

# IDENTIFICATION OF THREATS TO FINANCIAL INSTITUTIONS' ECONOMIC SECURITY AS AN ELEMENT OF THE STATE FINANCIAL SECURITY REGULATION

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**Abstract.** Government structures should start financial security regulation at the macro-level with the definition of a list of threats, which impact on participants in the financial market can destabilize their activities and lead to negative trends in the financial system functioning and development. The state of financial security of a country depends on the level of economic security in its financial sector. Unstable and unprofitable work of financial institutions poses a threat to the state financial security because it means the inability to fully meet the financial interests of the population and business structures. Therefore, it is important to establish a list of factors that can have a negative impact on their economic security level. *Purpose.* The research objective is to establish a list of external, hybrid, and internal threats to financial institutions' economic security for the purposes of regulating the state of financial security of the state. *Methodology.* For obtaining scientific results, the monographic method and the method of theoretical generalization were used in the article. On the basis of research materials of such scientists as Baranovsky O., Bovsunovsky G., Vovchenko R., Gladkikh D., Furman V., Gallagher H., Makmakhon V., Morrow R., De Oliveira I. S., Stickings A., Elliot D., Matanda E., Adrian T., Liang N. we systematized a list of hybrid and internal threats to financial institutions' economic security. In the paper, we used analysis techniques to establish trends in the number of bank and non-bank financial institutions in Ukraine during the last four years (2014, 2015, 2016, 2017). A list of internal threats to financial intermediaries' economic security has been generated while using information, obtained through comparing data from the survey and questionnaire of respondents – experts in the field of financial institutions economic and financial security management. Top management representatives of various types of professional financial market participants were interviewed during 2015, 2016, 2017; their answers have been analysed and the most significant threats to the normal functioning of the financial sector, and hence to the state financial security, have been identified. *Results of the survey.* It is established what threats to financial institutions economic security, and as a consequence, to the state financial security, can be called traditional ones. Hybrid threats to the Ukrainian financial market and its participants are systematized. The internal threats to the economic security of financial institutions are specified. Thus, the range of threats to the state financial security, the origin of which is the professional activity of economic entities in the financial market, is found out. *Practical implications.* Today, financial institutions are characterized by a large number of traditional and new threats to economic security, which they should learn in order to cope with because without this action their stable work will be impossible and it will also reduce the level of the country financial security. The list of threats found in the study can be used as an informational basis for the development of state strategies for ensuring the financial security of the state over the next five years. *Value/originality.* For the first time since gaining independence, Ukraine is experiencing a period of financial instability associated with military actions and the crisis of political power. To traditional threats to economic and financial security at the micro and macro levels, their new variations are added. They can only be detected in a timely manner by an expert in the field of security science and by a specialist in the practice field of managing a financial institution. The result of this study is a synergy of theoretical and practical specialists' efforts towards the search for effective approaches to the regulation of the state financial security through the threat-oriented management of financial institutions.

**Key words:** economic security, financial institutions, financial security, regulation, threat.

**JEL Classification:** D53, E44, G2

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## 1. Introduction

*The urgency of the research.* The past 2014-2017 were quite complicated for the financial market of Ukraine. Dozens of banks and other types of financial institutions were declared bankrupt and passed (or are still in the process of passing) the liquidation procedure. Lack of financial assets began to affect even the largest and the most stable participants in financial services markets, which significantly reduced their assets over the last four years. The main reason for this obstacle was the loss of a significant part of clients by financial institutions. At the same time, economic and political instability and its manifestations led to the emergence of a large number of unconventional threats to the financial intermediaries' economic security. This destabilized their activities and had a destructive effect on the level of the state financial security.

*Target setting.* Only developing a state policy of financial security regulation aimed at coordinating and controlling the activities of financial market participants, stabilizing their financial situation, and raising the level of economic security, it will be able to stop the destruction of Ukraine's economy financial architecture. However, it is necessary to start this process from the identification of modern threats to financial institutions' economic security.

*Actual scientific researches and issues analysis.* The issue of specifying the threats to the operation of financial institutions and individual segments of the financial market in the system of ensuring the state financial security is reflected in the works of well-known scholars. Thus, there are some threats specific to the financial security of the stock market and related to the circulation of securities (Baranovsky, 2016). In the insurance market, there are specific manifestations of threats to the financial security of insurance companies (Bovsunovska, 2015). The number of threats to the financial security of the banking sector in the national economy and the banking security of Ukraine is constantly increasing (Vovchenko, 2013, Gladkikh, 2015). Attempts to create a general list of threats to the economic security of domestic financial institutions are constantly being made (Furman, 2015). Certain threats to the economic security of financial institutions, the financial market as a whole, and as a consequence – the state financial security – are considered more detailed and require some special attention (Gallagher, McMahan, Morrow, 2014; De Oliveira & Stickings, 2016; Elliott, 2017; Matanda, 2015; Adrian & Liang, 2016).

*Uninvestigated parts of general matters defining.* The timely identification of threats, the impact of which may have negative consequences for the level of financial institutions economic security and the state of the country financial security, should be the first stage in the process of effective state regulation of the country's financial security.

*The research objective.* The research objective is to identify the threats to the economic security of financial institutions in order to obtain an information basis for setting concrete targets for the development of instruments for regulating the state financial security in order to minimize the risks for the stable functioning of professional participants in the financial market of Ukraine.

*Methodology.* During four years (2014-2017), the analysis of the state of the financial market in Ukraine was carried out systematically and the diagnostics of the state of certain financial institutions economic security of different types were carried out. In 2015, a questionnaire was developed to identify the internal threats inherent in modern financial intermediaries, which could be indicated only by individuals who directly work in financial institutions in positions providing them with access to comprehensive information on the economic security level. A sample of survey objects was made – 10% of the total number of institutions in the market from the banking segment, the insurance segment, the segment of asset management companies, the segment of financial companies (factoring, leasing companies), and the segment of credit unions. Experts were selected for questioning – they were representatives of financial institutions top management. In 2015-2017, an expert survey for identifying internal threats to the economic security of financial institutions was conducted. Its results, received at the beginning of 2018, are presented in this scientific paper.

*The logic of material presentation.* The authors identify changes in the number of banking and non-bank financial institutions in the financial market of Ukraine during the last four years. The second part of the main material presents the results of observations on the emergence and manifestation of various traditional types of threats to the economic security of professional participants in financial services markets. The third part systematized hybrid threats that due to the impact on the condition of certain types of financial institutions have negative consequences for the level of the state financial security as a whole. The fourth part presents the results of elaborating questionnaire data of experts, which were interviewed in order to determine the list of threats, which impact is particularly noticeable in the process of managing the financial institutions' economic security and regulating the level of the state financial security.

## 2. The current state of the financial market as an environment for the threats formation

The state of the financial market is important for the level of the state financial security. In the financial environment, the movement of capital flows, the transfer of assets from investors and financial donors to recipients are taking place; here financial resources are created and multiplied to fill the state budget and to catalyse the development of the economic system,

etc. The destructive processes that may occur during the functioning of the financial market should be timely recognized by the state regulators. In Ukraine, they are: the National Bank of Ukraine (NBU), the National Commission that performs state regulation in the field of financial services markets, and the National Commission on Securities and Stock Market. As the main characteristic of the condition, in which the state financial market is, we consider the number of institutions that operate in it. The trend towards its reduction is evidence that the level of economic security of professional market participants is insufficient to ensure their profitability, financial sustainability, and competitiveness. The financial market, where weak and volatile companies operate, cannot guarantee the realization of the financial interests of the population, economic entities, and government structures of the country.

As of the beginning of 2018, a tendency towards a gradual and continuous reducing of the number of banking and non-bank financial institutions is typical for the financial market of Ukraine (Figure 1).

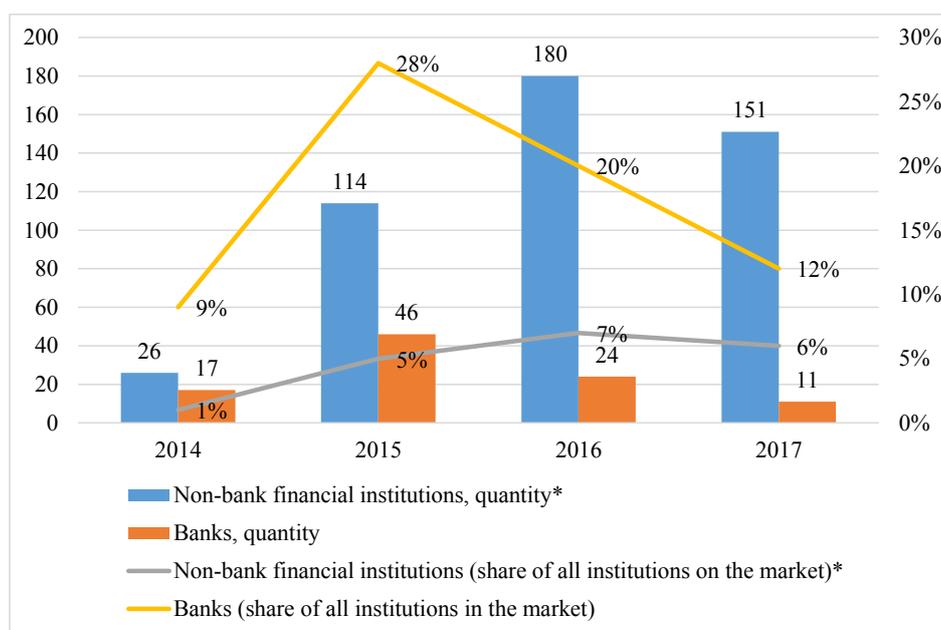
According to Figure 1, in 2014, the number of financial intermediaries (banking and non-bank institutions) in the financial system of Ukraine decreased by 43 institutions, in 2015 – by 160 institutions, in 2016 – by 204 institutions, and in 2017 – by 162 institutions. Only in the course of 2015, the banking segment of the financial system lost 28% of its participants, and consequently, its financial potential significantly decreased. We can positively estimate only

the tendency to slow down the rate of decrease in the number of professional participants in the financial market in 2017. However, leaving the market of a large number of financial institutions for four last years is a negative characteristic of its current state. Such a trend indicates the existence of many threats that accompany the activities of financial intermediaries and lead to bankruptcy and liquidation of those institutions which level of economic security is insufficient to continue the normal business activity.

### 3. Traditional threats to the economic security of financial institutions

By 2014, the main types of threats to the activities of banks and their economic security were recognized such as:

- decrease in the level of active and passive banking operations;
- fluctuations in exchange rates;
- fraud by customers and own bank staff;
- low quality of bank assets;
- lack of a due check of clients financial reliability in attempts to expand the volume of lending;
- leakage of information about managerial, investment, financial decisions from insiders;
- loss of customers in the competition;
- attacks by intruders on offices and branches of banks, especially on regional departments with a low level of physical protection;
- cyberattacks;
- corruption, erroneous actions of the regulator, etc.



**Figure 1. Reduction of the number of institutions in the financial market of Ukraine**

\*non-bank financial institutions include: insurance companies, credit unions, non-state pension funds and their administrators, managers of construction financing funds and real estate funds, product managers in groups, pawnshops, public-law legal entities, financial services companies that provide combined services and lessors

Between 2014 and 2017, there appeared other threats that traditionally were not inherent to professional players in the banking sector. Thus, the military actions in the east of the country led to the fact that the NBU by Resolution of August 6, 2014, ordered the banks of Ukraine to suspend the provision of financial services in a number of settlements, which at that moment were not controlled by the Ukrainian authorities. This caused the loss of a significant amount of material and financial resources, as well as of actual and potential customers. There are problems concerning compliance with the economic standards of banks in the banking sector. The instability of the exchange rate, which dynamics, in some cases, is completely unpredictable, remains a significant threat.

In the insurance market, such threats to the economic security of insurance companies are intensified:

- the loss of their financial stability over the lack of access to sources of funding for current activities caused by the withdrawal of capital companies abroad by foreign investors and the termination of investment support by non-resident shareholders of domestic branches and insurers' departments,
- decrease in the number of clients due to the rising cost of services and the loss by some citizens the sources of permanent income in the context of the conflict deployment in the East of Ukraine. Its consequences have also led to an increase in the number and size of insurance payments.

Also, crisis trends in the banking sector have led to a reduction in the amount of financial resources that banks have previously directed to lend to the activities of insurance companies; foreign insurers, whose branches were opened in Ukraine, and their investors, having weighed all the risks and calculated possible losses, directed the capital into more reliable investment instruments. As the problem of the Ukrainian insurance market, there remains the fact that a great part of insurance companies reimburse losses and expenses not by increasing the efficiency of operations and profitability of business but by attracting insurance premiums and revenues, without paying sufficient attention to the issue of forming insurance reserves. Banks operate according to a similar scheme, by returning deposits to individuals and legal entities whose term of payment has come, financial assets, according to which the term of payment should come later.

The big threat to the economic security of modern insurance companies traditionally remains a fraud by both – their own personnel, who can steal client bases, policy forms, tangible assets of an institution or exhibit excessive risk aversion in the provision of insurance services, and companies clients that often provide false information about the object of insurance or about an accident.

The most important for the economic security of credit unions are such types of threats, as:

- the possibility of losing of non-profit status,
- the dependence of repaying a credit on factors that are not affected by the manager (for example, loss of health or dismissal from the work of a credit union member);
- the inconsistency of the current legislation regulating relations between cooperative and financial activity;
- lack of state support in the sphere of consumer cooperation;
- weak market position compared to other types of financial institutions;
- reduction in the number and volume of deposits and loans;
- reduction in the number of credit unions members;
- increase in the percentage of arrears on loans;
- need to increase the level of services prices.

This list can be supplemented with the following types of threats: the introduction of settlement transactions registers in credit unions; lack of right for individual businessmen, farmers, cooperatives, and non-profit organizations to use the credit unions services – this significantly reduces the number of credit unions' potential clients; lack of a mechanism for guaranteeing deposits of credit unions members; insufficiency in guaranteeing the rights of credit unions members; imperfect system of prudential supervision in the credit institutions market.

Among the main threats to non-state pension funds (NPFs) can be named the creation of "internal" captive funds with distorted goals and redistribution of resources in favour of founders. The threat of mistaken estimation by managers of funds asset value, in which it is planned to invest financial resources for preserving and multiplying them, remains rather substantial. Regulatory prohibitions in using some areas of depositors' funds placement set a limited space for effective managing of the investment portfolio of NPFs and joint investment institutions in Ukraine. The existence of unreasonable quantitative restrictions for the structure of fund assets complicates the mobility of investment capital flows.

Among the threats to the economic security of financial companies and pawnshops remain:

- low effectiveness in the legislative protection of the financial interests of housing construction financing funds trustees;
- the absence of statutory and regulatory enactments regulating the problem aspects of pawnshop activity while interacting with clients;
- legislative unregulated factoring activity in the collector business and, as a consequence, a low level in the protection of citizens' interests before collectors;
- inaccessibility of financial services users to reliable information about the activities of these financial institutions due to their low level of transparency. This list can be supplemented by such types of threats as lack of financing activities sources, lack of investment resources, high level of operational risk and competition.

#### 4. Hybrid and internal threats to the economic security of financial institutions

Types of threats that are unconventional for financial institutions but now have a significant impact on the results of their operation are hybrid threats. The functioning of the financial market and its participants is currently under the control of a hybrid war caused by the conflict situation in the East of Ukraine. Accordingly, in the economic sphere, financial institutions can act as subjects of hybrid warfare, and their products and services – as instruments of hostilities. Hybrid threats to the functioning of the financial market and its professional participants are systematized in Table 1.

Despite the strong influence of external and hybrid threats on the economic security of domestic financial institutions, one should not forget about the threats of internal origin. Internal threats to the level of financial institutions' economic security are shown in Table 2.

The offered threat list is not exhausted. With each passing year, new forms and types of threats to the financial security of financial institutions will emerge in the financial market; therefore, the topic of the initiated research will not lose its relevance. At the same time, for the effective regulation of the level of the state financial security, the authorities will have to determine the priority threats to the economic security of institutions in the financial market in order to focus the main resources and efforts on their elimination.

#### 5. Views of experts on threats to the economic security of financial institutions

In order to identify in the current list the threats that need to be first taken into account when managing the economic security of various types of financial institutions, as well as identifying the threats specific to different types of financial institutions, an expert survey was conducted.

The mechanism for working with experts included the following steps:

- forming a sample of financial institutions (10% of financial institutions from each of the studied segments on the financial market – the banking sector, insurance sector, investment companies sector, financial companies sector, credit unions companies – were selected);
- there was sent a questionnaire requesting it to be filled in to each financial institution that was included in the sample: to three representatives of the senior management – for banks and insurance companies, to two representatives for AMC, to one representative for all other types of financial institutions (anonymous questionnaires filling was allowed);
- receiving completed questionnaires and analytical processing of the received data.

Taking into account the number of financial institutions in the Ukrainian market at the beginning of 2018, the analytical base for this year of the study was as follows (Figure 2).

Table 1

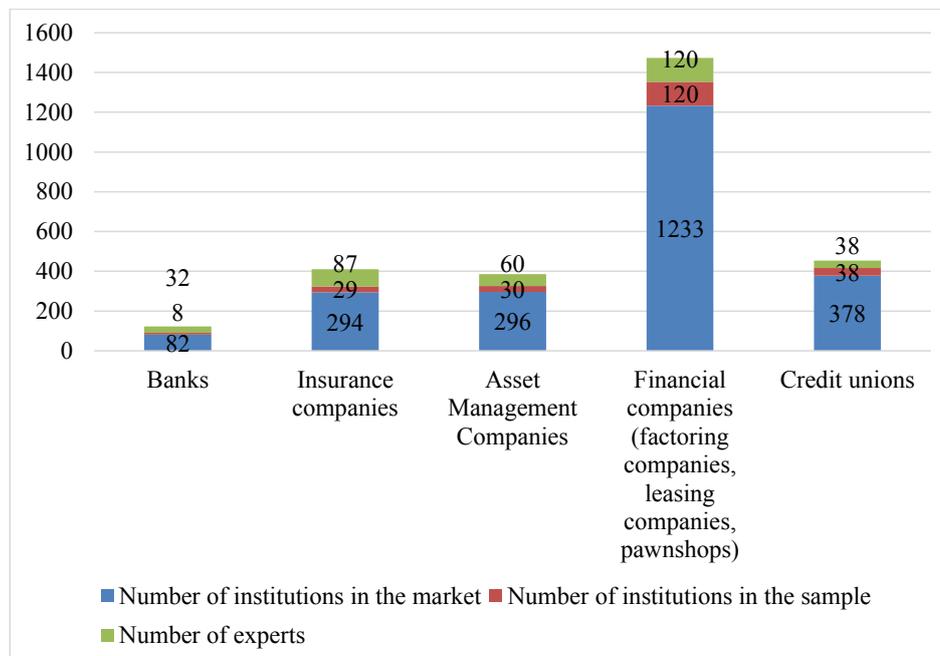
#### Hybrid threats to Ukraine's financial market functioning and to the activities of its participants

Hybrid threat	Impact on the state of the financial market, financial security of the country, and activities of financial institutions
A large number of financial institutions with a high proportion of Russian capital in the financing structure	The deterioration of the business reputation of professional market participants and the loss of public confidence in financial institutions and government, which allows the use of the capital of an unfriendly state in the financial system
Insolvency of financial institutions with Russian capital, their loss-making	Destabilization of the financial market architecture, bankruptcy of business entities that are counterparties and partners of pro-Russian financial institutions, limiting the possibilities for returning assets to their stakeholders
Legalization of capital from the occupied territories through the infrastructure of domestic financial institutions	Expansion of the shadow financial sector boundaries, fall of national currency value, caused by inflation, increase in the number of extraordinary inspections of the financial institutions' activities that block their work
Using domestic financial institutions for directing financial resources aimed at the expenditure in the occupied territories	Setting up the process of implementing financial products and services to finance terrorism, deteriorating the reputation of domestic financial institutions in the European and global financial markets, loss of investors
The impossibility of safe using pro-Russian billing electronic payment systems	Slowing the movement of financial flows, impossibility to meet the financial interests and needs of certain categories of customers
Non-repayment of loans by borrowers, non-fulfilment of obligations under customer agreements of clients staying in the occupied territories	Loss of assets, destabilization of the financial system state, lowering of the financial stability levels and financial institutions profitability, limitation of their resource base for carrying on the business activity, leaving the financial market
The subordination of individual financial institutions that have Russian co-owners or investors, to the government decision of a neighbouring state, and neglect of the domestic legal base	Violation of financial interests of Ukrainian citizens, loss of trust in the financial system, withdrawal of financial resources from the domestic financial system, negative investment image of the state as a whole
The deterioration of domestic financial institutions reputation by means of information warfare	Reduction in the number of clients, partners, investors; refusal of the stakeholders to use financial services

Table 2

**Internal threats to the level of financial institutions' economic security**

Internal threat	Influence on financial institutions' economic security
Low professional level of the personnel, its qualification, the tendency of employees to commit fraudulent actions	High risk of losing material, financial, information resources and customer base both through incompetence and through criminal actions of the employees
Opportunistic behaviour of insiders regarding the interests of financial institutions	A decrease in the level of the institution business reputation, loss of partner relations, a decrease of its value for investors in the market
Management inclination for excessive risk in the process of managerial, investment and financial decision making	Unexpected financial losses due to failures, deteriorating financial condition of institutions, loss of customers, partners, investors and their financial assets
Lack of information and analytical support in the process of countering threats, the low relevance of information resources	Irrational structure of the economic security system, excessive costs for the organization of protection and ineffective management of economic security
Ineffective time management	Financial losses or lack of profits over late management and financial decisions
Improper financial reserves in the situation of financial destabilization	Inability to compensate for the consequences of the negative impact of external and internal threats on the state of the institution economic security
Miss of the staff reserve for timely replenishment of the staff	Need for additional time and financial resources to find qualified staff
Use of unlicensed software, untimely updating of programs	The probability of hacker attacks, the possibility of access by third parties to confidential information
Absence or low efficiency of access control systems	The probability of third-party penetration into the building of the institution; theft, damage to the property of the institution and information about its activities
Low level of technical and technological support	The inability to organize the proper level of work with clients and the protection of the institution assets
The absence of a professional guard	The probability of abduction, property damage
Lack of monitoring in the economic security system	Failure to evaluate the economic security level, to detect flaws in its system of management, and timely identify the threat to the economic security of the institution
Denial of the legal department in the structure or position of a full-time lawyer	Lack of legal protection of the institutional interests
Loss, abduction, damage to information resources; their use against the interests of the institution	The risk of using information with a low level of certainty or lack of necessary information while making managerial decisions



**Figure 2. Analytical basis for assessing the threats to the economic security system of financial institutions in 2018**

Made by the author using data from government regulators

The results of the expert assessing of 10% of financial institutions from each segment of the financial market are summarized in Table 3, which shows the average interval values of the analysed indicators.

So, most managers of financial institutions do not see the likelihood of their companies' bankruptcy throughout the year. The state of economic security and the level of financial institutions management efficiency have received sufficient assessment only in the banking system, but banks also have reserves for improving these indicators.

In Table 4, we systematized the results of the answers received in the questionnaires on the question concerning the impact of specific threats on the state of financial institutions' economic security.

The identification of threats to financial institutions' economic security, the definition of their specific types for Ukrainian financial intermediaries, and those forms that have been reducing the efficiency level of the financial market functioning for several years, allow us to set guidelines for a mechanism in regulating the level of

Table 3

**Quantitative results of the assessment of threats to financial institutions' economic security, 2018  
(as of the beginning of the year)**

Indexes	Banks	Insurance companies	Investment companies (AMCs)	Factoring companies	Leasing companies	Pawnshops	Credit unions
The probability of bankruptcy by the end of the year	0-10%	51-90%	0-10%	51-90%	51-90%	0-10%	51-90%
The state of economic security (from the maximum possible 100%)	61-80%	21-40%	21-40%	0-20%	0-20%	0-20%	0-20%
Level of effectiveness of TOP management	61-80%	61-80%	61-80%	21-40%	21-40%	21-40%	21-40%
Reducing customers confidence	over 50%	over 50%	11-50%	over 50%	11-50%	11-50%	over 50%
Reducing the number of customers	11-50%	over 50%	over 50%	11-50%	11-50%	0	over 50%
The need to increase assets	21-40%	61-80%	61-80%	61-80%	61-80%	0-20%	81-100%
The deterioration of business reputation	over 50%	over 50%	11-50%	over 50%	11-50%	11-50%	over 50%
The need to attract additional financial resources	81-100%	61-80%	81-100%	81-100%	81-100%	61-80%	81-100%
Reducing the demand for financial services	41-60%	61-80%	61-80%	61-80%	61-80%	21-40%	41-60%
The need to increase regulatory capital	1-20%	1-20%	1-20%	within normal limits	within normal limits	within normal limits	within normal limits
The level of "qualitative" assets	21-40%	21-40%	41-60%	0-20%	41-60%	0-20%	0-20%
Loss of information (cases per year)	1-5	1-5	1-5	0	0	0	1-5
Fraud	over 20 times	11-20	0	11-20	11-20	11-20	11-20
Raider attacks	1-2	0	0	0	1-2	0	0
Failure of customers to fulfil obligations	over 21%	over 21%	over 21%	over 21%	over 21%	over 21%	over 21%
Level of staff qualification (from the maximum possible 100%)	21-40%	21-40%	21-40%	21-40%	21-40%	0-20%	0-20%
Liquidity level	5-10%	0-0,5%	0-0,5%	0-0,5%	0-0,5%	0-0,5%	0-0,5%
The permissible level of risks to be taken	61-80%	61-80%	81-99%	81-99%	81-99%	81-99%	81-99%

Made by the author using expert assessment

Table 4

**Results of diagnostics of the influence of some threats on the state of financial institutions' economic security**

Type of threat	Banks	Insurance companies	Investment companies (AMCs)	Factoring companies	Leasing companies	Pawnshops	Credit unions
Political pressure	+	-	-	-	-	-	-
Distrust of investors, creditors	+	+	+	+	+	+	+
Financial illiteracy of the population	+	+	+	+	+	+	+
Increase of economic and prudential norms	+	-	+	-	-	+	+
Falling of income levels	+	+	+	+	+	+	+
Corruption and nepotism	+	+	-	-	-	-	-
Increase of tax pressure	+	-	-	-	-	-	+
Economic downturn	+	+	+	+	+	+	+
Competition with foreign institutions	+	+	+	+	+	-	-
Instability of the exchange rate of hryvnia	+	+	+	+	+	+	+

Made by the author using expert assessment

economic security for its participants and to determine state priorities for minimizing threats and losses from their implementation. For organizing the process of regulation, the level of state economic security, it is advisable to propose a formula for dealing with threats: it is easier to prevent, than to avoid, to avoid is more rational than to counteract, to counteract is better than to manage, to manage is cheaper than to compensate for the consequences. Preventing the threat, as well as avoiding it, can be done only on condition of timely recognizing of their inherent nature for the institution. Thus, identifying threats is the first and main stage in managing economic security.

A concrete list of the most significant threats to financial institutions economic security is a necessary tool for Ukraine's financial security regulation process. Since the stable operation of the financial market is the basis of a stable and viable financial system, its infrastructure, which is being built on the institutions of financial intermediation, needs state support in the crisis period of functioning that is characteristic for modern Ukraine. At the state level, mechanisms for reducing the level of exposure to the most significant threats to the financial institutions economic security should be clearly defined, the directions for stabilizing the status of systemically important market participants have to be developed, the directives and

imperatives of the security-oriented activity of domestic financial intermediaries while realizing their professional functions must be created. Fierce and close monitoring of their compliance should become the basis of an innovative approach to state regulation of Ukraine's financial security.

## 5. Conclusions

The results of the study, lasting for four years, show that as of the beginning of 2018, financial institutions in Ukraine are characterized by a large number of both traditional threats to economic security and their newest forms, with which companies still should learn to fight since, without it, their further stable and cost-effective activity will be impossible. The identified lists of external, hybrid, and internal threats should be used as an informational resource for decision-making by state structures regarding the vectors for regulating the state financial security level in Ukraine, which is largely determined by the level of financial institutions economic security. In the long run, the specification of directions in state regulation of Ukraine's financial security remains an important theoretical and practical task. The separate vectors of state regulation should be aimed at minimizing the threats being identified by us within the framework of this study to financial institutions' economic security.

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