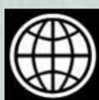
WORLD BANK WORKING PAPER NO. 81

The Development of Non-bank Financial Institutions in Ukraine

Policy Reform Strategy and Action Plan

Michel Noel
Zeynep Kantur
Angela Prigozhina
Sue Rutledge
Olena Fursova



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Contents

Acknowledgments vii

Acronyms and Abbreviations ix

Excutive Summary xi

Introduction: Financial Sector and NBFIs on the Road to EU Integration 1

1. Recent Evolution of NBFIs in Ukraine 3

Financial Sector Developments from the Mid-1990s to 2004 3

Recent Macroeconomic, Monetary and Fiscal Developments in 2005 9

Money and Securities Markets 12

Pension 23

The Insurance Sector 37

Investment Funds 42

Factoring and Leasing 43

2. Impediments to NBFI Development and Policy Reform Agenda 47

Capital Market and NBFI Regulatory and Supervisory Framework 47

Money and Securities Markets 50

Pension 63

The Insurance Sector 67

Corporate Governance 73

Broadening Access to NBFI Finance 80

Technical Annexes 95

A NBFI Regulators in Ukraine: Key Development Issues 97

B Donors Cooperation in the Area of NBFI Market Development in Ukraine 103

Bibliography 105

List of Tables

1.1 Key Macroeconomic Indicators 4

1.2 Flow of Funds 7

1.3 Bank Assets 8

1.4 Financial Sector Development, Ukraine and Comparators 10

1.5 Securities Market in Ukraine 13

1.6 Government Debt 16

1.7 Issuance of Government Securities 17
1.8 Composition of Domestic Government Debt Securities 18
1.9 Structure of investors in the Ukrainian state securities market 18
1.10 Dynamics in Ukrainian Corporate Bond Market, 1996–2003 20
1.11 Largest Ukrainian Corporate Bond Issues in 2003 20
1.12 Credit rating of Euro Bonds Issued by Ukrainian Issuers 21
1.13 Equity Markets Development in Eastern Europe 22
1.14 Ukraine Equity Market Indicators 22
1.15 24
1.16 Real Replacement Ratio (average pension/average wage), 1990–97 26
1.17 Maturation of Pension Systems, % 28
1.18 Pension Fund Own Revenues and Expenditures Excluding Transfers 28
1.19 Revenue Structure of the PFU as % of Total PFU Revenues, 1991–2002 29
1.20 Public Pension Expenditures vs. Replacement Rates, 1995–2001 30
1.21 Value of Old-age Pension as % of Minimum Subsistence Level 31
1.22 Average Pensions Granted under the Law of Ukraine "On Pension Provision" as Percentage of Average Wages, 1971–2005 33
1.23 Insurance Premiums and Payments in Ukraine 38
1.24 Insurance Market Performance in Ukraine, 1995–2005 41
1.25 New Institutions of Collective Investments (ICIs) 42
1.26 Factoring 43
1.27 Leasing 44
1.28 Distribution of Leasing Investments by Sectors of Economy 44
1.29 State Support to Leasing, 1999–2003 45
2.1 Overnight Interbank Market Volatility 51
2.2 PFTS Trading Volumes for 2002/03 76
2.3 Reporting Joint Stock Companies in Ukraine 78

List of Figures

1.1 Money supply/GDP 5
1.2 Credit Rate and Inflation 6
1.3 Loan/Deposit Spreads 9
1.4 Recent Economic Development Indicators 11
1.5 Short-term OVDPs Outstanding and New Issues 15
1.6 Average Yields on Short-term OVDPs 15

1.7 Population Aging, Ukraine, 1959–2026 27
1.8 Distribution of Pensioners by Ratio of Average Pension to Minimum Subsistence Level, January 1, 2003 32

List of Charts

2.1 PCGF Structure 83
2.2 LIIT Structure 87
2.3 PRG Structure 90

List of Boxes

1.1 Insurance Reserves and the Actuarial Profession in Ukraine 40
1.2 Violations in Activities of Insurers 42
2.1 PPP Structure and Public Accounting in the EU 82

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Acronyms and Abbreviations

AMC	Asset management company
BOO	Build-own-operate
BOT	Build-operate-transfer
CE3	Central Europe Three (Czech Republic, Hungary, Poland)
CEM	Country Economic Memorandum
COM	Cabinet of Ministers of Ukraine
CSD	Central securities depository
DVP	Delivery vs. payment
EU	European Union
GDP	Gross Domestic Product
FSA	Financial Services Authority
FOP	Free of payment
IAS	International Accounting Standards
IAIS	International Association of Insurance Supervisors
ICI	Institution of Collective Investment
IF	Infrastructure Fund
IFRS	International Financial Reporting Standards
IFS	International Financial Statistics
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISMA	International Security Management Association
LIIT	Local Infrastructure Investment Trust
MBS	Mortgage-backed securities
MFS	Inter-regional depository and clearing/settlement organization
MI	Mortgage default insurance
MOF	Ministry of Finance
MOLSP	Ministry of Labor and Social Policy of Ukraine
MSPIL	Mandatory state pension insurance law
MTPL	Motor third party liability insurance
NBFI	Non-bank financial institution
NBFIR	Non-bank financial institutions regulator
NBU	National Bank of Ukraine
NSPF	Non-state pension fund
NSPFL	Non-state pension fund law
OECD	Organization of Economic Cooperation and Development
OTC	Over-the-counter
OVDP	Treasury bill
PAYG	Pay as you go
PFTS	Persha Fondova Torgova Systema
PFU	Pension fund of Ukraine
PPP	Public-private partnership
PRG	Partial risk guarantee
PT	Pass-through

REIT	Real estate investment trust
SCRFSM	State Commission for Regulation of Financial Services Markets
SEC	Securities Exchange Commission
SNG	Sub-national government
SPF	State pension fund
STP	Straight through processing
SSCMC	State Securities and Capital Markets Commission
TRES	Total return equity swap
UAH	Hrivnya
UND	Ukrainian National Depository

Executive Summary

European Integration Presents Huge Opportunities and Challenges for NBFIs in Ukraine

As it sets its sights on European integration over the medium-term, Ukraine faces the challenge of accelerating the development of its financial sector to facilitate a smooth integration within the single EU financial market in the future. As evidenced by the experience of the recent accession countries of Central Europe, the dynamics of convergence create huge opportunities, as well as significant challenges, both for financial market participants and for financial sector regulators. This is especially the case for non-bank financial institutions (NBFIs), which tend to be the weaker component of the financial sector in the countries of Central and Eastern Europe.

First, convergence toward the EU single market creates strong pressure on domestic NBFI regulators to dramatically increase their performance in order to deliver their duties as home country regulators on par with other EU-member country regulators on the EU single market. Second, inefficient and costly securities market institutions are forced to restructure themselves or disappear in the face of direct competition from other EU-member country institutions. Third, domestic securities issuers face direct competition from other issuers in EU-member countries, forcing them to increase the quality of their issuances, and in particular to meet the standards of disclosure, financial reporting, and investor protection of the EU-member countries. Fourth, while domestic institutional investors gain access to deep, liquid EU securities markets, they also face direct competition from EU institutional investors in providing services to their clients. This has far-reaching implications for insurance companies, pension funds, and mutual funds. Last but not least, the capacity of key activities such as export finance, infrastructure finance and housing finance to reap the full benefits of integration in the EU single financial market critically depend on the development of well structured and market-friendly instruments to broaden the access of these sectors to NBFI finance.

By Most Measures, the Development of the NBFI Sector in Ukraine Lags far Behind that of Recent Accession Countries in Central Europe

In contrast to the very rapid growth of the private financial sector (from less than 13 percent of GDP in 2001 to more than 50 percent of GDP in 2005), where the banking sector plays a dominant role, the development of the NBFI sector remains very limited in Ukraine to date.

Although it has grown rapidly in recent years, reaching 38 percent of GDP in 2005, the Ukrainian equity market remains highly concentrated, with the 10 largest companies representing about 70 percent of the market. Liquidity is very low, and most trades take place over the counter. Free float by public companies is estimated at about 4 percent of market capitalization. The market is highly fragmented. In 2005, there were 12 stock exchanges and trading systems, 794 securities traders, 370 independent registrars, 143 custodians and 2 depositories. Activities on 10 of the 12 stock exchanges are dormant. More than 75 percent

of trading volume is concentrated on Persha Fondova Torgova Systema (PFTS). The development of the market is hampered by weakness and fragmentation of market infrastructure, and poor corporate governance, in particular lack of transparency of ultimate ownership and control structures of companies, weak shareholder voting rights, weaknesses in financial reporting and valuation procedures (particularly for transactions among related parties), and insufficient accountability of supervisory boards (see Chapter 2). The impact of weak corporate governance is to undermine investor confidence in the Ukrainian equity market—and to reduce the ability of the financial sector to provide needed capital for growth and expansion of the private sector.

In the money markets, the recent structural liquidity surplus has significantly reduced interbank market activity from levels that were modest to begin with—as most banks have long liquidity positions. However, as this excess liquidity has been concentrated in the very short-term maturities, there has also been very limited development of term interbank activity (for example, even beyond one week in maturity), largely because of concerns regarding credit quality. It is recommended that the NBU's policies and practices with regard to regulating the liquidity of the money markets be examined and amended to provide maximum incentive for banks to deal primarily interbank—either unsecured or through repo—rather than with the NBU in order to balance their positions.

Currently, secured interbank activity is largely by way of collateralized lending, as legal and tax uncertainties have worked against the development of a standardized interbank repo market (securities sale and repurchase agreements). The development of an effective repo market is a key element in financial market development and this issue should be addressed as a matter of priority.

The domestic government bond market was launched in 1996. Following the 1998 debt crisis and subsequent debt conversion, it took a long time for the Ministry of Finance (MOF) to restore confidence in the market. In 2005, out of a total of UAH 78 billion Government debt, UAH 29 billion (or about 8 percent of GDP) are in the form of securities, compared to about 39 percent in the CE3 countries. Of those, UAH 19 billion are Eurobonds. Of the remaining UAH 10 billion, 75 percent are held by the NBU, leaving about UAH 4 billion, or 1.4 percent of GDP worth of securities in domestic circulation. Starting in 2005, the MOF has also taken initial steps to reduce the extreme fragmentation and illiquidity of the domestic debt structure by reducing the number of auctions and introducing the reopening of existing issues. Going forward, it is recommended that the auction process be further improved in terms of transparency and that the reported introduction of switching facilities/reverse auctions be materialized on a significant scale as an important contribution to market development. While an issuance calendar has been introduced since the beginning of this year, the commitment by the Ministry to the calendar has remained somewhat qualified to date, and there remain opportunities for further increases in transparency and further dialogue with market participants.

The sub-sovereign bond market emerged in the 1985–1998 period, with 14 issuers raising about UAH 217 million over the period. Following the debt crisis of 1998, and in particular the default of the US$10 million Odessa bond in 1999, MOF and SEC introduced restrictive requirements for registration of sub-sovereign bonds and the market remained inactive until 2003. The city of Kiev placed a US$150 million Eurobond and a UAH 150 million domestic bond in 2003, equivalent to about 0.1 percent of GDP. This compares with the domestic sub-sovereign bond market share of about 0.3 percent of GDP in the

CE3 countries and about 1 percent of GDP in Russia. Although in 2004–2005 a number of SNGs have entered the bonds market (including new issues by Kyiv city, issues of municipal bonds by Kharkiv, Donetsk and other cities), the development of the market is hampered by deficiencies and inconsistencies in the legal and regulatory framework for sub-sovereign debt issuance.

The corporate bond market has grown rapidly since 2001, exceeding 2.5 percent of GDP over the 2003–2005 period, compared to less than one percent of GDP in the CE3 countries.

Prior to the reform of the pension system in 2004, Non-State Pension Funds (NSPFs) developed under the company law as not-for-profit organizations. By 2001, there were about 110 NSPFs. Since registration and investment activities of the NSPFs were unregulated, funds were misused, and pensioners and depositors incurred significant losses. The largest NSPF (Oberyg) collected savings from more than 200 thousand people all over Ukraine. Its failure in 1995 along with a number of other pyramid schemes severely undermined public trust in the financial sector in general and pensions funds in particular. By 2003, about 47 NSPFs established under the pre-reform legislative framework remained in operation, with assets of about US$60 million, or about 0.1 percent of GDP. This compares to a private pension fund penetration ratio of 3.8 percent of GDP in CE3 countries.

The Final Provisions of the Law of Ukraine "On Non-State Pension Provision" provides for the reorganization or liquidation of pre-reform non-state pension funds. To date, 31 non-state pension funds ignored the requirements of the legislature and failed to take action in accordance with the Law. To remedy this situation, State Commission for the Regulation of Financial Services Market (NBFIR) submitted documentation to oblast offices of public prosecutors so that effective measures are taken against these 31 offenders in accordance with the legislation.

The recalculation of pension benefits in August 2004, the rise in minimum pensions in September 2004, and the further rise in the subsistence minimum in September 2005 have shifted the PAYG system into a profound fiscal and social disequilibrium, translating into a huge expected fiscal deficit pension spending exceeding 14 percent of GDP (one of the highest in the world), and an almost-flat system of benefits providing excessively high replacement rates for low-income earners. These revisions threaten the implementation of the next stages of the reform because the implied fiscal deficits remove the fiscal space for financing the transition to Pillar II, and because the removal of the link between contributions and benefits generates perverse incentives that work against the development of voluntary pensions under Pillar III.

The total volume of insurance premiums increased 2.3 times during the period 2002–2005, with the total sum of insurance premiums received by insurers amounting to UAH 9.9 billion in that year. Insurance penetration reached a peak of 5.6 percent of GDP in 2004, while market density reached US$75 per capita, compared to 3 percent of GDP and US$184 per capita in CE3 countries. The high rate of insurance penetration observed in Ukraine was due primarily to the rapidly expanding volume of the voluntary property insurance segment, whose share in insurance premiums amounted to more than 85 percent in 2004. However, the very low level of payments (paid claims amounted only to 7.9 percent of total premiums in 2004) can be explained by the active use of insurance business for tax evasion and transfer of funds abroad via reinsurance. In 2005, insurance

penetration dropped back to 3.3 percent of GDP, while claims paid increased to 12.6 percent of total premiums. Overall, the development of the insurance sector is hampered by low level of transparency and weak consumer protection.

Investment funds multiplied during the mass privatization program to pool privatization vouchers from individual investors and to participate in the privatization of state-owned companies. After the passage of the Law on Institutions of Collective Investment (ICIS) in 2001, existing investment funds were to be closed or transformed into ICIs under the new Law. Since 2001, only 20 funds self-liquidated with a total amount due for settlement of UAH 1.9 billion. As of January 2004, 75 investment funds and 95 mutual funds established under the previous legal regime failed to close due to the absence of resources for settlement with investors. Since the passage of the Law, 32 investment funds have been registered, of which 22 are venture capital funds.

Factoring is not properly developed in Ukraine, although a number of banks have recently tried to offer factoring services to their clients. Factoring accounts only for 0.1 percent of total bank lending. There is no specialized legislation on factoring.

Leasing has not taken off in Ukraine following the passage of the Law on Leasing in 1997 and the subsequent Law on Financial Leasing in 2003, because relevant tax laws were not amended to address the major tax and accounting impediments facing the industry. As a result, leasing represents less than 1 percent of GDP in Ukraine today, compared to 3.2 percent of GDP in the CE3 countries.

Ukraine's Corporate Governance Rating is Lower than that of Russia and other CIS Countries, and Much Lower than EU Accession Countries

The development of the Ukrainian financial sector in general, and the NBFI sector in particular, is undermined by weak corporate governance. Under EBRD governance and restructuring rating scale ranging from 1(poor) to 4+ (advanced economy standards), Ukraine's governance rating of 2 is lower than that of Russia (2+), and much lower than ratings of CE3 countries (Czech Republic 3+; Hungary 3+, Poland 3+). Similarly, according to a survey carried out by the World Economic Forum, Ukraine's corporate governance was rated 3.5 (out of a range from 1 to 7) and ranked 77 out of 102 countries worldwide. On efficacy of corporate boards, Ukraine was ranked 69 out of 102 countries, and was ranked last out of 102 countries on protection of minority shareholders interests.

Ukrainian NBFI Regulators Lack Political Independence and Financial Autonomy, and have Poor Enforcement Capacity

Market participants identify the following problems in financial regulations as major impediments to financial market development in general and NBFI sector in particular:

- Regulators lack adequate political (legal and institutional) independence. There is continuous political intervention (from the Government, Parliament, and often powerful financial institutions) in the decisionmaking process of the financial regulators. Appointment of senior management is often driven by political favoritism rather than recognition of the competences and impeccable reputation of the appointees.

- Regulators face serious problems of under-funding. Because NBFIR pays by far lesser wages than the current level of remuneration on the market, NBFIR staff are distracted and the agency suffers from nearly 50 percent annual rotation of personnel.
- Existing technological support of regulators (IT/MIS, other equipment) does not allow timely collection and analysis of data (even mandatory regulatory reports) thus defusing the quality and timeliness of the regulatory analysis and corrective actions.
- Poor enforcement capacity of regulators results in low transparency, poor corporate governance, a non-level playing field in the market, and so forth.
- The confidence in financial market is still relatively fragile, especially in the area of NBFIs. Investors working in the NBFI sector and capital markets need stability, transparency and predictability in the actions of the regulators.

The Government program adopted by the Parliament in early 2005 envisages the merger of SEC and NBFIR. Unfortunately, this decision was not supported by the respective costs and benefit analysis of the implications of such merger. Neither information on the timing of the proposed reform nor the measures to be taken to address the current existing weaknesses in the regulatory process and institutional performance of the financial regulators are available or have been publicly discussed. In itself, a merger does nothing to resolve the fundamental deficiencies identified above and, if not carefully managed, could exacerbate current tendencies. If institutional reconfiguration of existing regulatory system and the merger of the regulators indeed be identified as a necessary step to strengthen the capacity and independence of the regulators, this reform will need to be managed very carefully over the medium-term (at least five years).

Ukrainian Authorities Need to Implement a Strategy Based on Six Main Pillars

To turn this situation around, Ukrainian authorities need to implement a strategy based on six main pillars:

- Pillar I: Carefully review the existing legal and regulatory framework for NBFIs activities and the performance of the NBFI regulators (SEC and NBFIR) and develop a comprehensive strategy for NBFI reform in Ukraine. Introduce measures to ensure political and financial independence and strengthen enforcement powers and capacity of regulators.
- Pillar II: Further develop money markets and the domestic government bond and municipal bond markets.
- Pillar III: Restructure equity markets and reform capital markets infrastructure towards its increased transparency, efficiency and consolidation.
- Pillar IV: Accelerate the introduction of funded pension schemes and improve transparency and consumer protection the insurance sector.
- Pillar V: Radically transform corporate governance and increase transparency of the market.
- Pillar VI: Broaden access to NBFI finance.

Pillar I: Strengthen the Capacity, Independence, Funding and Accountability of the NBFI Regulators.

The Government needs to take, over the nearest future, several measures to strengthen the independence and powers of the NBFI regulators: (i) to amend respective legislation on Financial Services and State Regulation of Financial Services Markets, Securities and Stock Exchanges, State Regulation of Securities Markets, Law on Business Regulatory Policy, Civil Services, and so forth to enhance independence, enforcement powers and accountability of financial regulators; (ii) to reform the funding mechanism for the new regulatory agency allowing it to collect fees from market participants; and (iii) to allow the new regulator to set salaries outside the civil service salary scale and at levels necessary to attract senior market expertise, by among other things introducing market fees from the supervised institutions.

In addition, to facilitate regulatory reform, the Government needs to: increase governance standards, efficiency, and transparency of the NBFI market; and launch accounting, auditing, and reporting reform of NBFIs and capital market participants to ensure their compliance with IAS/IFRS, ISA standards, and disclosure of information requirements of IAIS. Moreover, the Government needs to increase the power and capacity of the financial regulators to trace ultimate beneficial owners of capital market intermediaries and NBFIs, to carry out background checks of these owners, and to carry out fit and proper tests for controlling shareholders and managers of capital market intermediaries and NBFIs.

Over the 2006–08 horizon, the Government needs to bring the financial markets legislation of Ukraine, first of all, insurance, pension, and capital markets legislation, into compliance with EU directives and enhance the capacity of regulators to meet the standards of EU single financial market, IAIS and IOSCO. This envisions the need to (i) develop a comprehensive capacity building programs together with EU, multilateral and bilateral donors; and (ii) develop the capacity of the financial regulators to carry out risk-based supervision of NBFIs.

If the decision were to be made, following thorough review of the costs and benefits, to merge the financial regulators, a well planned and properly managed longer term program of actions will need to be designed and supported by the respective legal amendments and funding resources to meet the expectations for enhancing the quality of financial regulation in Ukraine. If the reform will not be properly planned and managed, it may become costly and highly disruptive, with possible negative implications for the whole financial sector and the economy of Ukraine.

Pillar II: Develop Money Markets, Government Bond and Municipal Bond Markets

Stabilize Money Markets. The development of a liquid and stable money market is critical for the development of the bond market in the country. To this end, the Government and NBU need to take a number of steps to stabilize money markets.

First, the Government and NBU need to intensify their ongoing efforts to strengthen the banking sector as a fundamental prerequisite for money market development. These include: (i) development of liquidity management capacity by banks; (ii) development of risk management capacity by banks and gradual transition to risks-based supervision of

banks; and (iii) enhancement of corporate governance and disclosure of information by banks (including full disclosure of real beneficial owners of banks and related parties transactions). These measures need to be taken in the next six months, also to support the increasing needs of banks to raise their capital and attract investments for sustainable economic growth and SMEs development.

Second, two actions need to be taken urgently by the Government: (i) to improve the forecasting of Government sector cash flows in and out of the banking system; and (ii) to identify and eliminate legal uncertainties re enforceability of collateral rights under repo agreements and also regarding tax treatment of repos.

Develop a Meaningful Long-Term Government Bond Yield Curve. The development of a liquid long-term government bond yield curve is critical to the sound development of the domestic bond market, including sub-sovereign bonds and corporate bonds.

To achieve this objective, the Government needs to take three upfront priority actions: (i) to review the organization of the primary market for government bond securities, in particular the auction process, participation requirements, and announcement of auction plan. Based on this review, identify main issues, and develop and publish auction procedures and issuance calendars (while an issuance calendar has been introduced since the beginning of the year, the commitment by the Ministry to this calendar has been somewhat qualified and there remain opportunities for further increases in transparency and dialogue with market participants); (ii) to standardize government securities instruments, specifically reduce the number of government securities tenors and concentrating them on a few standardized instruments; introduce tools such as reopening, buyback, and switch in order to strengthen the liquidity of government securities; and (iii) to establish a consultative group for the development of government securities market, to reach consensus on issuance process, consolidation of issues, restructuring of NBU portfolio, and development of interbank repos.

Over the next 12 months, the Government could then turn its attention to a review of the currency issuance strategy by comparing the pros and cons of domestic versus external borrowing, from a macro perspective, and to the development of an issuance strategy including clear debt management objectives and issuance policies. This strategy should be based on medium-term cost/risk and domestic market development considerations rather than short-term cost minimization. The Government could then develop and implement a plan for restructuring and gradual liquidation of NBU government securities portfolio by sale to the private sector.

Reform the Legal and Regulatory Framework for the Sub-Sovereign Bond Market. The development of the sub-sovereign bond market will be critical to finance the domestic counterparts of EU pre-accession and structural funds that are targeted at the sub-national level (see Chapter 2). To achieve this objective, the Government needs to design and implement a comprehensive reform of the legal and regulatory framework based on interconnected reforms of the Law on Local Borrowing and Guarantees, the Budget Code, and sub-national bond issuance regulations.

As a first priority, the Government needs to revise the draft Law on Local Borrowing and Guarantees with a view to adopt it over the next six months. This review would focus in particular on four key measures: (i) include guarantees issued by SNGs in the definition of SNG debt, restrict issuance of guarantees by Sub-National Governments (SNGs), and

value these guarantees using discounted value of probable loss methodology; (ii) simplify *ex-ante* MOF authorization procedure for SNG borrowings, using a simple set of transparent criteria for simple checking by MOF; (iii) prohibit related-party SNG lending and bond underwriting (between SNG and bank it owns); and (iv) establish clear SNG bankruptcy proceedings, that is, seizing financial control of defaulting SNG by government-appointed commissar, responsible for debt work-out and management of SNG finances until it emerges from bankruptcy.

As a second priority, the Government needs to simultaneously reform the Budget Code as it pertains to SNG borrowings, focusing in particular on the following five measures: (i) to restrict SNG borrowing to borrowing in local currency (specifically prohibiting local currency borrowings indexed to foreign currency) with the exception of refinancing of existing foreign currency debt; (ii) to establish a clear intercept authority for MOF vs transfers to SNGs; (iii) in case SNG current account is executed by Treasury, to establish that Treasury is not liable for executing court orders issued to a creditor in case of non-payment of due debt by a SNG; (iv) Creditors to serve such court orders to the defaulting SNG, which should be solely responsible for requesting execution of debt repayment by Treasury. In case of SNG default, the creditor would trigger SNG bankruptcy proceedings under SNG insolvency proceedings; and (v) strengthening internal auditing procedures for SNG budgets.

As a third priority, the Government would need to revise SNG bond issuance regulations, in particular to introduce different disclosure requirements for public offerings versus private placements of SNG debt.

Pillar III: Restructure Equity Markets

Ukrainian equity markets need to be profoundly restructured in order to have a chance to withstand competition and survive within the single EU financial market. This will require actions to streamline market infrastructure and to strengthen the market legal and regulatory framework.

As a matter of immediate priority, the Government should license PFTS as a formal exchange and establish it as the main functional Ukrainian market place in international bodies. By the end of 2006, the Government should evaluate the functionality of existing exchanges with respect to activity, rules, trading and information dissemination systems; and encourage sharing of systems and voluntary mergers between exchanges.

In parallel, SEC needs to take a number of measures to strengthen the market regulatory framework. As an immediate priority, SEC needs to issue a set of regulations to improve transparency of post-trade OTC trading, in particular on reporting obligations for traders and through establishing a dissemination system for this information, preferably reporting through the exchanges, supplemented over time by best execution rules. Over the next 12 months, SEC needs to take three key measures: (i) to establish regulations to push for consolidation of securities trades; (ii) to consolidate central securities depository (CSD) systems through improving regulation of the inter-regional depository and clearing/settlement organization (MFS), in particular reviewing capital requirements to ensure that they reflect the higher settlement risk of free of payment (FOP) vs. delivery versus payment (DVP) systems, licensing MFS as a registrar, and revising legislation to allow MFS to establish foreign links; and (iii) to establish regulations to push for

consolidation of registrars (independence requirements, minimum capital requirements, and systems).

Pillar IV: Accelerate the Introduction of Funded Pension Schemes and Improve Transparency and Consumer Protection in the Insurance Industry

Accelerate the Introduction of Funded Pension Schemes. To bring the reform of the pension system back on track, the Government needs, as a matter of urgent priority, to implement a package of expenditure reducing and revenue raising measures. Options for such a package are explored in detail in a World Bank Note entitled "Pension Reform in Ukraine: Remedy to Recent Fiscal and Structural Changes" dated February 10, 2005.

Before the end of 2006, the Government needs to proceed with measures to create the conditions for the introduction of Pillar II, rationalize Pillar III, and strengthen pension supervision.

Concerning Pillar II, the Government needs to amend the MSPIL Law simplify triggers for the introduction of the compulsory pension accumulation scheme. Revised triggers would be:

(i) Balance in Pension Fund budget based on international accounting standards;
(ii) Adoption of legislative acts necessary for operation and accumulation of pension insurance system;
(iii) Appointment of all members of Accumulation Fund Board; and
(iv) Tenders carried out and asset management companies (AMCs), custodian and auditor of Accumulation Fund contracted.

Concerning Pillar III, the Government needs to pursue the judicial procedure initiated against the 31 non-state pensions funds that are not in compliance with the Law, and to amend the Articles of the Law excepting Arkada corporation from regular pension regulation and supervision. Within the next six months, the next priority would be to examine the possibility of raising the limit for foreign investments by pension funds in investment-grade government, local government and corporate securities in EU-member countries after the AMCs attain experience for effective placement of pension assets in financial instruments within the framework set forth in the Law.

Concerning the strengthening of pension supervision, NBFIR needs to focus on three main activities: (i) to review and implement a comprehensive business plan for pension fund department; (ii) to enforce regulations concerning tracing of ultimate beneficial owners of pension fund companies and asset management companies, carrying out background checks on these owners, and carrying out fit and proper tests for directors (and significant shareholders) of pension funds and asset management companies, as part of the registration and licensing/relicensing process; and (iii) over the next 12 months, to enforce disclosure and financial reporting requirements for pension funds.

Improve Transparency and Consumer Protection in the Insurance Industry. To improve transparency, the Government and NBFIR will need to move decisively with a number of measures to reform the legal and regulatory framework and to enforce regulations.

As an immediate priority, NBFIR needs to focus on two actions: (i) to use its increased powers of investigation (see section on regulation) to effectively trace the ultimate beneficial owners of insurance companies and carry out background checks on these owners, and carry out fit and proper tests of directors (and significant shareholders) of insurance companies, as part of the registration and licensing/relicensing process; and (ii) to ensure compliance with capital adequacy requirements.

Over the next 12 months, the Government will need to design and implement a set of urgent legal and regulatory reforms in the sector, in particular: (i) enact new Insurance law compatible with EU directives, that among other things, revises the current classes of insurance, drastically reduces the number of compulsory types of insurance, introduces higher requirements for capital and disclosure of information by insurance industry, strengthens the powers of the regulator (NBFIR) in off- and on-site supervision cycle (including enforcement actions against non-compliant institutions); (ii) require express approval for changes of control and portfolio transfers; (iii) require the establishment of express audit function in insurance companies; and (iv) review existing taxation system of insurance activity and transfer taxation of insurance activity on the same basis. Ukraine also needs to enforce third party motor liability insurance requirements and develop adequate regulatory requirements and institutional framework.

Over the 2006 horizon, the Government will need to further pursue the reform of the legal and regulatory framework in the sector, focusing on: (i) reform the legal and regulatory framework for insurance intermediaries; (ii) coordinate special legislation with the provisions of the Civil Code on insurance contract law; (iii) grant priority to policy holders in case of liquidation and winding up of insurance undertakings; and (iv) regulate the actuarial profession.

By the end of 2006, the Government will need to introduce rules for protection of insurers under long-term types of life insurance. As one of the necessary elements of the reform, Ukraine needs to enforce accounting and reporting of all the NBFIs and especially insurance companies according to IAS/IFRS. Although this reform may take two to three years, this needs to be initiated immediately to increase the transparency of the market, protect the rights of insurance policy holders and attract investments into the contractual savings market.

Pillar V: Radically Transform Corporate Governance

Radically transforming corporate governance is on the critical path to sound development of NBFIs in Ukraine. To achieve this objective, the Government will need to take a set of fundamental measures to improve transparency of ultimate ownership and control structures, strengthen shareholder voting rights, strengthen financial reporting and valuation procedures, and strengthen authority and accountability of supervisory boards.

In the area of transparency of ownership and control structures, the highest priority is to require disclosure of ultimate beneficial owners of publicly-traded companies and all NBFIs. Over the next 12 months, the Government would need to take measures to secure the right of individual shareholders to access the list of company shareholders at any time, and to ensure easy public access to business registries of all companies. In addition,

all significant shareholders (both direct and indirect) should be required to publicly disclose their ownership and control interests in publicly-traded companies and NBFIs.

In the area of shareholder rights, the Government would need to take measures over the next 12 months to secure the rights of shareholders' meetings to annually elect supervisory boards and approve large asset transfers and any reorganization of the company, and establish clear preemptive rights for existing shareholders to participate in new share issues.

In the area of financial reporting and valuation procedures, the immediate priority is to require large companies to disclose their annual financial reports within three months after the end of the fiscal year, that is, before the shareholders' meeting. Over the next 12 months, the Government would focus on the following key measures: (i) to adopt IFRS for all publicly-traded companies, all financial institutions, and large companies of public interest; (ii) to ensure adequate reporting of transactions among affiliated parties, particularly among entities within the same financial-industrial conglomerate; and (iii) to require that all large asset sales and purchases be conducted at market prices or at prices confirmed by a certified valuation agent.

In the area of authority and accountability of supervisory boards, the Government would need to concentrate on four key measures by the 2006 horizon: (i) requiring that large companies elect supervisory board members using cumulative voting procedures; (ii) giving supervisory boards the right to approve asset transfers that are significant but still below the minimum threshold required for approval by the shareholders meeting; (iii) requiring that supervisory and management board members carry out their duties with due care and due diligence and in the interest of the company; and (iv) authorizing supervisory boards to appoint the members of the management boards.

Pillar VI: Broaden Access to NBFI Finance

Over the 2006–08 horizon, the Government would need to develop and implement a program to broaden access to NBFI finance, as an integral part of its strategy of EU integration. This would cover three priority areas: (i) developing credit insurance; (ii) developing debt enhancement and equity mobilization for infrastructure finance; and (iii) developing securities markets.

The Government would develop a strategy for private sector development of credit insurance, including alternatives for possible government support for export financing, compatible with OECD and EU rules.

In order to mobilize the local counterpart resources required to match EU pre-accession and structural funds, the Government would study the feasibility of a number of debt enhancement and equity mobilization instruments for infrastructure finance, in particular: (i) alternative partial credit guarantee facilities for municipal bonds; (ii) alternative equity mobilization instruments for Public-Private Partnerships (PPPs) for local utilities; and (iii) alternative partial risk guarantee facilities for PPPs for local utilities.

Finally, in order to broaden access to housing mortgage finance, the Government would study the feasibility of a mortgage insurance scheme and alternative strategies and instruments for Government support of mortgage securities markets.

Policy Reform Matrix and Action Plan

Theme	Issue	Recommendations	Priority	Timeline
Strengthen NBFI regulation and supervision	Develop a comprehensive strategy for strengthening regulatory and supervisory framework for NBFIs	Establish task force comprised of NBFIR, SEC, NBU, MoF, MoE, representatives of international financial institutions and the professional organizations of financial market participants, to discuss and develop a strategy for strengthening NBFIs regulation and supervision and enhancing the independence and institutional capacity of the financial regulators. Deploy international expertise to provide advice to reform design ahead of adoption of action plans.	A	Mid-2006
		Develop comprehensive NBFIs and capital markets development strategy and overall Financial Sector Development Program for 2005–2010.	A	Mid-2006
		Ensure that top management of regulatory agencies have indisputable professional reputation.	A	Immediate
		Enact adequate legal framework for financial regulators ensuring their independence vs Government and private interests.	A	Immediate
	Strengthen resources and powers of NBFI regulators	Reform funding mechanism for the new regulatory agency allowing it to collect fees from market participants.	A	Mid-2006
		Allow financial regulators to set salaries outside civil service salary scale and at levels necessary to attract senior market expertise.	A	Mid-2006
		Increase power and capacity of regulators to trace ultimate beneficial owners of capital market intermediaries and NBFIs, to carry out background checks of these owners, and to carry out fit and proper tests for controlling shareholders and managers of capital market intermediaries and NBFIs.	A	Mid-2006
	Prepare new regulator for integration in EU single financial market	Develop comprehensive capacity building program together with EU and other donors to ensure financial regulators deliver their duties as home country regulator within single EU market (twinning arrangements).	B	End 2006

(Continued)

Theme	Issue	Recommendations	Priority	Timeline
		Develop clear 3–5 year action plan and take measures to establish capacity of the financial regulators for risk-based supervision of NBFIs.	B	End 2006
Develop money markets	Reduce instability	Continue ongoing efforts to strengthen banking sector as a fundamental prerequisite for money market development including: (i) development of liquidity management capacity; and (ii) development of risk management capacity.	A	Ongoing effort
		To improve the forecasting of Government sector cash flows in/out of the banking system.	A	Immediate
		To resolve outstanding legal, accounting and tax uncertainties concerning repos and finalize ISMA-based master agreement consistent with Ukraine law.	B	Mid-2006
		To improve forecasting/tracking of short-term and medium/long-term FX flows at NBU.	B	Immediate
		To implement a more active and non-discriminating strategy for NBU interventions in domestic money markets to offset short-term liquidity situations.	B A	Mid-2006
Develop Government Bond Market	Develop a meaningful long-term government bond yield curve	Review the organization of the primary market for government securities, by examining the auction process, participation requirements, and announcement of the auction plan. Based on this exercise, identify main issues, and develop and publish auction procedures and issuance calendars.	A	Immediate
		Standardize government securities instruments. MOF and the NBU should consider reducing the number of government securities tenors and concentrating them on a few standardized instruments. Meanwhile, introduce tools such as reopening, buyback, and switch in order to strengthen the liquidity of government securities.	A	Immediate
		Establish a consultative industry group re development of securities market group to reach consensus on issuance process, consolidation of issues, further restructuring of	A	Immediate

(*continued*)

Policy Reform Matrix and Action Plan (Continued)

Theme	Issue	Recommendations	Priority	Timeline
		NBU portfolio, and development of interbank repos.		
		Review the currency issuance strategy by comparing the pros and cons of domestic vs external borrowing from a macro perspective. Following this review, develop an issuance strategy including clear debt management objectives and issuance policies. This strategy should be based on medium-term cost/risk and domestic market development considerations rather than short-term cost minimization.	B	Mid-2006
Develop Sub-sovereign Bond Market	Revise draft Law on local Borrowings and Guarantees	Include guarantees issued by SNGs in definition of SNG debt. Value these guarantees using discounted value of probable loss methodology. Restrict issuance of SNG guarantees to public purpose entities. Restrict issuance to local currency debt (see below).	A	Mid-2006
		Simplify ex-ante authorization procedure for SNG borrowings by MOF. Establish simple set of transparent criteria for checking by MOF. Limit criteria to verification of budget audit and publication and simple prudential criteria based on historical debt. Criteria to be independent of net recipient/contributor status of SNG.	A	Mid-2006
		Prohibit related-party SNG lending and bond underwriting (i.e. between SNG and bank it owns).	A	Mid-2006
		Establish clear procedures for seizing financial control of defaulting SNG by Government-appointed commissar, responsible for debt work-out and management of SNG finances until emergence from bankruptcy.	A	Mid-2006
		Prepare accompanying SNG bankruptcy regulations.	A	Mid-2006
	Strengthen Budget Code	Restrict SNG borrowing to borrowing in local currency (specifically prohibiting local currency borrowings indexed to foreign currency) with the exception of refinancing of existing foreign currency debt.	A	Mid-2006

(Continued)

Theme	Issue	Recommendations	Priority	Timeline
		Establish intercept authority for MOF vs transfers to SNGs.	A	Mid-2006
		Establish that Treasury is not liable for executing court orders issued to a creditor in case of non-payment of due debt by a SNG. Creditors to serve such court orders to the defaulting SNG, which should be solely responsible for requesting execution of debt repayment by Treasury. In case of SNG default, the creditor would trigger SNG bankruptcy proceedings under SNG bankruptcy proceedings (see above).	A	Mid-2006
		Strengthen internal auditing procedures for SNG budgets.	A	Mid-2006
	Revise SNG bond issuance regulations	Introduce different disclosure requirements for public offerings vs private placements of SNG debt.	A	Mid-2006
		Allow SNG bond issuance for the purpose of refinancing existing SNF debt obligations.	A	Mid-2006
Develop corporate bond market	Strengthen legal and regulatory framework	Require adoption of IFRS as a condition for listing (see corporate governance section below).	B	End 2006
		Resolve problems with implementation of Civil Code regarding registration of collateral.	B	End 2006
		Remove differences between Civil and Commercial Code re calculation of capital base for determining issuance ceilings.	B	End 2006
Develop mortgage securities market	Strengthen legal and regulatory framework	Ensure coherence between legislative acts in the area of mortgage finance.	B	Mid-2006
		Issue regulatory instruments defining the requirements to issue mortgage securities, and the specifics of Government supervision of their trading and the activities of issuers.	B	Mid-2006
		Standardize the terms on which mortgage loans are provided, procedures for their provision and servicing.	B	Mid-2006
	Strengthen institutional framework	Establish state registration of immovable property and state registration of mortgages.	B	Mid-2006

(*continued*)

Policy Reform Matrix and Action Plan (Continued)

Theme	Issue	Recommendations	Priority	Timeline
Restructure Equity markets	Streamline market infrastructure	License PFTS as formal exchange and establish it as the main functional Ukrainian market place in international bodies.	A	Immediate
		Evaluate the functionality of existing exchanges with respect to activity, rules, trading and information dissemination systems; encourage sharing of systems and voluntary mergers between exchanges.	B	End 2006
	Strengthen market regulatory framework	Improve transparency of post-trade OTC trading through a set of regulations on reporting obligations for traders and through establishing a dissemination system for this information, preferably reporting through the exchanges, supplemented over time by best execution rules.	A	Immediate
		Establish regulations to push for consolidation of securities traders.	B	End 2006
		Consolidate CSD systems through improving regulation of MFS, in particular by reviewing capital requirements to make sure that they reflect the higher settlement risk of FOP vs DVP, licensing MFS as a registrar, and revising legislation to allow MFS to establish foreign links.	B	Mid-2006
		Establish regulations to push for consolidation of registrars (independence requirements, minimum capital requirements, and systems).	A	Mid-2006
Put pension reform back on track	Restore fiscal balance of Pillar I	Implement package of expenditure reducing and revenue raising measures.	A	Immediate
	Create the conditions for introduction of Pillar II	Simplify triggers for introduction of Pillar II: Balance in Pension fund budget based on international accounting standards; Legislative acts necessary for operation and accumulation of pension insurance system adopted; All members of the Accumulation Fund Board appointed; and Tenders carried out and asset management companies (AMCs, custodian and auditor of Accumulation Fund contracted.	A	2007

(Continued)

Theme	Issue	Recommendations	Priority	Timeline
	Rationalize Pillar III	Pursue the judicial procedure engaged against 31 non-compliant pension funds.	A	Immediate
		Amend articles of the law re Arkada corporation and submit it to general provisions of the law.	A	Immediate
		Examine the possibility of raising the limit for foreign investments by pension funds in investment-grade government, local government and corporate securities in EU member countries after the AMCs attain experience with effective placement of pension assets in financial instruments within the framework set forth in the Law.	B	Mid-2006
		Introduce changes in the Law by establishing precise requirements on submission of reports and requirements for such reports during the transitional period, prudential supervision over activity of institutions, as well as timelines for the reorganization of old funds into pension fund in order to bring them in conformity with the Law.	A	Mid-2006
	Strengthen pension supervision	Review and implement comprehensive business plan for pension supervision department of NBFIR.	A	Ongoing effort
		Trace ultimate beneficial owners of pension fund companies and asset management companies, carry out background checks on these owners, and carry out fit and proper tests for directors (and significant shareholders) of pension fund and asset management companies.	A	Immediate
		Develop and enforce disclosure and financial reporting requirements for pension funds.	A	Mid-2006
Improve transparency and consumer protection in the insurance industry	Reform legal and regulatory framework	Enact new Law on Insurance compatible with EU directives and regulatory principles endorsed by the IAIS. The legal reform should include, inter alia, revision of current classes of insurance, drastically reducing the number of compulsory types of insurance, strengthened powers and broadened enforcement instruments of the regulator, streamlined procedures	A	End 2006

(*continued*)

Policy Reform Matrix and Action Plan (Continued)

Theme	Issue	Recommendations	Priority	Timeline
		for reorganization and liquidation of insolvent companies, improved disclosure of information, accounting, reporting and auditing of insurance industry in compliance with IAS/IFRS and ISA.		
		Require express approval for changes of control and portfolio transfers.	A	End 2006
		Establish enhanced on-site supervision framework for insurance companies and require insurance companies to conduct express audit.	A	End 2006
		Reform the regulatory framework for insurance intermediaries.	B	2007
		Coordinate special legislation with the provisions of the Civil code on insurance contract law.	B	End 2006
		Grant priority to policyholders in case of liquidation and winding up of insurance undertakings.	B	End 2006
		Regulate the actuarial profession.	B	End 2006
	Enforce regulations	Trace ultimate beneficial owners of insurance companies and carry out background checks on these owners; carry out fit and proper tests of directors and significant shareholders of insurance companies.	A	Immediate
	Strengthen consumer protection	Ensure compliance with capital adequacy requirements.	A	Immediate
		Enforce third party motor liability insurance requirements, introducing proper checks and sanctions for non-compliance.	A	Mid-2006
		Introduce and enforce consumer protection rules.	B	End 2006
		Introduce alternative dispute resolution mechanisms for insurance services.	B	End 2006
Transform Corporate Governance	Ensure transparency of ultimate ownership and control structures	Require public disclosure of significant ultimate beneficial owners of Non-Bank Financial Institutions, including insurance companies, pension funds, investment funds (mutual funds and private equity funds) and leasing companies.	A	Immediate
		Secure the rights of individual shareholders to access the list of	A	Mid-2006

(Continued)

Theme	Issue	Recommendations	Priority	Timeline
		company shareholders at any time.	A	Mid-2006
		Ensure easy public access to business registries of all companies.	A	End 2006
		Require public disclosure of significant ultimate beneficial owners of publicly-traded companies.	A	Mid-2006
	Strengthen shareholder voting rights	Secure the rights of shareholders' meetings to annually elect supervisory boards and approve large asset transfers and any reorganization of the company, including creation of subsidiaries, joint ventures and conduct of company takeovers.	A	Mid-2006
		Establish clear preemptive rights for existing shareholders to participate in new share issues.		
	Strengthen financial reporting and valuation procedures	Adopt International Financial Reporting Standards (IFRS) for all publicly-traded companies, financial institutions (including banks, insurance companies, and investment fund management companies) and large companies ("of public interest").	A	Mid-2006
		Ensure adequate reporting of transactions among affiliated parties, particularly among entities within the same financial-industrial conglomerate.	A	Immediate
		Require large companies to disclose their annual financial reports within three months after the fiscal year, i.e. prior to the shareholders' meeting.	A	Mid-2006
		Require that large asset sales or purchases of assets be conducted at market prices or at prices confirmed by a certified valuation agent.	B	End 2006
	Strengthen the authority and accountability of supervisory boards	Require that large companies elect supervisory board members using cumulative voting procedures.	B	End 2006
		Give supervisory boards the right to approve asset transfers that are large but still below minimum threshold required for approval by the shareholders' meeting.	B	End 2006

(*continued*)

Policy Reform Matrix and Action Plan (Continued)

Theme	Issue	Recommendations	Priority	Timeline
		Require that supervisory and management board members carry out their duties with due care and due diligence and in the interest of the company.	B	End 2006
		Authorize supervisory boards to appoint the members of the management boards.	B	End 2006
Broaden Access To NBFI Finance	Develop credit insurance	Develop a strategy for private sector development of credit insurance, including alternatives for possible government support for export financing compatible with OECD and EU rules.	B	End 2006
	Develop debt enhancement and equity mobilization for infrastructure finance	Study the feasibility of alternative partial credit guarantee facilities for municipal bonds.	B	End 2006
		Study the feasibility of alternative equity mobilization instruments for municipal utility Public-Private Partnerships.	B	End 2006
		Study the feasibility of alternative partial risk guarantee facilities for municipal utility Public-Private Partnerships.	B	End 2006
	Develop mortgage insurance and mortgage securities markets	Study the feasibility of a government-sponsored mortgage insurance scheme.	B	End 2006
		Study the feasibility of alternative strategies and instruments for Government support of mortgage security markets.	B	End 2006

INTRODUCTION

Financial Sector and NBFIs on the Road to EU Integration

As it sets its sights on European integration over the medium-term, Ukraine faces the challenge of accelerating the development of its financial sector to ensure a smooth integration within the EU single financial market in the future. As evidenced by the experience of the recent accession countries of Central Europe, the dynamics of convergence create huge opportunities as well as challenges both for financial market participants and for financial sector regulators. This is especially the case for nonbank financial institutions (NBFIs) which tend to be the weaker component of the financial sector in the countries of Central and Eastern Europe.

First, convergence toward the EU single market creates strong pressure on domestic NBFI regulators to dramatically increase their performance in order to deliver their duties as home country regulators at par with other EU-member country regulators on the EU single market. Second, inefficient and costly securities market institutions are forced to restructure themselves or disappear in the face of direct competition from other EU-member country institutions. Third, domestic securities issuers face direct competition from other issuers in EU-member countries, forcing them to increase the quality of their issuances, and in particular to meet the standards of disclosure, financial reporting, and investor protection of the EU-member countries. Fourth, while domestic institutional investors gain access to deep, liquid EU securities markets, they also face direct competition from EU institutional investors in providing services to their clients. This has far-reaching implications for insurance companies, pension funds, and mutual funds. Last but not least, the capacity of key activities such as exports finance, infrastructure finance and housing finance to reap the full benefits of integration in the EU single financial market critically depend on the development of well structured and market-friendly instruments to broaden the access of these sectors to NBFI finance.

CHAPTER 1

Recent Evolution of NBFIs in Ukraine

Financial Sector Developments from the Mid-1990s to 2004

Ukraine's private financial sector has grown significantly over the 2001–04 period from less than 13 percent of GDP in 2001 to more than 50 percent of GDP in the first half of 2004. After a difficult initial period where real GDP shrank by more than 60 percent between 1993 and 2000, conditions improved substantially. Since 2000, GDP has grown by an average of 8.3 percent per year. Growth came firstly as a result of the favorable environment which emerged for Ukrainian exports which resulted in large current account surplus of 10.5 percent of GDP in 2004. Exports expanded by 53 percent during 2001–04 (See Table 1.1).

Ukraine's economic recovery and positive future economic outlook resulted in the upgrading Ukraine's sovereign rating to "BB–" and "B positive" by two international rating agencies. FDI increased by $1.25 billion in 2003. The Government recently placed a 10-year Euro bond in the amount of $1 billion at the rate of 7.65 percent, which is the lowest rate achieved since Ukraine's independence in 1991.

Recent growth has been concentrated in large financial-industrial groups.[1] While this is a positive development, the failure of businesses outside these groups to grow is a cause for concern. A report by Standard & Poor's[2] cites intra-group lending as a major weakness in the Ukrainian banking system suggesting that banks reinforce this concentration of growth within these groups.

Macroeconomic stabilization allowed rapid re-monetization of the economy, fiscal sustainability, a sharp reduction of public debt and a significant expansion of international

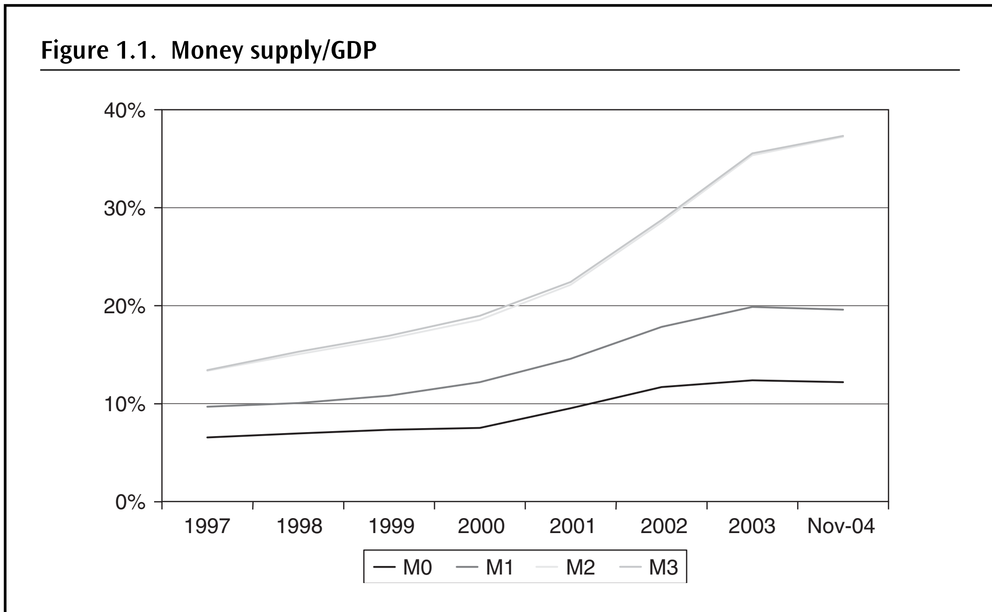
1. Ukraine Country Economic Memorandum, 2004.
2. Bank Industry Analysis: Ukraine (Republic of,).

Table 1.1. Key Macroeconomic Indicators

Percent	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP growth	–14.2	–22.9	–12.2	–10.0	–3.0	–1.9	–0.2	5.9	9.2	5.2	9.3	12.1
Inflation, eop	10156	401	181.7	39.7	10.1	20.0	19.2	25.8	6.1	–0.6	8.2	12.3
Exchange rate, UAH/US$	0.1	1.0	1.8	1.9	1.9	3.4	5.2	5.4	5.3	5.3	5.3	5.3
Real Effective Exchange rate	49.8	70.5	84.4	99.4	112.5	109.7	106.7	100.0	100.4	95.2	86.7	81.7
Current account	–1.3	–2.4	–3.2	–2.7	–2.7	–3.0	5.4	4.6	3.7	7.5	5.8	10.5
External debt	5.9	10.0	14.3	16.3	17.4	24.5	35.3	32.4	55.2	52.1	47.5	47.2
Fiscal balance	–28.1	–8.7	–4.9	–3.2	–5.6	–2.5	–2.3	–1.1	–1.6	0.5	–0.9	–4.4
Government debt	30.8	41.8	27.1	23.4	28.8	50.7	48.8	37.7	31.0	28.6	24.7	19.6
M2	32.6	26.7	12.6	11.1	13.3	15.0	16.6	18.6	22.1	28.5	35.3	36.4
Savings	36.0	32.2	23.6	20.1	18.4	18.5	23.0	24.8	23.4	24.6	24.5	26.7
Investments	36.3	25.3	26.7	22.7	21.5	20.8	17.5	19.8	21.8	20.2	22.0	19.2
Exports, US$ mil.	7817	16641	17090	20346	20355	17621	163324	192485	21086	23351	28953	39719

Source: WB ECSPE Staff Estimates, Live Database (The World Bank), Central Bank of Ukraine, IMF, SSCU, MoE.

Figure 1.1. Money supply/GDP



Source: NBU.

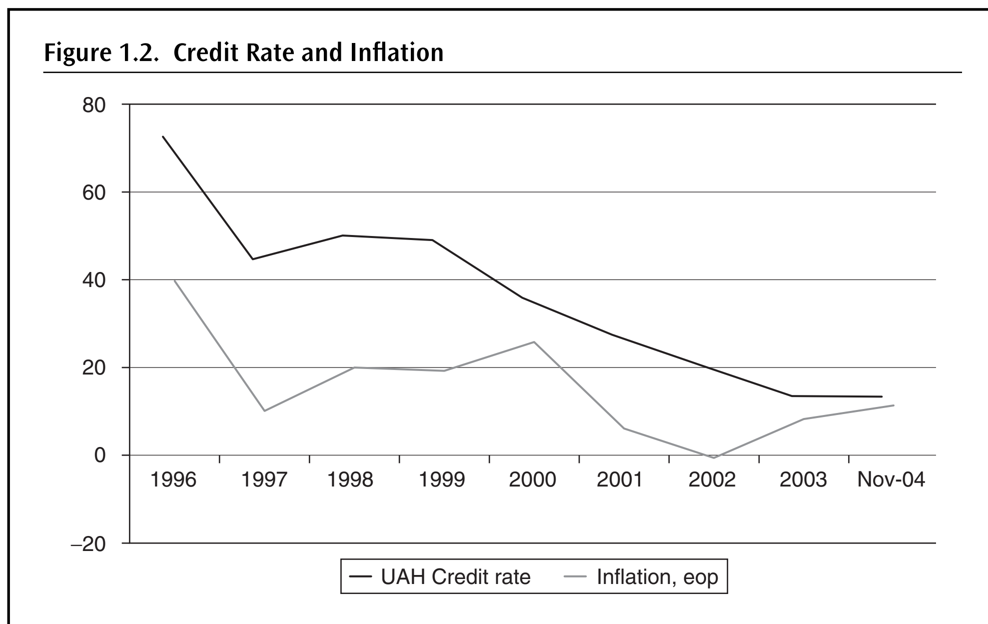
reserves. Despite the proclaimed floating currency regime, the National Bank of Ukraine maintained a de-facto fixing rate of the Hrivnya to US dollars at 5.33, which changed insignificantly during 2000–2004. Gross international reserves increased to more than $7 billion at the end of 2003 and reached $9.5 billion in December 2004. Inflation remained in single digits between 2001 and 2003 and stood at 12.2 in 2004. Real GDP growth was 12 percent in 2004—the highest since Ukraine's independence.

A strong increase in money demand allowed an increase in M2 from 16.6 percent of GDP in 1999 to 35.5 percent in 2003 while reducing inflation from 19.2 to 8.2 percent over the same period (see Figure 1.1 and Figure 1.2). Thus, monetization has changed from lagging that of other countries in the region to being among the highest in the region without generating inflationary pressure.

Unsterilized capital inflows fueled the rapid money and credit growth. A flow-of-funds analysis (see Table 1.2) shows that foreign flows to the private sector have ranged from 3.1 to 5.5 percent of GDP since 2000. These capital inflows were only partially sterilized by the National Bank of Ukraine (NBU). The analysis also shows that the current account surplus accrued in the private sector.

The banking sector expanded rapidly since 1999, as evidenced by the increased credits and deposits. Household deposits in commercial banks grew on average by 58 percent during the 2000–03 and increased by more than 70 percent in 2002, 68 percent in 2003, and 28.4 percent in 2004. The size of the average household deposit increased from UAH 806 to UAH 2800 (or US$152 to US$528), which triggered deposit insurance coverage increase under the Fund of Deposit Insurance from UAH 500 in 2001 to UAH 3000 in May 2004.

Figure 1.2. Credit Rate and Inflation



Source: NBU.

Total bank assets grew from 16.2 to 34.8 percent of GDP over the period 1999–2004 (see Table 1.3). This growth almost entirely reflected increased credits to the non-financial private sector, which now equals 26.5 percent of GDP, although this remains low by comparison with other emerging markets in the region.

The maturing of the banking sector has also lead to decreased spreads (see Figure 1.3), although they remain high by international comparison. The decrease since 1999 probably reflects both a more stable macroeconomic environment and a more efficient sector.

Non-bank financial institutions remain underdeveloped in Ukraine compared to all comparators in Table 1.4. In 2002, insurance premiums equaled just 2 percent of GDP, although the market grew almost 6 percent over the first nine months of 2004 at least due in part to the growth of tax evasion schemes. Until January 2004, the State was the sole formal provider of formal pensions[3] and non-State pension funds developed without regulation and supervision. Stock markets are incipient and have little activity.

Social reforms initiated by the Government in 2002–03 and continued in 2004, including pension reform, resulted in wage and pension growth and an increase in the population's purchasing power that triggered consumer spending and created a stronger demand for financial resources, first of all bank lending. Legislative improvements in the area of financial leasing, insurance, credit unions activities, and mortgage finance encouraged development of new financial services and fast growth of NBFI sector, beginning with insurance. Enactment of the new law on Protection of creditor rights and registration of charges in November 2003 laid down a foundation for safer lending and future expansion of investment activities.

3. AXCO report on Ukraine life and benefits insurance market report.

Table 1.2. Flow of Funds

Percent of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Domestic Sectors										
Government Balance	–4.9	–3.2	–5.6	–2.5	–2.3	–1.1	–0.9	0.5	–0.4	–1.9
Private Sector Balance	2.5	0.5	2.9	–0.6	7.5	5.8	4.6	7.2	6.6	12.4
Foreign Sector										
Current Account	–2.4	–2.7	–2.7	–3.1	5.3	4.7	3.7	7.7	6.2	10.5
Capital and Financial Account	0.2	0.9	3.8	–1.5	–0.2	–0.1	0.1	0.6	0.6	–10.4
Government									6.9	4.8
Banks	–0.7	0.2	–1.0	–0.1	0.1	–0.2	0.4	–0.2	0.9	1.2
Private Sector	1.8	2.1	4.2	5.0	–2.2	–4.3	–3.1	–5.5	–4.1	
Monetary Authorities	2.5	1.7	0.6	0.7	0.2	–2.0	–0.2	–0.5	–0.5	
Reserves	–1.0	–2.0	–0.8	3.2	–0.9	–1.3	–4.2	2.5	4.1	3.4
Bank Sector (change in stocks)										
Deposits	3.9	1.9	2.4	4.7	12.4	20.7	18.0	29.1	50.4	6.3
Credit to private sector	0.5	0.7	2.3	13.5	9.9	24.9	20.0	31.8	54.0	6.1
Credit to Central Government	0.4	1.3	2.1	–0.7	–1.3	–1.1	1.6	0.0	–0.5	–0.5
Credit to non-fin. public enterprises	4.6	2.8	1.2	–9.8	1.1	0.4	2.5	0.0	0.2	0.1

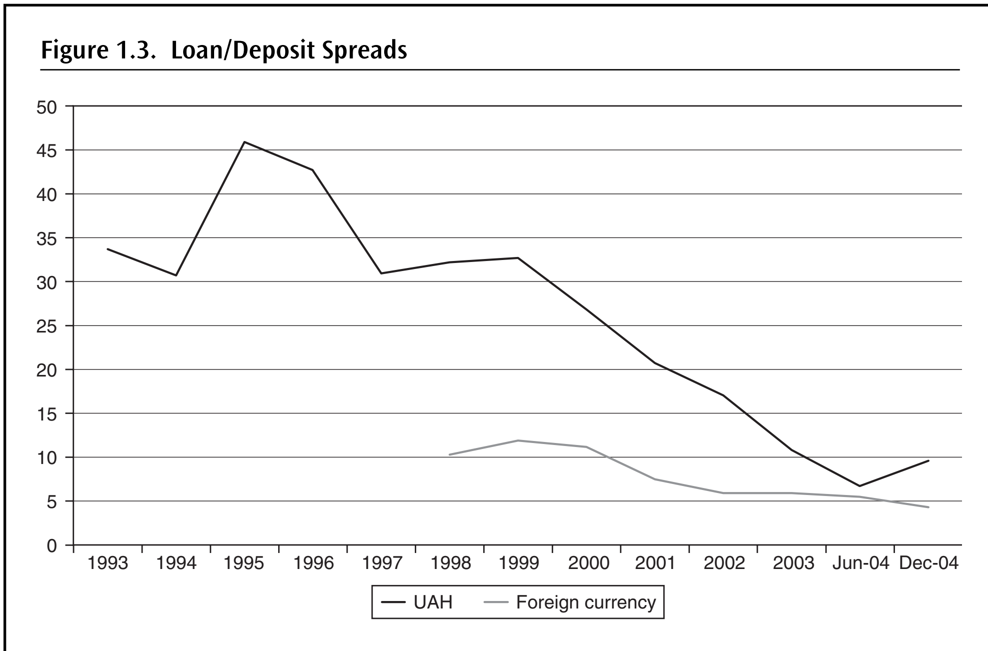
Source: WB ECSPE Staff Estimates, Balance of Payments Statistics (IMF), International Financial Statistics (IMF), Live Database (The World Bank).

Table 1.3. Bank Assets

Percent of GDP	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Number of Active Banks												160
Reserves	12.3	6.3	1.8	1.0	1.0	1.4	2.0	2.8	2.7	2.0	2.7	3.4
Foreign assets	10.8	12.1	3.4	2.2	2.0	3.0	3.4	2.9	2.0	2.1	2.7	3.5
Central governments	1.2	0.0	0.4	1.0	1.9	1.5	0.9	0.5	0.7	1.2	1.0	0.8
Non-financial enterprises	26.3	11.9	6.7	6.1	5.9	1.4	1.4	1.1	1.4	1.7	2.1	1.8
Private sector	1.4	4.6	1.5	1.4	2.4	7.7	8.5	11.1	12.9	17.9	24.3	25.0
Non-monetary financial institutions	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.3	0.3
Total	51.9	35.0	13.8	11.6	13.3	15.2	16.2	18.5	19.9	25.0	33.0	34.8

Source: WB ECSPE Staff Estimate, NBU, Association of Ukrainian Banks, International Financial Statistics.

Figure 1.3. Loan/Deposit Spreads



Source: National Bank of Ukraine.

Insurance companies and non-State pension funds hold significant assets with banks and in the form of government debt securities, but they do not hold substantial corporate sector assets—neither in the form of bonds nor equity. Most of the corporate sector bonds appear to be held by banks, which already have a credit assessment of private corporations. Thus, while the contractual savings institutions have the potential to become important investors in the capital market, they do not play that role at this stage.

Recent Macroeconomic, Monetary and Fiscal Developments in 2005

Real GDP growth in 2005 significantly declined to 2.6 percent from 12.1 percent in 2004. The real IIP growth in 2005 decelerated to 3.1 percent comparing with 12.5 percent in 2004. In 2005, merchandise export growth decreased to 4.9 percent comparing with 41.6 percent in 2004, while merchandise imports grew in 2005 by 24.6 percent, only 1.3 percentage points less than in 2004. The current account balance was—US$0.2 billion in the third quarter of 2005. It became negative for the first time starting from the first quarter of 2000 (though it is still in surplus cumulatively in Jan–Sep: US$2.1 billion). Inflation decelerated in 2005, with the CPI reaching 10.3 percent annually, which is 2 percentage points lower than in 2004 (see Figure 1.4)

After appreciation of the Ukrainian currency in April 2005 by about 4 percent, the NBU continued to maintain the official exchange rate at 5.05 UAH/US$ by the end of 2005. International reserves of the NBU increased during 2005 by US$9.9 billion to US$19.4 billion—almost half of this increase was attributed to the bought out forex revenue from

Table 1.4. Financial Sector Development, Ukraine and Comparators

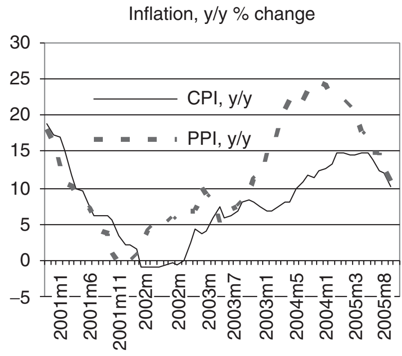
2002 unless otherwise noted. Share of GDP unless otherwise noted.	Stock Market Capitalization, 2003[1]	Number of Listed Companies[2]	Bank Assets	Insurance Premiums[3]	Insurance Company Assets, 2001[4]	Pension funds, 2001[5]	Investment Funds, 2001	Leasing Turnover, 2002[6]
Bulgaria	4.7	354	40.7	1.9		1.2		
Kazakhstan			28.3	0.6				
Romania	10.0	4870	24.9	1.1		0.0		
Russia	63.6	196	36.2	1.5	1.4			0.7
Serbia and Montenegro			26.5	2.2				
Ukraine	7.5	184	24.9	2.0				
CE3								
Czech Republic	22.9	78	72.7	4.0	8.4	2.5	2.6	
Hungary	21.6	48	55.0	2.9	5.5	3.9	4.8	
Poland	19.2	216	48.3	3.0	5.2	2.6	1.8	
Other emerging markets								
Brazil	47.4	399	60.9	2.8				
India	44.7	5,650	56.2	3.3		.		
Korea, Rep.	52.4	1,518	117.6	11.6	38.9	3.2	35.1	
South Africa	216.2	450	91.2	18.8		6.2		
OECD								
Germany	57.8	988	183.9	6.8	41.3	3.3	36.4	
Japan	53.9	2,471	148.2	10.9	60.3	18.5	9.5	
United Kingdom	155.1	1,923	292.5	14.8	97.1	66.4	27.5	

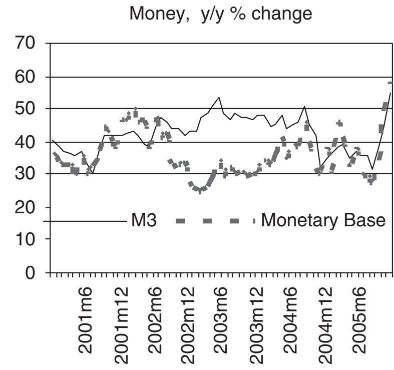
[1]Bulgaria, Kazakhstan, Ukraine, Korea and Czech Republic are 2002 data. OECD countries are 2001 data. [2]OECD countries are 2001 data. [3]Russian data exclude estimated premiums from so called "wage schemes." See chapter 1.4. [4]Source for Russia is AXCO and only reflect life-business. [5]Bulgaria is 2003 June data. South Africa is 2001 data. [6]Source for Russia is Russian Association of Leasing Companies.

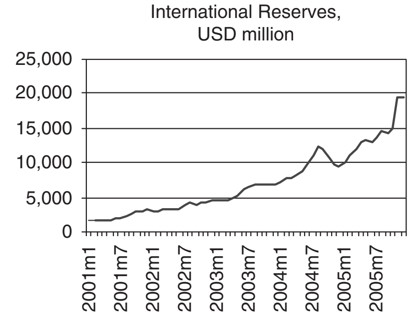
Source: World Development Indicators (The World Bank), Emerging Market Database (Standard & Poor).

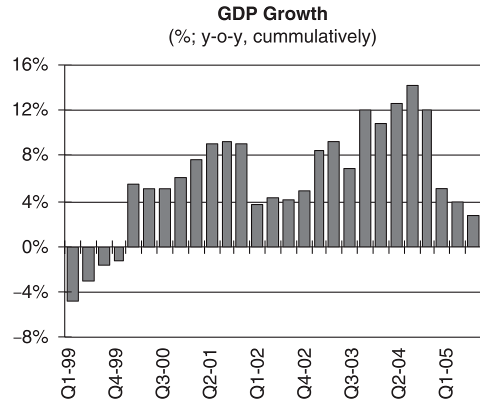
Institutional Investors Statistical Yearbook (OECD), International Financial Statistics (International Monetary Fund), AXCO Reports.

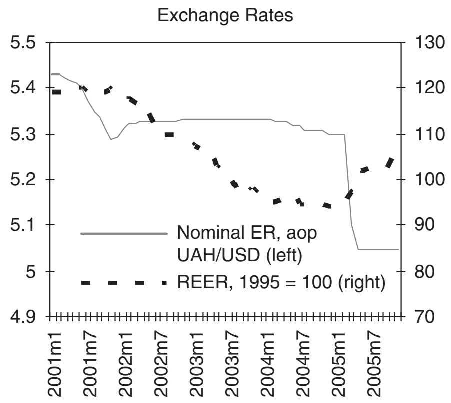
Figure 1.4. Recent Economic Development Indicators

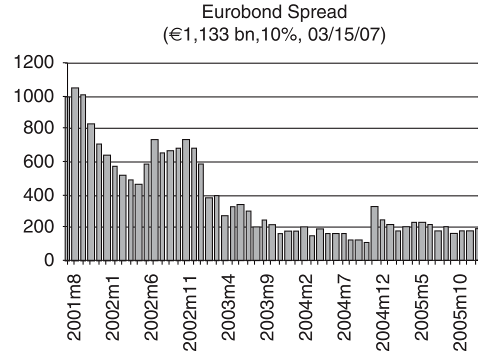












Source: World Bank staff estimates.

"Kryvorizhstal" re-privatization. The monetary base and the money supply growth accelerated in 2005 to 53.9 and 54.8 percent annually respectively—these growth rates were the highest starting from 1998. The acceleration of growth occurred in the fourth quarter of 2005 mainly due to increased fiscal spending in the end of the year and low base of the previous year. Commercial banks deposits increased in 2005 by 60 percent, while loans grew at almost the same rate of 61.9 percent. In 2005, with sale of three big Ukrainian banks, the share of foreign capital in the banking system of the country increased by about 1.9 times to 23 percent.

In 2005, the consolidated (state + locals) budget deficit arrived at 1.8 percent of GDP. Share of fiscal revenues in GDP increased in 2005 by about 5.8 percentage points to 32 percent primarily due to growth in shares of VAT (by 3.2 percentage points to 8.1 percent) and EPT (by 0.9 percentage points to 5.6 percent). Fiscal expenditures as a share of GDP increased by about 4.4 percentage points to 33.8 percent primarily due to social security and welfare expenditures, which were raised by 3.9 percentage points to 9.5 percent of GDP. The Parliament adopted 2006 budget law with envisaged state budget deficit of 2.6 percent of GDP (UAH 12.9 billion) based on 7 percent real GDP growth projection. It is expected that the budget will be revised after Parliamentary elections (which are scheduled on March 26th), since the macroeconomic forecast used for budget calculation is overly optimistic.

Money and Securities Markets

Securities Market Institutions

The Ukrainian securities market is shallow, highly fragmented, illiquid and non-transparent. Its development during 1995–2004 was marginalized by inadequate and non-transparent government policies and weak corporate governance. More than 98 percent of securities are sold outside the organized market. Most investors are inactive and risk-averse. Those who operate in the market often face the risk of unfair competition, incomplete or inaccurate reporting, and poor transparency and accountability of enterprise majority shareholders and managers.

Created chiefly to facilitate the mass privatization process in early 1990s, the Ukrainian securities market gradually evolved to feature a large number of institutions, well in excess of the needs of the local market. These include 794 securities traders (brokers and dealers, banks, investment companies), 370 independent registrars, 143 custodians and 3 depositories (National Depository of Ukraine, National Bank of Ukraine (for state securities) and MFS (Interregional Stock Market Union), a private depository established with support from USAID). MFS is the only licensed depository. Information about market infrastructure is presented in the Table 1.5.

Despite a large number of intermediaries, trades are sporadic and dealer commissioned, and are mainly performed for clients' on their own money since the majority of dealers are small and unsophisticated. The market is dominated by a few large strategic investors rather than by portfolio investors. Anecdotal evidence suggests that ownership or control of more than 60 percent of assets of privatized companies are concentrated in the hands of the six largest Ukrainian industrial financial groups.

Table 1.5. Securities Market in Ukraine

	1999	2002	2003	2004	2005
Stock exchanges and trading systems	8	9	10	10	12
Securities traders	836	860	876	780	794
Custodians	75	106	124	140	143
Depositories*	2	2	1	2	2
Registrars	357	365	375	371	370
Asset managers	n/a	25	27	91	93
Investment Funds	n/a	n/a	n/a	139	139
Collective (mutual) Investment funds**	22–28	28	32	103	130
Of which venture funds	n/a	n/a	22	73	73
SROs	9	11	11	12	12

*Licensed depository. *Note:* as of 2005 there are 3 depositories in Ukraine: 1 licensed private depository, 1 national and 1 NBU depository, serving the government securities only
**Voucher investment companies and funds
Source: SSMCU (SEC).

An excessive number of institutions, limited free float, corruption and heavy political intervention impact the quality of traders, lead to high costs and excessive margins. This also undermines the liquidity of the market. Moreover, despite the abundance of participants, the choice of securities is limited.

Activities at ten of the stock exchanges are dormant since more than 75 percent of organized market trading volume belongs to Persha Fondova Torgova Systema[4] (PFTS). Despite over 5.2 million shareholders and 35,400 thousand joint stock companies, securities market capitalization is low, despite a significant increase to more than US$29.1 billion in 2005. Free float in 2003 did not exceed UAH 800 million or 0.8 percent of market capitalization. The majority of newly issued shares are distributed among the existing shareholders or on pre-determined terms avoiding the public trades.

Until 1997, many Ukrainian enterprises were allowed to hold their own shareholder registries, leaving the registries open to possible abuse by company management or by controlling shareholders. After amendments to the legislation, all joint stock companies with more than 500 shareholders were required to use the services of external "independent" share registrars. This resulted in creation of a significant number of small, often "pocket" registrars, which generally serve the needs of a single enterprise and do not maintain records in an electronic format. At the end of 2005, there were 370 independent registrars in addition to 755 registrars at joint stock companies that were licensed to maintain their own registries. Only a few registrars are considered as truly independent.

At the same time, 143 custodian banks work in a non-documentary form or with electronic securities. Information does not flow well among depositories, and the registration

4. Directly translates into First Stock Trading System.

of new share owners by registrars occurs only after significant delays, thus creating serious problems for shareholders.

Money Markets

A competitive and efficient money market will reduce the interest rate risk-premium by lowering liquidity risk and reducing volatility in short-term rates; enable investors to hold larger portfolios of term debt due to the reduced liquidity risk on the market; and increase competition in financial intermediation. In particular, market conventions on pricing formulas and settlement procedures should be clear, and the timing and size of central bank open market operations should correspond to the needs of market participants to manage their liquidity positions. Information on market activity and money market indices should be publicly disclosed and taxation of money market transactions should be neutral.

Money markets remain relatively small and underdeveloped in Ukraine to date. However, it should be acknowledged that banking markets coped reasonably well both with the setback in the Russian market in summer 2004 and with the political turmoil in Ukraine in the fall 2004, pointing to an increasing robustness within the system and to increasing capability of NBU in overseeing the sector.

The monetization of the economy has been increasing at a rapid pace in recent years, such that M2/GDP has risen threefold over the last seven years, from 10 percent to over 30 percent, even allowing for higher than official estimates of the shadow economy, bringing it towards the level of recent EU accession countries.

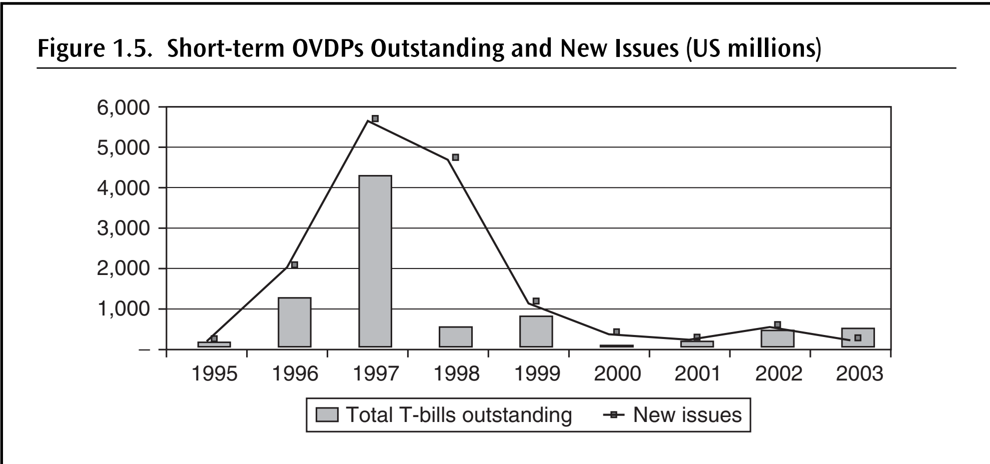
The interbank deposit market remains limited. While there has been some growth in activity in recent years, this has been sporadic and intermittent. The level of interbank funding has generally been of the order of 2 to 4 percent of bank liabilities, not a material source of bank funding. Deposits are concentrated in overnight maturities with very little activity in maturities beyond one week and no meaningful yield curve beyond one month. The market remains fragmented and grouped into a number of segments based on perceived credit quality. For example, most foreign banks operating in Ukraine (seen as the highest quality segment) only lend unsecured short-term funds overnight to one week to a very small number of domestic banks (less than 6 out of a total of 160 domestic banks). A similar practice also applies to leading Ukrainian banks.

While a KIBOR reference rate service exists for the calculation of interbank rates, the standards applied and enforced by many of the participating quoting banks are reported to be quite weak, rendering the resulting KIBOR rates of doubtful value in the context of a highly-tiered banking system and limited interbank activity beyond overnight maturities.

The volatility in the market has decreased since mid-2001 following the introduction of averaging of required reserves over monthly holding periods,[5] and the maintenance of generally ample bank liquidity. However, liquidity management in a number of banks remains fragile while the lack of agreement between NBU and the Ministry of Finance on the use of state treasury funds resulted in serious volatility in the inter-bank market when interest rates grew from 2 percent to almost 80 percent and even 100 percent overnight in

5. The average rate of required reserves for banks currently constitutes 7.7 percent of attracted funds and 5.2 percent, considering their right to form reserves at the expense of available cash.

Figure 1.5. Short-term OVDPs Outstanding and New Issues (US millions)

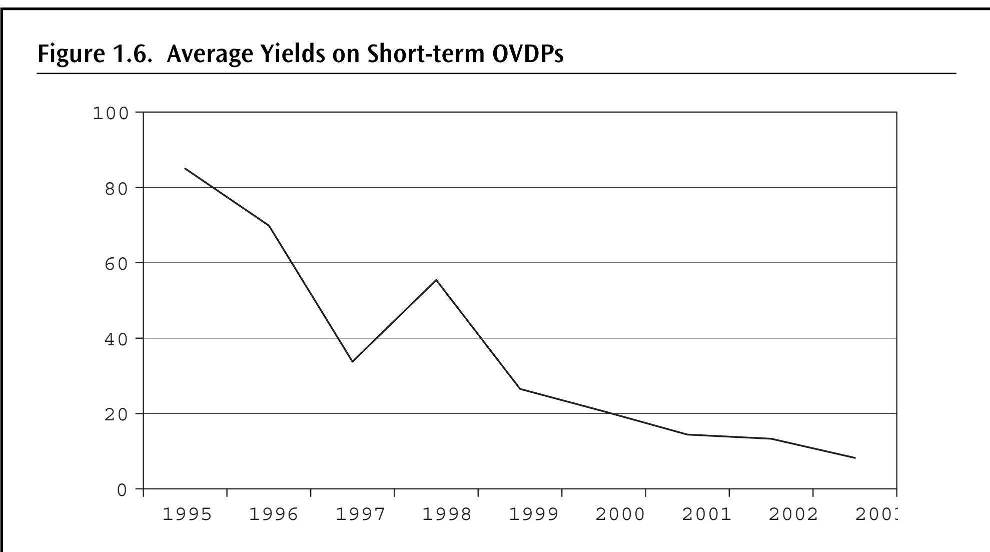


Source: Ministry of Finance.

October 2003. Subsequently, rates on inter-bank credits have largely been maintained at the levels of 1–2 percent for overnight credits, 7–10 percent on weekly loans, and 10–15 percent on monthly loans. Following the recent political situation in November–December 2004, NBU offered refinancing at 14 percent for overnight secured loans and 20 percent for overnight unsecured loans. Banks lending on the interbank market have strict ceilings for borrowing banks and charge risk premiums of up to 10 percentage points to riskier banks.

Most short-term OVDPs issued are zero-coupon bills with maturities of up to one year, and although the government has offered 12- and 18-month bills, none of these issues have been sold except for a very small amount in 2001 and 2002 (around 5 percent of the total OVDPs outstanding). Short-term OVDPs are the dominating securities in the domestic

Figure 1.6. Average Yields on Short-term OVDPs



Source: Ministry of Finance.

Table 1.6. Government Debt

	UAH bil. 2002	UAH bil. 2003	UAH bil. 2004	Percentage of Total, % 2004	UAH bil. 2005	Percentage of Total, % 2005
Total*	64.4	66.1	85.4	100	78.15	100
External	43.1	45.6	46.73	54.72	43.96	56.25
Marketable Securities	13.4	16.7	19.6	22.95	18.7	23.93
Other (Guarantees)	29.7	28.9	27.13	31.77	25.26	32.32
Internal	21.3	20.5	20.95	24.53	19.19	24.55
Marketable Securities	10.9	10.1	11.23	13.15	10.02	12.82
Held by NBU	8.7	7.5	9.72	11.38	9.17	11.734
Other	2.2	2.6	0	0	0	0

*Only Direct Debt is included. Contingent liabilities (Guaranteed Debt) are excluded from the table.
Source: MinFin.

government securities market, with more than 60 percent of the outstanding stock. Issuance of OVDPs increased steadily up to 1997, but declined sharply in 1998 following the debt crisis and subsequent debt conversion. At the end of 2004, the nominal value of outstanding short-term OVDPs was US$42 billion (less than 4 percent of GDP). Most of this debt is owned by NBU and commercial banks and hardly ever traded. Average yields on short-term OVDPs have been very high although gradually falling to single digits in 2003, reflecting the progressive decline in inflation rates in the country. The average yield on short-term OVDPs in 2004 was 11.2–11.6 percent. The small market for treasury bills is also impeding the development of the interbank market where few instruments are available to use as collateral.

Bond Market

Government Bond Market. The debt over GDP in Ukraine in the past few years appears to be well-contained; and external debt is about twice as much as domestic debt as shown in Table 1.6. In 2003, the total public debt amounted to 25.1 percent of GDP. Compared with 52 percent on the average among BB rating peers, this is relatively low. Recently, Fitch upgraded Ukraine sovereign rate from B+ to BB–[6].

The first issue of Ukrainian government bonds was registered in the second half of 1996. Out of the total UAH 78.15 billion Government debt outstanding at the end of 2005, UAH 28.72 billion is in the form of securities (see Table 1.6). Of those, UAH 18.7 billion are external debt in the form of Eurobonds. Of the remaining UAH 10.02 billion issued locally, the central bank holds the vast majority of government bonds.

6. Internal Credit Analysis by Fitch Ratings (January 21, 2005).

Following the 1998 debt crisis and subsequent debt conversion, it took a long time for the MOF to restore confidence in the market. At the same time, the absence of other instruments pushed local investors and state institutions (including NBU, the State pension fund and the State Savings Bank) to invest into Government bonds as the only available and highly profitable instrument in the market. For example, in 2001, the State Pension Fund purchased 70 percent of all State bonds issued that year. Up till 2002, international auditing firms and NBU as a banking supervisor had reservations about the quality of these securities and required a 20 percent risks-weighting of Government bonds on the books of banks.

Table 1.7. Issuance of Government Securities

UAH bil.	Amount Planned	Amount Placed
1999	2.5	n/a
2000	2	n/a
2001	1.5	1.27
2002	1	2.95
2003	1.8	1.19
2004	4.5	158.7

Source: Ministry of Finance.

Starting in 2002, MOF began issuing genuine T-bills to meet its immediate financing needs. On average, MOF issues UAH 100–150 million in t-bills annually. Treasury bills and bonds are sold at the by-weekly auctions announced by MOF and organized by NBU. From February 1, 2005 the MOF reduced the frequency of T-bonds to once a month.

Activities of market operators on primary and secondary markets are regulated by joint Resolutions of NBU and MOF. The Law on State Budget of Ukraine establishes the amount of state budget deficit to be covered by issue of Government securities. Government limits on the issue of domestic debt are shown in Table 1.7. In 2004, the domestic issuance of OVDP in UAH was much lower than planned as a result of interest rate differences between local currency and Euro.

The term structure of government securities is very fragmented. As shown in Table 1.8, the instruments include interest bearing internal debt bonds (maturities up to 6 years), 3–6 month short-term internal debt bonds (KDO). 18–24 month medium term internal debt bonds (SDO); and long-term internal debt bonds (SDO), that are not shown here due to the lack of information about their issues.

At the same time, given the volatility of the local interbank market and the gradual reduction of interest rates in domestic money markets, MOF is developing a strategy for expansion of local debt market. In February 2003 NBU allowed domestic commercial banks to trade Ukrainian Euro bonds although they could be sold in a local market only in UAH. Moreover, banks are allowed to buy Eurobonds only within the amount of the banks' own FOREX cash and cannot purchase foreign currency in the Ukrainian interbank market for this purpose.

In early 2004, the Parliament endorsed the initiative of the Government to restructure outstanding Government debt on VAT reimbursement by issuing new types of Government bonds, i.e., VAT bonds. In 2004 the Ministry of Finance issued 5-year VAT-bonds in the amount of UAH 1.9 bil.. This decision is supported by the IMF and the World Bank programs. The Law on the 2004 State budget foresees issue of VAT bonds in the range of UAH 1-2 billion with 5-year maturity and a rate defined as 120 percent of NBU refinancing rate.

Table 1.8. Composition of Domestic Government Debt Securities

	Time to Maturity	Amount, UAH bil.	Current Yield, %	Share of Total Domestic State Debt, %
End 2003				
Interest bearing internal debt bonds (POVDP)	Up to 6 years		8.68	77
Short-term internal debt bonds (KDO)	3–12 months		5.5–9.5	2
Medium term internal debt bonds (SDO)	18–24 months		11.6	8
End 2004				
Interest bearing internal debt bonds (POVDP)	Up to 6 years	4.30	11.2–11.8	5.03
Short-term internal debt bonds (KDO)	3–12 months	0.20	6.5–6.7	0.24
Medium term internal debt bonds (SDO)	18–24 months	1.33	7.0–7.5	1.55
End 2005				
Interest bearing internal debt bonds (POVDP)	Up to 6 years	7.07	11.4–11.94	9.04
Short-term internal debt bonds (KDO)	3–12 months	0.45	6.5–6.7	0.57
Medium term internal debt bonds (SDO)	18–24 months	2.51	7.0	3.21

Source: MinFin, UkrSotsBank.

According to MOF, nearly 40 percent of total UAH 2.2 billion of State securities in circulation is purchased by non-residents. The primary market is operated only by banks (market makers), with NBU providing depository and clearing and settlement services.

Sub-sovereign Bond Market. Until 2001, borrowings by Sub-National Governments (SNGs) took place in an environment marked by an extremely poor legal and regulatory

Table 1.9. Structure of investors in the Ukrainian State Securities Market (primary market)

UAH mil.	1996	1997	1998	1999	2000	2001
Banks, including NBU	1100	3100	7200	9400	9900	9900
Clients of banks–residents	680	330	67	53	180	610
Clients of banks–non-residents	0	3300	270	5	0	1
TOTAL	**1780**	**6740**	**7560**	**9450**	**10120**	**10510**

Source: National Bank of Ukraine.

framework and porous Sub-National Government (SNG) budget constraints. Loans from higher levels of government were the most widespread form of borrowing by SNGs. The process of intergovernmental loans was extremely non-transparent and there were no clear guidelines for deciding when and how to allocate intergovernmental loans. The share of unpaid intergovernmental loans was high, generating moral hazard on the sub-sovereign finance market. A second, widely-used source of SNG borrowings consisted of Veksels that were issued without regulation. Many SNGs also maintained one or more bank accounts with commercial banks, and oblasts and oblast level cities borrowed from commercial banks, although this source of borrowing remained limited. SNGs accumulated arrears with utilities.

In this environment marked by weak legal and regulatory framework and in the absence of tight budget constraints, a fragile SNG bond market emerged, with a total of 14 issuers raising about UAH 217 million between 1995 and 1998. These were interest earning bonds (with yield generally equal to 50 percent of NBU refinancing rate) and special purpose bonds. In 1998, SEC registered three sub-sovereign bonds: Crimea, Odessa and Brovary. Out of these three issues, only Brovary debt was fully repaid. The Odessa bond default (UAH 91.5 million) constituted a signal event in the short history of the sub-sovereign bond market in Ukraine. On the one hand, the Odessa default revealed the destructive potential of poor market legal and regulatory framework on the development of the sub-sovereign debt market. On the other hand, the decisions of the Government not to bail out Odessa and not to pay the bondholders established a clear precedent that there is no sovereign guarantee of sub-sovereign debt issues, explicit or implicit.

Following the Odessa bond default, a Presidential Decree was issued in 2001 prohibiting the issuance of sub-sovereign debt without approval from MOF. At the same time, SNG accounts were transferred to the Treasury, and the issuance of Veksels by SNGs was prohibited. The Ministry did not approve any sub-sovereign borrowing until December 2003, when the city of Kiev placed a Euro bond and a domestic bond issue. However, significantly, only 75 percent of the domestic bond was subscribed. Other cities are currently planning to issue domestic bonds, including Donetsk and Zaporozzhya.

Corporate Bond Market. The corporate bond market took off in 2001 when several large enterprises registered public placements of corporate bonds and thus opened the market for investors. The first large issuers of domestic corporate bonds in 2001 were "Titan," the leading chemical enterprise and "Kiev-star GSM," one of the three largest mobile operators in Ukraine.

The development of the corporate bond market was triggered by two major events. First, until 1999, the issuance of bonds was economically unprofitable since funds raised from the sale of bonds were treated as taxable revenue, subject to 30 percent income tax as compared to 0 percent tax on bank loans. This impediment was removed in 1999 when Parliament enacted the Law "On amendments to other legal acts of Ukraine aimed at facilitating investment activities." Second, SEC passed a regulation on the Procedure for issuance of corporate bonds that was registered in the Ministry of Justice in August 2003. The passage of the Law on Financial Services and State Regulation of Financial Services Market (2001) added one more argument for use of bonds for fundraising. Specifically, the law prohibited inter-enterprise lending without a special financial services license. This prohibition related to the activities of all non-finance

Table 1.10. Dynamics in Ukrainian Corporate Bond Market, 1996–2003

UAH mil.	1996	1997	1998	1999	2000	2001	2002	2003
Corporate bonds issued	13	116	8	132	70	694	4,275	4,240
Of which issued publicly						120	323	1,036

Source: Ministry of Finance.

companies, including large holding groups that distributed funds between their subsidiaries and daughter companies.

These measures and the favorable macro economic environment encouraged a sharp increase of activities in the bonds market as shown in Table 1.10. During nine months of 2004, SEC registered 122 issues of corporate bonds for a total amount of 2.2 UAH billion. In 2003, SEC registered 169 issues of corporate bonds for a total amount of UAH 4.24 billion, compared to 108 issues for UAH 4.24 billion in 2002. A large share of the bonds issued in 2003 was sold to pre-determined investors or via private placements.

Along with the growing dynamics in the market in 2002 and 2003, the market is also changing its structure. If in 2002 only 7.55 percent of new bonds were issued publicly, this number grew to almost 61 percent in 2003. To date, there are no cases of default on any of the corporate bonds in Ukraine.

Out of UAH 4.24 billion of bonds issued in 2003, UAH 2.1 billion or nearly 50 percent was listed at PFTS and more than UAH 1.5 billion was successfully sold. Corporate bonds constituted almost 78 percent of overall trading volume of PFTS in 2004. Nonetheless, the market remains illiquid, and with low frequency of trades.

The majority of 2003 corporate bond issuers were large known companies (see Table 1.11), some of which managed to obtain international credit rating slightly lower or

Table 1.11. Largest Ukrainian Corporate Bond Issues in 2003

Issuer	Amount of Issue, Mil. UAH	Share in Total Bonds, %	Issue Date	Days in Circulation (maturity)	Yield, Percent
Ukrainian South-West Railway	500	11.79	May 03	1096	12
Enegroatom	500	11.79	Dec 03	1092	12
Ukrtransgaz	300	7.07	Sept 03	1096	12
Zaporozh Auto Maker	150	3.53	Oct 03	1092	14
Aval Bank	80	1.89	July 03	546	12
Kievstar GSM	59	1.39	Apr 03	549 (A), 731 (B)	17
Total	1589	37.46			

Source: Ministry of Finance.

Table 1.12. Credit Rating of Euro Bonds Issued by Ukrainian Issuers

Indicator	Sovereign Bonds 2004	Privatbank 2004	Ukrsibbank 2004	Sovereign Bonds 2005	Privatbank 2005	Ukrsibbank 2005
Moody's	B1	n/a	B1	B1	B2	B2
Fitch	B+	B–	B–	BB–	B	B–
Standard & Poor's	B	B–	n/a	n/a	n/a	n/a
Coupon yield (%)	7.65	10.875	10.5	6.64	10.88	16
Volume of issue	$ 1 bil.	$ 100 mil.	$ 100 mil.	600	100	100
Maturity	10 years	3 years	3 years	10 years	1 year	3 years

Source: Ministry of Finance, SSMCU, Privatbank, Bank Aval, UkrSibBank.

at the level of sovereign credit rating (see Table 1.12). In parallel, the market also witnessed several smaller issues of relatively young enterprises without existing credit history or credit rating (25.3 percent of total corporate bonds issue). About 62 percent of all the bonds issuers were located in Kiev, with Kharkov city being the second largest region with only 8 percent of total corporate bonds issue.

For the first time in the history of Ukraine, several commercial banks, namely Privatbank and UkrSibBank placed Eurobonds in the amount of US$100 million each on international markets. Moreover, Moody's assigned a B1 credit rating to Ukrsibbank's Euro bonds, the same rating as for sovereign bonds issued in December 2003.

Equity Market

The Ukrainian equity market has grown considerably within the past few years. Market capitalization at the end of 2005 stood at US$29.1 billion (35 percent of GDP), compared to US$1.5 billion or 4 percent of GDP in 2001. Although the number of listed companies exceeds 250, concentration is high as the 10 largest companies amount to 68 percent of total market capitalization.

Market liquidity is low, and most significant trading occurs over the counter. Among listed companies, only 40 seem to be regularly trading their securities, with the five largest companies accounting for more than 50 percent of trades on PTFS, a NASDAQ-type over the counter trading system. Most of the country's 900 strategically important enterprises are not listed or traded at all. Enterprises in the energy sector and banks dominate the list of the most liquid and actively traded securities. Market turnover ratio is just above 2 percent, one of the lowest among the Eastern European markets.

Free float by public companies is extremely low. Although this information is not readily available on a company-by-company basis, average float for listed companies is estimated around 4 percent. The majority of newly issued shares are distributed among existing shareholders or on pre-determined terms in order to avoid public trades.

Ukrainian companies' exposure to international markets is moderate with about 15 companies having ADR/GDR programs.

Table 1.13. Equity Markets Development in Eastern Europe (End 2003)

	Number of Companies	Market Cap (US million)	Market Cap (% of GDP)	Trading Value (US million)	Turnover Ratio (%)
Russia	214	230,786	67	81,010	35.10
Czech Republic	63	17,663	25	8,796	49.80
Hungary	49	16,729	25	8,299	49.61
Poland	203	37,165	20	8,497	22.86
Turkey	284	68,379	37	99,610	145.67
Bulgaria	356	1,755	11	197	11.22
Croatia	66	6,126	27	237	3.87
Estonia	14	3,790	59	564	14.88
Latvia	56	1,141	14	145	12.71
Romania	4,484	5,584	13	442	7.91
Slovenia	32	5,209	25	528	10.14
Ukraine	267	4,803	10	106	2.46

Source: Staff estimates.

Demand Structure

Banks are the most active traders and investors into securities, primarily bonds, and often act as advisors and underwriters for corporate bonds issuance. Some of the banks also significantly increased their investment portfolio of corporate bonds due to limited volume and unattractive yields of government securities. For example, in 2002 investments of commercial bank in T-bills exceeded investments in corporate bonds. However, in 2003 commercial banks started to invest more actively in the corporate bond market, and by the end of year 2003, the portfolio of corporate bonds in the banking system exceeded their investments

Table 1.14. Ukraine Equity Market Indicators

	1998	1999	2000	2001	2002	2003	2004	2005
Stock Market capitalization, US$ mil.	10,742	1,735	1,742	1,501	4,370	4,803	11,780	29,100
Stock Market capitalization % of GDP	26	5	7	4	10	10	20	35
Capitalization of 10 largest companies (% of total)			56	44	48	68		
Number of listed companies	135	432	249	286	275	267	191	262
Number of companies publicly-traded (listed and non-listed)			128	128	148	189		
Number of new listings			43	46	55	120		
Number of delistings			53	3	35	178		

Source: SSMCU (SEC), ING Bank, USAID, MinFin.

in T-bills. Pension funds and insurance companies are not significant investors in the capital markets at this stage and prefer to keep their deposits with banks. The lack of portfolio diversification and cross-ownership between institutional investors and banks raise serious concerns for the regulators. However, lack of adequate credit rating and unreliable financial reporting of corporate securities issuers (with certain exception of banks which transferred to IAS in 1998) makes it very difficult to assess the quality of many corporate securities. As part of the continued reform agenda, in 2003 SEC introduced several requirements for improved disclosure of information and annual reporting of listed companies on the basis of IAS.

Pension

Ukraine adopted the Pension Law in November 1991 and the Pension Fund of Ukraine (PFU) started operating in 1992. The system offered a defined benefit scheme financed on a pay-as-you-go (PAYG) basis. In parallel, non-State Pension Funds (NSPFs) developed rapidly under the general company legislation without any regulation and supervision from the authorities. In 2003, Parliament adopted a comprehensive reform of the pension system, including a reform of the PAYG scheme (Pillar I), the introduction of a funded, compulsory, defined contribution scheme (Pillar II), and of a voluntary, funded component (Pillar III). In parallel, measures were taken to bring existing NSPFs under the new legislative and regulatory framework. Table 1.15 summarizes the evolution of the legal and regulatory framework for pensions in Ukraine from 1991 to the present.

Development of the Pre-reform PAYG System

The pre-reform pension system in Ukraine was characterized by a high system dependency ratio, large expenditures of the PFU relative to GDP, and high contribution rates that were not linked to benefits. An unfavorable demographic situation, adverse demographic dynamics (aging population), low retirement age, numerous early retirement schemes for privileged groups and widespread tax evasion led to fiscal unsustainability of the system. Meanwhile, the PFU attempted to preserve a minimum standard of living for all pensioners. This was achieved by narrowing the range of payments and reducing the overall benefit level. As a result, the existing PAYG pension system in Ukraine has essentially become a basic safety net.

The retirement age in Ukraine is set at a relatively low level: 60 for men and 55 for women. The increase in the retirement age has been discussed as part of the pension reform process but has been rejected as a result of political pressure. Comparatively, average retirement age in OECD countries is 64.4 for men and 62.9 for women.

There are over 13 million pensioners and other recipients of various types of allowances from the PFU. According to the general Law on Compulsory Pension Insurance the pension system provides five different types of benefits:

- Old age including preferential old-age pensions;
- Disability pensions;
- Survivor's pensions;
- Service pensions;
- Social pensions.

Table 1.15.

Date	Legislative Framework	Pension System & Features	Supervisory Mechanism
1991	Law of Ukraine on Pension System N° 1788-XII (5 November 1991)	**Pillar I:** Mandatory state pension insurance system. Defined Benefit Scheme—funded on a PAYG basis. The system provides 5 different types of pensions: ■ Old-age including preferential old-age ■ Disability ■ Survivor ■ Service ■ Social Employer's contributions: 32 percent payroll tax Employee's contributions: 1 percent gross taxable income. Replacement rate of about 55 percent.	The Pension Fund of Ukraine acts as administrator and record keeper of **Pillar I**.
2003	Law of Ukraine on Mandatory State Pension Insurance N° 1058-IV (9 July 2003)	**Pillar I & Pillar II:** Mandatory state pension insurance system & accumulation pension system. Reformed **Pillar I** provides 3 types of pensions: ■ Old age ■ Disability due to a general disease ■ Survivor No increase in pension age 5 years of service required to receive any pension Minimum pension: 20 percent of average wage (for 25 years of service for men and 20 for women) 1 percent accrual rate for **Pillar I** pensioners 0.8 percent accrual rate for those covered by **Pillar I & II** No cap on maximum pension benefit Pensions indexed on consumer price plus 20 percent of wage growth Recalculation of current benefits in 2004 according to these new rules	The Pension Fund of Ukraine acts as administrator and record keeper of the Accumulation Fund, collects contributions of Pillar II, and allocates them among selected asset managers. The Accumulation Pension Fund (AF) is being formed by the Pension Fund as a targeted above-budget fund, whose structure consists of the AF Council, the Executive Directorate for administrative management of the AF, the asset manager (asset management company selected through tender), as well as investment advisors and non-state fund asset custodians

(*Continued*)

Table 1.15. (Continued)

Date	Legislative Framework	Pension System & Features	Supervisory Mechanism
		Pillar II: Accumulation Fund funded through a 7 percent wage contribution. The Accumulation Fund is expected to start operating in 2007, and will be compulsory for all workers with 20 years of remaining service and voluntary for those with 10–20 years to go. The introduction of **Pillar II** is conditioned upon a set of macroeconomic triggers, institutional arrangements, experience in voluntary pension funds, and a minimum pension not lower than the subsistence level.	
2003	Law of Ukraine on Non-State Pension Provision N° 1057-IV (9 July 2003)	**Pillar III**: Accumulation pension system. Defined Contribution Schemes -Fully Funded. Under the Law, 3 types of non-state pension funds are permitted: ■ Corporate pension funds, whose founders may be one or several legal entities (employers) ■ Professional pension funds, whose founders may be an association of legal entities (employers, associations of physical persons, including trade unions (or their associations), or physical persons linked by their professional activity (occupation) ■ Open pension funds, whose founders can be one or several legal entities Several modifications were introduced in July 2004 to several laws on taxation of corporate profits and personal income to stipulate which legal entities and physical persons are entitled to decide to pay pension dues to NSPFs.	The Law regulates the establishment, activity requirements of subjects of non-state pension provision, as well as principles of government supervision and control of non-state pension provision. The selection and conclusion of agreements with administrators, fund managers and custodians are carried out by the supervisory agency responsible for supervision of non-state pension funds, the Pension Fund Council. A specialized administrator or asset management company may found any pension fund. However, services of fund administration and management can be provided only under individual formation of a corporate pension fund (under special license).

The pension system covers all non-working age retirees, invalids and survivors. Beneficiaries receive payments in the form of pension benefits, supplements, compensatory payments and additional pension benefits. Benefits are complemented by a system of privileges, compensations, guarantees, housing subsidies, and other types of social assistance to senior citizens, invalids and families with children, and so forth.

The old-age pension program is the most important one, accounting for about 80 percent of total pensioners. The privileged group of pensioners represents a non-negligible portion of beneficiaries and amounts to roughly 20 percent of the total pensioners.

Revenues to the PFU include:

- mandatory contributions payable by enterprises, institutions, and organizations;
- mandatory contributions payable by individuals;
- transfers from the State Budget and social insurance funds;
- other proceeds.

Revenues of the PFU derive from insurance contributions of employers set at 32 percent of the total wage bill and employee contributions set at 1 percent of the total wage bill.

The five types of pensions are financed by PFU's own revenues. Military pensions, support for II World War veterans, allowances for Chernobyl victims and allowances for children aged between 1.5 and 3 are managed by the PFU but financed by the State and local budgets, as well as from other funds (Chernobyl fund and more recently unemployment fund and work injury fund).

Calculation and Level of Benefit. According to the Law on Compulsory Pension Insurance, the replacement rate is set at 55 percent of the average individual wage for the best five or the last two years of service for men and women having the required length of service (25 years for men and 20 years for women), with a 1 percent increase for each year of additional work experience up to a maximum of 75 percent of the average individual wage. However, the actual replacement rate has been squeezed for the last 6 years and reached its lowest level in 1994. An average pension benefit in Ukraine was 54 UAH in 1998, that is, 54 percent below the official level of the poverty line approved by the Ukrainian Parliament (118 UAH per month). Table 1.16 presents real replacement ratios for the period 1990–97.

Table 1.16. Real Replacement Ratio (average pension/average wage), 1990–97

End of Year	Currency	Average Pension	Average Wage	Replacement Rate (percent)
1990	RBL	104	479,7	22
1991	RBL	540	1523,5	35
1992	KBV	9735	17826	55
1993	KBV	292000	882300	33
1994	KBV	784000	3719000	21
1995	UAH	38,7	81	48
1996	UAH	51,9	138	38
1997	UAH	52,2	156	33

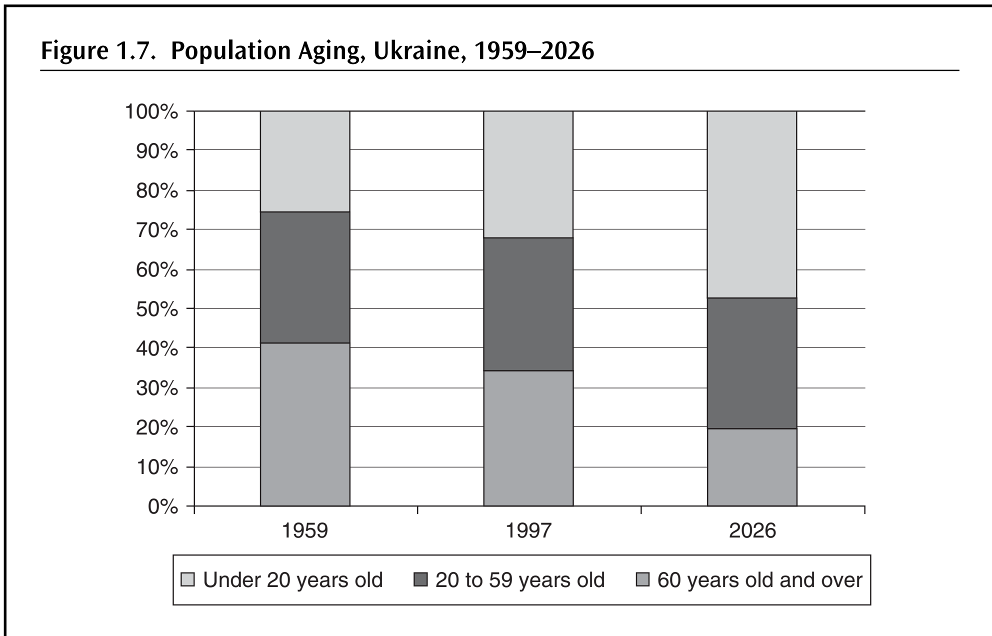
Source: Staff estimates.

In a context of financial crisis of the pension system, the PFU had to reduce the levels of pension benefits along two lines: (i) applying a regressive scale to calculate the replaceable salary for high-income earners; and (ii) imposing minimum and maximum levels of pension benefits. Thus, the old-age pension benefit dropped considerably for all beneficiaries, while remaining unaffordable for the system. Despite these measures, the general pension policy was generous and highly re-distributive in favour of those who contributed little or nothing to the system. This further enhanced tax evasion and escape into the informal sector.

Before the 2003 reform, the PFU was faced with a deteriorating situation of its revenues and a steady increase of its financial obligations. Several factors, common to most PAYG systems throughout the world, contributed to these processes. The system had been excessively generous in terms of its structure (low retirement ages, high intrinsic replacement ratios), given the demographics of Ukraine. As such it was not viable in the medium run. In addition, the system had no linkage between contributions and benefits until the recent law and reform.

An Unfavourable Demographic Context. Ukraine's demographic transition has resulted in smaller families and longer life expectancy. The baby boom in the 1960s and 1970s was followed by a critical decline in the birth rate in the 1980s and 1990s, coupled with a longer life expectancy results, and thus resulted in growing imbalances between those of pension age and those of working age. This will worsen after the year 2020 as shown in Figure 1.7.

Figure 1.7. Population Aging, Ukraine, 1959–2026



Source: Ministry of Labor and Social Policy of Ukraine (MoLSP) & Pension Fund of Ukraine (PFU) "Social Insurance and Pensions, Ukraine, 2003."

Table 1.17. Maturation of Pension Systems, %

Country	Demographic Age Ratio	System Dependency Ratio
USA, 1993	30	32
OECD, 1990	34	39
Argentina, 1990	27	67
Russia, 1992	31	46
Czech Republic, 1992	32	49
Poland	28	49
Hungary, 1993	36	66
Bulgaria, 1992	37	77
Ukraine, 1997	**41**	**62**

Source: World Bank, Ukraine, CEM Pension Note, 1998.

Together, these factors have raised the demographic age ratio (total number of population over working age divided by total number of population in working age) from 38 percent in 1990 to 41 percent in 1997. This "graying of the population" means that a smaller cohort of the working age population has to support a growing cohort of old people.

As a result, the unfavourable demographic context negatively impacts on the pension system by increasing its system dependency ratio (number of beneficiaries divided by number of contributors): this ratio has increased sharply from 49 percent in 1990 to 62 percent in 1997.

Contributions to the PAYG system are compulsory. The employer pays a 32 percent payroll tax and the employee pays 1 percent of gross taxable income, with an additional 1 percent for high wage earners. The same rate is applied across almost all sectors. There are exceptions for self-employed, single and flat agricultural taxpayers, whose fixed tax fee is divided between the PFU and the State budget.

Prior to 1993 and in 1994, the Pension Fund, unlike the rest of the public sector, was running a surplus. The PFU collected roughly 10 percent of GDP every year in contributions, which were paid out as pension benefits to more than a quarter of the population (Table 1.18).

In July 1995, the PFU started facing fiscal problems and accumulating arrears both in the contribution collection and in the payment of pension benefits. Table 1.19 shows the

Table 1.18. Pension Fund Own Revenues and Expenditures Excluding Transfers

	1991	1992	1993	1994	1995	1996	1997
PFU revenues (Million UAH)	0.3	4.8	96	955	4308.4	7412.5	8812.0
PFU Revenues as % of GDP	8.3	9.6	6.5	7.9	7.9	9.1	9.5
PFU Revenues as % of Total Revenues	32.5	39.3	19.3	18.3	20.8	24.5	24.5
PFU Expenditures (Million UAH)	0.3	3.3	113.8	810.8	3908.6	6736.6	8489
PFU Expenditures as % of GDP	8.3	6.5	7.7	6.7	7.2	8.3	9.2
PFU Expenditures as % of Total Expenditures	25.5	17	19.9	12.9	16.1	19.7	20.3

Source: Staff estimates.

Table 1.19. Revenue Structure of the PFU as % of Total PFU Revenues, 1991–2002

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
PFU own Revenues	85%	94%	71%	94.5%	95%	95.50%	89.50%	92%	90%	83.50%	84%	87%
Transfers from State Budget	15%	6%	27.50%	2%	2%	1.50%	6%	5%	7%	12%	9.50%	9%
Transfers from Local Budgets	—	—	0%	1%	1%	0.50%	1%	0.50%	0.30%	0%	0%	0%
Transfers from Chenobyl Fund	—	—	1.50%	2.50%	2%	2.50%	3.50%	2.50%	2.50%	4%	3%	3%
Transfer from Unemployment Fund	—	—	—	—	—	—	—	—	0.2%	0.50%	0.50%	0.50%
Transfer from Work Injury Fund	—	—	—	—	—	—	—	—	—	—	0.10%	0.50%
PFU Revenues as % of GDP	**11.3**	**10.1**	**9**	**8.3**	**8.1**	**9.2**	**10.3**	**9.4**	**9.5**	**8.8**	**9.2**	**10.1**

Source: World Bank, 2003 CEM Pension Note: Reforming the Ukrainian Pension System.

Table 1.20. Public Pension Expenditures vs. Replacement Rates, 1995–2001

	1995	1996	1997	1998	1999	2000	2001
Public Pension Expenditures as % of GDP	8.6	10.1	11	n/a	10.3	9	9.7
Replacement Rate	36.07	36.63	38.92	36.12	39.05	36.6	31.97

Source: CEM Pension Note: Reforming Ukrainian Pension System.

revenue structure of the PFU from 1991 to 2002. The main source of revenues are PFU own revenues, amounting to roughly 90 percent of total PFU revenues, except for 1993, a year of hyperinflation which led to a situation of erosion of contributions in row values. Meanwhile, within two years, the number of pensioners increased by almost 1 million, thus creating a severe imbalance between spending and contributions. Pension arrears grew rapidly throughout the 1990s and by September 1998 cumulative pension arrears reached the level of UAH 1.8 billion. In September 2000 though, the Government eliminated payment arrears and managed to stabilise the situation.

Contribution rates in the pre-reform system were not enough to finance the PAYG system, and that without structural and actuarial reform measures, a deficit of the PFU was unavoidable. Notwithstanding its "parametric" generosity, the system actually provides very poor benefits to most of the working population. This is mainly due to the system's distortions, contribution evasion, and a lack of linkage between contribution and benefits.

Table 1.20 shows that replacement rates remain low despite changes in public pension expenditures.

A large portion of the benefits granted by the pre-reform system was below the poverty line (which is not surprising, given that marginal wages have been below such levels for large portions of the population). This lowering level of benefits implied that the PFU was barely able to keep the elderly out of poverty. Table 1.21 shows the value of old-age pensions as a percentage of the minimum subsistence level.

Figure 1.8 shows the distribution of pensioners by ratio of average pension to minimum subsistence level. Figures show that out of the 13.7 million pensioners, only 2 percent had a pension above the minimum subsistence level.

The average old-age pension is approximately one third of wages (see Table 1.22). Even with 2003 increase the average retirement pension is only 54 percent of the minimum subsistence level for not-able-to-work individuals.

The fundamental problems of pension arrangements in Ukraine are their *ad hoc* treatment of different categories of workers and the high level of evasion. Several categories of workers enjoy a privileged status at the expense of the pension plan, and receive special transfers which normally should be either direct subsidies from the central budget, or direct contribution by employers.

The number of people eligible to early retirement has been constantly growing since the 1970s: from 7 percent of all pensioners in 1971, it reached 16 percent in 2001 and over 20 percent in 2002. Privileged pensions have also increased throughout the period with 15.4 percent of pensioners receiving such a pension in 1999 and 20 percent in 2003.

Table 1.21. Value of Old-age Pension as % of Minimum Subsistence Level

Year	Minimum Subsistence Level for Able-to-Work Individuals (UAH)	Minimum (Lowest) Pension (UAH)		Minimum (Lowest) Pension as % of the Minimum Subsistence Level	
		General	To Single Individuals	General	To Single Individuals
1996	KRB6810,000	KRB 3300,000	KRB 4800,000	48.46	70.48
1997	70.9	37	48	52.19	67.7
1998	73.7	37	48	50.2	65.13
1999	90.7	41	53.5	45.2	59
2000	118.3	46	53.5	41.33	45.22
2001	248.16	55	59.87	22.16	24.13
2002	268	86.9	80	32.43	29.85
From July 1st 2003	268	91.8	80	34.25	29.85
2004*	237	284		119.83	
2005*	262	332		126.72	

**Note:* According to the Law on the State Budget of Ukraine, the rates of government planned minimum pensions in 2004–05 exceeded the rates of minimum wages.

Source: Ministry of Labor and Social Policy of Ukraine (MoLSP) & Pension Fund of Ukraine (PFU) "Social Insurance and Pensions, Ukraine, 2003," Accounting Chamber of Ukraine, Law on the State Budget of Ukraine for 2004–2005.

Together, these special treatments inflict a high cost on the Ukrainian pension system as they amount to approximately 2 percent of the GDP in 2001.

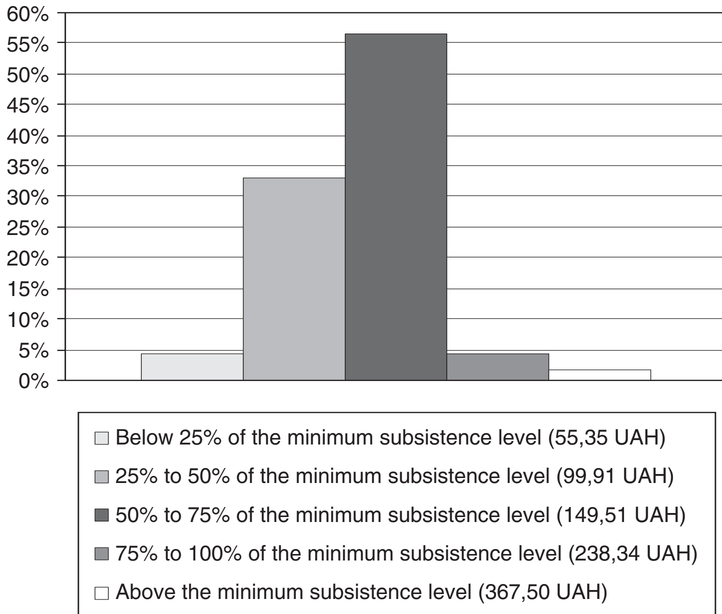
Poor performance of the system combined with significant payroll tax burden has increased public mistrust translating into widespread tax evasion. Employers and employees in large percentages fail to contribute to the system. Evasion is widespread and contribution is not enforced, especially since until 2003, no individual record keeping system existed.

The pension system is further weakened by the large size of the informal sector, with estimates ranging from 30 to 50 percent of GDP. The de-shadowing of the informal economy, and the extension of coverage and reduction of evasion from contribution are key targets to make Pillar I more viable and provide more adequate benefits to a broad working population.

Development of Non-state Pension Funds (NSPFs)

In parallel with the PAYG system, non-state pension funds (NSPFs) developed rapidly in the framework the general company legislation and performed their activities as not-for-profit organizations. In the absence of reliable statistics, experts estimate that in 2001 there

Figure 1.8. Distribution of Pensioners by Ratio of Average Pension to Minimum Subsistence Level, January 1, 2003.



Source: Staff estimates.

were about 110 NSPFs; only 47 of them survived by 2003. The majority of the funds were established as corporate funds, although some operated as open-end funds. Fifteen pension funds were members of the Association of Non-State Pension Funds of Ukraine created in December 1996.

Since registration and investment activities of NSPFs were unregulated, funds were misused, and pensioners and depositors incurred significant losses. Many pension funds operated similarly to trust funds (that were established according to the Presidential Decree of 1994 on Trust Funds and Trust Companies). They collected voucher certificates and cash that were invested into privatized companies, bank deposits and used to finance various investment projects. NSPFs promised pensioners monthly or quarterly payments of fixed amounts upon retirement age or lump-sum payments at a fixed date. At a time of high inflation and manipulative stripping of assets of privatized companies, deposits of many trust companies were eroded, investments expropriated by a handful of enterprise managers, and cash stolen by management or founders of trust funds.

It is believed that the largest private pension fund "Oberyg" collected savings from more than 200 thousand people all over Ukraine. Its failure in 1995 along with a number of other "financial pyramid" schemes significantly undermined public trust in the pension fund industry in Ukraine—and highlighted the critical importance of strengthening corporate governance in order to develop investor confidence in NSPFs and other investment funds.

Table 1.22. Average Pensions Granted under the Law of Ukraine "On Pension Provision" as Percentage of Average Wages, 1971–2005

Year	Currency	Average Wages	Average Pension**	Average Pension as % of Average Wages
1971	KRB	106.97	30.42	28.44%
1980	KRB	155.1	51.36	33.11%
1990	KRB	244.3	85.23	34.89%
1991	KRB	479.7	173.2	36.11%
1992	KRB	1523.5	537.59	35.29%
1993*	KRB	14204	9716	68.40%
1994	KRB	745523	336000	45.07%
1995	UAH	32.08	11.57	36.07%
1996	UAH	103.28	37.83	36.63%
1997	UAH	126.68	49.31	38.92%
1998***	UAH	136.82	49.42	36.12%
1999	UAH	148.16	57.86	39.05%
2000	UAH	180.97	66.23	36.60%
2001	UAH	253.39	81	31.97%
2002	UAH	320.76	120.04	37.42%
2003	UAH	400.59	133.4	33.30%
2004	UAH	589.62	182.2	30.90%
2005	UAH	806.18	316.2	39.22%

Note: Contribution rate was 61 percent effective 1992, 37 percent effective 1993, 32 percent effective 1997;
*Conditional value;
**Including compensatory payments and targeted assistance;
***Yearly values are taken for 1971, 1990, 1991;
Rated average pension is taken for March 1998.
Source: SSCU (UkrStat). Ministry of Labor and Social Policy of Ukraine (MoLSP) & Pension Fund of Ukraine (PFU) "Social Insurance and Pensions, Ukraine, 2003.

As of the end of 2003, information was collected by the regulator on the activity of 47 NSPFs. Of these, 22 were directly occupied with non-state pension provision, the location of 12 funds could no be established, 0 institutions were not occupied with a financial and economic activity, and 4 carried out activities not connected with non-state pension provision. The total amount of assets of operating pension funds was estimated at close to UAH 16 million, with about 31 thousand clients. All resources attracted in non-state pension provision were invested in bank deposits.

The 2003 Pension Reform and 2004–05 Revisions

In July 2003, the Ukrainian Parliament passed two laws which reformed the existing pension system, one applicable to the mandatory pension system ("Law of Ukraine on Mandatory

State Pension Insurance—MSPIL"), and the second establishing a voluntary supplemental pension system ("Law of Ukraine on non-State Pension Funds—NSPFL").

Mandatory Pension System. The mandatory pension system changes included changes in the parameters for the publicly provided pensions (Pillar I) as well as the introduction of mandatory individually funded pensions (Pillar II) once fiscal and institutional conditions permit, with specific triggers defined in the law.

Publicly provided pensions (Pillar I): The parametric changes for publicly provided pensions (Pillar I) included the following:

- An increased benefit to those who delayed retirement, beginning with a 3 percent increase in pension benefits for one year of delay to a total 85 percent increase for a 10 year delay.
- Benefits set as 1 percent of the pensionable wage per year of service, compared to the previous 2.2 percent for men and 2.75 percent for women for the first 25 and 20 years of service respectively.
- An increase in the averaging period for pensionable wage to the best 5 years prior to 2000 plus all years past 2000 from the best 5 years or the last 2 years with revalorization of past earnings to average wage growth.
- Indexation of pensions in payment specified as 100 percent of inflation plus at least 20 percent of real wage growth compared to the previous ad hoc increases in pensions.
- A ceiling on income subject to contributions of 7 times average earnings.
- A ceiling on pensionable salary also equal to 7 times average earnings compared to the previous ceiling which was less than twice average earnings.
- Separation of work injury related disability from other forms of disability.
- Specification of disability benefits as a percentage of projected old age benefit rather than as percentage of salary.
- Movement of the elderly not eligible for a labor pension from the pension fund to a social assistance system funded by the state.

The reforms were oriented both toward providing fiscal relief within the pension system as well as improving the functioning of the pension system. Encouraging later retirement would both potentially raise revenue and reduce pension expenditures. Lowering the accrual rate would result in lower initial benefits for those retiring and provide some incentive to work longer to achieve reasonable retirement income, which could raise revenue. The increase in the averaging period again would lower the pensionable salary, resulting in lower benefits. The change in the indexation of pensions would provide purchasing power security but generally increase costs since the previous increases often did not cover even inflation; similarly imposing a ceiling on contributions and raising the pensionable salary would tend to reduce revenues and raise expenditures, respectively.

In terms of system design, the reforms moved toward strengthening the tie between benefits and contributions. Such a link is generally regarded as fair, since those who contribute more should receive more. It further increases individual incentives to contribute

since benefits are received for each contribution, thus potentially increasing compliance. Several of the measures, such as removing the ceiling on pensions and pensionable salary will reward those who contribute more. Increasing the averaging period for pensionable salary results in a better alignment of the pension paid with the average salary on which contributions were paid instead of pensions being based on only the best salary years. Finally, removing the poverty based social pensions from the social insurance structure clarifies the role of social insurance in the Ukraine, to provide benefits to the elderly or disabled based on the contributions they have made.

The reform laws were projected to bring the pension fund into surplus in 2004. However, two factors have intervened in the meantime.

> *Recalculation of pension benefits.* The 2003 law allowed for recalculation of pension benefits for those already retired, which took place in August 2004. The issue is that previously there had been a maximum pension of 3 minimum wages plus a reduction in the pensionable salary such that almost all individuals were receiving the same flat pensions. Because the ceiling on pensionable earnings is now 7 times average wage and there is no ceiling on pensions, pensioners were asking to have their pension recalculated under the new rules. This took place in August and resulted in a rise in expenditure on pensions from 8.5 percent of GDP in 2003 to almost 10 percent in 2004.

> *Rise in minimum pension.* The minimum pension which had been roughly equivalent to 43 percent of minimum wage and 18 percent of average wage was suddenly raised in September 2004 to the level of subsistence minimum, which was set at 120 percent of minimum wage and 49 percent of average wage. This almost threefold increase in the level of the minimum pension increased expenditures dramatically, from the almost 10 percent to 16 percent of GDP on an annualized basis.

Based on the pension formula, even average wage earners with 40 years work history will now qualify only for the minimum pension. This explains that 11.7 million out of the 13.3 million pensioners in 2004 received the minimum pension, which results in an undoing of the contributions-benefit link established in the 2003 law.

The Parliament has further raised the subsistence minimum for 2005, to which the minimum pension is now automatically linked, and estimates suggest that pension expenditures will rise to more than 14 percent of GDP.

Mandatory individually-funded pensions (Pillar II): MSPIL introduced mandatory individually-funded pensions (Pillar II) conditional upon the realization of specific triggers:

- Two consecutive years of GDP growth above 2 percent;
- Pensions of the solidarity system paid in amounts provided for by Article 46(3) of the Constitution of Ukraine (i.e. not lower than the subsistence minimum);
- Pension fund budget balanced according to international accounting standards;
- Institutional components in place for operation of the accumulation pension insurance system, including:
  - Fully functional personified record keeping system and automated reporting system for accumulation pension accounts of insured individuals, taking into account the status of their pension assets;
  - Fully functional IT systems for collection of contributions to the Accumulation Fund, compatible with electronic transfer system;

- Legislative acts necessary for operation of the accumulation pension insurance system are adopted;
- All members of the Accumulation Fund Board are appointed;
- Tenders are carried out and the Asset Management Companies (AMCs), custodian and auditor of the Accumulation Fund are contracted;
- There is an experience in the operation of the Non-State Pension Fund (NSPF) system; and
- Insurance is made for the State budget to compensate for the part of insurance resources lost by the solidarity system as parts of insurance contributions are transferred to the Accumulation Fund.

Voluntary Pensions. The NSPF law establishes a framework for voluntary pension savings based on the individual-account defined-contribution principle. Non-state pension funds (open-end, corporate and occupational) may be established by a legal entity-employer, their associations, associations of individuals including trade unions and their associations, or physical persons linked by their professional activity (occupation). Non-state pension funds are designed to provide investment services during the accumulation phase and payout of pension benefits, with the exception of a life annuity which can only be provided by an insurance company. Non-state pension fund administration may be performed by a specialized administrator, asset management company or a founder subject to obtaining a certification to administer a fund (founder may administer only own corporate pension fund). Fund assets may be managed by an authorized asset management company, a specialized administrator that obtains a license to perform activity on the stock market including asset management, or a commercial bank.[7] Minimum capital requirements for establishing administration or asset management companies is set low: at €300,000, while for a company performing both services, the minimum capital is €500,000, below international practice.[8] Assets are to be kept in authorized custodian banks. The law establishes caps on management fees, asset management fees, stock exchange fees and custodian fees which are to be specified in supplementary acts.

The law specifies cash deposits, securities, real estate and bank metals as eligible pension assets. Eligible securities comprise government bonds, corporate bonds and shares, as well as foreign bonds and shares. Investment in securities issued by related persons is prohibited, with the exception of corporate pension funds which are authorized to invest up to 5 percent of its assets in the securities issued by the founder over the course of the first 5 years of activity of such fund and 10 percent thereafter, non-listed securities and derivatives. No more than 40 percent of pension assets can be kept in bank deposits; maximum

7. A commercial bank is allowed to manage only its own corporate pension fund.

8. For example, the minimum required capital for pension fund management company is commonly above €5 million, and raising with number of participants. Required level of minimum capital of a fund management company in Ukraine is very low given the requirement that the pension fund management company "is liable to fund members up to its total assets". Although such a decision was motivated by a desire not to limit entry into the market to domestic companies, it may result in higher investment risk for fund participants.

50 percent can be invested in securities guaranteed by the Cabinet of Ministers of Ukraine; up to 20 percent in local loan bonds; up to 40 percent in corporate bonds issued by residents of Ukraine; up to 40 percent in assets of Ukrainian insurers; up to 40 percent in mortgage instruments; up to 20 percent in foreign securities; up to 10 percent in real estate and up to 10 percent in bank metals.

Voluntary pension taxation follows the EET rule that exempts contributions from income taxation up to 15 percent of annual salary, exempts investment return from income taxation, but taxes the pensions paid from voluntary pension funds up to the 15 percent threshold. Such a taxation rule is common in most voluntary pension systems. The activity of asset management companies and custodians is not subject to VAT. However, the activity of administration is subject to VAT.

The NSPF law explicitly excludes the pension scheme offered by Bank Arkada and real estate investor Kyivmiskbud, which has been regulated by a separate legislation. There is no economic rationale for exclusion of this scheme from the transition, particularly in current period of growing real estate prices during which the transition to either pension fund or housing mortgage based saving and financing could be done without major problems.

Occupational Pension Funds. In September 2004, the Government established an occupational pension fund for all public servants including those that have already been enjoying a privileged pension determination according to special laws, such as scientists, military personnel, police officers and civil servants.[9] These laws already establish retirement age, vesting periods, benefit levels and other features of the merit pensions and establish a responsibility to mandatory finance them from the central budget.

There are at least three issues linked with establishing such an occupational pension fund. First, it is not clear what the rationale is for contributing to supplementary pensions for the already privileged categories. Second, the annual contribution for such a large number of beneficiaries may pose a serious burden for the budget which would not be sustainable in either short or long run.[10] Third, this pension fund would, if designed for such a large number of members which need not have much in common, would soon become a strong factor in the capital markets and the political risk would emerge.

The Insurance Sector

Recent Evolution of the Market

The insurance market in Ukraine is the fastest growing segment of the financial services market. The total volume of insurance premiums increased yearly by more than 4 times during the period of 2002–04. In 2004, the total volume of insurance premiums reached UAH 19.4 billion. Insurance penetration increased to 5.62 percent of GDP, while insurance

9. According to CMU Resolution No. 1247, of September 22, 2004 “Some issues of establishing a non-state pension fund of employees of budget-supported institutions.”

10. For example, if the Government decides to put 13th wage in this voluntary pension fund, the fiscal cost could stand as high as 0.7 percent of GDP.

Table 1.23. Insurance Premiums and Payments in Ukraine

	Insurance Premiums, UAH mil.				Claims Paid, UAH mil.			
	2002	2003	2004	2005	2002	2003	2004	2005
Life insurance	24	73	187	226.4	3	3	11.8	5.8
Other insurance, of which	4,418	9,062	19,244	9682.7	540	858	1528.5	1246.8
–voluntary personal insurance	258	368	415	401.3	147	182	347.6	193.6
–voluntary property insurance	3,414	7,734	16,613	8146.9	227	448	923.6	880.6
–insurance of financial risks	1,625	4,444	8,974	3397.8	49	165	241.2	366.6
–3rd party liability insurance	341	451	1,567	358.1	55	56	47.9	34
–non-state mandatory insurance	351	460	562	731.2	59	124	130.9	94.9
–state mandatory insurance	55	49	88	45.2	52	47	78.5	43.7
TOTAL (all types)	4,442	9,135	19,431	9,909.1	543	861	1540.3	1252.6

Source: DFP (NBFIR).

market density reached only $75 per capita at the end of 2003, compared to 3 percent of GDP and US$184 per capita in CE3 countries.

Such unprecedented growth rate derives first of all from the rapidly expanding segment of voluntary property insurance which represents 85 percent of total insurance premiums. While other types of insurance are also growing fast, their share of the insurance market remains insignificant. Despite a rapid increase in life insurance (255 percent between 2003 and 2004), this segment of the market accounts for only 0.96 percent of total insurance premiums in 2004. Although Ukraine has 43 types of mandatory insurance, the size of this market is small and largely based on allocations from the State Budget to cover insurance premiums and claims.

Such rapid growth of insurance premiums as compared to very low volume of insurance payments (paid claims equaled only 7.9 percent of total premiums for 2004) can be explained by the active use of insurance business for tax evasion by economic entities in other sectors of the economy, and transfer of funds abroad via reinsurance. This was especially widely resorted to following the introduction of preferential tax regime for insurers (3 percent income tax on total premiums with the exception of insurance premiums transferred for reinsurance by insurers-residents). At the same time, a 25 percent VAT was introduced for the remaining enterprises. The interest in the insurance market (especially for tax minimization and capital outflow purposes) increased significantly, notwithstanding the strengthening of the regulatory and supervisory regime and the toughening of anti-money laundering regulations.

It is generally estimated that at the end of 2004 at least one third out of 387 insurance companies in Ukraine were established for tax evasion purposes. According to NBFIR estimates, at least 20 percent of top fifty insurance companies are captive insurers. Most captive insurers are established by banks or are part of the large industrial and financial conglomerates. This creates major concern for both NBU as Bank Supervisor and NBFIR as Insurance Regulator with respect to massive capital outflow from the banking sector as a result of regulatory arbitrage and distinctive differences in tax regimes. This also poses a threat to the reputation of the market and thus undermines the performance of the best companies.

As of January 1, 2005, reinsurance premiums exceeded UAH 11.7 billion of 60 percent of total insurance premiums, as against UAH 5.4 billion or 59 percent of total premiums in 2003. In order to prevent the flow of capital abroad through reinsurance schemes, NBFIR adopted a number of by laws and introduced a supervisory action allowing for the termination of reinsurance operations with reinsurance companies that are not in compliance with legislative requirements. As a result, the pattern of reinsurance has changed, with 50 percent of insurance payments under reinsurance agreements remaining on the internal reinsurance market in 2004 (twice as much as in 2003). Reinsurance channels were closed with respect to Lithuania and Latvia, which did not fall under government supervision. A greater share of reinsurance agreements were concluded with insurance companies with high credit rating. In 2004, 9.8 percent of insurance premiums were transferred to non-resident insurers, as opposed to 34 percent in 2003. The largest share of reinsurance premiums with non-residents consisted of voluntary property insurance (29 percent, except financial risks) and financial risks (52 percent). Insurance payments to non-resident insurers under life insurance agreements amounted to UAH 40 million (2.1 percent of total premiums to non-resident insurers), or 21.4 percent of total life insurance premiums.

Cross-ownership between banks and insurance companies also allows significant capital misrepresentation in banks and insurance companies. In 2004, the volume of financial risks insurance increased by 202 percent and reached UAH 9.0 billion or 46.2 percent of total insurance premiums. While Ukraine does not have proper hedging instruments, the demand for financial risks insurance indeed has a potential to grow. Nonetheless, the largest share of premiums in this category were paid by banks to: (i) minimize their income tax; and (ii) increase banks' capital via additional issues of shares to be purchased by the captive insurers.

The insurance market is highly fragmented with a large share of small and inefficient companies. Due to various historical reasons and in response to existing non-level playing field, poor competition and selective Government support to certain insurance services, a number of negative structural aspects can be observed in the market. First of all, segmentation and sectoral specialization of some companies results in monopoly position in certain market segments. The majority state owned insurance company Oranta continues to play a significant role in the agro insurance market. The market has a large number of insurance companies that are part of the larger holding groups. The market share of the top three insurance companies (based on premiums) amounted to 22.3 percent in 2004 (down from 23.1 percent in 2003). Overall, the Herfindahl-Hirshmann index equaled 177.0 in 2005, compared to 282.1 in 2003 and to 309.98 in 2004.

The role of foreign insurance companies is still very limited, but is growing. As a result of the elimination of 49 percent foreign ownership restriction per single insurance

Box 1.1: Insurance Reserves and the Actuarial Profession in Ukraine

Total insurance reserves for end of September 2004 reached UAH 7.3 billion, with technical reserves for non-life companies accounting for 98 percent of total reserves. Reserves of life insurance companies did not exceed UAH 113.3 million despite their 248 percent increase since 2004. Reserves, similarly to the capital of insurance companies, require diligent auditing, as they may be highly overestimated. Unfortunately, a very limited group of insurance companies uses the services of actuaries. Moreover, the quality of accounting and auditing of insurance companies is low and non-compliant with IFRS and ISA.

company in 2001, the number of insurance companies with partial or fully foreign ownership is increasing. As of April 1, 2005, there were 65 insurance companies with foreign capital.

In 2004, Ukraine had 78 insurance brokers mostly located in Kyiv.

Capital Requirements and Reinsurance

The new Law on Insurance (October 2001) introduced new capital requirements for insurance companies, namely €1 million for non-life and €1.5 million for life insurers. According to the phased capital compliance schedule, all the insurance companies must fully meet minimum regulatory requirements by October 2004, three years after the introduction of the new law. As many insurance companies were not able to comply with the intermediate capital targets, NBFIR withdrew licenses and initiated liquidation of more than 50 insurance companies in 2003. Many more companies are expected to exit the market before end 2004. Nevertheless, the total number of insurers as indicated in the Table 1.24 above continues to grow on account of newly-registered companies, including foreign insurers.

Ukraine lacks a well-developed industry of actuarial profession. In 2000, only 42 actuaries were registered in Ukraine, upon completion of a 2-year specialized training program organized by the British Actuarial Society and funded by the British Government. In 1999, Ukraine established an Actuarial society including 42 full members and 7 associates. According to experts estimate, less than 30 actuaries were working in the market in 2003, while the NBFI regulator was not able to attract any of the trained actuaries to work in the state regulatory agency.

Reinsurance premiums exceeded UAH 8.5 billion as of September 2004 or 61 percent of total insurance premium compared to UAH 5.4 billion or 59 percent of total insurance premiums in 2003. From this amount, 21 percent of reinsurance premiums were transferred to non-resident reinsurers compared to 59 percent in 2003. Because of a lack of long-term risk-free assets and the restrictive regulation of investments into foreign assets, reinsurance is often used by companies to minimize FOREX or maturity mismatches between assets and liabilities. The biggest portion of reinsurance premiums was due for voluntary property insurance (89 percent of total reinsurance premiums), where financial risks insurance alone accounted for 55 percent of reinsurance premium amount. Life insurance was reinsured only with non-residents for the amount of UAH 23.9 million or 33 percent of total collected life insurance premiums.

Table 1.24. Insurance Market Performance in Ukraine, 1995–2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Insurance Companies,total	500	369	212	254	263	283	328	338	357	387	399
Of which life insurance companies						17	19	28	31	45	51
Insurance premiums, % of GDP	0.5	0.4	0.4	0.8	0.9	1.2	1.5	2.1	3.5	5.64	3.33
Inflation, %	182	40	10	18	17	26	6	0	7	12.3	10.3
Insurance premiums, mil. UAH	244	318	408	789	1,16	2,136	3,031	4,442	9,135	19,.431	9,909
Insurance payments (claims paid), mil. UAH	144	147	129	178	361	407	424	543	861	1,540	1,253
Insurance payments to total revenues and premiums, %	50	38	28	20	29	18	13	12	9	4.88	6.68
Total expenses to insurance premiums & other revenues, %	66	56	50	34	41	32	26			87.57	84.17
GDP, UAH mil.										344,822	297,584

*Division of companies by life and non-life began in 1997 after the passage of the new Law on Insurance (March 7, 1996). There were not many newly registered insurance companies in 1997–1999. Instead, the market saw a large number of liquidations, primarily among non-life companies, as a result of strengthening capital requirements.

Source: DFP (NBFIR).

Box 1.2: Violations in Activities of Insurers

- In 2002, 25.5 percent of total violations were related to insurers' non-compliance with the contractual obligations and resulted in abuse of policyholders' rights.
- Discrepancies in the activities of insurance agents were identified in 9.9 percent of cases.
- Non-compliance with the requirements for creation of reserves was found in 6.0 percent of inspected insurance companies.
- Violation of terms for termination of insurance contract, 5.6 percent of cases.

Investment Funds

Up until 2002, the Ukrainian investment industry was represented by a large number of investment funds and companies established according to the Presidential Decree on Investment Funds and Investments Companies (1994 with amendments of 1995 and 1999). Without exceptions, these funds were created during the mass privatization program to pool capital (primarily privatization vouchers) from individual investors and participate in the privatization of state companies. In 1999, 228 institutional investors were regulated by the above-mentioned decree. The number of investment funds was even larger before the painful years of 1994–95, which are remembered by multiple failures of trusts and investments funds as part of "financial pyramids" crisis.

After the passage of the Law on Institutions of Collective Investments (ICIs) in March 2001, existing investment funds were to be closed or transformed into the new type of investment funds within two years from the date of the enactment of this law (by mid-2003). Nevertheless, as of January 2004, a large number of the old investment funds (75 investment funds and 95 mutual funds) were not yet closed due to the absence of resources needed for settlement with investors. The legislation of Ukraine required that all the funds in operation as of March 2001 were to open accounts with the State Savings Bank and settle their obligations with the clients by liquidating the securities or transforming into the new funds. Only 20 investment funds self-liquidated since 2001. The total outstanding amount due for settlement with the investors of these funds exceeded UAH 1.9 billion.

According to the new law, in 2003 SEC issued 32 licenses to the newly established (and reregistered) ICIs. During the first six months of 2004, another 18 ICIs were registered (see Table 1.25).

To support the implementation of the ICIs law, SEC issued 28 regulatory acts governing the activities of ICIs, assets managers, establishing investment limits and reporting requirements for ICIs. However, existing accounting and reporting rules for ICIs requires strengthening.

Table 1.25. New Institutions of Collective Investments (ICIs)

	Total Registered
Corporate investment fund	4
Share investment fund	28
TOTAL	32
Of which Venture Funds:	22
–Corporate investment fund	3
–Share investment fund	19

Source: NBFIR.

The existing ambiguities in legislation on asset management and trust management require further streamlining to avoid significant discrepancies and malpractices in the market.

The law on ICIs established the notion of assets management. Banks and insurance companies are not allowed to manage assets directly without establishing a subsidiary company. According to the Law, SEC licensed 53 asset managers during 2003–04. The total paid in capital of assets managers amounted to UAH 240 million.

Factoring and Leasing

The general conditions and procedures for factoring transactions are established by the Civil Code of Ukraine (Chapter 73, Factoring) and by the Economic Code (Clause 350). As of May 1, 2005, among 57 financial companies in the State Register of Financial Institutions, 15 have the right to provide factoring services. As of 2004 Q2, factoring services were provided by only three financial services companies. By the end of 2005 Q1, the total value of executed agreements amounted to UAH 3.4 million (see Table 1.26).

The leasing industry attracted regular attention of Parliamentarians and Government of Ukraine since 1996. Unfortunately, lengthy rhetoric did not bring significant results, apart of new Law on Financial Leasing, which was passed in 2003 to substitute the 1997 Law on Leasing. In addition, the Ministry of Economy has developed a draft of the Law of Ukraine on Accession to the UNIDROIT Convention on Financial Leasing, and submitted the Ministry of Foreign Affairs with the required documentation in May 2005. The objective of this Law is to enable Ukraine to join the International Convention on financial leasing signed in Ottawa on May 28, 1988. This Convention would play the role of a basic international legal and regulatory framework in the area of leasing. In particular, it would enable economic agents to increase the efficiency and availability of leasing transactions as well as support the development of international financial leasing. However, the major impediments (tax legislation and accounting) remain to be addressed. For this reason, the appetite of many investors for leasing faded away and a number of companies, including foreign lessors, left the market in 1998–2000. This subsequently influenced the performance of the industry with total assets less than 1 percent of GDP, perhaps the smallest leasing market in the region.

Although banks are allowed to operate in the finance leasing market either directly or via subsidiaries, the volume of banks-originated lease agreements did not exceed UAH 66 million or slightly more than US$11 million in 2003. Until the passage of the Law on

Table 1.26. Factoring

	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3
Number of concluded agreements	1	6	13	11	37	48
Number of executed agreements	0	2	3	14	30	39
Value of concluded agreements (UAH mil.)	0.2	3.4	3.7	6.02	13.55	18.88
Value of executed agreements (UAH mil.)	0	1.4	1.8	3.4	n/a	n/a

Source: DFP (NBFIR).

Table 1.27. Leasing

	2004 Q1	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3
Effective agreements at beginning of period (units)	57	366	646	790	3,732	4,138
Concluded agreements (units)	24	169	134	146	287	461
Executed agreements (units)	1	8	3	15		
Effective agreements at end of period (units)	80	527	771	921	3,997	4,402
Value of concluded agreements during period (UAH mil.)	13.3	69.8	56.6	36.2	211.5	262
Value of unfulfilled agreements at end of period (UAH mil.)	46.1	2.7	2.3	1.8	2,426.4	2,382.8

Source: DFP (NBFIR).

Financial Services (2001) and the creation of the NBFIR, financial leasing operations were not regulated in Ukraine. For this reason, there are no reliable statistics on the sector, and all the analyses produced to date are based on experts' estimates. According to the information of the State Statistics Committee, more than 60 leasing companies were registered in Ukraine during the period of 1994–2003. As of April 1, 2005, the State Register of Financial Institutions contained 14 financial companies which can provide financial leasing services. In addition, 48 leasing companies were registered at the State Committee for Regulation of Financial Services. As of the end of 2005 Q1, leasing companies had 921 effective leasing agreements valued at UAH 36 million (see Table 1.27).

Most of the bank-related leasing companies were established to facilitate sale or rent of the assets repossessed from defaulted borrowers. Other leasing companies are involved mainly in finance lease (UAH 320 million or 84 percent of all the transactions). The size of single leasing transactions varies from $10,000 to $950,000, while average lease agreement amounted to $200,000. The down payment generally equals to 20–25 percent of the value of the leased equipment. The average term of lease agreement does not exceed two or three years. The structure of leasing investments by sectors is presented in the Table 1.28.

Table 1.28. Distribution of Leasing Investments by Sectors of Economy

Percent	1998	1999	2000	2001	2002
Manufacturing	16	18	22	25	40
Agriculture	42	40	38	35	29
Transportation	32	33	30	20	22
Communications	1.5	1.0	1.0	0.5	1.0
Construction	3.0	3.5	3.0	3.0	4.0
Other (real estate, utilities, publishing)	5.5	4.5	6.0	16.5	4.0

Source: Ukrainian Leasing Association.

Table 1.29. State Support to Leasing, 1999–2003

UAH mil.	1999	2000	2001	2002	2003
Total leasing transactions	1,812	1,750	1,500	1,348	504
State budgetary allocations for leasing	140.8	66.6	170.9	59.4	130.0
Share of state support as % of total leasing transactions	7.8	3.8	11.4	4.4	25.8

Source: Ukrainian Leasing Association.

The large share of leasing transactions in the agricultural sector and in transportation, as well as the growing amount of leasing operations in manufacturing, is explained by the special Government treatment of leasing in these areas. In 1997, the Government of Ukraine established a special leasing fund that was later transformed into the 100 percent state owned leasing company "Ukragroleasing". Until today, Ukragroleasing is entitled to annual budgetary allocations (in the range of UAH 100–150 million) used for procurement of agricultural machinery (tractors, harvesters) from the domestic producers. Two more state companies operate in the leasing market, Ukragromashinvest and Ukrtransleasing.

Unfortunately operations of these companies, besides their direct negative impact on competition and pricing, have also set the precedent to poor payment discipline of lessees. For years, Ukragroleasing was not able to collect more than 4 percent of payments from farmers who received leased equipment. Also, by nature of these transactions, these programs seem to support the producers of equipment rather than meet the needs of the lessees.

Foreign investors operate in the markets primarily via dealers of machinery and vehicles. Direct international leasing is constrained by the existing tax legislation. In 2003, Ukraine signed a 2001 UNIDROIT Convention on mobile equipment and is considering signature of the 1998 International convention on leasing and 2001 UNICITRAL Convention on accounts receivable.

CHAPTER 2

Impediments to NBFI Development and Policy Reform Agenda

Capital Market and NBFI Regulatory and Supervisory Framework

The development of capital markets and NBFIs is critically dependent on the establishment of a sound regulatory and supervisory framework in which regulatory authorities are independent of the executive power and have a strong capacity for enforcing regulations.

Major impediments remain on the road to achieve this objective.

The State Securities and Stock Exchange Commission (SEC) is, by law, independent of the executive power and has the right to issue its own regulatory acts and decisions on corrective measures. The SEC suffers from major weaknesses. Following the retirement of the previous management in December 2003, a long period of uncertainty followed and the Commission Chairman and three new members of the Commission were not appointed by Parliament until July 2004. The process was heavily politicized as a result of the desire of powerful business and political interests to influence developments in the stock market ahead of ownership transformation of remaining state-owned companies. Despite its large staff, the capacity of the Commission is overstretched by its mandate to monitor more than 35,000 joint-stock companies, which distracts it from its core responsibility for securities market regulation and supervision. As a result, the enforcement capacity of the Commission is very weak, and its reputation in the market is seriously undermined.

The NBFIR was established in December 2002 to supervise NBFIs, including pension funds, investment funds, insurance and leasing. The responsibility for insurance supervision was transferred from the State Committee for Insurance Supervision and a special Department of Insurance Supervision at MOF to the newly created NBFIR in 2003. Since its creation, NBFIR has made substantial progress in developing its regulatory capacity, with technical assistance support from the Bank and other donors. However, the NBFIR lacks financial autonomy, and its capacity remains low, particularly in the area of enforcement.

As in the case of SEC, NBFIR management faces major problems to attract and retain professional staff because it is not allowed to charge fees and to use the proceed of these fees to pay competitive salaries.

Market participants identify the following problems in financial regulations as major impediments to financial market development in general and NBFI sector in particular:

- Regulators lack adequate political (legal and institutional) independence. There is continuous political intervention (from the Government, Parliament and often powerful financial institutions) into the decision making process of the financial regulators. Appointment of senior management is compromised and is often driven by the political favoritism rather than recognition of the competences and impeccable reputation of the appointees.
- Regulators face serious problems of underfunding. Small wages (NBFIR pays less than 50 percent of what NBU pays to its staff and less than 20 percent of the market remuneration levels) distracts professional staff and results and high rotation of personnel.
- Existing technological support of regulators (IT/MIS, other equipment) does not allow timely collection and analysis of data (even mandatory regulatory reports) thus defusing the quality and timeliness of the regulatory analysis and corrective actions.
- Poor enforcement capacity of regulators results in low transparency, poor corporate governance and non-level playing field in the market, etc.
- Confidence in the financial market is still relatively fragile, especially in the area of NBFIs. Investors working in the NBFI and capital markets would appreciate stability, transparency and predictability in the actions of the regulators as well as legal framework.

The program of the Government of Ukraine submitted for Parliament's review in February 2005 envisaged the merger of SEC and NBFIR. However, there has been no further professional discussion in this regard. Moreover, the local financial markets community has seriously questioned the timeliness and the rationale for such a merger, provided that no in-depth review of the existing problems has been made. The market also has a significant concern regarding the commitment, willingness and ability of the Government of Ukraine to address the existing legal (such as independence and enforcement capacity) and institutional deficiencies (low funding, poor skills and motivation of the personnel, inadequate IT/MIS support) in the activities of the NBFIR and SEC that are imperative for successful institutional reform of the regulators and future market development. International experience shows that merging regulators is always a difficult undertaking. For example, it took more than five years to complete the merger of activities of separate regulators into the new Financial Services Authority (FSA) in the United Kingdom. The existing institutional weaknesses of both SEC and NBFIR and the lack of political consensus on the objectives and the outcomes of the reform will make this into a formidable challenge in Ukraine.

Should Ukraine move towards integration of the regulators, successful implementation of this process would require the following key priority actions:

- Establish a Task Force to advise on the nature and the timing of the merger including a number of highly reputable international and local experts from the financial regulators (NBU, SEC, NBFIR), the Ministry of Finance, Ministry of Economy, the Anti-Monopoly Committee, and selected representatives from the private financial sector or their professional organizations (banking community, securities market and NBFI market).
- To instruct the Task Force to discuss and design a strategy of merger of two regulators that will include such details as: (i) objectives; (ii) phasing; (iii) reform management mechanism (special Transition Management Committee similar to UK or Hungary); (iv) legislative and institutional changes required to implement the reform and ensure proper independence and accountability of the regulator; (v) benchmarks allowing the assess the success or failures of the reform as well as identify existing or potential weaknesses in the performance of the integrated regulator; (vi) cost plan for the implementation of the reform; and (vii) HR/staffing plan (which will include the proposed strategy for redeployment of staff, severance payments etc). The Task Force should be given 3 to 5 months to accomplish this task.
- To present the proposed strategy to the professional constituency as well as Government for discussion and finalization. The transition timetable should reflect realistic assessment of the strengths and weaknesses of the financial regulators, human resource limitations, knowledge gaps and absorption capacity of the existing or new staff of the regulators. Moreover, the transition should ensure smooth transfer (merger) of functions without undermining the actual quality of supervision and compromising the interests of the market.
- To appoint a Transition Management Committee or a specially authorized Coordinator of the reform. At the same time, both regulatory agencies (NBFIR and SEC) should continue to perform its statutory regulatory and supervision functions to prevent unnecessary market disruptions and mitigate the risks associated with possible increasing uncertainties about the course and results of the reform.
- To deploy international expertise, as required, to provide professional consultations and guidance on the course and substance of the reform before action plans and timetable is adopted.
- To ensure that the top management of the regulatory agencies and champions of the reform have undisputable professional reputation and have no conflict of interest which might discredit the value of the reform in the financial sector.

Regardless of the decision on the merger of the regulators, the following reform measures would need to be undertaken as a matter of priority:

- To reform the funding mechanism for the new regulator, allowing it to collect fees from market participants.
- To allow the new regulator to set salaries outside the civil service salary scale and at levels that allow it to attract and retain the senior market expertise that it will require.
- To tighten the registration and licensing/relicensing process for capital market intermediaries and NBFIs, in particular by increasing the power and the capacity

of the new regulator to trace the ultimate beneficial owners of capital market intermediaries and NBFIs, to carry out background checks on these owners, and to carry out fit and proper tests for controlling shareholders and managers of capital market intermediaries and NBFIs.

- All these measures are critical to ensure the integrity of the regulation and supervision of the market. The last measure can play a critical role in streamlining capital markets and in reducing the number and fragmentation of the institutions operating on the market.

Over the longer term, as part of the process of EU integration and modernization of the financial sector, the Government will face two fundamental policy challenges:

- First, to ensure that the performance of the financial regulators in general, and the new capital markets/NBFI regulator in particular, are strengthened to the point where they can perform their duties as home country regulators under the single EU financial market; and
- Second, to build the capacity of the financial regulators in general, and the new capital markets/NBFI regulator in particular, to move to risk-based supervision of financial institutions.

To meet these challenges, the Government should consider establishing twinning arrangements with financial regulators in one or several EU-member countries, and to design and implement, as part of this twinning program, a comprehensive capacity building program to strengthen the capacity of the Ukrainian regulators up to the standards of other regulators on the EU single financial market, and to design and implement a strategy to develop risk-based supervision of financial institutions, both banks and NBFIs. Moreover, Ukraine should take active part in international working groups and Basle committees that develop decisions and promote best standards and practices for financial regulation and supervision, including IAIS and IOSCO.

Money and Securities Markets

Money Markets

Money markets in Ukraine experience periodic bouts of illiquidity, with significant volatility in short-term interest rates. For example, in the first quarter of 2004, spreads of high to low interest rates in the overnight inter-bank market ranged from 6.3 to 3.9 percentage points (see Table 2.1). In November–December 2004, the inter-bank market ceased to function due to the political situation in the country.

From time to time however, for example in late 2003, the market experienced extreme illiquidity with short-term inter-bank rates exceeding 50 percent per annum. Contributory factors to this high volatility of rates include:

- A weak and fragile banking sector;
- Weakness in the Governments cash flow forecasts;

- Insufficient capacity/willingness of the NBU to intervene actively to offset such short-term liquidity fluctuations in the domestic market, despite a high and rising level of external reserves; and
- Lack of significant measures to improve the banking sector by the NBU. Many banks are poorly managed and very fragile. To sustain the banking sector, the NBU provides liquidity support at favored conditions to them from time to time.

Table 2.1. Overnight Interbank Market Volatility

	Jan '04	Feb '04	Mar '04
Highest–lowest rate in percentage points	6.3	2.0	3.9
Highest rate/ lowest rate in percent	68	95	143
Lowest rate in percent	9.3	2.0	2.7

Source: NBU.

As a result, short-term inter-bank liquidity is constrained by factors impacting the aggregate net liquidity position of the banking system as well as by factors impeding the ability of the banking system to redistribute liquidity between banks. Moreover, the interbank government securities repo market is underdeveloped, further limiting the interbank market's capacity to distribute liquidity efficiently *within* the banking system, as well as working against the development of the bond market.

To overcome these impediments, the most fundamental action is for NBU to take significant measures to improve the quality of the banking sector as a whole. In addition to this fundamental requirement, a number of policy actions need to be taken as a matter of priority:

- To improve the forecasting of Government sector cash flows in/out of the banking system;
- To implement a more active and discriminating strategy for NBU interventions in domestic money markets to offset short-term liquidity situations; and
- To identify and eliminate legal uncertainties re-enforceability of collateral rights under a repo agreement and also re tax treatment.

Government Bond Market

Recent Government policy has been to rely primarily on the external debt markets for the financing of the government's borrowing needs. Moreover, reflecting the tight budgetary management policies followed in recent years, aggregate net debt issuance requirement has been modest, with the cumulative fiscal deficit over the three year period 2001–03, amounting to less than 4 percent of GDP, such that government debt outstanding currently amounts to some 25 percent of GDP.

In 2003, while planned issuance of domestic government bonds was UAH 1.8 billion, the actual issuance amounted to only UAH 1.2 billion; meanwhile, issuance of dollar denominated 10 year Eurobonds amounted to some UAH 5.5 billion equivalent. Moreover, a somewhat higher issuance volume on the external markets is planned for the current year.

The coupon yield of the recent ten-year Eurobond was 7.65 percent p.a., while the all in cost allowing for fees, etc. would be slightly higher. This compares with a cost of domestic funding, in much lower volume and for very much shorter maturities, of the order of 10–11 percent per annum. Given the cost, liquidity and signal effects of raising such funds in the Eurobond market, it is not surprising that sovereign debt management policy has taken this direction. Against a background of limited aggregate government funding need, however, the net result of this approach has been that the structure and capacity of the domestic government securities market remains very limited.

In this context, specific impediments to government bond market development include: (i) lack of transparency; (ii) fragmentation of issues; (iii) issuance policy; (iv) auction process; and (v) limitations to repo transactions.

Lack of Transparency. The uncertainty resulting from lack of transparency is a major issue for the development of the bond market. MOF and NBU announce the issuance of government securities only one day in advance on their website. This announcement only provides information of the issuance event per se. It does not provide an indicative volume for each instrument. There is no information on auction procedure, issuance calendar, modalities of participation in the primary market and who can participate.

From early 2005, the authorities started announcing the monthly issuance plan. This practice was well received by market participants. However, since April 2005, the authorities went back to the original practice, and auctions resumed at irregular intervals.

The market will charge for uncertainty premium on bids, resulting in extra costs due to lack of transparency. Since data and information is limited, it may be advisable to engage in a dialogue with the relevant authorities on how they currently operate the primary market of government securities, identify specific problems, and provide recommendations on how to improve transparency step by step.

Fragmentation. Against a background of a small level of outstanding debt, the large number of types of instruments and the large number of individual bond and/or bill issues outstanding further limits secondary market liquidity.

At the beginning of 2005, the authorities consolidated the issuance on a few instruments (2, 3, 5 years) and announced the monthly auction plan. This practice was well received by the market. As a result, some issues, notably the five-year securities reached a significantly large amount outstanding. However, this practice was gradually abandoned in April 2005. From April 2005, the issuance of especially four- and five-year securities was replaced by shorter maturity issues ranging from three months to 1.1 years. Auctions resumed at irregular intervals.

The fragmentation into small issuance size may be favored by the authorities as a means of spreading the maturity of the debt and of reducing refinancing risk. However, the result is a lower level of secondary market liquidity. Many countries seek to reduce the number of issues outstanding in order to develop secondary market liquidity and thereby the cost of debt; in such cases refinancing risk is normally managed on a dynamic basis by reverse auctions, buybacks, switching programs, and so forth, well in advance of the maturity of the issue.

While such consolidation creates a greater degree of unevenness in the maturity structure of the debt, international experience of other small/medium size markets has been that this "static" perspective has been more than offset by the development of a deeper market and the use of market based techniques to manage refinancing risk.

Issuance Policy. The issuance strategy of Euro bonds over domestic bonds needs to be reviewed from broader perspectives. Currently, the authorities reduce the domestic issuance and increase Euro-bonds insurance simply on the ground of lower nominal interest rate difference between Euro and the local currency. This movement may lead to two problems:

- This exposes the government to potential currency risk. Currently, about 70 percent of public debt is in foreign currency.[11] If capital can freely flow in and out of the border, the real interest rates between different entities would be similar. The difference of nominal interests reflects the inflation difference. Therefore, the currency with high nominal interest rate would depreciate against currency with low nominal interest rate in the future. The inflation rate in Ukraine is higher than the Euro area. This may increase the government future debt burden in terms of local currency.
- This issuance strategy may also hurt the development of domestic pension and life insurance industry. It appeared that the demand from domestic institutional investors has been higher than the supply of government securities. Domestic investors feel lacking instruments to invest. This movement from domestic issuance to Euro bonds would further reduce the supply of instrument, thus impeding domestic bond market development.

The combination of limited domestic issuance as a result of primary emphasis on external foreign currency funding, and the need for banks to hold government securities for liquidity management purposes (for example, for repo at NBU) creates a situation where the authorities are able to hold yields on government bonds to artificially low levels, canceling or limiting auctions if they feel that the rate being offered by the market is too high.

Auction Process. Apart from the number of auctions, the existence of a two-step price setting process adds further and unnecessary complexity to the process.

Bidders are required to submit bids by 11 a.m.; these are then sent to MOF which announces a new "indicative" interest rate to bidders by 1 p.m. But they can raise the amount and the price (lower the yield) in the second stage; so they have an incentive to bid low prices for low amounts, and not reveal their true demand. The end result is that information about market demand in the first stage is incomplete. The auction is on a multiple price basis; this together with the two stage price setting process work against aggressive competitive bidding by investors; a single stage price auction would be more likely to produce keener pricing in a more transparent and simplified process.

Repo Transactions. Interbank repo activity is underdeveloped, further constraining the interbank market's capacity to distribute liquidity efficiently within the banking system, as well as working against the broader development of the bond market. Repo transactions are actually conducted through separate spot and forward transactions, which are also reported to provide market participants with a mechanism to circumvent restrictions on short-term positions. Market participants cite both legal uncertainties over the enforceability of collateral under a repo as well as uncertainties regarding tax treatment of

11. Fitch Rating Report on Ukraine, January 21, 2005.

interest/coupon income in a repo as two major factors working against the wider development of repo markets (the latter is reported to result in negative repo rates from time to time). Moreover, ISMA master agreements are not in use.

To address these impediments, a number of policy actions should be taken as a matter of priority:

- Review how the primary market of government securities is organized by examining the auction process, participation requirements, and announcement of the auction plan. Based on this exercise, identify main issues, and improve the auction process and strengthen transparency.
- Review the currency issuance strategy by comparing the pros and cons of domestic borrowing vs. external borrowing from broader perspectives. Following this review, develop an issuance strategy including clear debt management objectives and issuance policies. This strategy should be based on medium-term cost/risk and domestic market development considerations rather than short-term cost minimization.
- Standardize the instruments of government securities. MOF and the NBU should consider reducing the number of government securities tenors and concentrating them on a few standardized instruments. Meanwhile, introduce tools such as reopening, buyback, and switch in order to strengthen the liquidity of government securities.
- Establish a consultative industry group re development of securities market group to reach consensus on issuance process, consolidation of issues, and development of interbank repos.

Sub-sovereign Bond Market

Key Impediments to Sub-sovereign Bond Market Development. The development of the sub-sovereign bond market is hampered by deficiencies and inconsistencies in the legal and regulatory framework for borrowing by sub-national governments (SNGs). These impediments pertain to (i) Execution of SNG budgets by State Treasury; (ii) Approval procedures for SNG borrowing; (iii) Purpose of borrowing by SNGs; (iv) Restrictions on the issuance of SNG debt; (v) Issuance of SNG guarantees; (vi) Regulations on characteristics of SNG debt; (vii) Regulations on revenue pledges, intercept authority and reserve funds; (viii) Disclosure requirements; (ix) Prudential investment of proceeds from borrowings; (x) Lender remedies in case of SNG default; (xi) Central government approval, monitoring and intervention; and (xii) SNG insolvency.

(i) *Execution of SNG budgets by State Treasury:* According to the Budget Code, all SNG budgets are executed by the State Treasury and all budget accounts of municipalities are held in State Treasury. Specifically, Article 15 para. 4 of the Budget Code stipulates that expenses to repay debt pertinent to loan agreements undertaken by SNGs shall be financed regardless of the amount of funds allocated by the city council for this purpose in its decision on the city budget. Therefore, according to the Code, the State Treasury is bound to pay a creditor who submits to it a court decision requiring payment of a due debt that a SNG has failed to pay. However, in practice, the State Treasury indicates that it would refuse to execute such court decision, because the Budget Code does not contain a provision allowing the State Treasury to require the defaulting SNG to adjust its accounts to reflect the amount of debt paid by the State Treasury on its behalf.

Notwithstanding the practical refusal of the State Treasury to execute a court order for payment of a debt due but left unpaid by a SNG, the transfer of budget execution authority to the State Treasury without possibility of recourse for non-payment of debt by a SNG leads to a potentially severe moral hazard in the fiscal decentralization system.

(ii) *Approval procedures for SNG borrowing:* The regulatory framework for approval of SNG borrowing is inconsistent. According to the Presidential Decree adopted as a result of the Odessa default, all SNG debt must be approved by MOF, and MOF subsequently established a procedure requiring the submission of internal borrowing to MOF. The Budget Code, which was passed in 2001, (following the above Presidential Decree and MOF regulation) does not explicitly require any approval of SNG borrowing, but stipulates that borrowing by SNGs shall be subject to the procedures set forth by the Cabinet of Ministers of Ukraine (Article 74, para. 6). Such a procedure was only approved in 2003 (COM Resolution 207 *On establishing a Procedure for Making Borrowings to local Budgets,* dated 3/24/03). The interval between the two documents explains the lack of borrowing by SNGs between 2001 and 2003. According to Resolution 207, SNGs must seek the approval of MOF to borrow either internally or externally, issue bonds or provide a guarantee.

There are different procedures for approval of different types of debt. For example, SEC requires specific authorization procedures by the local council for the issuance of bonds by SNGs. This creates unnecessary complications and possible confusion for market participants. Authorization procedures for borrowing should be contained in SNG debt legislation, and SEC's only concern should be to verify that the bonds have been authorized in accordance with the law and not to create supplementary (an potentially conflicting) authorization requirements for SNG debt. The new draft Law on Local Borrowings and Local Guarantees currently under preparation should resolve these inconsistencies.

(iii) *Purpose of borrowing by SNGs:* The Budget Code limits borrowing by SNGs for capital expenditures only but does not impose any public purpose criteria for such borrowing. This opens the door for possible SNG borrowing to finance various private entrepreneurial activities, or for SNG to issue guarantees for debt related to such activities.

SEC regulation 414 of 10/7/03 provides that the purpose of a bond issue must be indicated and that the proceeds of a new bond may not be the source of payment of a bond issue. While this is an attempt to prevent pyramid financings, this regulation de facto prohibits any refinancing of outstanding bonds through a new bond issue.

(iv) *Restrictions on the issuance of SNG debt:* The prudential limits set forth in the Budget Code on borrowing by SNGs contain numerous deficiencies and internally inconsistent provisions, which constitute a barrier to sound development of the SNG debt market. These include (but are not limited to):

(a) Compliance with various limitations require projections and estimations of future finances rather than being based on historical performance;
(b) Variable interest rate debt can cause problems with compliance with debt limits in the future, resulting in non-compliance in a year subsequent to the year in which debt was issued;
(c) Debt test based on expenditures rather than revenues does not relate to SNG ability to pay;
(d) Guarantees issued by SNGs not included in debt test at the time of issuance but only counted in case a guarantee is called;

(e) Five year prohibition on new borrowing for defaulting SNG may prohibit work-out refinancing; and
(f) The provisions of the Budget Code on debt service are interpreted as relating only to interest and do not include principal payments; this can result in debt service profile that does not bear any relationship with ability to pay.

(v) *NG Guarantees:* The regulatory framework for the issuance of guarantees by SNGs contains several inconsistencies. Although the Budget Code provides that payment of guarantees shall be treated as debt, there are different authorization procedures for debt and guarantees, different approval requirements, and currently no restriction on the nature and purpose of a SNG guarantee. As an example, although cities with population of less than 800 thousand are not permitted to borrow externally, this restriction does not apply to guarantees. Therefore a smaller city may guarantee external debt and therefore become obligated to pay such debt in case the guarantee is called. Finally, the Budget Code provides that a guarantee may be issued by a SNG subject to a counter-guarantee, but does not define the term, which has been subject to inconclusive discussions as to its meaning.

(vi) *Regulations on characteristics of SNG Debt:* The Budget Code provides that only cities with a population exceeding 800 thousand may borrow "externally". However, the above provisions do not define the term "external borrowing." It is unclear as to whether this refers to borrowing from international lenders or debt issued in a foreign currency, or both. Although there is no consensus on the meaning of this provision, it should be the issue of exchange risk that would most likely justify different treatment of such borrowing rather than the domicile of the lender.

(vii) *Regulations on revenue pledges, intercept authority and reserve funds:* The existing legislation does not prohibit local governments from pledging future revenues to secure debt obligations. Theoretically, the State Treasury is able to segregate a pledged revenue stream if so instructed by the city council. However, in order to seize such pledged revenue stream, the creditor will have to go to court, unless the Treasury is given the authority to transfer a pledged stream to creditors accounts (see para (i) above).

As mentioned in section (i) above, the Budget Code currently does not authorize the State Treasury to intercept a transfer due to a SNG in case the latter fails to repay a due debt.

Under the current Budget Code, there is uncertainty as to whether a Reserve Fund established for the purpose of securing a SNG debt would have to be held at Treasury, and how it would be administered. In addition, if such funds were to be non-interest bearing at Treasury, there would be substantial negative arbitrage cost to the borrower.

(viii) *Disclosure requirements:* Current SSMC disclosure guidelines do not distinguish between public offering and private placement of securities. This would hamper the development of a SNG bond market, as the initial development of such market typically involves private placement of such securities.

(ix) *Prudential investments of proceeds from borrowings:* Under the current Budget Code, proceeds from borrowings by SNGs are held in non-interest bearing accounts by State Treasury. This entails substantial negative arbitrage costs for SNG borrowers.

(x) *Lender remedies in case of SNG default:* Current experience with enforcement of remedies in the event of SNG default is very limited. Its predictability cannot therefore be determined.

(xi) *Central government monitoring and intervention; prior notification and approval of debt issuance:* Under current regulations, there is no continuous monitoring of the financial viability of SNGs or of their compliance with debt payment obligations. There is no requirement for SNGs to receive independent audits.

(xii) *SNG insolvency:* The existing legal framework does not provide for SNG insolvency.

In recent months, MOF has prepared a draft Law on Local Borrowings and Local Guarantees to regulate borrowing by SNGs. The draft Law introduces very complex procedures for approval of borrowings and guarantees by SNGs by MOF. These procedures are unnecessary in the face of the Draft Law explicit provision that SNG debt is not guaranteed by the State. Moreover, the very presence of such complicated procedures severely undermines the credibility of the no-State-guarantee provision, and therefore fuels moral hazard in the market.

Key Policy Recommendations. In order to address these impediments, a comprehensive reform of the legal and regulatory framework for SNG borrowing is required. This reform would of essence need to be structured around coordinated modifications in the Law on Local Borrowings and Local Guarantees, the Budget Code, and SSMC regulations, and the introduction of a SNG Insolvency Law and accompanying regulations.

The key elements of the reform of the Law on Local Borrowings and Local Guarantees would be as follows:

(i) to assert that SNG borrowing is not guaranteed by the Government of Ukraine, and therefore that private investors lend to SNGs at their own risk;

(ii) to include guarantees issued by SNGs in the definition of SNG debt stock, and to require that these guarantees be valued using the discounted value of probable loss methodology in calculating the guarantee reserves in special funds (as opposed to blanket 80 percent set aside as required under current Draft Law (see below). To establish that SNG guarantees may be issued only to public purpose entities, and for debts in local currency (see below);

(iii) to drastically simplify the ex-ante authorization of SNG borrowing by MOF. SNG borrowing should be subject to a simple set of transparent criteria for verification by MOF. These criteria should be limited to verification that SNG budget has been audited, that the results of the audit have been published widely, that borrowing is for public purposes only, and that basic prudential debt limits based on historical (as opposed to projected) parameters are met (debt outstanding/revenue ratio; debt service ratio). These criteria should be totally independent of the net recipient/contributor status of the SNG the equalization grants; and

(iv) to prohibit related-party SNG lending or bond underwriting (between a SNG and a bank that it owns).

The key elements of the reform of the Budget Code as far as SNGs are concerned would be three-fold:

(i) to restrict SNG borrowings to borrowing in local currency (specifically prohibiting local currency borrowings indexed to foreign currency), with the exception of refinancing of existing foreign currency debt;

(ii) to establish a broad intercept authority for MOF transfers to SNGs; and

(iii) to establish that Treasury is not liable for executing court orders issued to a creditor in case of non-payment of due debt by a SNG. Creditors should serve such court orders to the defaulting SNG, which should be solely responsible for requesting execution of the debt payment by Treasury. In case of SNG default, the creditor would trigger SNG bankruptcy proceedings under revised Law on Local Borrowing and Local Guarantees.

The key elements of the reform of SEC regulations would be that these regulations do not add any additional regulatory burden on SNG borrowers beyond established disclosure requirements. Specifically:

(i) SEC regulations to introduce different disclosure requirements for public offerings vs private placements of SNG and corporate bonds (see the next section); and
(ii) SEC regulations to allow SNG bond issuance for the purpose of refinancing of existing SNG debt obligation.

As part of the new Law on SNG Borrowing, the Government should introduce SNG insolvency proceedings, establishing a clear procedure for seizing of financial control of defaulting SNG by a Government-appointed commissar, that would be responsible for debt work-out and management of SNG finances until it emerges from bankruptcy (Chapter 11 type procedure).

Corporate Bond Market

The recent growth of the corporate bond market reflects the removal of two previous impediments, relating to the elimination of taxation of bond issuance proceeds as income and the introduction of a requirement for licensing of inter-corporate direct lending.

Notwithstanding the strong growth of the corporate bond market over the past two years, there remain a number of impediments to the future development of the market including: (i) weakness of financial reporting; (ii) weakness of corporate governance; (iii) exclusion of certain entities from the regulatory process; and (iv) deficiencies in collateral legislation.

Financial Reporting. The limited level of application of IAS and best practice standards of reporting and transparency constitute major longer term structural constraints for the future development of the corporate market.

Progress has been made in this area, with the SEC in 2003 introducing several new requirements for improved disclosure for listed companies in line with international standards. The challenge, however, remains the degree of actual implementation of these guidelines.

Corporate Governance. Weakness in corporate governance standards and practice remain significant issues, impacting investor appetite for both domestic and foreign investors. A "Corporate Governance Code" was approved by the SEC and circulated to the market at the end of last year as a recommended code of practice. It will take some time before it becomes apparent how seriously this issue is treated by the corporate sector, particularly in the absence of statutory fiduciary duties for members of supervisory and management boards (see next subsection).

As with financial reporting standards and credit ratings, the development of high and transparent standards of governance is particularly important for protecting the development and maturing process of the corporate bond market from a shock event (for example, the default of a particular issuer). Whereas the strong performance of the economy, growth in liquidity and the limited depth of the government bond market have created favourable circumstances for the rapid development of the corporate market over the past couple of years, its *continued* growth will require an ability to demonstrate that it is a well ordered market with high and consistent standards. Otherwise, the market would run the risk of imploding in the event of a setback such as the default of an individual issuer, similar to what happened with the municipal market in the latter part of the 1990s.

Arkada. Arkada Fund and Arkada Bank feature in the top five issuers and traders of corporate bonds. Arkada was successful in lobbying for exclusion of its pension fund from regular supervision. While this has not happened in the case of corporate bond activity, the potential of a knock-on effect on the corporate bond market in the event of difficulties with Arkada's property related pension fund activity should be noted. Also, perception of immunity of specific entities from even-handed regulation undermines the required market confidence in the existence of a secure and consistent regulatory framework, the provision of which constitutes essentially the main task of government in the development of the corporate bond market.

Collateral. Whereas changes were introduced in the Civil Code in 2003 in regard to collateral on corporate bonds, prospectively bringing legislation into line with best practice, problems remain in relation to the registration of collateral and the effective implementation of this new legislation. This specifically relates to the implementation of the Law on Secured Transactions, which came into force in January 2004 and envisions use of movable property (including securities and intangible assets) as collateral.

Civil/Commercial Code. Conflict and contradiction exists between the civil and commercial codes in regard to the permitted level of corporate bond issuance relative to a corporation's capital base and how that capital base is calculated.

To address these impediments, key reform priorities are as follows:

- Require adoption of IFRS as a condition for listing (see corporate governance section below);
- Resolve problems with implementation of Civil code regarding registration of collateral; and
- Remove differences between the Civil and Commercial Code regarding the calculation of capital base for determining issuance ceilings.

Mortgage Securities Market

The Law of Ukraine on Mortgage entered into effect on January 31, 2004. This law conforms to modern international standards and is one of the most liberal and progressive in Eastern and Central Europe.

Following up on the adoption of the law, the Government needs to focus on the development of the regulatory framework for mortgage securities and on specific actions designed to enable the development of a primary and secondary market for mortgage securities. Specifically, the Government would need to focus as a matter of priority on the following actions:

- To ensure coherence between legislative acts in the area of mortgage finance;
- To issue the regulatory instruments defining the requirements to issue mortgage securities, and the specifics of government supervision over their trading and the activities of issuers;
- To establish a state registration of immovable property and the state registration of mortgages; and
- To standardize the terms on which mortgage loans are provided, procedures for their provision and servicing.

Equity Market

Issuer Side Impediments. The most fundamental impediments for the development of the equity market are to be found on the issuer side of the market. As in many other transition economies, the corporate culture in Ukraine is heavily dominated by a control mentality in which only majority stakes are seen as valuable. Trading is accordingly dominated by large strategic investors. This is further reinforced by the strong presence of a handful of large financial-industrial conglomerates. Takeovers are high on the agenda in the wake of privatizations. In spite of adoption by the SEC of a corporate governance code, minority shareholders are ignored or abused. Settlements of disputes through the legal system are difficult with a clash between civil and commercial courts and lack of arbitrage systems.

The organized equity market is seldom used for generating additional capital, and IPOs are rare. While further privatizations are expected to take place in the coming years, they are not expected to lead to much additional material for trading on the organized markets.

At present there is no focus on realizing values within the financial industrial groups by spinning off companies and listing them on the exchange. Also, the activity in private equity and venture funds possibly leading to future listings is limited—and the organized capital market is at present not seen as the most obvious exit possibility. The exchanges are currently too fragmented to launch organized campaigns for promoting IPOs and fostering a market place for upcoming medium size enterprises and to address perceptions of complexity and costs of issuance in the marketplace.

Investor Side Impediments. Many of the issuer side impediments for building an organized equity market are also reflected on the investor side of the market.

First, there is little trust in the functioning of the market and strong perceptions of political and investment risk. Best execution is hardly possible to secure. There are great uncertainties as to the real value of equities. Second, there is only a limited presence of institutional investors and their focus is more on bank deposits and bonds than on equities. Third, private investors are few, and investment possibilities through mutual funds are nearly not present. To the extent they have investable funds, private investors concentrate on real estate or prefer bank deposits or bonds.

International Investors. There is only a limited number of international investors, and it is difficult to estimate to what extent they are actually foreign investors or if they instead are offshore Ukrainian funds. That Cyprus and British Virgin Islands are among the top five countries for foreign direct investment into Ukraine points to the existence of large off-shore capital flight returning to the country.

Cross border mergers are occurring with Russian companies on the buy side but such deals are not carried out through organized market places.

Foreign portfolio investors are rare and there is only a limited number of Ukrainian ADRs and GDRs.

Exchanges/Market Places and Information Systems. The exceptionally high degree of fragmentation is the most fundamental impediment to the future development of the equity market in Ukraine.

To address this issue, the first priority is to ensure that PFTS is established and licensed as an exchange and take its place in international bodies as the main functional Ukrainian market place. If needed, changes in PFTS operations and/or SEC regulations should be modified to make this possible.

Second, existing exchanges should be assessed and their functionality evaluated with respect to activity, rules, trading systems and information dissemination systems. As they may not be able to afford the necessary updating of their systems, these exchanges should therefore cooperate and share systems (together or with, for example, PFTS). Voluntary mergers between exchanges should be welcomed, possibly with the present exchanges functioning as local representatives of a major national exchange.

Third, post-trade transparency of OTC trading should be established through a set of regulations on reporting obligations for traders and through the establishment of a dissemination system for this information (time, price, and quantity). In the short run, daily reporting and dissemination would constitute a major progress. Probably the most efficient avenue for reporting would be to the exchanges as they already operate (or should operate) information dissemination systems, market surveillance systems and can facilitate Straight Though Processing (STP) to settlement systems. Over the medium term, this should be supplemented with best execution rules.

Derivatives. There are few derivative products on the organized markets. Several attempts to offer foreign exchange derivatives at the Ukrainian Interbank Currency Exchange (which is also a Stock Exchange) have failed. Most of what is labeled option trading on PFTS are of a very special character and would not be seen as options by international norms.

Futures and options on the PFTS index should be considered only after the market place matures and becomes more transparent.

CSD & Clearing & Settlement /(CCP) /Payment System. For government bonds, NBU operates a CSD system with fully dematerialized instruments and Delivery Versus Payment (DVP) settlement. The industry seems satisfied with the operation of this system. As other segments of the bond market develop, the need for a unified CSD system facilitating netted settlement of arbitrage trades across bond types will emerge.

For non-government bonds and equities, the custodian owned MFS is the operational CSD. SEC and NBU recently created the Ukrainian National Depository (UND), which is

currently not operational except for being the Ukrainian member of the Association of National Numbering Agencies (ANNA). The rationale for the creation of UND is not clear. If the authorities motivation for establishing UND was dissatisfaction with the operations of MFS, it would have been more logical to push for more regulation of the CSD. If their motive was to gain political control of the CSD, it would have been logical to try to buy (part of) MFS. The present state of affairs threatens the development of MFS.

In addition to the potential threat from UND, the development of MFS faces a number of impediments.

First, even if MFS offers DVP settlement (T + 3 as standard, but T + 0 or 1 is also used by participants), it is seldom used and by far the largest part of the settlements are FOP (Free of Payment), with the money side of the deals settled outside MFS. Counterparties tend to manage the resulting settlement risk by having the stronger party in the deal demanding prepayment or pre-delivery from the least creditworthy counterpart. Reasons for preferring FOP instead of DVP may include:

- Transactions of non selling nature,
- Lower fees for FOP settlements,
- Settlement in foreign currency (offshore),
- Wish to hide price,
- Not market conform pricing, and/or
- Tax evasion motives (hide capital gains).

MFS states that the DVP fee is higher than FOP and is too high to motivate the use of DVP. MFS could lower the DVP fee with little economic consequence in order to remove at least this justification for the use of FOP.

The widespread use of FOP should concern the authorities, as it increases systematic risk. The authorities should review capital requirements to ensure that they correctly reflect the higher settlement risk of FOP. If the motive for the use of FOP is a wish to avoid any registration in the CSD of the price component of the trade, better post-trade transparency of OTC trades should neutralize this motive.

Another impediment is the very weak connectivity between the CSD and the registrars. A well-functioning electronic message system would seem suitable to resolve this issue. With around 1000 fully registered issues in the CSD, it would also seem advisable to license the CSD as a registrar—and perhaps even as the mandatory registrar for all listed companies.

Concerning international connectivity, MFS had contacts with EuroClear (mainly related to Eurobonds), but no formal agreements have been signed. The CSD has no possibility for having foreign members under current legislation. In addition, MFS has no foreign links, as only (UNA) has the right to establish such links.

Registrars, Custodians, etc. The present fragmentation of registrars cannot provide a guarantee of independent and proper governance among shareholders. There is a need to restructure the industry so that registrars reach a minimum size allowing them to be economically independent of individual clients and can afford more efficient operations and systems. Part of the registrar industry seems superfluous with the growing use of CSD functions with efficient links to the custodians.

Policy Recommendations. Based on the above, a number of actions need to be taken as a matter of priority to correct major deficiencies in market infrastructure:

- License PFTS as a formal exchange and establish it as the main functional Ukrainian market place in international bodies.
- Evaluate the functionality of existing exchanges with respect to activity, rules, trading and information dissemination systems; encourage sharing of systems and encourage voluntary mergers between exchanges.
- Improve transparency of post-trade OTC trading through a set of regulations on reporting obligations for traders and through establishing a dissemination system for this information, preferably reporting through the exchanges, supplemented over time by best execution rules.
- Establish regulations to push for consolidation of securities traders.
- Consolidate CSD systems through improving regulation of MFS, in particular by reviewing capital requirements to make sure that they reflect the higher settlement risk of FOP vs. DVP, licensing MFS as a registrar, revising legislation to allow MFS to establish foreign links.
- Establish regulations to push for consolidation of share registrars (establish independence requirements, minimum requirements, and systems and require that publicly-traded companies use independent registrars).
- Prohibit insider trading (with a clear definition of insider trading) and monitor trading activity to identify violations.

Pension

Major impediments to the future development of the pension industry in Ukraine include: (i) fiscal imbalances resulting from the 2004–2005 revisions of Pillar I; (ii) excessively tight triggers for the introduction of Pillar II; and (iii) weaknesses in the regulatory and supervisory framework.

Fiscal Imbalances Resulting from 2004–05 Revisions of Pillar I

As described in Chapter 1, the recalculation of pension benefits in August 2004, the rise in minimum pension in September 2004, and the further rise in the subsistence minimum in September 2005 have shifted the PAYG system into a profound fiscal and social disequilibrium, translating into a huge expected fiscal deficit pension spending exceeding 16 percent as a share of GDP (one of the highest in the world), and an almost-flat system of benefits providing excessively high replacement rates for low income earners.

The resolution of the large fiscal imbalances created by the 2004–05 revisions will require a combination of measures to reduce expenditures and increase revenues, with the objective to restore balance in Pillar I in the short-term. The menu of options open to the Government to achieve this objective is analyzed in detail in a separate World Bank note entitled "Pension Reform in Ukraine: Remedy to Recent Fiscal and Structural Changes" dated February 10, 2005. The Note concludes that immediate reduction in the minimum pension

to a more sustainable level is the fastest way to bring the system back in balance. Should the Government choose a more gradual path to reducing and/or redefining the minimum pension, this would have to be combined with a set of other expenditure reducing measures, such as retirement age increase, price indexation, tighter early retirement eligibility and treatment of working pensioners. The reform of the pension administration system (single social contribution rate, unification of social contribution collection and modernization of PFU) is expected to result in higher compliance and collection rates. However, raising PAYG revenues through higher pension contribution rates or financing the residual deficit through the budget should be avoided and only utilized as short-term stopgap measure.

The 2004–2005 revisions of Pillar I threaten the implementation of the next stages of the reform because the implied fiscal deficits remove the fiscal space for financing the transition to Pillar II, and because the removal of the link between contributions and benefits generates perverse incentives that work against the development of voluntary pensions under Pillar III.

Excessively Tight Triggers for the Introduction of Pillar II

The triggers for the introduction of Pillar II are excessively tight.

First, the requirement that there is experience with Non-State Pension Funds (NSPF) before Pillar II can be introduced should be relaxed in order to open the door for the parallel introduction of a well-regulated Pillar II as an instrument to rebuild confidence in the pension fund industry.

Second, the requirement that the State budget compensate for part of the insurance resources lost by the solidarity system as a result of the transition to Pillar II is unnecessary. Since the costs of transition to Pillar II constitute an investment into a balanced and sustainable pension system over the long-term, financing this investment through Government bond issuance would appear to be optimal from a fiscal policy perspective. It would also provide a well-justified opportunity for the Government to design and implement a coherent strategy for the development of a long-term government bond market, thereby providing a solid foundation for the development of domestic capital markets, in particular for the development of municipal bonds and corporate bonds markets, which are themselves critical to finance investments and growth in the country over the long term.

Remaining Issues in the Regulatory and Supervisory Framework

The NSPFL law specifies cash deposits, securities, real estate and bank metals as eligible pension assets. Furthermore, eligible securities comprise state and quasi-state bonds, corporate bonds and shares, and foreign shares and bonds, while prohibits investment in related persons' securities, non-listed securities and derivatives. Corresponding investment limits are set in terms of minimums/maximums; out of total assets not more than 40 percent can to be kept in bank deposits, maximum 50 percent in sovereign Ukrainian bonds, up to 20 percent in local government bonds, up to 40 percent in domestic corporate bonds, up to 40 percent in domestic equity, up to 40 percent in mortgage instruments, up to 20 percent in foreign securities, up to 10 percent in real estate and up to 10 percent in bank metals.

These limits, combined with the limited development of the domestic government bond market, are likely to result in excessive allocation of pension fund portfolios toward high risk domestic securities. In these circumstances, consideration should be given to raising the limit on holdings of investment-grade government, local government and corporate securities from EU-member countries. This would have the additional benefit of placing Ukraine in partial compliance with Article 56 of the European Community Regime on the free movement of capital once Ukraine joins the European Union, which will require abolition of this limit vs other EU-member countries.

One major shortcoming in the NSPFL law relates to special treatment of the pension fund established by Bank Arkada. Arkada, the largest housing finance bank in Ukraine, which was established by Kiev municipality and a group of construction companies, which are major clients of the bank under the Law of Ukraine "On conducting experiment in housing construction on the basis of KyivMiskBud Holding Company, with specified experiment validity term of January 1, 2006. To finance construction, Arkada launched several special savings mobilization schemes under which deposits are not insured by the Deposit Insurance Fund of Ukraine and investors are directly exposed to numerous risks. Additionally, Bank Arkada established an open-end pension fund, which is now investing most of its resources into securities issued by bank Arkada's investment fund. The complex nature of activities of the bank and its subsidiaries requires strict supervision and full segregation of operations between all the institutions involved. Instead, strong lobbying by Bank Arkada resulted in exclusion of its pension fund from the general prudential supervision, which can potentially undermine the confidence in the market if activities of the fund are not properly regulated. This experiment needs to be effectively terminated as of January 1, 2006 as specified in the Law.

As part of the implementation of the NSPFL law, NBFIR has practically completed the drafting of the by-laws for the functioning of non-state pension funds. As of May 25, 2005, NBFIR drafted and registered 26 by-laws directly required for the creation and functioning of NSPFs. These by-laws to date fully provide the conditions for the functioning and development of NSPFs and administrations of NSPFs. In addition, NBFIR has issued by-laws on the submission of reports and calculations of major financial indices on the activity of NSPFs. In order to improve the quality and timelines for analyzing these reports, NBFIR plans to develop an automated information system for reception, processing and analysis of the reports, subject to funding availability.

Since July 1st 2004, all non-state pension funds currently offering voluntary pension schemes have a six-month period to decide whether to comply with the law or convert into another type of financial institution. If a fund chooses to comply with the law, it is given a five-year period for transition. Each organization is supposed to draft a business plan, and the NBFI regulator will examine it and approve or reject its application with a view to protect the rights of plan beneficiaries.

According to the NSPF law, enterprises, establishments and organizations providing non-state pensions prior to law effectiveness, or establishments whose name include "non-state pension fund" or "pension fund," with the exception of the Pension Fund of Ukraine and its agencies as well as enterprises, establishments and organizations under the management of the Pension Fund of Ukraine, can be reorganized into pension funds in conformity with the law, or be liquidated, or exclude the words "pension fund" from their

name and be reorganized into one type of non-bank financial institutions in accordance with the Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets." Following the adoption of the law, NBFIR participated in the development of individual plans for the reorganization of five non-state pension funds, which adopted a decision for reorganization into pension funds in accordance with the provisions of the law. To date, two of these five funds have been liquidated with full transfer of liabilities to legal successor funds established in conformity with the law.

To date, 31 non-state pension funds ignored the requirements of the legislature and failed to take timely actions provided in the law. In order to bring the activities of these funds in conformity with the legislation, NBFIR prepared the necessary documents and forwarded them to the oblast offices of public prosecutors so that effective measures could be taken against offenders in conformity with the provisions of the law. Specifically, NBFIR requested the liquidation of the state registration of these funds due to violation of the legislation and filed appeals to 17 oblast offices of public prosecutors with respect to these 31 funds (including 12 non-state pension funds belonging to the "Ukkopspilka" system. This judicial procedure now needs to be completed efficiently.

In June 2004, NBFIR adopted Edict No. 1100 setting forth terms for submission of reports by NSPF administrators to the regulator and to the NSPF Council, as well as requirements for report contents. In this framework, fund administrators are required to submit two types of reports: (i) report on pension fund activity (separately for each pension fund with which the administrator has concluded an agreement on pension fund administration); and (ii) report on pension fund administration activity. In December 2004, NBFIR adopted Edict No. 3100 setting forth procedures for informing the public on pension fund activity by NSPF administrator and the requirements for report contents. Also in December 2004, NBFIR adopted Edict No. 2968 introducing methodological recommendations on accounting of major operations of NSPFs, with the objective to harmonize NSPF accounting policy and methodology. In addition, procedures for the provision of administrative data by pension fund managers were adopted by SEC in August 2004. These regulatory requirements now need to be effectively enforced.

NBFIR has recently raised concern about the existing lenient legislative requirements for asset managers that may lead to an unmanageable and excessive creation of poorly capitalized and inefficient asset managers that can damage the performance of the pension funds.

At some point in the future, the State Pension Fund (SPF), in its function of administrator of the mandatory component of the central pension plan, will convert from Ministerial status into an independent 'administrator'. At that stage SPF will fall under the supervision of the NBFI regulator. In addition, the final stage of Pillar II reform foresees the possibility of individual mandatory central DC account holders to design their own choice of pension administrators. At that point, the NBFI regulator will also be responsible for supervising Pillar II administrators.

These developments place increased pressure on NBFIR to develop its capacity in the area of pension fund supervision through the implementation of a comprehensive business plan currently being developed for its pension fund department, placing a special emphasis on enforcement of registration and licensing/relicensing requirements, and on the development and enforcement of disclosure and reporting requirements.

Policy Recommendations

Based on the above, the Government would need to focus on the following policy reform priorities:

Second Pillar.

- Simplify the triggers for the introduction of the Pillar II, focusing on:
  - Balance in the Pension Fund budget (net of mandatory transfers) based on international accounting standards;
  - Adopting legislative acts necessary for operation of the accumulation pension insurance system;
  - Appointing all members of the Accumulation Fund Board; and
  - Carrying out tenders and contracting asset management companies (AMCs), custodian and an auditor of the Accumulation Fund.

Third Pillar.

- Enforcing regulations and by-laws issued by NBFIR and complete the judicial procedure initiated by NBFIR against non-compliant pension funds;
- Ensuring that The Akadia pension fund is subjected to the NSPF Law; and
- Considering possibility of raising the limit for investments by pension funds in investment-grade government, local government and corporate securities in EU-member countries (in partial compliance with European Community Regime on Free Movement of capital

Pension Supervision.

- Finalizing and implementing comprehensive a strategic plan for NBFIR in the area of pension supervision; and
- As part of implementation of this business plan, focus in particular on:
  - giving NBFIR full authority to trace ultimate beneficial owners of pension fund companies and asset management corporations, carrying out background checks on ultimate beneficial owners, and carrying out fit and proper tests of pension fund and asset management company directors (and significant shareholders of asset management companies); and
  - giving NBFIR the means to enforce disclosure and financial reporting requirements for pension funds.

The Insurance Sector

Major impediments to the development of the insurance sector in Ukraine include: (i) deficiencies in the legal and regulatory framework; (ii) structural impediments specific to specific insurance subsectors, in particular motor third-party liability (MTPL) insurance, and crop insurance; and (iii) a lack of adequate consumer protection.

Legal and Regulatory Impediments

To date, the main legislative act in field of insurance is the "Law of Ukraine on Insurance" in the wording of law No. 2745-III of October 4, 2001[12], as amended by law No. 2775-III of November 15, 2001 and law No. 2893-III of December 13, 2001, which is aimed at creating an insurance service market and strengthening insurance protection of property rights of enterprises, institutions, organizations and individuals. The several changes and amendments to the previous versions of the Law on Insurance included the opening up of the market to foreign investors, with the abolition of ownership restrictions[13] and a further increase in the minimum capital requirement for life and non-life companies.

Only insurers which are residents of Ukraine can be licensed to conduct insurance operations in Ukraine. Therefore, according to rules at present in force, branches of foreign insurers cannot conduct insurance business in Ukraine. The offer of cross border insurance services by foreign insurance companies is equally prohibited. NBFIR has prepared a draft Law "On Amendments to Article 2 of the Law of Ukraine on Insurance according to which branches of non-resident insurers will be allowed to carry out insurance operations in Ukraine. This draft Law is currently before Parliament. This move is aimed at facilitating Ukraine's accession to the WTO.

Since 1996, life insurance and non-life insurance undertakings are clearly separated and insurers which have obtained a license for life insurance are not eligible to conduct other types of insurance activity.[14] This is in line with the European legislation and with international best practices.

However, the definition of risks and classes of insurance in Ukraine, for licensing purposes, is not based on the above mentioned (and widely accepted) distinction between life and non-life insurance classes of insurance, but rather on a deceptive distinction between voluntary and compulsory insurance. Pursuant to article 6 of the law, there are 22 classes of voluntary insurance, while article 7 (as amended in June 2003 and February 2004) encompasses an overwhelming list of 40 classes of compulsory insurance.

The problem is that this extremely long list of compulsory types of insurance so far mostly remained on paper, since there are no enforcement mechanisms, nor sanctions for non-compliance. Moreover, the fact that insurance is deemed compulsory merely means that the terms, conditions and tariffs are set by the State, without any obligation to purchase coverage. A reform is required to phase-out this system and align insurance classification in Ukraine in line with international best practice.

To this purpose, while NBFIR may define characteristics and classification features of voluntary insurance types, it cannot take any autonomous action with regard to compulsory types.

In order to bring the list of compulsory types of insurance in consistency with European standards, Parliament adopted a Decree in June 2004 on the basis of the draft Law of

12. An earlier version of the "Law of Ukraine on Insurance," as mentioned, was introduced in 1996.

13. The restriction of foreign ownership of domestic insurance companies has been eased. Foreign entities can now own 100 percent of a Ukrainian insurance company, while previously foreign participation was limited to 49 percent.

14. See article 38 of the Law on Insurance currently in force; see also article 2.9 of the "Licensing Terms for Insurance Activity." It should be noted that life insurers in Ukraine are *not* allowed to write accident and sickness insurance, not even on a complementary basis.

Ukraine on Amendments to Some Laws of Ukraine Concerning Compulsory Types of Insurance reducing compulsory types of insurance to 11.

According to articles 30 and 31 of the Law, Insurers are obliged to meet the established capital requirements (€1,500,000 for life insurance companies; €1,000,000 for non-life insurance companies), to create and maintain insurance reserves sufficient to meet the obligations towards their insured and to maintain a solvency margin over their projected normative liability reserves. As a general rule, pursuant to article 2.5 of the "Licensing Terms for Insurance Activity" (approved by Instruction N.40 of August 28, 2003, as amended in December 2003), the authorized capital shall now be fully paid in cash.[15]

Active insurers are required to meet the capital requirement stated by Article 30 of the Law on Insurance according to the following transitional schedule:

- insurers that provide insurance service other than life insurance—€500,000 within two years of the date of enactment of the Law and €1,000,000 within three years of the date of enactment of the Law;
- insurers that provide life insurance service—€750,000 within two years of the date of enactment of the Law and €1,500,000 within three years of the date of enactment of the Law; and
- Insurance companies established after the enactment of the Law, instead, must meet the new requirements from the outset.[16]

In relation to insurance intermediaries, the current legislative and regulatory framework is definitely deficient and should be reformed. One of the main problem lies in the fact that the current version of the Law lacks clarity and preciseness in the definitions related to the insurance mediation. Some of the essential features of the professional activities conduced by brokers and agents are not fully acknowledged by the legal rules currently in force in Ukraine.[17]

According to recent amendments of the insurance regulations, insurance brokers are reportedly not allowed to receive commissions from insurance (and reinsurance) companies, due to the fact that they are supposed to act exclusively for the benefit of prospective policyholders. According to international practice, even if brokers do act on behalf of policyholders (i.e. their clients), they are allowed to receive commissions from insurers as a percentage on premiums. It is correct to note that brokers must avoid any conflicts of interest, but they may nevertheless be allowed to collect brokerage fees from parties to an insurance contract if they have been instrumental in bringing them together.

Moreover, it is not clear from the current definition in Article 15 of the Law on Insurance whether a broker is allowed to act as a consultant/expert only in the context of a particular insurance/re-insurance transaction or it could render advisory services related to

15. From The Executive Opinion Survey of the World Economic Forum's 2003 Report on Global Competitiveness. The survey is based on questionnaires received from about CEOs and senior managers of the economy's business sector.

16. See: Law of Ukraine on Insurance of 4 October 2001, Section V. Final Provisions, n.3.

17. The importance of insurance intermediaries in the development of the insurance market has been recently stressed in the Report on the state of financial integration following the EU FSAP submitted to the European Commission on May 7, 2004 by the "Expert Group on Insurance and Pensions."

the insurance/reinsurance industry without reference to a particular insurance/re-insurance contract. Moreover, such type of activity as risk management consulting, (which is not always directly connected to insurance/re-insurance), that is normally included in the scope of brokerage activity internationally, cannot not be performed by brokers in Ukraine under the current legal definition.

Based on a proper understanding of the scope of the brokerage activity, the respective taxation principles should also be reestablished. At present, it is not clear whether brokerage fees are subject to VAT (value added tax) or not. It is advisable, therefore, to clarify the issue in the VAT legislation, which currently exempts "insurance services," without specifying the treatment of insurance mediation services. NBFIR currently developing a draft Law on improvement of taxation of the insurance business.

Additional operating problems have been reported by reinsurance brokers with respect to the placing of reinsurance coverage with non resident companies. Some of the problems arise out of the controversial taxation regime for reinsurance premiums, while others relate to the currency regulations governing the transfer of money abroad. In both cases, the regulatory framework was perceived as an obstacle to international brokerage activities. Another reported problem relates to lack of understanding of the legal significance of the so-called cover-note issued by reinsurers. In the past, the former supervisors and other authorities have manifested perplexity in recognizing this as a valid reinsurance agreement.

The definition of insurance agent should also be revised. According to a general understanding, the 'insurance agent' is considered a person rendering insurance services, rather than an insurance intermediary. Furthermore, insurance agents are currently *not subject to registration, nor supervision* and this needs to be urgently addressed by reform. A comprehensive reform of the legal framework concerning insurance mediation in Ukraine should also take into account the rules contained in the Resolution of the Cabinet of Ministers No. 1523 of December 18, 1996 on insurance intermediaries and lead to an improvement of the wording and structure of all the relevant provisions.[18]

In many areas, legal concepts and notions defined in the special insurance legislation should be carefully harmonized with the provisions of the Civil Code, the main legislative act in field of private law. Until this year, the soviet Civil Code of 1963 was still in force. On January 16, 2003, however, after several years of political debate, Parliament finally passed a new Civil Code, as well as a new Commercial Code. The President of Ukraine signed both Codes into law on March 3, 2003 and, pursuant to the transitional provisions, they entered into force on January 1, 2004.

The new Civil Code includes a Chapter devoted to the insurance contracts.[19] Under the Ukrainian legal system, very few provisions deal with insurance contract law; in addition to the scattered rule contained in Chapters 1 and 2 of the Law on Insurance, other provisions are comprised in articles 979–999 (Chapter 67, Book 5) of the Civil Code. Basic legal concepts—such as insurance undertaking, parties to the insurance contract (insurer/insured/beneficiary/policyholder), sum insured, policy limit, insurable interest, indemnity payment, over-insurance, underinsurance, coinsurance, and so forth—are poorly defined

18. Guidance can be found in the recent Directive 2002/92/EC on insurance mediation.
19. See Chapter 67, Book 5 of the new Civil Code of Ukraine.

and rights and duties of the parties are poorly regulated. The organization of rules in articles and paragraphs is also misleading (see for example article 9 of the Law on Insurance). Furthermore, in addition to a substantial overlap between the provisions in the Law on Insurance and those in the new Civil code, there are also significant gaps. For instance, clear rules on third party liability insurance, multiple insurance, disclosure of information by policyholders, the effects of changes in the risk insured and the effects of non-payment of subsequent premiums are missing. In general, there is a need for a comprehensive revision of the current rules on the insurance contract, in order to make them more coherent and more accessible, as well as to coordinate them with the other relevant rules in the new Civil code. Pursuant to article 268 of the new Civil code, for example, claims made by the insured against the insurer to obtain payment of the indemnity are *not subject to limitation of action*; this provision can create serious problems in terms of exceedingly long-term liabilities for insurers and difficult calculation and management of IBNR loss reserves.

The enforcement of normative acts is entrusted to the judicial system. However, in practice it seems that the judiciary is subject to considerable political interference from the executive branch and that it also suffers from corruption and other operational inefficiencies. A substantial reform of the judiciary is reportedly under way to improve efficiency, transparency and enforcement of judgments[20]. In light of the above, alternative dispute resolution mechanisms (such as an Insurance or Financial Ombudsman) should be carefully considered to foster growth of the insurance sector.

Other Impediments

Compulsory Motor Third Party Insurance. Compulsory motor third party liability insurance (MTPL) was introduced in 1997, but was limited to third party bodily injury only with a minimum indemnity limit. In May 2000, MTPL coverage was extended to cover third party property damage and the indemnity limit was based on a multiple of the national minimum wage. The indemnity limit was also increased for third party bodily injury. The minimum levels of coverage were too low and needed be raised. Even if MTPL is already obligatory, enforcement of MTPL is extremely limited. Reportedly, only 10–20 percent of circulating vehicles are insured.

The Law of Ukraine on Compulsory Civil Liability Insurance of Vehicles Owners was adopted in January 20005 in accordance with European standards.

Voluntary Market for Agricultural Insurance. Crop insurance is another area in which the new products developed by insurance companies could be able to satisfy the need for security of both individuals and small business enterprises. The agrarian insurance market in Ukraine is very young. Considering that agriculture accounts for 13.5 percent of GDP in Ukraine, market opportunities are notable.

In this field, however, there are several technical difficulties, including: (i) a lack of reliable statistical data on incidents of adverse weather conditions and on the subsequent losses of harvest; and (ii) a lack of expertise and skills in farm risks evaluation.

20. With respect to contractual rights, such as those arising out of the relationship established between the insurance company and the insured, the availability on an effective enforcement mechanism is clearly fundamental.

Pursuant to the Regulation of the Cabinet of Ministers No. 1000 of July 11, 2002, obligatory insurance of harvests of agricultural crops and perennial plantings by state-owned agricultural enterprises and harvests of cereal crops and sugar beet by agricultural enterprises of all forms of ownership shall be carried out in order to guarantee the economic and provisions security of the State, to create favorable conditions for the development of the agrarian sector of the economy, and to protect the interests of agricultural enterprises. The mandatory rates and tariffs are stated in the regulation (Addendum 1), as well as the terms and conditions of coverage (Addendum 2). The obligatory coverage is multi-peril, including: hail, fires, frost killing, hurricanes, storms, torrents, landslides, floods, mud torrents, droughts, and complete sudden destruction of plantings by quarantine pests.

In theory, 50 percent of the cost of mandatory insurance premiums should have been subsidized by the State, but in 2003, for example, no funds have been allocated for this purpose in the State Budget. Farmers are reluctant to buy mandatory insurance coverage because they perceive it as another tax without properly understanding the insurance mechanism. This, therefore, appears to be another failure of compulsory insurance in Ukraine.

In order to develop the voluntary market for agricultural insurance, the following measures appear necessary:

- Suspend or reduce direct indemnification of producers' losses from the government budget, as these steps remove incentives to buy insurance;
- Have the government budget allocate funds to rebate a portion of insurance premiums; and
- Encourage development of reinsurance (especially with non-resident professional re-insurers).

Consumer Protection. A stronger legal protection of policyholders' rights would greatly benefit insurance companies since it would have the potential to open up an entirely new dimension of the market. To this purpose, legal protection of policyholders should operate at least at two levels:

- contractual level—for example, by means of new legal rules aimed, *inter alia*, at: monitoring unfair terms in consumer contracts, providing guidance in the interpretation of standard forms, establishing non-waivable consumers' rights of cancellation, withdrawal, information, and so forth;
- enforcement level—for exmaple, by means of new legal rules aimed, *inter alia*, at: governing claims handling practices, introducing alternative dispute resolution mechanisms, and so forth.

Policy Recommendations

Key policy reform priorities to address these impediments are as follows:

Reform Legal and Regulatory Framework.

- Reform current classes of insurance, drastically reducing the number of compulsory types of insurance.

- Require express approval for changes of control and portfolio transfers.
- Require the establishment of express audit function of insurance companies.
- Reform the regulatory framework for insurance intermediaries.
- Coordinate special legislation with the provisions of the Civil Code on insurance contract law.
- Grant priority to policyholders in case of liquidation and winding up of insurance undertakings.
- Regulate the actuarial profession.

Enforce Regulations.

- Trace ultimate beneficial owners of insurance companies and carry out background checks on these owners; carry out fit and proper tests of directors (and significant owners) of insurance companies.
- Ensure compliance with capital adequacy requirements.
- Enforce third party motor liability insurance requirements, introducing proper checks and sanctions for non-compliance.

Strengthen Consumer Protection.

- Introduce and enforce consumer protection rules.
- Introduce alternative dispute resolution mechanisms for insurance services.

Corporate Governance

Weak corporate governance is a key issue undermining the development of NBFIs in Ukraine. Under ratings developed by the EBRD, Ukraine's corporate governance and restructuring rating is weaker than that of Russia or other former Soviet Union countries, and far weaker than the Central European countries that recently joined in the European Union. Similarly, the World Economic Forum surveyed 102 countries on various corporate governance categories. On reliance of professional management, Ukraine was rated 3.5 (out of a range from 1 to 7) and ranked 77th. On efficacy of corporate boards, Ukraine was rated 4.2 (out of range from 1 to 7) and ranked 69th. On protection of minority shareholders' interests, Ukraine was rated 2.5 (out of range from 1 to 7) and ranked[21] 102nd.

When reviewing the corporate governance framework in Ukraine, several key issues stand out. They are:

- Incomplete disclosure of ownership and control of traded companies;
- Inadequate shareholder voting rights;
- Unreliable financial reporting and valuation procedures; and
- Weak responsibility and accountability of supervisory boards.

21. Taken from Global Competitiveness Report 2003 by the World Economic Forum.

Transparency of Ownership and Control of Companies

The current laws of Ukraine do not require adequate disclose of ownership and control structures of publicly-traded companies. Legal requirements to disclose ownership of traded companies (and relations with affiliated parties) are of high importance for small shareholders, who often do not have access to inside information on the company. The law should require that significant (and ultimate) shareholders of publicly-traded companies disclose their holdings to the company, the securities regulator and the public. It would be helpful if the Ukrainian legislation were to include the provisions of the EU Directives on disclosure of indirect control, including the definitions of controlled and controlling parties.

Current legislation does not provide shareholders with right to access the list of company shareholders at any time. Such information is critical for shareholders to verify their ownership positions and to learn the names of other shareholders. All shareholders should been able to obtain a copy of the full list of shareholders, even if that lists consists only of "nominal" or the first-level of shareholders. Information contained in shareholder list provides substantial data about shareholder identities and may subsequently shed the light on transactions with related parties as well as explain corporate behavior of some shareholders. Furthermore, the right to know other shareholders creates opportunities for mergers and acquisitions through ordered tender offers to company shareholders. Therefore, shareholder list shall be available from either share registrar or Securities Commission upon request of any shareholder either for free or for a fee covering the relevant costs. For that reason, independent share registrars shall be required to maintain the shareholder lists and to disclose the list of shareholders to both Securities Commission and interested shareholders.

In order to develop a national stock market and improve corporate transparency, a general legal requirement to disclose shareholder lists of publicly-traded companies and registries of all companies is necessary. The most convenient way to disclose the shareholder lists is to require companies post the lists of shareholders at their web-sites or at the official web-site of the stock exchange. Alternatively, the Securities Commission may require the share registrars to disclose the lists of shareholders to the public upon request. Registrars could be allowed to charge fee covering the costs to prepare shareholder lists. It is important that shareholder lists cover not only nominal, but also ultimate company owners.

Neither shareholder lists of publicly traded companies nor registries of all companies are publicly available in Ukraine. In fact, only a small fraction of companies listed on major stock exchanges in Ukraine consistently disclose their financial reports. Moreover, the company registry is almost impossible to attain by general public. Easy public access to the company registry should be established by law.

Local offices of commercial courts or local administration should be entrusted with responsibility to maintain company registries and disclose those registries to any member of the public. Therefore, all companies should be required to submit their registries to the appointed public offices and promptly notify the offices of all changes in the registries. The company register under consideration should at minimum include copies of the company charters, decisions of the shareholders' meetings and the list of the company founders with their original shareholdings.

Shareholder Voting Rights

Fair voting rights for shareholders are critically important, both for domestic and foreign investors. Shareholders should be guaranteed, at a minimum, the right to elect supervisory board, approve large asset transfers, create new subsidiaries, and exercise pre-emptive rights according to fair voting procedures. Ukrainian legislation does not ensure shareholders' right to elect supervisory board annually. In the dual board system favored by Ukrainian legislation, the supervisory board plays the second most important role after the shareholders' meeting. Therefore, the shareholders' meeting should have the authority to elect the supervisory board members in the way that would guarantee the representation of all shareholders' interests. It is also crucial to prevent the favorable treatment of a few dominant shareholders by supervisory board members and to guarantee full accountability of the latter to all owners of the company. For that reason, the supervisory board should be required to report to the shareholders' meeting annually and be either re-elected upon approval or replaced. Voting should use cumulative voting procedure and authority and responsibility of supervisory board members should be clearly determined.

Currently, the shareholders' meeting does not have an exclusive and non-transferable legal right to approve large asset transfers, an important mechanism to prevent asset stripping and disadvantageous transactions with affiliated parties. To remedy this situation, the shareholders' meeting should have the right to approve asset transfers above a certain threshold (for example, 50 percent of company assets) and this right should not be transferable to the supervisory or management boards. Any transfer of this right to either supervisory or management boards dramatically increases the likelihood of unfair asset transfers to the favor of large shareholders or company management.

Under current legislation, the shareholders' meeting is the exclusive authority to approve any reorganization of a company, i.e. creation of subsidiaries, joint ventures and conduct of company takeovers in accordance with the Civil Code (Art. 2, Clause 159). However, this provision is not always respected in practice.

Currently, a special commission formed by management/supervisory board performs both vote counting and minute preparation at the shareholders' meeting. However, such a procedure does not provide adequate guarantee for fair vote counting and sound maintenance of records. Corporate practices in Ukraine show that vote counting are frequently abused and minutes of the shareholders' meeting are lost. Therefore, it should be legally required that an independent registrar count the votes and prepare the minutes of the shareholders' meeting. The mechanism would secure that vote counting abuses are minimized and shareholders' meeting minutes are readily accessible to interested shareholders.

Current legislation does not provide shareholders with the right to access the list of company shareholders at any time, which is critical to verify their ownership positions and to learn the names of other shareholders. Information contained in shareholder list provides substantial data about shareholder identities and may subsequently shed the light on transactions with related parties as well as explain corporate behavior of some shareholders. Furthermore, the right to know other shareholders creates opportunities for mergers and acquisitions through ordered tender offers to company shareholders. Therefore, shareholder lists should be available from either share registrar or Securities Commission upon request of any shareholder either for free or for a fee covering the relevant costs. For that reason, independent share registrars should be required to

maintain the shareholder lists and to disclose them to both Securities Commission and interested shareholders.

The preemptive right of shareholders for additional share subscriptions are recognized in the Law of Ukraine on Economic Associations (1991), and the procedure for exercising this right is set in the Regulation on the Procedure for Increasing/Decreasing the Size of Statutory Fund of a Stock Company (2000). However, this right is not always respected by existing practices.

Financial Reporting and Valuation Procedures

Ukraine has not adopted international financial reporting standards (IFRS), although all traded companies within the EU will be required to follow IFRS starting in 2005. Adoption of IFRS by at least publicly-traded entities is a minimum pillar of sound corporate sector development and a basic prerequisite to creation of an environment conducive to attracting foreign direct investment. To promote compliance and orderly transition to international standards, the requirement should also be attentive to include all types of publicly-traded companies, i.e. companies both shares and bonds of which are traded on official stock exchange (see Table 2.2). Should some fraction of companies be exempt from IFRS requirement, the financial reporting reform will turn into a merely pilot project involving selected companies rather than a comprehensive step towards full IFRS adoption by national business sector.

The priority should be to adopt IFRS rather than to adapt national domestic reporting standards to IFRS. It is very important to ensure that Ukrainian publicly-traded companies follow IFRS in their entirety and without any reference to domestic reporting standards rather than modify existing national accounting standards as of a certain date. International experience shows that any adaptation to IFRS inevitably results in a number of differences between new reporting system and IFRS. The problem usually stems from conceptual incompatibilities of national reporting standards to which adaptation is applied. Furthermore, the gap between IFRS and adapted national standards may broaden over time since new international standards are issued periodically. Any adaptation of IFRS will approximate national reporting standards to IFRS only at certain date, while further updates are highly unlikely. Besides, any adjustment procedure is to be burdensome for national regulatory body and to be done untimely due to lengthy time span of legal approval and subsequent enforcement of new regulation. As a result, most of the countries that steered to adapt their reporting standards to IFRS ended up not having IFRS reporting standards for publicly-traded companies in place. The only way to enforce IFRS properly is to issue high instance legal regulation for adoption of IFRS and enforce the mechanism of compliance by some regulatory body.

Table 2.2. PFTS Trading Volumes for 2002/03 (millions of UAH)

Type of Securities	2003	2004
Corporate bonds	*2038.11*	*4338.14*
Corporate stock	546.68	1082.40
Treasury bonds	520.97	651.38
Options	97.34	15.31
Municipal bonds	13.20	886.70

Source: PFTS, www.pfts.com.

Implementation of and compliance with IFRS/ISA should be strictly enforced and supervised. Control over IFRS/ISA adoption and company compliance with new regulations is crucial to the success of the reform. Since the transfer to IFRS/ISA is an extremely complex process, strict measures are required to avoid possible gaps in both implementation of and compliance with new standards. Numerous deficiencies that are likely to emerge originally will need to be adequately addressed by competent and specially trained staff in charge. For that reason, financial and human resource capacity of several governmental regulators, like Securities Commission, NBFIR and NBU, need to be substantially expanded through extensive training and certifying arrangements. Namely, all sector regulators will need to create special departments charged with responsibility to observe proper IFRS/ISA implementation among companies. Usual practice in such instances is to establish a Department of IFRS/ISA Compliance or, alternatively, to vest similar responsibilities to the Department of Corporate Finance. Either of the departments should be responsible for enforcing report preparation and disclosure, reviewing statements, and acting to remedy any errors. Besides, sector regulators need to provide for comprehensive ISA audits of annual financial statements and limited reviews of interim financial statements submitted by listed companies.

Companies are currently required to disclose their annual financial reports within nine months after the fiscal year. However, current requirement undermines the fundamental shareholder right for complete information. Since most of corporations hold their shareholders' meeting in April or May, it is crucial that shareholders have an opportunity to get familiar with financial reports before the day of meeting. Otherwise, shareholders may be forced to approve annual financial reports and to vote other business related decisions without clear understanding of company performance results. In order to enable shareholders' access to financial reporting in proper time, company management should be required to disclose annual audited financial reports within at most three months after the fiscal year. The reports should also be available to any shareholder upon request to company management and for free.

By law, companies are not required to conduct asset valuation at market based price or by a certified valuation agent. However, it is fundamentally important to ensure that both procurement and sales of assets are conducted at market-based prices. When market based price is impossible to be determined, independent and certified valuation agents need to be employed for price determination of the asset in question. The direct risk associated with non compliance with market based price principle is an asset stripping problem often occurring in the companies where major investors tightly control the supervisory boards and assign pocket agencies to conduct valuations. Therefore, the market based price of an asset should be properly defined and given priority in application before valuation by an independent agent. Even if introduction of legal definition for market price may not directly obstruct the asset-stripping practices, it will provide solid argument to the dissenting shareholders trying to protect their ownership rights in court. Whenever the market price can not be determined, a valuation agent selected under competitive procedure and approved by shareholders' meeting should be employed to conduct asset valuation. To minimize the chances that valuation process is abused, a special certification procedure for valuation agents should be introduced and consistent valuation procedures to follow international practice should be implemented by the Government.

Responsibility and Accountability of Supervisory Boards

Table 2.3. Reporting Joint Stock Companies in Ukraine (December 2001)

Number of shareholders	Open	Closed	Total
More than 50,000	12	0	12
49,999–10,000	145	0	145
9,999–5,000	272	58	330
4,999–1,000	1,632	261	1,893
999–500	1,549	338	1,887
499–100	3,981	1,046	5,027
Less than 100	2,253	5,964	8,217
Total Companies	9,844	7,667	17,511
Total Shareholders	11,888,959	4,845,457	16,734,416

Note that the total number of reporting companies is smaller than the total number of companies because of non-compliance with reporting requirements. The table is reprinted from the ROSC Corporate Governance Assessment Ukraine, draft of July 11, 2002.
Source: SCSSM.

Currently supervisory boards do not have a legally set minimum responsibility or accountability. Since supervisory boards represent shareholders and permanently interact with company management, supervisory boards should thus be legally authorized to hire and fire management, approve large asset transfers and systems for financial management and internal controls.

The law does not require the election of supervisory board members with the application of cumulative voting procedure. Supervisory boards should represent interests of most shareholders, including those of minor shareholders. Yet, only cumulative voting procedure allows minor shareholders to accumulate votes to elect their representatives to the supervisory board. It is also important that cumulative voting become routine procedure for all companies required to elect a supervisory board. Should a cumulative voting method be restricted to companies with, for example, 1,000 or more shareholders, the voting rights of at least 2.4 million minor shareholders are to be seriously jeopardized (the number is likely to be considerably higher due to widespread non-compliance with reporting requirements practices in Ukraine).[22] Therefore, it should be required that cumulative voting is exercised in all joint-stock companies.

The supervisory board is not authorized by law to recommend management board members and to approve asset transfers below the threshold for shareholders' meetings. Although OECD corporate governance principles provide for a less formal role for supervisory boards, in transitional economies it is critical to ensure that the shareholders' meeting has the exclusive right to approve the management board, in order to ensure transparency in relations between owners and managers. Therefore supervisory boards should be fully authorized to monitor the activities of the management board. In addition, supervisory boards should have the authority to approve major asset transfers, below the threshold set for shareholders' meeting but above that for company management. Asset transfer approvals by the supervisory board should be unanimous so as to reduce opportunities for asset stripping.

22. The estimated number of minor shareholders has been calculated as a median cumulative adjusted for the assumed number of large shareholders in each company not to exceed five.

Supervisory and management boards should also have full fiduciary duties set by law. They should be required to conduct their duties with due care, due diligence and in the interest of the company. The requirement that supervisory and management boards act in the interests of the company is a primary pillar of the corporate governance framework worldwide. More importantly, it is a primary OECD principle, which establishes the accountability of the supervisory and management boards. The applied value of the principle lies in its conjunction with the Code of Corporate Governance that must clearly define what activities are deemed as conducted 'in spirit of the company interests'. The requirement has its practical meaning in court litigations involving management/ supervisory board fraud, where it provides both the aggrieved part with the legal instrument to protect its rights and courts with the legal ground to make a socially fair decision in relation to property rights. Thus, "the due diligence" requirement should become an integral part of the corporate governance framework in Ukraine.

Policy Recommendations

To address these weaknesses, the key priority policy reform actions are:

- Increasing transparency of ultimate ownership and control structures of companies, in particular:
  - Requiring the disclosure of significant shareholders who are ultimate beneficial owners of publicly-traded companies and non-bank financial institutions, including insurance companies, pension funds, investment funds (mutual funds and private equity funds) and leasing companies.
  - Securing the rights of individual shareholders to access the list of company shareholders at any time.
  - Ensuring easy public access to business registries of all companies.
- Strengthening shareholder voting rights, in particular:
  - Securing the rights of shareholders' meetings to annually elect supervisory boards and approve large asset transfers and any reorganization of the company, including creation of subsidiaries, joint ventures and conduct of company takeovers.
  - Establishing clear preemptive rights for existing shareholders to participate in new share issues.
- Strengthening financial reporting and valuation procedures, in particular:
  - Adopting International Financial reporting Standards (IFRS) for all publicly-traded companies, financial institutions (including banks, insurance companies, and investment fund management companies) and large companies ("of public interest").
  - Ensuring adequate reporting of transaction among affiliated parties, particularly among entities within the same financial-industrial conglomerate.
  - Requiring large companies to disclose their annual financial reports within three months after the fiscal year, that is, prior to the shareholders' meeting.
  - Requiring, for large asset sales or purchases, that companies obtain valuations at market prices or by a certified valuation agent.

- Building on the existing system so that recommendations shall not jeopardize the achievements of the current accounting system (that is, with respect to tax collection).
- Promoting a gradual process of improvement whereby the financial sector, the listed companies and other public interest entities shall lead the reform process.
- Meeting the minimum requirements of the current level of economic and market development and recognizing the necessity to build the foundations for future development in Ukraine.

- Strengthening the responsibility and accountability of supervisory boards, in particular:
  - Requiring that large companies elect supervisory board members using cumulative voting procedures.
  - Giving supervisory boards the right to approve asset transfers that are large but still below minimum threshold required for approval by the shareholders' meeting.
  - Requiring that supervisory and management board members carry out their duties with due care and due diligence and in the interest of the company.
  - Authorizing supervisory boards to appoint the members of the management boards.

Broadening Access to NBFI Finance

As the Government proceeds with the reform of the legal, regulatory, supervisory and governance framework for NBFIs, and as NBFIs grow in depth and diversity as part of the development of the financial sector on the road to EU accession, domestic economic agents will gain access to new sources of equity and debt finance and new possibilities for risk mitigation. At the same time, the Government can play a proactive role in broadening the access of economic agents to NBFI finance through developing a range of market-friendly enhancement instruments in critical sectors such as export credit insurance, debt enhancement and equity mobilization for infrastructure finance, and mortgage default insurance and mortgage security enhancement.

Private Credit Insurance and Export Credit Insurance

Credit insurance, including export credit insurance, is a powerful tool to support the development of the private sector. Private sector credit insurance in OECD countries and in comparable countries in emerging Europe (for example, Slovenia, Poland, Hungary, Czech Republic) is largely based on domestic credit insurance. In these emerging countries, however, domestic credit insurance has developed in the wake of officially supported export credit insurance. This is no doubt due to the difficult business environment that was prevalent in the early years of transition in these countries. Potentially, the Ukrainian market is large enough to attract private sector credit insurers.

In many countries, including every OECD country and all countries of Central and Eastern Europe (other than Albania), the Government supports the financing of exports. Croatia, the Czech Republic, Hungary, Poland, Slovakia and Slovenia all have relatively mature systems that involve Government-owned agencies that assist in the financing of

exports. One reason for setting up a Government-supported export credit agency is to assist in the development of enterprises, including SME's and enterprises engaged in relatively high technology activities. Another is to offer support to the capital goods and services sector without which industries in these sectors would be at a comparative disadvantage to their counterparts in other countries that enjoy this type of assistance. The viability of many enterprises depend upon economies of scale that can only be developed with export activity.

There is a "gentleman's agreement" between OECD governments that is intended to limit and make more transparent member Government's support for financing trade, mainly for medium-term transactions where the private sector is not able to be fully involved. There are also rules binding members of the Berne Union and Prague Club[23] that limit the extent to which member agencies can support the financing of trade.

A number of Government-owned export credit agencies (such as the Bulgarian, Czech, Hungarian, Polish and Slovenian agencies) also provide credit insurance for domestic receivables. This is considered necessary in smaller economies to ensure that the government agency is a viable unit with adequate economies of scale, thereby being able to discharge its mandate to support the development of exports. A government-owned agency subject to the OECD mandate cannot be the vehicle for subsidizing exports, except where this may be necessary in financing medium term buyer credits or buyer credit guarantees.

A most important element in the system of export credit insurance is the distinction drawn between "marketable" and "non-marketable" risk. Marketable risk in general terms is defined as risk that can be reinsured in the private insurance market. Under European Union rules, a government owned agency must operate its marketable risk portfolio under conditions that are designed to ensure that the government owned agency competes with private sector credit insurers on a level playing field. Thus, it would be important for any system developed by the Government of Ukraine to comply with these rules. In particular, under EU rules, a government supported export credit insurance agency cannot be housed inside a commercial bank.

The Government of Ukraine could consider developing a comprehensive strategy for private sector development of credit insurance in the country. This strategy could include alternatives for possible government support for the financing of exports that is in harmony with OECD and EU rules in this area.

Debt Enhancement and Equity Mobilization for Infrastructure Finance

In line with the experience of recent and prospective accession countries of Central Europe, Ukraine will need to align its infrastructure standards with the relevant EU Directives within agreed transition periods. This will require considerable investments both at the national and at the regional and municipal levels, in addition to the investments resulting from the decapitalization of existing systems.

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23. The Berne Union is an association of credit insurance agencies which include most of the major government owned agencies such as US Eximbank and ECGD of the United Kingdom. The Prague Club is an association of young and/or small export credit agencies that are ineligible because of size, to join the Berne Union. Some government owned export credit agencies e.g. the Czech Republic, Hungary, Poland and Slovenia have joined the Berne Union after a number of years as Prague Club members. The administration of the Prague Club is undertaken by the Berne Union.

The only available estimates of infrastructure investment requirements to meet the standards of EU Directives in Ukraine pertain to the water and wastewater sector. Total capital costs requirements to achieve 24-hour supply service level fulfilling EU water quality standards with a national coverage rate of 78 percent have been estimated at €12–14 billion (DANCEE 2003). Rehabilitation of technical facilities and increasing coverage to improve service level over the next 20 years to near EU standards will require investments in wastewater estimated at €10–12 billion (DANCEE 2003). This translates into a total investment requirement of €22 to 26 billion in the water and wastewater sector in Ukraine.

There are no total estimates of infrastructure investment requirements to meet the standards of EU Directives in Ukraine. Taking the above estimates for water and wastewater, and assuming the same requirement per person as estimated in EU8 accession countries to meet the requirements of the large combustion plants directive, the integrated pollution prevention and control (IPPC) directive, the waste management directive, and district heating compliance investments, total estimated compliance investments requirements in infrastructure would amount to €84 billion in Ukraine. Assuming a 20-year compliance period, this would translate into investment requirements of €4.2 billion per year, of which about €3 billion, or 70 percent, would lie at the sub-national level.

Prior to EU accession, Ukraine could have access to pre-accession funding for these investments. This funding would cover only part of the cost of the investment projects, requiring the mobilization of local counterpart resources. While both the volume of pre-accession funding and the share of project costs to be covered by such funding in Ukraine are unknown as of to date, past experience would suggest that such funds could cover about 75 percent of project costs on average. Based on the projected yearly investment requirement estimated above, this would translate into domestic counterpart mobilization requirements of €750 million per year over 20 years, of which about 525 million at the sub-sovereign level.

Both central Government and SNGs may chose to mobilize these domestic counterpart resources either through borrowing on their own account, or through Public-Private Partnership arrangements. In the latter case, depending on the precise risk-sharing structure of the PPP, the debt mobilized to finance the investments may not be counted as part of general Government debt (see Box 2.1). Given their large share of the required investments,

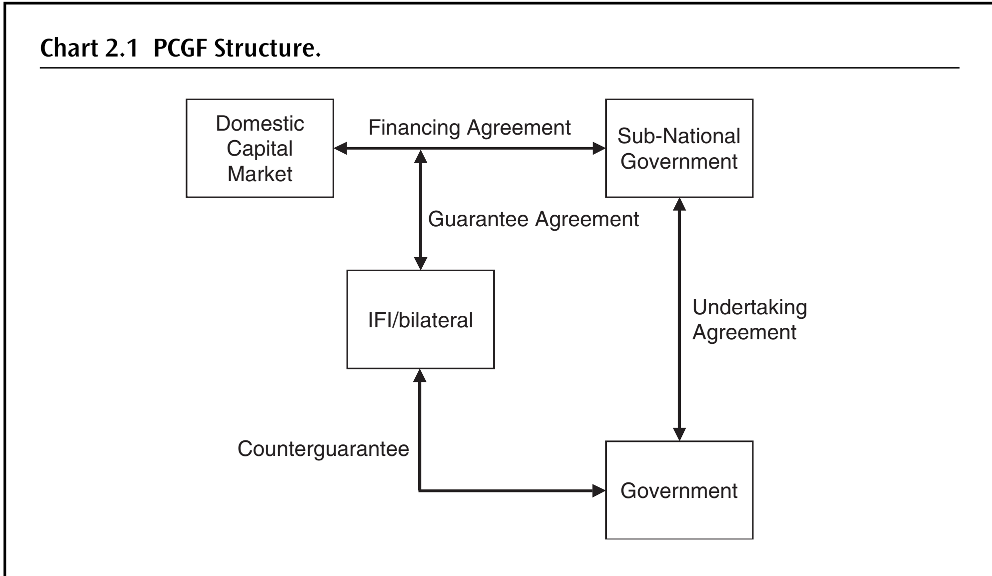
Box 2.1: PPP Structure and Public Accounting in the EU

At the level of the EU, the accounting of PPPs is governed by guidance from Eurostat of February 2004 (ESA95). Under this guidance, the assets involved in a PPP should be classified as non-government assets, and therefore be recorded off the balance sheet of the government, if both of the following conditions are met:

- the private partner bears the construction risk; and
- the private partner bears at least one of either availability or demand risk.

While ESA95 governs general government accounting at the EU level, individual member States are not required to adopt the guidance in their national accounting standards, so a given PPP structure may be accounted for differently across member states and at the EU level.

Chart 2.1 PCGF Structure.



developing access of SNGs to domestic capital markets will be particularly critical to mobilize these counterpart resources.

The Government of Ukraine could consider playing a proactive role in this regard through developing a range of debt enhancement and equity mobilization instruments.

Public Finance Model. For SNGs that opt to borrow on their own account, the Government could envisage establishing a partial credit guarantee facility (PCGF) for SNG bonds in domestic currency. Under one possible scenario, the PCGF would guarantee the repayment of the principal of a SNG bond at maturity (non-accelerable guarantee). The PCGF would take the form of a SPV, and would be backed by a AAA guarantee from an IFI or from a bilateral institution (see Chart 2.1). The IFI guarantee would be counter-guaranteed by the Government of Ukraine. The Government would back its counter-guarantee by an intercept arrangement between itself and the participating SNG.

In case a guarantee is called, the IFI would step in and repay the principal of the bond at maturity. It would obtain repayment of the Government through the counter-guarantee agreement. The Government would recover its counter-guarantee payment through the exercise of its intercept power with the defaulting SNG.

The expected impact of such Facility would be to reduce spreads and extend maturities on SNG bonds participating in the Facility. Enhanced SNG bonds would be sold to domestic institutional investors including insurance companies, mutual funds, and the new pension funds being established as part of the pension reform. Access to the Facility by SNGs would be regulated through carefully structured and subject to tight criteria in terms of budget transparency, management and disclosure, quality of the investment program, and credit rating. This Facility would work for a broad range of SNG risks and would contribute to deepening the domestic market for sub-national investment finance in Ukraine, while

broadening the range of available securities for diversification of institutional investors' portfolios.

For SNG risks that are closer to investment grade, a Partial Credit Guarantee Facility *without counter-guarantee from the Government* could be envisaged (PCGF2). Such Facility would take the form of a SPV, and would enhance bonds issued by SNGs on the domestic market. PCGF2 would be backed by a guarantee facility provided by an IFI, either directly or through a special IFI Facility. PCGF2 would complement the role of the guaranteed Facility by providing enhancement for a narrower band of SNGs risks.

Public-Private Partnership Model. For SNGs that chose to finance these investments through Public-Private Partnerships (PPPs), the main challenge is to create the conditions to attract equity investors in these transactions. In this model, SNGs would seek the participation of the private sector in infrastructure through various Public-Private Partnerships (PPPs) such as management contracts, leases, concessions, BOOs, BOTs and divestiture. The first objective of PPPs is to achieve improve value for money, or improved services for the same amount of money as the public sector would spend to deliver a similar project. In countries facing limited headroom for financing of infrastructure investments through the public finance model, a second objective of PPPs is to finance infrastructure investments without increasing general government debt (see Box 2.1 above).

The key challenge facing SNGs in establishing PPPs is to attract equity investors in these transactions. Attracting private investors in PPP transactions requires overcoming a number of critical constraints that are encountered across emerging markets in all regions. These include:

- Increasing reluctance of traditional investor/operators to commit equity in PPI transactions, especially at the sub-sovereign level;
- Lack of social sustainability of tariff adjustments to cost-recovery levels, leading to contract failure and/or renegotiations;
- Lack of confidence of private investors in the capacity of local contract resolution and court procedures to protect their rights in case of breach of contract, especially at the sub-sovereign level; and
- Weakness of national institutions responsible for regulating PPPs.

To overcome these constraints, an improved PPP framework could be structured around a number of mutually-reinforcing instruments.

- To address the equity constraint two complementary instruments could be envisaged:
  - a first round Infrastructure Fund (IF) that would take equity positions in state-owned utility companies, and exit at a three to five year horizon, and would be financed through domestic bond issues and through lending from IFIs. Convertible bonds would be issued to a private sponsor who would run the utility through a management contract (See Sirtaine, Sophie and Luis de la Plata, op.cit).
  - a second-round Local Infrastructure Investment Trust (LIIT) that would buy-out equity positions from first-round investors, including from the Infrastructure Fund, would hold these equity positions for the long-term, and be marketed to domestic and international institutional investors and to IFIs.

- To address the tariff social sustainability constraint, an Output-Based Aid (OBA) system could be implemented to smooth the transition to cost-recovery tariff for low-income households until efficiency improvements resulting from the turnaround of the utility work their way into the tariff structure.
- To address weaknesses in contract enforcement, a Political Risk Insurance (PRI) and/or Partial Risk Guarantee (PRG) Facility could be implemented to protect private investors in local utilities against sub-national breach of contract risk

First-Round Infrastructure Fund:[24] The Infrastructure Fund (IF) is a first round equity fund that takes equity participations in greenfield infrastructure projects or in utility companies to be privatized or concessioned over a interim period until strengthening of the legal and regulatory framework enables a direct equity participation by the private sponsor. The IF would be financed through bond issues on the domestic market, and would benefit from an IFI guarantee to enhance its bond issues on the domestic market. The project or company would be tendered to a strategic private project sponsor under a management contract agreement. The IF could also issue convertible bonds to project sponsors.

The IFI would support the Infrastructure Fund in three ways:

- *As a lender*, through unsecured loans to the project company, or through a loan to the Government to finance part of the project' investments, to the maximum extent in local currency;
- *As an intermediary capable of raising local capital market debt:* through the Infrastructure Fund, the IFI would issue bonds on the local capital market in domestic currency. These bonds would be placed with institutional investors and possibly with project sponsors; and
- *As a passive equity investor* through the Infrastructure Fund, and using the proceeds of bonds issued on the domestic capital market, the IFI would acquire an equity stake in the project or utility company, and the Government would acquire the remaining part of project equity. The equity risk carried by the IF would be passed back to the Government through a total return equity swap (TRES), thereby shielding the IFI from equity risk. The TRES is an arrangement between the Government and the Infrastructure Fund whereby the host government commits to purchase the underlying shares back from the Infrastructure Fund at maturity of the structure at market value and whereby in return, the Infrastructure Fund commits to pass on to the Government 100 percent of any equity appreciation or depreciation in the value of the underlying infrastructure project's share during the life of the financing structure. The Infrastructure Fund would transfer its voting rights to the government, less a veto right.

24. This Section draws heavily, with the permission of the authors, from the paper by Sirtaine, Sophie and Luis de la Plaza: *New Approaches to attract and Finance Private Sector Participation in Infrastructure*, World Bank mimeo, May 2004.

This structure aligns the interest of the government, the project sponsor and the Infrastructure Fund behind a successful project outcome or turnaround of the utility company:

- Because the government keeps the equity risk, it has an interest in a successful project outcome, that is, a successful placement of the underlying equity at the highest possible price, and therefore in strengthening the legal and regulatory framework to make such placement possible;
- Because it holds convertible bonds, the project sponsor also has an interest in maximizing shareholder value of the project or of the utility company;
- Furthermore, through WBIF, the Bank would keep a veto right so that it could oppose any action that could threaten the success of the project or of the company turnaround.

The project sponsor would initially operate the project company under a management contract and would engage as debt investor via WBIF. This debt investment would be converted into equity once the project has matured and regulatory ambiguities have been lifted.

At that time, the company would be privatized. The project sponsor could convert its debt into equity or other equity investors could be encouraged to participate. A sale to private equity investors could be envisaged, for example to a second-round Local Infrastructure Investment Trust.

This structure would encourage the entry of private investors in infrastructure projects or utility companies in the interim period until the legal and regulatory framework is improved to the point where they or other investors can commit.

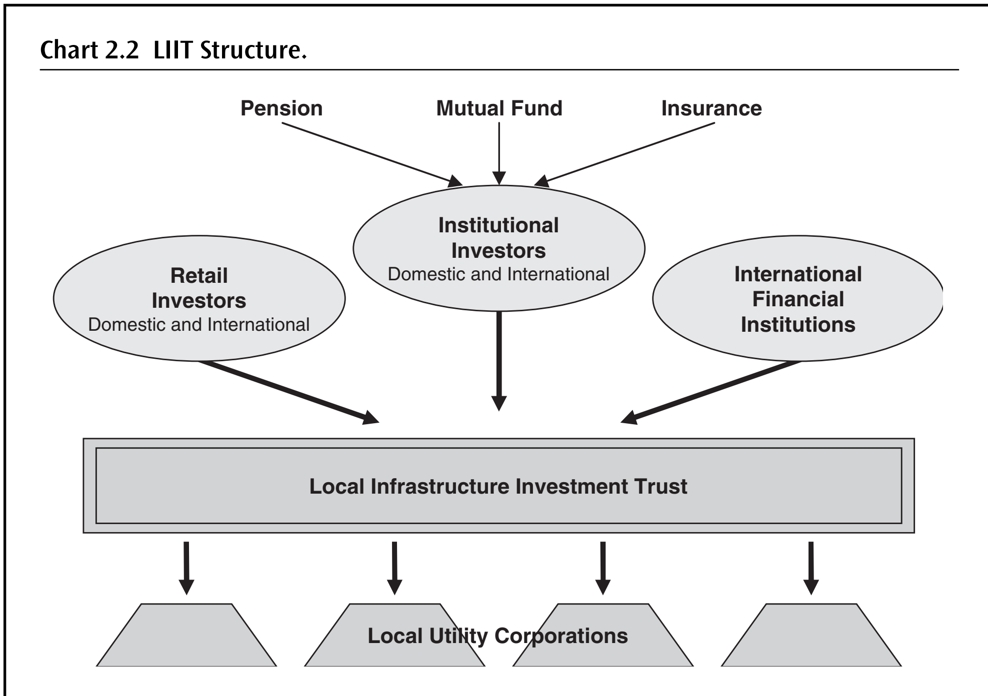
Local Infrastructure Investment Trust (LIIT): The Local Infrastructure Investment Trust (LIIT) is a second-round investment fund that invests in a mixed portfolio of tradeable securities and of long-term equity positions in local utility corporations. The LIIT raises resources through equity, quasi-equity and debt issues on the domestic and international market. The LIIT would buy equity positions in local utility companies from first-round investors, including from the first-round Infrastructure Fund, and would sell its shares and issue bonds to institutional investors, including insurance companies, pension funds and mutual funds (funds-of-funds) both domestically and abroad. The LIIT would be managed by a recognized private fund management company.

The LIIT would be listed on multiple securities exchanges, both domestic and abroad, including potential US or EU host exchanges. With this reach, both foreign and domestic retail and institutional investors could buy shares in the LIIT. Moreover, as the chart above shows, International Financial Institutions (IFIs) could participate through equity as well as through quasi-equity or debt instruments in order to provide leverage and, therefore, enhance the expected investment return scenario. Investments in local infrastructure utilities would be made and monitored by the LIIT. While these underlying investments would span 15 to 20 years, the mixed structure would ensure that investors could trade in and out of the trust more readily, thus assuring the necessary liquidity.

Key issues in structuring a LIIT include:

- *Redemption requirements to facilitate liquidity.* Similar to a real estate investment trust (REIT), a LIIT offers investors liquidity in otherwise illiquid real asset investments. To achieve this objective, the trust must be able to liquidate its portfolio to meet

Chart 2.2 LIIT Structure.



redemption demands. The structure of the trust may range from purely closed-end, tradable only in secondary markets, to open-ended, tradable on demand. A truly open-ended option is not feasible given the illiquid nature of the underlying investments, and a complete closed-end trust is not optimal given the desire for improved marketplace liquidity. One possible solution is that of a hybrid trust that invests a percentage of its portfolio in long-term local infrastructure assets, with the remaining portion in tradable, emerging market securities. Questions to be addressed under the feasibility study would include the optimal share or range to be invested in private equity vs. tradable securities, the necessity for advance notice period for redemptions or minimum hold period for investors, and the opportunity of a backstop to prevent full depletion of assets retained in tradable securities.

- *Investment focus.* The feasibility study would analyze in detail investors needs, and how these change over time, pertaining to reduced hold periods, performance expectations (target IRR and volatility), diversification across countries and sectors.
- *Legal and regulatory framework.* The feasibility study will examine the legal and regulatory framework for the trust itself depending on the jurisdiction of registration and the level of fund investments, in particular the legal and regulatory framework for utilities privatization. As well as PPP laws in jurisdictions of interest.
- *Fund pre-marketing.* The fund would be pre-marketed to domestic and international investors with the objective to identify a potential Fund sponsor. IFIs could then be approached with an offer to take an equity stake in the Fund or to provide leverage through quasi-equity or debt.

Political Risk Insurance (PRI) and/or Partial Risk Guarantee (PRG) facilities to cover sub-sovereign breach of contract risk: To address weaknesses in contract enforcement at the sub-sovereign level, the proposed PPP framework would integrate a political risk insurance (PRI) or a partial risk guarantee facility (PRGF) to cover private investors in local infrastructure utilities against breach of contract by sub-sovereign authorities.

At the sub-sovereign level, the choice between the two types of instruments is governed by the policy risk profile of the sub-sovereign involved in the contractual relationship with the private investor. At one end of the spectrum, policy risk enhancement instruments may not be needed in the case of sub-sovereigns at or above investment grade. In the middle are sub-sovereigns with intermediate policy risk profile in which case third-party policy risk insurance without sovereign counter-guarantee may be attractive. At the other end of the spectrum are sub-sovereigns with high policy risk profile, in which case third-party policy risk guarantees would not be attractive without sovereign counter-guarantees.

To cover transactions with sub-sovereigns with intermediate policy risk, a political risk insurance (PRI) facility *without counter-guarantee from the Government* including coverage against sub-sovereign breach of contract risk could be established by an IFI.

The PRI Facility would be negotiated between the IFI and interested first-round private equity funds and second-round local infrastructure investment trust. Under the agreement, the fund/trust would apply for coverage for a specific risk or a combination of risks transaction by transaction, as needed. The coverage would apply in the case of an equity investment, or shareholder loan, or non-shareholder loan. Such coverage is also available for management contracts and many other forms of cross border investments, hence being a crucial element in the promotion of PPP. In addition, coverage may be provided also if the project is supported by a subsidy scheme. In this case, the investors may want to cover the risk against the breach by the government of the obligation to make funding available.

To cover transactions with sub-sovereigns with high policy risk profile, governments would establish a partial risk guarantee facility against sub-sovereign breach of contract risk *with counter-guarantee from the Government.* Under this facility, an investor in a local infrastructure utility corporation issues a bond to finance the investment required to improve efficiency and/or reach environmental standards. The investor will be concerned about the sustainability of the operational and tariff policy agreements with the pertinent sub-sovereign authority, especially following any future changes of local administration. Under the proposed facility, the IFI provides a partial risk guarantee (PRG) against the breach of the tariff policy agreement by the local authority. In the event the contract is breached and, as a result of this breach, the private investor is unable to repay the principal of the bond at maturity or service loan principal, the guarantee would be called. The IFI would make payment under the guarantee and then exercise a counter-guarantee with the central government. Finally, the central government would turn to the local sub-sovereign authority responsible for the breach and exercise fiscal transfer intercepts to recover the costs the central government incurred through exercise of the counter-guarantee by the IFI. Within this scenario, the investor would be protected against tariff policy agreement breach of contract, and the involved local authority is provided a strong incentive to honor its commitments.

The PRG facility would offer key advantages sought by many private sector investors as well as by local sub-sovereign authorities: (i) better financing terms through spread

reduction and maturity extension; (ii) incremental public debt at a fraction of capital investment leveraged; and (iii) better discipline of all involved parties. The PRG facility should be considered as a transitional solution to be implemented in an environment where there is progress in policy improvement and reform programs. Even so, the PRG model and its components should be designed carefully in a way to prevent moral hazard. This can be done through structuring ex-ante and ex-post risk management mechanisms.

Ex-ante risk management mechanisms hinge on selective criteria that the local entities have to meet in order to access the PRG Facility and take advantage of its risk mitigation instruments. Localities have to meet precise positive criteria related to budget and budgeting, tax, debt management, asset management and regulatory and contractual framework for local utilities (accreditation system).

Ex-post risk management mechanisms are based on a quadrangular relationship between the IFI, the central Government, the local government and the investor in a local utility. The PRG is structured in such a way that incentives for maintaining contractual undertakings are maximized. Critical is the exercise of intercept power[25] by the central Government in case a guarantee is called following local government in breach of contract. In this instance, the power of the Central Government is not only limited to the intercept of revenue transfer, but also to the intercept of tax shares, grants, dedicated revenue stream and seizing of accounts of localities.

Mortgage Insurance and Mortgage Securities Enhancement

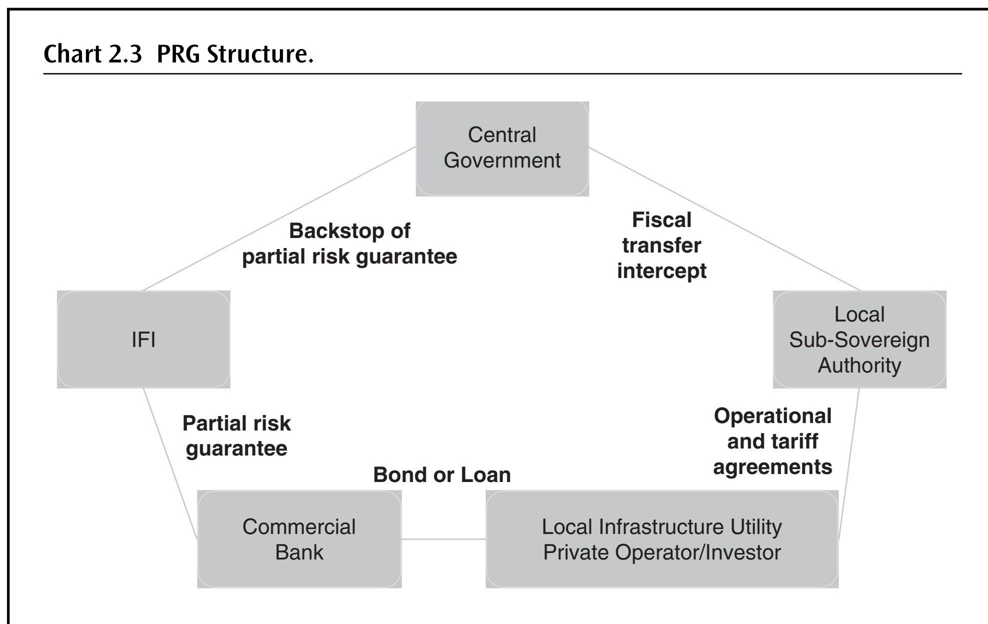
As the Government moves to establish the legal, regulatory and institutional framework for the mortgage market, including the establishment of state registration for immovable property and state registration of mortgages, it could set its sights on the development of instruments to broaden access of lower-income households to the primary housing mortgage market and subsequently to support the development of the secondary mortgage market.

In this context, the Government may consider developing mortgage default insurance (MI) on the primary market, and subsequently developing enhancement instruments for mortgage securities.

Mortgage Default Insurance (MI).[26] Mortgage default insurance (MI) coves lenders and investors against losses resulting from borrowers defaulting on their home mortgages. For direct lenders, MI can expand available credit for home-ownership by inducing more liberal lending criteria, usually in the form of a lower down payment requirement. For potential purchasers of residential mortgage loans or mortgage-backed securities, MI backed by sufficient risk capital can help provide the essential safety, liquidity, and investor confidence needed to make residential mortgages competitive with other instruments in the NBFI sector. Furthermore, to the extent that mortgage insurance becomes a critical link to accessing mortgage capital, the mortgage insurer may exert considerable influence on housing construction standards, property appraisal standards, loan documentation and data collection standards, and general credit and property underwriting standards.

25. This section draws from Blood (1999).
26. This section draws from Chiquier, Hassler, and Lea (2004).

Chart 2.3 PRG Structure.



The existence of a fully functional primary mortgage market is on the critical path to the successful introduction of mortgage default insurance. Initial conditions include in particular: (i) economic and financial stability; (ii) legal and regulatory mechanisms to ensure contract enforceability; (iii) market and loan level experience data availability; (iii) system for transferring, recording and establishing clear title to real estate; (iv) existence of institutional lenders competent in originating and administering home mortgage loans of investment quality (incl. property valuation and individual income and credit evaluation mechanisms and data); (v) functioning real estate markets, which capable agents and market data to serve buyers and sellers); (vi) effective banking regulation in place to assure the ongoing financial solidity of insured lenders and mortgage default insurers; and (vii) homeownership culture and commitment to repay financial obligations in the general population, along with acceptance of foreclosure in case of failure to repay mortgage debt.

The Government may consider alternative strategies to support the development of mortgage insurance in the country. On the one hand, it may decide to stay out of the market altogether. On the other hand, it may opt to support the development of mortgage insurance through some sort of Government sponsorship. Under the second alternative, a number of fundamental features would need to be considered:

(i) Shared credit risk with loan originators. The insurer needs to structure a form of coverage that entails the partial retention of risk by the lender, less moral hazard is generated and the lender may, over time, underwrite and transfer excessive risk to the insurer;

(ii) Full coverage to the secondary investor. Unlike the primary lender, the institutional secondary investor has no role in creating or managing the underlying credit risk and will have good reason to seek 100 percent coverage, the mortgage insurance

program should provide the secondary investor with full protection while requiring the primary loan obligator to retain some risk exposure;

(iii) Limitation of types of mortgages covered. While instruments such as dual indexed mortgages offered in several countries with volatile financial markets may protect borrowers against near term payment shock, such instruments also permit outstanding loan balances to increase dramatically (negative amortization) and possess risk features that are not well suited for credit insurance protection;

(iv) Capital credit for the guarantee. Home mortgages that carry qualified mortgage default insurance should be made eligible for reduced capital requirements, thereby recognizing both the costs and the benefits of the insurer's incremental capital support. This will also help to avoid the problem of adverse selection of risk by the loan originator.

The Government of Ukraine may consider conducting an assessment of the capacity of the domestic primary mortgage market to support the basic activity of mortgage default insurance, adopt regulations applicable to public and private mortgage default insurers, and assess alternative options concerning possible Government sponsorship, sources of capital and relationships between public and private sector participants.

Enhancing Mortgage Securities.[27] As the primary mortgage market develops, possibly supported by a MI scheme, the Government may consider developing a strategy to support the development of the secondary market for mortgage securities. These may include specialized agency bonds, mortgage bonds, and mortgage-backed securities (MBS) such as mortgage pass-through (PTs) securities, and mortgage pay-through securities. Most mortgage security issuance by banks in developed and emerging markets are pay-through structures. In economies with emerging pools of contractual savings such as insurance, pension or mutual funds, mortgage securities can tap new funds for housing. Funding through capital markets through issuance of mortgage securities can increase the liquidity of mortgages, thereby reducing the risk for originators and the risk premium charged by lenders. The introduction of mortgage securities can increase competition in primary markets. Securitization can allow small, thinly capitalized lenders who specialize in mortgage origination and servicing to enter the market. In turn, increased competition and specialization can increase efficiency in the housing finance system.

In developing its strategy for development of the mortgage securities market, the Government of Ukraine may consider several lessons learned from the experience of other emerging and industrial countries:

(i) *A strong legal and regulatory framework is a necessary but not sufficient condition for success*. While flaws in the legal and regulatory framework may sometimes explain difficulties in market development, exogenous obstacles may stunt the actual use

27. This section draws from the World Bank's 2001 financial sector study "Ukraine. Financial Sector and the Economy: The New Policy Agenda", May 2002 joint WB-IMF Financial Sector Assessment Program (FSAP) Report, November 2004 Report on Development of State Commission for Regulation of Financial Services Markets (SCRFSM) produced by Jeffrey Carmichael, former chairman of Australian Prudential Regulation Agency (APRA), under the Bank-funded project.

of the framework. For example, lengthy lien registration processes in courts may impede the issuance of mortgage bonds. For MBS, a major hindrance may be the lack of a market for credit risk, as many emerging economies lack insurers or guarantors or investors ready to take over the risk from lenders. In this case, MBS sellers must use internal credit enhancement tools, which are necessarily very expensive if high ratings are sought. Also in the case of pass-through securities, there are often very few investors willing to buy the prepayment options embedded in the loans, which are difficult to value in the absence of historical data and uncertainties about borrowers behavior. Finally, the primary market for mortgages must reach a critical mass before making efficient use of capital market instruments.

(ii) *Market demand.* In many emerging markets, the need for securitization has been low as capital ratios improve implying less need for off-balance sheet financing. Most depositories are liquid and not in need of significant new sources of funds. In most markets deposit funding is significantly cheaper than capital market funding, providing a further obstacle to the latter. In markets dominated by a few large lenders, these may not need the funding and can price out competitors using wholesale funding out of the market.

(iii) *Simpler instruments and institutional designs.* Across emerging markets, the more successful institution designs have been liquidity facilities rather than conduits. While appealing, securitization and conduits that issue such securities are complex, and the cost of issuance reduces investor demand. Simpler product variants such as mortgage insurance and guarantees to facilitate investor acceptance may be preferable in the early stages of market development. The development of mortgage securities should be seen as an evolutionary process, starting with simple designs that do not tax the infrastructure or investor capabilities and introducing more complex designs as market develop. Development efforts in many emerging countries have focused on the creation of conduits with government involvement. In many cases these institutions are ahead of their time, or at best solutions in search of a problem;

(iv) *Government role.* All mortgage securities market development success stories in emerging markets have the following in common: (i) the existence of a strong legal and regulatory infrastructure for markets; and (ii) significant government support. Governments can provide seed capital to specific institutions, for example a mortgage securities issuer, or help jump-start the market as the main investor in mortgage bonds or through its concurrent effort of creating institutional investors, in particular pension funds. Governments can also support the development of a secondary market in mortgage securities through liquidity support and required reserve eligibility, or through government guarantees. Credit enhancement through government guarantees can be an important instrument to catalyze the development of the market. Guarantees need to be structured carefully, however, to avoid adverse selection and the build-up of large contingent liabilities for the Government. Involving the private sector in a first-loss provision provides a way to control liability risk for the Government. However, such strategy needs to be well regulated and supervised as it creates economic rents for the institutions benefiting from the guarantee and lead through greater risks for the Government.

Subject to the above caveats, the Government of Ukraine may consider a number of instruments to support the development of mortgage securities markets. These include creating new public institutions, providing guarantees for securities issued by private sector institutions, and providing market liquidity support.

Under the first alternative, the government would create and support institutions that support market needs or policy objectives. For example, the Government may sponsor the creation of a mortgage insurer that provides enhancement to facilitate institutional investment in mortgage securities (see previous section). The Government may also consider establishing a secondary market institution (bond issuing facility or conduit) with the objective to reduce the cost of security issuance by developing economies of scale in bond issuance and liquidity in its securities. Such institutions can reduce the cost of credit risk assessment, as the investor only has to underwrite the intermediary or insurer rather than a large number of primary market entities. In theory, they also reduce the level of credit risk taken by investors through monitoring of primary market lenders.

The Government can create or sponsor an intermediary or insurer as a means to jump-start the market. However, it may be difficult to isolate such an institution from political pressures. Alternatively, the government may sponsor a private institution. In this case, it may be difficult to resolve the inherent conflict of interest between the profit maximizing motive of management and owners and the social mission of the institution. This may result in privatizing the profit and socializing the risk. Also, government involvement in such institution should best be seen as temporary.

Under the second alternative, the Government may consider providing guarantee for private sector security issuers to increase acceptance by investors. Government guarantees can promote competition in the market if offered to all lenders. The disadvantage is high agency costs of monitoring and lack of economies of scale in securities issuance.

Under the third alternative, the Government can help improve market liquidity through: (i) Central Bank support of the repo market by accepting mortgage securities as collateral in repo transactions; (ii) provision of guarantees to develop a private repo market; and (iii) establishment of contingent government fund that would stand ready to buy mortgage securities in the secondary market.

TECHNICAL ANNEXES

TECHNICAL ANNEX A

NBFI Regulators in Ukraine: Key Development Issues

A number of Bank reports produced during 2002–04 have emphasized the need for further strengthening of financial regulation system in Ukraine in order to increase its efficiency and bring it into compliance with best international practices and Basle-recommended supervision principles. The reform will need to focus on: (i) legislative amendments necessary harmonize Ukrainian laws in harmony with EU directives, principles of insurance supervision developed by the International Association of Insurance Supervisors (IAIS), IOSCO etc.; (ii) institutional enhancement of the State Commission for Regulation of Financial Services Markets (SCRFSM) and the State Securities and Capital Markets Commission (SSCMC) that should envision reconfiguration of the regulators' structure, funding and staffing policy; and (iii) strengthening of institutional independence of the regulators while increasing their accountability and transparency. The issues and recommendations outlined below present some of the most important aspects of institutional reforms which need to be undertaken to improve the performance SCRFSM and SSCMC.

Core Deficiencies in the Performance of NBFI Financial Regulators

Inadequate institutional independence and high level of political intervention which results in compromised decisions and undermined reputation of the regulatory agencies (first of all, SSCMC).

Legal provisions for appointment/dismissal of the senior management of financial regulators are ambiguous; weak "fit & proper" criteria for appointment of senior management and protectionism exercised by politicians often result in conflict of interests, undermined powers and competences of senior management, poor business culture and governance of the regulatory agencies.

(*continued*)

Core Deficiencies in the Performance of NBFI Financial Regulators (Continued)

Adverse policy environment for financial regulators: neither politicians nor financial markets appreciate the role and acknowledge the importance of regulators in ensuring financial stability, protecting the interests of investors, advocating sound business practices and discipline and creating level playing field for market participants.

Weak institutional capacity in the areas of regulation and prudential supervision stemming from low remuneration of staff and high rotation of personnel, limited knowledge and skills, especially in the area of financial regulation, due to the absence of the historic record of regulation (SSCMC exists since 1995, SCRFSM operates since December 2002).

Serious understaffing of SCRFSM due to lack of skills and low attractiveness of the job.

Overstaffing of SSCMC due to unclear mandate (such as responsibility for oversight of 35,000 JSC), poor division of responsibilities and serious problems with information/data processing and analysis.

Underdeveloped and inadequate enforcement powers and skills of the regulators due to:(i) limited or ambiguous enforcement powers granted by the legislation; (ii) biased/corrupt court decisions; (iii) political intervention leading to regulatory favoritism and/or forbearance; (iv) limited knowledge and skills of the regulators; (v) absence of the professional trustees, administrators or liquidators that can assist regulators with problems resolution; (vi) limited funding of the regulators which doesn't allow to contract professional external expertise; (vii) insufficient legal protection of the regulators against litigations during their tenure.

Significant underfunding of the regulators which hampers development of adequate information and risks analysis systems prevents creation of adequate database and registries. Moreover, limited funding does not allow the regulators to offer adequate remuneration to the staff (implicit via bonuses or explicit via wages).

Undermined powers of financial regulators to react promptly and at their discretion with the respective regulatory decisions (by-laws) due to the existing contradictions between specialized legislation on financial regulation (such as Law on Financial Services and State Regulation of Financial Services Markets, Law on State Regulation of Capital Markets which mandate regulators to issue their own decisions and by-laws) and general Law on State Regulatory Policy (that requires from financial regulators to have preliminary consultations and agreement on the substance of by-laws with the State Entrepreneurship Committee).

Organizational structure of the SCRFSM and SSCMC requires reconfiguration to: (i) avoid duplication; (ii) distribute limited human and institutional resources adequately according to the needs and systemic risks; (iii) develop regional representation according to the concentration of risks; and (iv) improve coordination between regulators and increase synergy in the activities of different experts/regulatory institutions.

Institutional Challenges for the State Commission for Regulation of Financial Services Markets of Ukraine (SCRFSM)

In the face of extremely adverse conditions SCRFSM has done an impressive job in creating regulatory framework for NBFIR since its establishment in December 2002. The demands of effective non-bank regulation, however, will require a major upgrade in the skills and experience of SCRFSM staff if it is to meet the challenges going forward.

Good regulators cannot be created overnight. The skills and experience needed require years of sustained training and capacity building. The effectiveness of that training and capacity building will be seriously undermined unless a solid core of dedicated staff can be established at the SCRFSM.

Staffing Arrangements

Staffing levels at the Commission are low by both international standards and by comparison with the NBU, which has approximately 30 times the regulatory staff per institution compared with the Commission.

Both domestic and international comparisons, however, combined with the rate of staff attrition, suggest that Commission remuneration is well below what is needed to recruit and retain appropriately skilled staff.

Operational Support and Technology

The Commission's technical support in terms of hardware and software is well below international standards for an agency with the Commission's responsibilities. The Commission's attempts to upgrade this level of support have been hampered by the limitations on its funding.

Overall Funding Needs

Based on evidence at the Commission and on international comparison, it is clear that the Commission is seriously under-funded. It is unlikely to expect that the Government will be ready to substantially increase the funding of the regulators in the light of the increasing fiscal pressures in 2005–06. Thus, Ukraine may want to consider introducing market fees/premiums to be paid by the supervised institutions to improve the quality of the regulators.

Budget of Financial Regulators in Ukraine

	SCRFSM	SSCMC	NBU	Financial Monitoring Unit
Source of Funding	State Budget	State Budget	Self-Financing	State Budget within funds allocated to MOF
Regulators (staff)	200	700	530	150
Regulators per regulated institution	0.2	0.02*	3.5	—
Budget per head (th. UAH)	23.3	22.3	40.5	367.9
Levels of salaries and fees, bonuses	set by the state (COM)	set by the state (COM)	Salaries determined by the state, but there is special NBU scale for various sources of benefits and bonuses	set by state COM
Budget per year UAH (th.) (Expenses)	6743.6	15631.2	463000 (2003) (just personnel and administrative expenses)	47829.9

*This number takes into account the total number of Joint Stock Companies currently under the surveillance of SEC.

Independence, Powers, and Accountability Framework

While a full review of the SCRFSM's powers, independence and accountability arrangements should normally be carried out after the agency has been in existence for around five years, there are some areas in which more immediate attention might be paid, especially if other legal amendments are being implemented. The following are top three priorities:

- That the appointment and dismissal provisions of the Law on Financial Services and State Regulation of Financial Services Markets (LFS) should be strengthened by deleting Article 24(2)(6) and spelling out transparent conditions under which the President may direct the Commission in its actions;
- Financial regulations drafted under powers granted explicitly to the Commission (and the NBU and SCSSM and other financial regulators) should be excluded from the jurisdiction of the Committee on Regulatory Policy and Entrepreneurship; and inconsistencies between the powers in the LFS and the underlying industry laws be resolved by clarifying the powers in the LFS and removing them from the underlying industry laws.

Accountability

Other than the general provision in Article 24(6) which states that the Head of the Commission is individually accountable for the activities of the agency, there are very few explicit accountability requirements in the LFS.

For example, there are no:

- Formal reporting requirements;
- Requirements to account to industry (other than the consultation requirements on draft regulations);
- Accounting or auditing provisions;
- Requirements to appear before Parliament or Parliamentary committees;
- Formal appeals processes, although decisions of the regulator can be appealed in the Ukrainian courts.

With respect to the enforcement of regulations, the Law should generally give affected parties an opportunity to make representations before the decisions (for example, revocation of a license) become effective.

Regulatory decisions should be subject to review by an internal panel of agency staff not involved with the original decision. The Law should spell out the circumstances and mechanisms under which such opportunities will be given

Institutional Challenges for the State Securities and Capital Markets Commission (SSCMC)

Like SCRFSM, the Securities and Capital Markets Commission faces similar institutional challenges and problems. Thus, the reform should equally address the needs of both regulators.

However, unlike SCRFSM that had only two years of practical experience in the market, SSCMC had more than ten years to exercise its powers and build up proper institutions and market discipline. However, Ukrainian capital markets are underdeveloped while the reputation of SSCMC is weak and enforcement capacity is virtually non-existent. Thus, in addition to addressing the institutional weaknesses of the SSCMC, the Government may need to review the existing strategy for the development of capital markets in Ukraine and the adequacy of the SSCMC structure and mandate, upgrade the legislation (especially in the area of corporate governance and protection of rights of the minority shareholders), reform judicial system, introduce transparent and unambiguous dispute resolution process as well as increase accountability of the SSCMC.

Vision and Model for Capital Markets Development

Securities market regulation and supervision have been undermined by Ukraine's excessively complex market structure, resource constraints at the State Commission on Securities and Stock Market, and technological incompatibility of the markets. In a formal sense, most IOSCO principles have been implemented or partially implemented, with only two principles not implemented. The SSCMC has the potential to act as a strong regulator with comprehensive powers, and it has the willingness to carry out its supervisory mandate. However, effective supervision of more than 35,000 public joint-stock companies is nearly impossible under existing circumstances.

Mandate is Too Broad While Regulatory Powers are Weak; Accountability is Poor

The mandate of the SSCMC is too broad and should be limited. The authorities should consider introducing a minimum threshold number of shareholders and minimum capital requirements for corporations that trigger mandatory annual reporting to the SSCMC.

The SSCMC could itself improve its internal governance, for example, by instituting a system for regular consultation with interested parties when regulations are drafted or amended, and by providing the public with timely and verified financial information on its activities. Securities supervisors should also have legal indemnity or limited immunity when acting in good faith.

Staffing and Funding Limits

Like SCRFSM, SSCMC suffers from low civil service wages and high turnover. Because of resource constraints, the staff of the SSCMC have been unable to participate in most IOSCO meetings and the pre-eminent international training courses. However, any further institutional strengthening of SSCMC should focus on review of the SSCMC mandate, clear division of powers and responsibilities between its staff and members of the Commission and creation of sound internal mechanisms for data sharing, information flow and analysis and accountability.

Legal and Regulatory Framework Incomplete

The legal framework, while much improved, still needs further amendment.

- Law on State Regulation of capital markets and Law on Securities and Capital Markets need to be amended to strengthen the enforcement powers of the SSCMC and increase sanctions for violations of the regulatory requirements;
- Passage of the draft joint stock company law will help provide better governance and greater protection of minority shareholders.
- The SSCMC needs to exempt securities market activity from the new Licensing Law.
- Legal sanctions need to be introduced to stop market manipulation or insider trading. Actions against market fraud need to be enforceable through a change in the legal framework that defines an insider or related party, as well as the possible offences and sanctions.
- Parallel regulations to the collective investment institution law are also needed.

The current legal and regulatory framework for corporate governance remains a core impediment to future investment and growth. The very large number of "public" joint stock companies (reportedly over 35,000 with more than 17 million shareholders) impairs the ability of the SSCMC to enforce existing rules. Limited disclosure of information results in very low transparency of corporate decisionmaking, and further undermines investor confidence. Share registration mechanisms need to be improved through the adoption of a single central depository.

Donors Cooperation in the Area of NBFI Market Development in Ukraine

Following the Bank's 2001 report "Ukraine. Financial Sector and the Economy: the New Policy Agenda" and the pronouncement of the Government intention to reform pension system in Ukraine, international community paid much greater attention to the developments in the non-bank financial sector. This resulted in the increased amount of technical assistance and policy advice from the Bank, USAID and other bi-lateral donors.

USAID

In 2001, USAID launched Pension Reform Project which extended technical assistance to the Government of Ukraine and State Pension Fund aimed at preparing new pension reform legislation, reforming PAYG system and introducing personalized pension accounts, introducing legal and regulatory framework for creation of non-state pension funds (3rd pillar). In addition, the program offered various training opportunities to the Government officials, financial regulators and private sector participants with the aim of knowledge transfer, skills building and reform promotion. It is expected that the program implemented by PADCO (the contractor under the contract with USAID) will be extended till 2007.

In addition, in December 2004 Pragma Corporation, the Contractor under USAID funded project "Access to Credit Initiative," launched the new multi-faceted TA program that covers such areas as mortgage, leasing, municipal and mortgage securities, and credit information systems. This program is closely linked with and complements the objectives of the Bank's Access to Financial Services Project. It is expected that in the next four years Pragma Corporation will work closely with Ukrainian constituency, including National Bank of Ukraine, Ministry of Finance, National Mortgage Association, Bankers Association, commercial banks and other private sector institutions in providing extensive

training and building capacity of banks and leasing companies in such areas as leasing and mortgage finance, preparing foundation for issuance of mortgage securities and municipal bonds and assisting in establishment of Ukraine's credit information bureau. This work is closely coordinated with other donor agencies and is guided by the memorandums of understanding (MOUs) signed by Pragma Corporation with the various counterparts.

In 2006–09, USAID is planning to extend its support to the State Commission for Regulation of Financial Services Markets (SCRFSM) and State Securities Commission (SSCMC) to promote their institutional development and improve legal framework. It is expected that this new USAID program will focus on strengthening regulatory powers of SCRFSM and SSCMC, improving legislation in the area of contractual savings, beginning with the pension system and collective investment funds, and enhancing legal framework and enforcement in the area of corporate governance and disclosure of information.

IFC

Despite the enormous interest in the financial market in Ukraine and the ability to finance new investments, IFC has thus far relatively built up a limited portfolio of equity investments in financial institutions, all in the banking sector. At the moment, IFC has equity holdings in four commercial banks and several loans extended to commercial banks and one leasing company. During the period of 1999–2001 IFC provided technical assistance to develop leasing legislation and build skills of leasing companies. A new technical assistance project on leasing funded by the Dutch Government and implemented by IFC started in October 2004. IFC is committed to expand lending and equity finance to the eligible leasing companies, provided that legal framework and institutional capacity for doing leasing will strengthen.

In 2004, IFC in cooperation with the Bank provided policy advice to the Government of Ukraine in developing draft legislation on mortgage securities. In addition, under the Bank's Access to Financial Services Project, the Bank and IFC experts have been discussing the concept for creation of the 2nd tier mortgage finance institution. IFC is considering potential equity investment into the newly established International Mortgage Bank (opened in January 2005).

IFC is provides advice to corporations for adoption of the corporate governance code and provides advice to the government for corporate governance legislation.

EBRD

Although EBRD has no technical assistance or equity holdings in the NBFI area, it shows great interest to the developments in the legal and regulatory framework for NBFIs, especially in such areas as leasing, insurance and pension funds. In 2004, EBRD extended several loans to commercial banks for housing finance and is interested to increase its portfolio in the nearest future. EBRD plans to expand its activities in the capital markets by opening new equity fund in Ukraine. Once legal and regulatory framework for insurance and pension will improve, EBRD may be interested to consider possible equity investments in these areas as well. During the period of 2002–2004, in cooperation with the Bank, EBRD provided advice on development of the legislation for sub-national borrowing. However, the EBRD initial interest for investing in this market has been hampered by the delays in adopting adequate legislation and normative framework.

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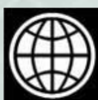

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