



FINANCIAL SECTOR DEVELOPMENT PROGRAM (USAID/FINREP-II)



FINREP-II FINAL REPORT (ABRIDGED)

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Executive Summary

The goal of the Financial Sector Development Program in Ukraine (FINREP-II, 2012-2015) was to increase financial sector stability and restore public trust in financial markets through a wide range of technical assistance. FINREP-II aimed to reduce financial and macroeconomic risk, strengthen supervision and regulation to improve market oversight and transparency, and increase public outreach to citizens on financial literacy and consumer rights.

This Final Report details FINREP-II's key achievements from 2012-2015. It begins with a background section on the tumultuous political and economic environment in which FINREP-II operated, specifically describing how the *EuroMaidan Revolution* affected FINREP-II and the country. It also describes the Project's overall design, staffing structure, and GOU and private sector counterparts.

FINREP-II had three primary Objectives. This Final Report is organized accordingly: Objective 1: Strengthening Supervision and Regulation of the Financial Industry, describes work with key regulators and GOU entities, including the NBU, NSSMC, FSR, DGF, MOF, MLSP and PFU. Objective 2: Developing Financial and Derivatives Markets, details the Project's unique effort to establish a Ukrainian financial futures market, including drafting derivatives legislation that permits safe and transparent trading of agricultural derivatives, and later foreign exchange and other financial derivatives. Objective 3: Increasing Financial Literacy for the General Population, summarizes the Project's work in developing consumer rights legislation, creating a National Financial Literacy Strategy and Website, expanding FINREP's Financial Literacy Course for students on a national scale, and highlighting broad public outreach efforts to educate citizen's on basic financial skills and consumer rights.

The Report describes two "add-on" programs that were funded by USAID: the Growth of Women's Business and Leadership Program ("Go Women") Program; and Combating Anti-Corruption in the Financial Sector Initiative. Other mandatory factors and cross-cutting themes addressed in this Report include: gender equality activities; local capacity building; public-private alliances; and geographic focus areas.

From 2012 to 2013, FINREP-II worked to achieve all Project objectives in a difficult—often corrupt—environment that resisted serious reform. In the winter of 2014, however, the *Maidan Revolution* launched a new era of transparency, accountability, and real reform. To sustain this effort, FINREP-II promoted activities in anti-corruption, legislative development, and market reform. FINREP-II continued the approach of proactive, yet flexible, technical assistance, based on strong local knowledge of the GOU, the financial sector stakeholders, and civil society organizations.

FINREP-II leaves a robust legacy for follow-on activities, particularly in concert with implementation of FINREP-II-created Roadmaps that set forth paths to reform on critical issues, including: Securities Markets, Pillar II Pension Stability, Government

Debt, IFRS, Commodity Derivatives, Financial Literacy, Women's Empowerment, and Anti-Corruption.

Together these initiatives supported greater stability, increased protection for international and local stakeholders, and informed citizens about their rights in financial matters. Despite the successes of the FINREP-II program, USAID determined to terminate the Project on October 31, 2015 so that the Mission could design a new program to respond to the unprecedented post-*Maidan* challenges facing Ukraine, and which could complement the revised IMF reforms package that the Government of Ukraine has agreed to implement.

Summary of Project Achievements

Over the three years of implementation, Project activities achieved anticipated results as measured by indicators developed with USAID and incorporated into FINREP-II's Performance Monitoring & Evaluation Plan (PMEP). A summary of achievements by technical area include:

Legal and Regulatory: FINREP-II experts reviewed over 400 drafts of legislation and regulation affecting the financial sector to identify gaps and inconsistencies with EU Directives. This review resulted in extensive commentary to the GOU and stakeholders for improving and harmonizing legislation in line with EU standards and international best practices. FINREP-II provided over 3,000 hours of training to financial sector supervisors on international standards and best practices, far exceeding PMEP targets. Post *Maidan*, regulators at the NSSMC, DGF, and FSR, became energetic consumers of FINREP-II education and training.

Government Debt Strategy. After the GOU renewed its work with IMF in 2014, FINREP-II assisted the MOF in assessing its government debt strategy, specifically with regard to expanding the number of economic indicators used to improve accuracy, and extend the timeframe for budget forecasting. FINREP-II also helped the MOF develop a strategy for coordinating crisis efforts with the NBU. FINREP-II published 114 issues of FOCUS (USAID's online newsletter on GOU debt and financial sector developments). FOCUS attracted over 200 policy-level subscribers from a cross-section of GOU and senior private sector stakeholders.

Pension Reform. FINREP-II remained the leader in technical assistance to the MLSP, PFU, and Verkhovna Rada on pension reform, including developing actuarial projections covering various fiscal scenarios and policy choices, leading to recommendations on a retirement age increase, contributions, and Pillar II precursors. FINREP-II delivered technical assistance to the FSR to improve the GOU regulatory system's oversight of privately managed individual retirement accounts. FINREP-II provided regular publications of "Global Experience in Pension Reform," a quarterly technical analysis of Ukrainian and international trends in implementing changes. FINREP-II conducted a country-wide review of the PFU's IT systems and its ability to handle reporting requirements during implementation of government-managed

individual retirement accounts. The Project delivered recommendations for technical implementation of IT systems for Pillar II. FINREP-II prepared analysis for GOU stakeholders on major pension developments in OECD countries and delivered multiple trainings to pension regulators on risk management and oversight of investment activities. And, the Project produced a comprehensive plan on Pillar II roll-out that set forth economic and operational precursors necessary for successful Pillar II implementation, and approaches to achieve them.

Deposit Guarantee Fund. The Project developed a comprehensive Action Plan for the DGF to provide long-term technical assistance on procedures and internal regulations on bank resolution and guaranteed deposit payouts. FINREP-II delivered crisis communications training to the DGF and NBU to improve public outreach and inter-GOU coordination. This included one-on-one training for NBU Governors during the height of the banking crisis in 2014 to enhance public communications. FINREP-II coordinated international trainings between the U.S. FDIC and the DGF to improve bank resolution practices. FINREP-II helped develop and implement the DGF's new Customer Call Center, which significantly increased the DGF's capacity to handle public inquiries—from two calls at a time, to thirty simultaneous calls. The system also tracks an expanded list of statistics that will assist the DGF to better manage public inquiries and public relations. The DGF, in its Published Annual Report 2014, mentioned FINREP-II and USAID assistance eight times as the most active donor project and agency.

Anti-Corruption. FINREP-II led efforts to support the adoption of anti-corruption measures in the financial sector, including developing Corruption Prevention Plans for the DGF and NSSMC. FINREP-II used the Legal Corruption Impact Review (LCIR) and Institutional Corruption Risk Management (ICRM) methodologies. These methodologies were supported by the MOJ, and are scheduled to be implemented at other GOU institutions.

International Financial Reporting Standards (IFRS). FINREP-II worked with the MOF to complete the incorporation of IFRS into the Ukrainian regulatory framework. FINREP-II delivered 16 regional seminars over 2 years, conducting over 13,000 hours of accounting and IFRS training for financial sector professionals, of which 9,000 hours were completed by female professionals. FINREP-II also partnered with the MOF, NBU, FSR, NSSMC, and DGF to develop and complete a Pilot Program for implementing XBRL electronic reporting. The Program exceeded the anticipated volume of training for financial sector professionals by a wide margin.

Local Capacity Building. FINREP-II assisted USAID to prepare a local accounting association for direct grant support from USAID to further support IFRS implementation in Ukraine. FINREP-II increased capacity at the Active Audit Agency (AAA) to enable it to be a more prominent stakeholder in anti-corruption efforts with the GOU. The Project implemented a nation-wide Train-the-Trainer campaign for teachers to increase local capacity to deliver financial literacy training. And as part of the Go Women Program, FINREP-II helped build the capacity of four local NGOs ("Women's Perspectives," "The

Ukrainian Women’s Fund,” “Extra Consulting Ltd.,” and “Change Agency ‘Perspectives’”) to deliver technical assistance and training to women entrepreneurs, women-owned SMEs, and poor and vulnerable women heads of households.

Derivatives Markets Development. FINREP-II led Working Groups with the MEDT, NSSMC, and other public and private sector stakeholders to develop new draft laws “On Derivatives” and “On Commodity Exchange Markets.” Because of FINREP-II’s sustained efforts, on November 20, 2015, the GOU delivered a “Law on Derivatives” to the Rada for passage. The Law incorporated extensive FINREP-II recommendations on EU Directives, IOSCO provisions, and international best practices. FINREP-II also conducted the first-ever comprehensive survey of agricultural market participants, and developed a Roadmap to achieve effective commodity and derivatives trading for price-discovery and price insurance via hedging. FINREP-II delivered a comprehensive Roadmap to GOU counterparts in 2015, “Roadmap: Commodity Futures Markets Development in Ukraine 2015 Onward”.

Financial Literacy. FINREP-II remained a leader in the public-private dialogue on financial literacy and consumer protection. The Project worked with the Rada, NBU, DGF, NBU Banking University, Ministry of Education, and local NGOs to formulate and implement strategies for financial literacy training in public schools. The 10th grade financial literacy pilot program expanded to over 650 schools, reaching over 18,000 students each school year. FINREP-II exceeded the 3-year goals for national roll-out of the pilot program in terms of: educational professionals trained; schools involved; and students taking the course. The Project also worked with IBM and the NBU Banking University to develop an open-source digital version of the pilot program’s textbook. The digital version contains interactive lessons and works both online and offline. FINREP-II helped the NBU become a member of the OECD’s International Network on Financial Education during 2014, and played a critical role in helping the NBU develop a long-term National Financial Literacy Strategy and Website (the NBU later put this work on hold due to internal reorganization and other priorities addressing the crisis in the banking sector). FINREP-II helped the DGF develop online financial literacy courses for adults to improve public knowledge of the deposit guarantee system, and rebuild confidence in the banking system. FINREP-II also led the drafting of two consumer protection laws in accordance with EU standards, accepted by the Rada. FINREP-II was also an active participant in USAID’s Mistechko Field Days Initiative. Mistechko Field Days was a major USAID outreach event which sought to introduce USAID-funded projects active in a city to its residents. FINREP-II’s booth was the most visited during the Field Days, and it had the most active participation as citizens could “learn-as-you-go” and experience first-hand the principles of effective budget planning, personal efficacy, and consumer rights protection.

“Go Women.” FINREP-II launched the Go Women Program which delivered targeted training to two main groups: vulnerable women, and female-owned micro- and small-enterprises. FINREP-II competitively selected, and then trained, four Ukrainian NGOs that delivered 327 trainings to over 5,000 women trainees. Exit testing showed that 90%

of the women improved their business acumen, financial literacy, and personal financial efficacy.

Going Forward

The GOU's economic policy goals can be simply stated: implement reforms that restore macro-economic stability, strengthen transparency and eliminate corruption, and generate sound and sustainable economic growth while protecting the most vulnerable. Detailed roadmaps to achieve these goals have been accomplished, many by FINREP-II. Indeed, if there is a silver lining to the Ukrainian political and economic turmoil, it is that the economic problems have been thoroughly analyzed, with solutions set forth.

Implementing economic reform must occur in the following areas: pension reform; capital markets development; government corruption; macro-economic stability; budget and fiscal policy; government debt management practices; bank stability via recapitalization; DGF assistance with bank resolutions; increased SME access to finance; Naftogaz reform; exchange rate flexibility and currency management; IFRS and XBRL reform; tax policy, agricultural sector reform, and financial education.

The donor community is committed to assist, and it offers a profuse field of actors with the IMF, World Bank, European Union, USAID, U.S. Department of Treasury, and others. The strategic course for USAID should be to avoid duplication with other donors. By example, the World Bank has been the leading donor with the NBU and on banking sector legal reform, banking solvency, and DGF capacity building. The U.S. Treasury offers complementary assistance on bank intervention and resolution strategies for the DGF, monitoring and enforcement schemes for the NBU, and debt management strategies for the MOF. And, the IMF stands out with mandates on monetary policy liberalization, fiscal austerity, and anti-corruption—all tied to billions in bail-out funds.

USAID should thus provide assistance in those areas where it has the strongest legacy, institutional memory, and credibility. USAID could properly lead in the following financial sector areas: 1) Implementing long lasting pension reform, working with the MLSP, PFU, and NSSMC; 2) Assisting capital markets development under a new commitment by the NSSMC to reform with adherence to IOSCO principles; 3) Developing new financial instruments, including derivatives in agriculture products, interest rates, currencies, metals, stock indices, and asset-backed instruments; 4) Supporting legal and regulatory development with sustained capacity assistance to financial regulators and private financial sector entities; 5) Completing the IFRS adoption (as the EU has not invested heavily in this areas as of yet); 6) Developing loan guarantees, including sovereign debt, DCAs, and revitalize commercial bank lending; 7) Completing anti-corruption activities that affect the financial sector; and 8) Institutionalizing the national financial education, financial literacy, and consumer protection effort.

Pension Reform

Pillar II pension reform involves mandatory funded systems with individualized accounts. The purpose of Pillar II funds is to provide a higher pension replacement level for future retirees, without excessive stress on government spending. The MLSP has prepared Pillar II legislation with a two tier phased-in commencement schedule that requires revision.

Technical assistance is needed in three areas. First, to help the GOU establish the precursors necessary to successfully commence Pillar II reform. This involves technical assistance for achieving sound macro-economic policies as measured by real GDP growth, inflation, the fiscal deficit, government debt, and development assistance as a percentage of the government budget.

Second, it is imperative to develop the fledgling Ukrainian financial sector that must be able to absorb the capital collected in Pillar II investment funds, and effectively grow businesses to generate profits and develop a robust securities market. This requires technical assistance for the development of new financial instruments, securities payments settlement systems, trading platforms, accurate financial reporting of valuations and reliable transparency, and training auditors to protect financial integrity.

And third, USAID could help develop the management skills necessary for Pillar II pension fund implementation—a hurdle for every nation, and Ukraine is no exception. Technical assistance is required to train asset managers, administrators and custodians, and to assist the MLSP, FSR, NSSMC, PFU in writing the regulatory and operational rules and procedures and to enforce them.

Capital Markets Development

Securities and commodities markets development contributes to economic growth. Ukraine is not providing the functioning capital markets necessary to propel growth largely because the legal system that pertains to the capital markets is incomplete, unreliable, and prone to corruption. The NSSMC needs, and seeks, technical assistance in the following areas: 1) operational independence; 2) statutory authority to conduct effective investigations; 3) express jurisdiction over non-registered persons; 4) consequential sanctioning authority sufficient to protect the integrity of the capital market and investors; 5) outreach capability to educate the judiciary on potential securities market wrong-doing and internationally common punishments; 6) authority to conduct appropriate compliance examinations of market participants; 7) authority to engage in meaningful international cooperation and join the IOSCO MMOU; 8) procedures to license, monitor, and enforce the actors and activities of managers of capital pools created by Pillar II pension reform; 9) coordination with the MLSP, PFU, and FSR on these activities.

Commodity Derivatives in Agriculture Products, Interest rates, Currencies, Metals, Stock Indices, and Asset-Backed Instruments and Regulatory Framework

Ukraine is the only major agricultural producer without a modern commodity derivatives market.

The World Bank has stressed for over a decade that derivatives markets – with price discovery and hedging for risk mitigation – are a *core part* of any nations' economic development strategy. The Ministry of Agrarian Policy and Food's recent strategy and the NBU's "Comprehensive Program of Financial Market Developments of Ukraine until 2020" stress the economic value of and need for derivative markets. A critical first development step, as asserted by the NBU, is "improving legislation on the functioning of commodity markets to ensure transparent price formation and the development of efficient supervision."

In support of this priority, FINREP-II developed a comprehensive report, "*Roadmap: Commodity Futures Markets Development in Ukraine 2015 Onward*." It was vetted with all classes of actors in the agriculture sector, from producers large and small, processors, elevator operators, transporters, exporters, banks, and GOU regulators who are (or should be) involved in the development of derivatives markets. The purpose of the *Roadmap* was to assist policymakers and market participants to achieve two objectives. First, to create an environment for properly structured commodity exchanges. Second, to establish the infrastructure that will facilitate greater access to finance, and develop numerous risk management products.

These objectives have been thwarted in the past by market-distorting interventions by previous GOU actors (*e.g.*, the imposition of quotas, export contract registration requirements, the creation of the ACX, and NBU currency restrictions). These actions have alienated the natural users of commodity futures contracts. Ukraine's immediate priority must be to end those former distorting actions, which the Prime Minister has pledged to do.

While the USAID sponsored *Roadmap* concentrates on the agriculture sector, the essential development point is understanding that the economic concept and regulatory oversight needs are identical for all underlying commodities. Soybeans or wheat, gold or nickel, interest rates or currencies or stock indices—all commodity futures products require the same legal, regulatory, and operational protections. Proven models exist. International protocols have been established. The International Securities and Derivatives Association (ISDA) and IOSCO provide established methods and rules for successful derivatives markets operations.

USAID could commit to providing the technical assistance required for developing derivatives markets in Ukraine with technical assistance in the following areas: 1) Provide on-going legislative drafting assistance to the NSSMC and Rada on the two draft Commodity and Derivatives Laws; 2) Support GOU practices to adhere to the elimination of market-distorting practices; 3) Establish a legal and regulatory regime

for commodity exchanges that ensures financial and operational integrity; 4) Support GOU membership in IOSCO and ISDA to ensure adoption of international best practices and necessary protocols; 5) Develop greater transparency of spot market prices via an electronic platform and other means; 6) Support the NBU removal of administrative barriers for access to FX for legitimate hedging in offshore markets; 7) Support corrective taxation reform so that the application of VAT and income tax laws that apply to on-exchange commodity futures transactions conform to international practices; 8) Establish certification requirements and procedures for all agricultural commercial storage facilities; 9) Develop training programs on risk management and the uses, benefits, and risks of commodity derivatives for hedgers and speculators, commodity derivatives regulators and SROs, and facilitating institutions, such as banks; 10) Implement all initiatives as detailed in the USAID FINREP-II Roadmap.

Legal and Regulatory Reform, Monitoring, and Capacity Building

USAID has led in assisting the GOU's financial sector agencies. This support could continue through technical assistance with legal and regulatory drafting, legislative monitoring and commentary, financial sector analysis, public outreach, and leading public-private dialogues. USAID could support greater integration of financial sector regulators into international networks (e.g., IOSCO, U.S. SEC, ISDA, IFRS, FDIC, etc.). USAID could continue its direct financial support of GOU financial sector counterparts by assuming costs related to training, capacity building, administrative issues, IT systems upgrades, and development and implementation of monitoring and enforcement tools such as ESCRIN.

IFRS

Numbers are the language of finance, and the *lingua franca* is IFRS. A single set of high quality, understandable, enforceable, and globally accepted financial reporting standards exist with IFRS, and must be implemented by Ukrainian companies that seek capital. Capital markets can only be robust when financial records meet these standards of uniformity and reliability. This is the foundation of good corporate governance. Technical assistance is needed for the Ukrainian accounting professions, and at the NSSMC, MOF, FSR, and the NBU. IFRS compliant training is also necessary for the leading banks, and the bank's customers, the leading businesses borrowers. The securities exchanges in Ukraine require IFRS training, and they should in turn offer training to all listed and prospective listed companies. With USAID technical assistance, trained entities would then have a sustainable fees-for-service activity. Training could be coordinated with local entities such as UFPAA and international leaders such as the IASB and AICPA.

Loan Guarantees

Capital is more readily mobilized if the repayment risk is mitigated. For example, sovereign debt guarantees from international donors (IMF, EU, U.S., etc.) greatly reduce interest costs. USAID could introduce money-backed guarantees that

immediately spur lending. By example, USAID could promote the success of the USG's previous sovereign debt guarantees, and support their continuation.¹ USAID could also support the roll-out of DCAs to encourage lending in certain growth sectors, such as technology and agriculture. Likewise, USAID could consider establishing a Ukrainian Credit Guarantee Fund (previously discussed by other donors, including OPIC) which would guarantee bank loans to targeted SME clients in a prudent and sustainable manner. This Fund would greatly increase "additionality," so that capital is mobilized to businesses that were previously un-bankable. Technical assistance is also needed at the firm-level to improve SMEs financial management skills and profitability.

Anti-corruption Activities in the Financial Sector

The *Maidan Revolution* was a catalyst for accountability and transparency at all levels of government. It is now openly acknowledged by the GOU that corruption has spoiled previous attempts at reform, so the people and current administration have made anti-corruption a leading reform priority. USAID's Democracy & Governance Office will assuredly support the GOU's efforts to fight corruption. But, there are specific financial sector anti-corruption complementary activities that USAID's Economic Growth Office could promote. First, FINREP-II's ICRM and LCIR tools are in place at the DGF and NSSMC, and supported by the MOJ. These tools could be expanded to other GOU agencies. Second, USAID could support FINREP's key financial sector counterparts to implement corruption prevention plans (CPPs) that address specific arcane financial sector issues. This includes conflict of interest management, broker-dealer ethics, obtaining clarity on ultimate beneficial ownership, licensing, securities registration, insider trading, and capital pools management. USAID could also train judges and prosecutors on financial sector issues so they better understand, identify, and prosecute financial malfeasance. USAID could also assist financial sector institutions with procurement reform, financial decentralization, and other national reforms targeted at reducing corruption.

Financial Education and Consumer Protection

The benefits of financial education are manifold. People with financial knowledge do a better job of saving for important life moments, such as buying a home, paying for a child's education, or planning for retirement. They understand banking, borrowing, credit, and avoid large transaction fees and usurious interest rates. Financially savvy investors diversify risk. The individual decisions of financially knowledgeable people benefit themselves and their nation's economy.

FINREP-II continued the expansion of its Financial Literacy Course for students. It is now being rolled-out nationally as a core part of schools' curricula. USAID could continue support of this national roll-out, in addition to creating new courses for university students entering the workforce.

¹ FMI recognizes that USAID cannot unilaterally accomplish a sovereign debt guarantee. USAID can, however, promote sovereign debt guarantees through public outreach, financial analysis, and independent monitoring and evaluation.

USAID could also continue supporting key GOU institutions to strengthen financial literacy and consumer protection by facilitating the launch of the DGF Financial Literacy Website and the NBU adoption of a National Financial Literacy Strategy. USAID could also promote restoring public trust in commercial banks (of which one-third failed during the recent financial crisis), and provide training for vulnerable groups such as woman, the poor, and adults approaching retirement.

[End of Abridged Final Report]²

Acronyms and Abbreviations Used

DCA	Development Credit Authority
DGF	Deposit Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EU	European Union
FSR	Financial Services Regulator
GDP	Gross Domestic Product
GOU	Government of Ukraine
ICT	Information and Communications Technology
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
MEDT	Ministry of Economic Development and Trade
MOJ	Ministry of Justice
MLSP	Ministry of Labor and Social Policy
MOF	Ministry of Finance
NBU	National Bank of Ukraine
NSSMC	National Securities and Stock Market Commission
SME	Small- and medium-sized enterprise
NGO	Non-Government Organization
OECD	Organization for Economic Cooperation and Development
PFU	Pension Fund of Ukraine
TA	Technical Assistance
U.S. SEC	United States Securities and Exchange Commission
U.S. FDIC	United States Federal Deposit Insurance Corporation
USAID	United States Agency for International Development
USG	United States Government
XBRL	Extended Business Reporting Language

² The complete FINREP-II Final Report is over 80 pages in length. You may access the Report on USAID's DEC, or you may request a copy by email to fmi-hq@fmi-inc.net