking institution itself, but there is an approach in which the security of a bank is considered exclusively in conjunction with the security of the national banking system and even - the world banking system. D. Shcherbatyh connects the security of a separate bank with the security of the banking system as a whole. In his opinion, they affect one another. On the one hand, the problems that arose in one bank can cause a "domino effect" and lead to a systemic banking crisis. This is explained by the nature of banking activity, because banks work mainly with someone else's money [6]. D. Alekseev also appeals to the national banking system. In his works bank security is a durable, financially stable state of the national banking system, which allows sustainable implementation of banking transactions and contracts (and also operational recovery after the negative influences of unforeseen circumstances) by its participants, regardless of existing or potential threats (risks) [7]. R. Vovchenko appeals to the complex and multidimensional concept of banking safety. Bank security is interpreted as a certain state; possibility of further development; function of the state; regulation of economic standards, obligatory economic standards and requirements; the activities of the central bank, state bodies, as well as commercial banks for management functions in the implementation of banking transactions and contracts; set of technical regulations and requirements [8]. Bank security should be considered in the context of its main varieties. Thus, M. Zubok highlights the personal security of the bank, collective, economic and informational [9]. That is, banking security should create conditions for adequate circumstances, timely, planned, efficient work of a separate banking institution and the system as a whole.

#### 4. DISCUSSION

It should be noted that banking security should be based on a reasonable mechanism for overcoming the current and long-term problems of the banking system, as well as for adequate regulation of risks arising in the banking sector. Classically, international practice works in such manner. So, if we are talking about the problems of Ukrainian banking system, it is advisable to focus on what today really formed huge list of restrictions which directly indicate the development of depressive tendencies in the Ukrainian economy. In particular, we are talking about both the risks and the problems of the banking sector in Ukraine. So, summarizing the above information, we can present the real problems of the banking system of Ukraine (Fig. 1).



**Figure 1** Systematization of modern problems of Ukrainian banking system

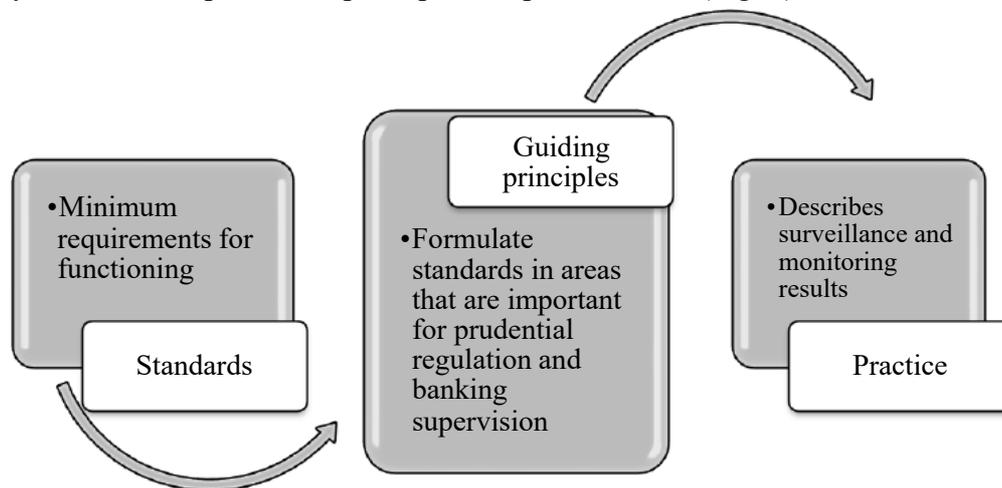
**Source:** Done by authors based on their own research

So, taking into account the information presented in Fig. 1, it can be concluded that in today's conditions of existence and functioning of Ukrainian banking system, not only the preservation of the banking sector stability, but also the expansion of real sector lending is a priority task. And this indicates that at the current stage of Ukraine's development, the priorities and interests of domestic representatives of the banking system and foreign banking structures do not always coincide. In particular, it is a fact that banks in European Union's countries primarily focused on solving problems related to liquidity, including through the suspension and financing foreign branches and subsidiaries, withdrawal from less developed countries.

The legal basis for banking is the rules that regulate financial standards and reserve requirements that form liquidity. Given the formal division into the level of individual banking institutions, the level of the banking system and the macro level (the state), it is

necessary to have a legal basis in case of necessity of leveling up of negative factors and crisis situations at each of the above levels. It is necessary according the fact that banking security is one of the main components of the national security of the state. National security of the state should always be a priority, no matter what foreign policy steps have been taken. Today Ukraine's integration into the European Union is the main goal of the country's foreign policy. The implementation of the first step towards membership in the EU, namely the entry into force of the Association Agreement between Ukraine and the European Union, requires specific measures in various areas of activity, including in the banking sector. According to the Law of Ukraine "On State Program of Ukraine's Adaptation to Law of European Union", the first stage of the program priority areas in which the adaptation of the Ukraine, is, among others, the scope of banking law. In the priority areas, and hence in the field of banking security, the adaptation of Ukrainian legislation is carried out in the following order: definition of acts of the *acquis communautaire* governing the legal relationship; translation of certain acts into Ukrainian language; realization of complex comparative analysis of regulation of legal relations in Ukraine and in the EU; recommendations' development for bringing the legislation of Ukraine in line with the *acquis communautaire*; conducting economic, social and political analysis of the implications of implementing recommendations; defining of the list of draft laws; preparation of draft laws of Ukraine and other normative legal acts included in the list of draft laws and their adoption; monitoring of their legislative acts' implementation [10]. Under these circumstances, one can expect a change in the principles of the relationship not only between banks and their clients, but also inside banking sector: between banks and the National Bank of Ukraine. The NBU itself proposed the "Strategy for the Development of the Banking System 2016-2020: "Synergy of Banks' Development and Economic Industrialization" [11]. This project takes into account all necessary changes to the legislation in order to adapt it. The text of the Agreement does not contain any direct requirements regarding the necessity for Ukraine to comply with the Basel Committee on Banking Supervision. However, the desire to reform the sector and create truly competitive and safe banking institutions should be encouraged before the transition to these standards. The development of the banking sector in order to ensure financial stability and sustainable development should be based on the provisions of Basel III. The principles of this provision, in accordance with the NBU's plans, will make it possible to increase the institutional capacity of regulators through the introduction of consolidated financial sector's supervision. Among the main areas of activity aimed at achieving the Program's goal is the provision of stability and dynamic development of the financial sector through the strengthening of the solvency and liquidity requirements of financial sector participants. In this context, it is necessary to study the principles enshrined in the system of documents prepared by Basel Committee on Banking Supervision. Current processes in the system of international relations' development indicate a reduction in the weight of each individual country as a "player" in the world market. The countries give way, in part of their powers, to other participants in international relations, including international organizations. In the financial sector, such an organization is one of the oldest (the creation of 1930) intergovernmental organizations – the Bank for International Settlements (BIS). Although the initial purpose of its foundation was to accumulate and coordinate revenues from Germany's reparations, which it was forced to pay after defeat in World War I, today the BIS is working to promote monetary and financial stability in the world. The main tips and recommendations are formed during the dialogue between representatives of the BIS member countries and in the ongoing work and monitoring of the commissions that are part of the organization. The above-mentioned Basel III is an indisputable example of such work. Recommendations are provided by the Basel Committee on Banking Supervision (BCBS). The Committee, according to words of its participants, acts as a forum for systematic interaction on banking

supervision issues. BKBN forms a global standard for prudential regulation of banks [12]. Obviously, these actions are aimed at achieving the maximum possible level of financial stability. The package of activities called “Basel III” was developed in response to the need to respond to the global financial crisis of 2007-2009, and therefore it can be concluded that the ultimate goal of its implementation should be to ensure the banking institutions from the risks and outcomes of their offensive. Members of the BIS are obliged not only to implement and use in the process of functioning Basel III, but also to do so within a specific time frame. Ukraine, as non-member of this international organization, is not obliged to adhere to these requirements; however, there is no doubt about the appropriateness of their implementation, given that they are the minimum requirements for banks’ activity in the international markets, as well as during European integration processes. In the very same European Union today there is no institution that would directly control the publication of normative legal acts on supervisory activities. As in other areas of activity, banking supervision should be based on the provisions of the regulations (direct legal force in all EU member states), directives (included in national legislation), recommendations (do not provide for mandatory implementation, but “teach the correct behavior”). A wide range of consultative information can greatly facilitate the process of principles’ implementation (Fig. 2).

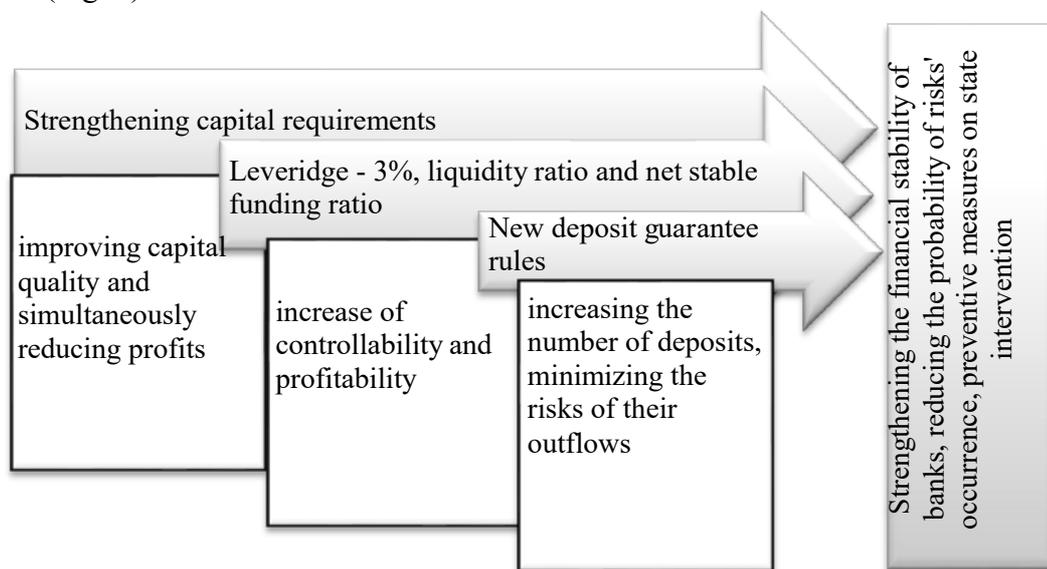


**Figure 2** Basic benchmarks for the implementation of Basel III

**Source:** developed by the authors according to (Basel Committee on Banking Supervision, 2018).

In the process of reforming Ukrainian banking sector it is necessary to adhere certain standards, rely on the principles presented in the basic documents and refer to existing practice. Such a scheme will ensure that banking supervision is balanced quantitatively and qualitatively. Quantitative balancing is the formation of specific quantitative requirements, for example, in terms of capital, and quality is, first of all, standards of current practice. Decision of the Board of the NBU dated 04/05/2017 № 207rshc On Approval of Plans for EU’s Legislation Implementation for the Realization of the Association Agreement and the above-mentioned Program of the Financial Sector Development in Ukraine show that, despite all the complexities, capital requirements and liquidity will gradually be introduced at the national level within the framework of building risks-oriented-management [13]. Main risks in this context will be the risks of non-fulfillment of obligations by the borrower (both in terms of financial insolvency and unfairness of the borrower), risks of losses from fluctuations in market prices (interest, currency, share, commodity, settlement, etc.), liquidity risk the bank’s failure to regulate the reduction of liabilities and finance asset growth, operational risk from losses through internal or external processes, or imperfections of the system [14]. The positive dynamics observed in the statistics of the National Bank of Ukraine indicates a

certain stabilization of the sector by 2017. Problems remain with the banks' reduction of deposit rates, which can be explained by an increase in the NBU discount rate as a result of inflationary predictions. Significant presence of state influence, negative expectations from the business side, non-operating loans continue to constitute developmental risks for the current year. At the same time, the NBU reports on the beginning of the active introduction of the EU's Directives and the Basel Recommendations. It is planned to put into effect the LCR liquidity standard. Specialists are preparing new rules for the calculation of regulatory capital (the acceptability of its components). Starting this year, an annual assessment of the stability of banking institutions will be carried out. It will include procedures for analyzing asset quality and, so-called stress testing [15]. Compliance with the Basel III rules will result in changes not only in certain banking institutions, but also in the banking system as a whole, which will affect the macroeconomic indicators of the state. Assessing the changes in the three main requirements and referring to the research of the National Institute for Strategic Studies, we schematically outline the possible results of reforming Ukrainian banking institutions (Fig. 3).



**Figure 3** Reforming the requirements for banks in the framework of the European integration of Ukraine based on Basel III

**Source:** developed by the authors according to (Introducing new capital requirements in accordance with Basle and EU legislation, 2018), (On the integration of the Ukrainian banking system into the European Union banking system, 2018), (Basel III: Finalising post-crisis reforms, 2018) [13, 16,17]

The first block of changes forms, the so-called “anti-cyclical buffer”, which will improve the level of anti-crisis management, that in turn will reduce the probability of the main risks’ of activity occurring. “Fashion” for the running banking business in such a way can be a reason for the refusal of small banking institutions to participate in high-risk operations, which in the short-term may lead to a decrease in profits.

The second block provides the expansion of tools that can help to monitor the liquidity. It was forecasted that the awareness of sources of funding and timely information on debt obligations can have a positive effect on profitability. Banks, in the conditions of such reforming, will receive additional incentives to expand offers.

Non-proportional minimum guarantees for population deposits for the EU countries (100 thousand euros) and Ukraine (150 thousand UAH) are the indisputable evidence that, even if there are slight worries, there will be an outflow of deposits.

The changes that will take place in the banking sector reform are necessary not only from the point of view of compliance with European integration obligations, but also as important levers to resolve existing problems. Thus, due to the research that was held in 2017, was recommended that for all countries in the world should be inherent “inclusive growth”, which foresees the strengthening economy with full employment. But the employment rate should comprise 75% of the population aged from 20 to 64 years and banking activity is not an exception [18]. At the same time, one can't agree with V.V.Shpachuk, who in his studies emphasizes that “the introduction of recommendations of “Basel III” is not a guarantee of automatic improvement of the efficiency of the domestic banking institutions’ activities as well as the stability of the banking system” [19]. We are talking about the necessity to take into account the national features of the banking system and the situation in the country, which is also a significant factor of influence. Basel III was developed in 2010-2011 years, and the final date for its full implementation should be March 2019. According to the NBU, the activation of capital buffers and the introduction of new requirements for indicators of leverage is planned for 2020, a year earlier, a new capital structure is planned to be introduced and updated capital requirements to cover operational and market risks. The ratio of fixed capital to the additional one since 01.01.2019 should be 70/30 (today it is about 50/50).

## 5. CONCLUSION

Long-term systemic security problems in the sphere of banking can be problems in adapting Ukrainian banking legislation to EU requirements, and given the unfavorable market conditions and outflow of capital, these problems can even lead to crises. When unfavorable conditions or challenges react without the usage of a specific strategy, the actions of regulators can become additional "shock situations" for the bank. In turn, the crisis of the banking system will lead to a financial, economic or currency crisis and inequality in the state. Many academicians and social commentators argue that the high levels of economic inequality have negative effects on societies [20]. The systematization of problems that slow down the adaptation of banking law to EU requirements is as follows: 1) permanent shortage of resources with maturities in more than 5-10 years; 2) banking institutions cannot fulfill their obligations to provide credit support for the reform processes in specific sectors of the economy. In Ukraine, banks do not meet the investment needs, and therefore, they cannot influence the development of specific sectors of the economy; 3) inconsistency of short-term and long-term obligations of banks, which leads to negative consequences in case of deposits’ outflow; 4) currency mismatch for obtaining loans with currency for obtaining income for repayment of loans; 5) attraction of foreign capital (after entering the Ukrainian market of banks with foreign capital) for the active financing of imports; 6) deterioration of the banking market’s structure: an increase in the concentration of foreign capital and a decrease in competition in the banking market; 7) Ukraine shows the worst result among the 140 countries of the world in terms of "strength of banks", etc. (Strategy of banking system’s development for 2016-2020: “Synergy of development of banks and industrialization of the economy”, 2016) [21]. Under established conditions, banks should systematically monitor the existence of all types of threats, study the possibilities and ways of their prevention and take all possible measures for their localization and neutralization of harmful effects [22]. Adaptation of legislative norms to the requirements of the EU’s Directives should be carried out in the framework of amending some legislative acts of Ukraine on increasing trust between banks and their clients, improving the protection of the rights of financial services’ consumers, liberalization of currency transactions to facilitate investments and exports, ensuring transparency of the National Bank’s of Ukraine activities, and raising its responsibility to society, improving the system of guaranteeing deposits of individuals and procedures for withdrawing banks from the market, clarifying the terms of the appointment

and dismissal of the Chairman of the National Bank of Ukraine. In pursuance of the strategy of the banking system's development, a number of draft laws are also being drafted, in particular regarding insurance, restructuring of the Ukrainian citizens' obligations for loans in foreign currency, received for the purchase of single housing, financial leasing, credit unions, regulation of activities for the provision of non-bank loans secured by movable property, activities of forex companies. Thus, we arrive at the following conclusions. Unfortunately, the current state of affairs in the area of adaptation of Ukrainian legislation on banking security to European standards is unsatisfactory. In our opinion, the need for constant public reporting of responsible bodies on the current state of implementation and adaptation's measures will help to correct this situation. Ukrainian side should not only take into account the comments, recommendations and proposals of European institutions in this case, but also carry out a thorough analysis of their content and possible consequences.

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