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Financial Sector Analyses

Part II

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Financial Sector Development: The Need for Good Legislation and Effective Enforcement

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A basic premise for the effective functioning of the financial sector of any country is the development of core legislation and effective enforcement of the norms of the legislation. A well functioning legal and judicial system is critical to the development of the economy and builds the trust necessary for a competitive market economy. While legal traditions vary among countries, there is general recognition that in developing economies there is a "wide gap" between the formal provisions of the legislation and effective implementation. This "wide gap" is clearly evident in Ukraine and further complicated by the fact that the development of certain sectors of the economy has outpaced the legislative framework.

The business environment in Ukraine is characterized by a weak legal system, and excessive red tape and unnecessary government interference in the process. The lack of meaningful reform has resulted in Ukraine's failure to obtain recognition as a market economy, hinders its accession to WTO, and helped keep foreign direct investment below its potential.

> **"The strength of laws in Ukraine lies in the fact that they do not work."**
>
> *Volodymyr Matveev, Verkhovna Rada Deputy.*

The major hindrances to integration of Ukraine into the international economy are a lack of political will at both the executive and parliamentary level. This has resulted in failure to adopt the necessary legal framework for real economic growth coupled with the lack of an independent judiciary trained in the laws that govern a competitive market economy. The Ukrainian judiciary suffers from low wages, often-nonexistent court space and equipment, and a heavy caseload, all of which contribute to an institutionalized system of "telephone justice."

I. The Role of the Government and the Judiciary in Financial Sector Development

A brief review of the current legislative and judicial systems is essential to understand the factors that hinder economic development and the establishment of the rule of law in Ukraine. Key conclusions include:

- Activities to date have placed emphasis on economic reform on a random basis without the necessary legal framework to support and sustain this development.
- Significant legislative, procedural and enforcement gaps in the fundamental legislation hinders establishment of a well regulated financial sector, providing the legal flexibility necessary to meet the rapid changes experienced in a developing market economy.
- The legislative process is slow and opaque with little or no public involvement leading to patchwork laws that support the cronyism evident in the parliament, which is reinforced by government interference in the judicial system.
- Judicial enforcement is equally slow and opaque with limited public availability of written decisions and court decisions that lack legal reasoning or explanation.

Since Ukraine's independence in 1991, it is estimated that over 1770 laws have been enacted that govern all aspects of transforming the society and economy of the country. In the last five years, over 100 laws and substantive amendments have been adopted that directly affect the financial sector. The dramatic changes in the political, economic and social relationships resulting from this explosion of legislative enactments has resulted in unprecedented strains on new institutions created to oversee these new laws, and the judiciary called upon to enforce the new laws. The challenges facing Ukraine in developing a rational legislative framework that promotes economic growth are numerous:

- Laws are too often internally inconsistent, lack clear definitions and standards for a functioning market economy and conflict with other laws and regulations;
- Few laws contain international legal norms and standards that promote recognition of Ukraine as a market economy, or membership in the WTO;
- Gaps in the legislation promote telephone justice and fail to address the requirements for a well-regulated capital market;
- Enforcement provisions are either lacking or based on Soviet era concepts in which the administrative, civil or criminal punishment do not address or fit the violation resulting in little or no effective enforcement or deterrence;
- International legal concepts are provided in the legislation with little understanding by the legislators, the judiciary or the regulator as to the meaning of these market economy concepts leading often to misinterpretations of the law or enforcement of merely technical violations rather than substantive violations; and
- Conflicts between the new Civil Code and the Commercial Code result in lack of a clear, easily understood and enforceable legal framework.

Effective Financial Sector Legislation

2000

Jan	• Bankruptcy Law
Dec	• Law on Banks and Banking

2001

Jan	• Law on National Program on Small Business Support
Apr	• Law on Collective Investment Institutions
Aug	• Law on Financial Services and State Regulation of Financial Services Market
Oct	• Law on Individual Deposit Insurance Fund
Nov	• Law on Insurance

2002

Jan	• Law on Credit Unions
Feb	• Law on Economic Competition Protection
Aug	• Law on Innovation Activity
Dec	• Law On Conception of State Program on Adaptation of Ukrainian Legislation to European Union Legislation

2003

Jun	• Law on Prevention of Money Laundering
Oct	• Law on Basics for State Regulatory Policy in the Sphere of Business Activity

2004

Jan	• Civil Code
	• Commercial Code
	• Law on Mortgage
	• Law on Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates
	• Law on Financial and Credit Mechanisms and Property Management in Homebuilding and Real Estate Transactions
	• Law on Ensuring Creditors' Claims and Registration of Encumbrances
	• Law on Mandatory State Pension Insurance
	• Law on Non-Governmental Provision of Pensions
	• Law on Financial Leasing
Jul	• Law on State Registration of Legal Entities and Natural Person-Private Entrepreneurs

The World Bank and other international donor organizations, including USAID and the TACIS Ukrainian-European Policy and Legal Advice Centre (UEPLAC), have worked extensively in the area of legal reform with some evident successes.[1]

[1] Since 2001, USAID/FMI International Business Standards and Corporate Governance Project has held regional seminars for the judiciary on issues related to the Law of Ukraine on Business Associations and Securities and

However, many of the issues noted continue to present a roadblock to a rational legal framework and effective implementation of the rule of law.

Civil Law Regime. Ukraine, like many European countries, is a civil code jurisdiction in which its Civil Code establishes the basic provisions of the laws of the country with supporting legislation that completes the Codes. In contrast, the common law system, following the medieval English law tradition, is established on specific fact patterns in litigated cases leading to decisions that compel lower courts to follow higher courts decisions. Many of the current laws in Ukraine that govern its commercial and economic activities incorporate legal concepts based on common law concepts, particularly in the capital markets area, without the legal prescriptions in the law or the legal practice to effectively implement the common law concepts.

Basic Legal Framework. Although Ukraine is entering its fourteenth year of independence, its legal system and consequently its economic growth continues to suffer from the lack of a rational legal framework that promotes transition to a market economy. At the time of its independence a "transitional" legal framework was established that largely continues to govern the country. The transitional framework provided that until Ukraine established its own legislative acts the legislative acts of the USSR would continue in force if they did not conflict with the Constitution of Ukraine or the laws of Ukraine.[2]

Problems of the Ukrainian Civil Law Framework Impeding Establishing the Rule of Law in Economic Activities

- Letter of the law prevails over the spirit of the law.
- Checklist application of the legal provisions with little judicial interpretation.
- Limited public access to written decisions, and decisions often lack analysis and judicial interpretation of the law.
- Judges free to apply the law resulting in significantly different decisions based on the same provision of the law.
- Major gaps and unclear provisions giving judges freedom to apply the law resulting in significantly different decisions based on the same provision of the law.
- Lack of consistency and uniform application of the law.
- Lack of interpretation of the law that compel lower courts to implement the law in similar situations.
- If laws fail to specifically prohibit a particular activity then it is permitted and essentially unregulated.
- Common law concepts in laws not accompanied by specific prohibitions result in judicial misunderstanding and application of the law in an inconsistent manner.

Economic legislation establishing a capital market was adopted in the early 1990s and amendments were made to existing legislation to address new business concepts such as registration of enterprises and tax laws. Temporary procedures were put in place to address the rapid changes occurring during the early years of independence. Legal Acts, in the form of Presidential Decrees, were prepared on economic issues not regulated by the law.[3] The transitional provisions governing Presidential Decrees provided that this power would have a three year life and that

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Stock Exchange Law and related regulations and the new Civil Code, effective January 2004, governing the operations of joint stock companies and shareholder rights. The USAID/Deloitte Commercial Law Center has sponsored training programs on the Law of Ukraine on Bankruptcy, Mortgage Law, Secured Lending Law and Civil Code and Commercial Code. TACIS has worked with the judiciary on issues in the Civil Code and harmonization with EU legislation and legal methodology for harmonization of legislation with EU directives and laws.

[2] See the Law of Ukraine "On Legal Continuity of Ukraine", dated December 9, 1991 and the Law of Ukraine "On the Procedure of Temporary Effectiveness of Separate Legislative Acts of Ukraine from the Soviet Union" dated December 9, 1991.

[3] See the 1995 Constitutional Accord (adopted pre-Constitution in 1996).

simultaneously with the issuance of the decree there would be a law submitted to the Rada regulating the same issue. Presidential Decrees were to remain in force if the Rada did not approve or reject the law within 30 days. In addition to the Presidential Decrees, the Cabinet of Ministers and Ministries issued other "legal acts" that regulated economic activity. These legal acts frequently addressed crisis situations and resulted in lack of rationale legal norms.

This process has resulted in a legal framework supplemented by "legal acts", particularly when the Rada did not adopt laws supporting these acts. For example, on April 15, 2004, the Cabinet of Ministers created a new Commission as an advisory body to the Cabinet of Ministers to handle pre-court resolution of disputes between investors and executive bodies. The announced authority of this new Commission, headed by Vice Prime Minister Azarov, is to handle disputes similar to an arbitration proceeding and resolve the issue before a case is filed with the court. The decisions of this Commission are reported to be non-binding and made by general consensus of the members. The role and purpose of this Commission is not clear. The actual legal authority and enforcement powers of this "ad hoc" court system have not been publicly announced but the continuing involvement of the State in the judicial process is clear which is contrary to the rule of law.

Legislative Powers of the Government. Under the Constitution of Ukraine[4] the Verkhovna Rada, the parliament of Ukraine, is the sole legislative body of the country. It alone has the power to adopt legislative acts and amendments to existing laws that govern legal relationships for the country.

The Rada is comprised of 450 members, called Peoples Deputies, who are elected every four years for a term of four years. The next election will be held in March 2006. Of the 450 members, 225 were elected by popular vote on a regional basis depending on the population of the region, 225 members were elected based on the popular vote for a particular party list of candidates throughout Ukraine. This election process, commencing in the mid-1990's resulted in the Rada becoming more politicized and resulted in a particular party list of candidates gaining power in the Rada. As part of the political reform currently taking place in Ukraine, the Rada passed a Law on Election of People's Deputies, effective in 2005, providing for election of Rada members based on party list of candidates. This will further politicize the legislative process.

As in other countries there are numerous specialized legislative committees, and the Rada has the power to contract outside experts for assistance. There is a detailed process for consideration and approval of legislative actions. In general, one committee is assigned primary responsibility for the initial review of the legislation and obtaining views and comments from other members of the Rada. Each legislative initiative generally requires three readings before the Rada. The first reading is to discuss and consider the draft law in general, the second reading is a more intensive reading and consideration of the law by sections, and the third reading is to discuss and approve or reject the draft law. However, there may be additional readings of an unlimited number.

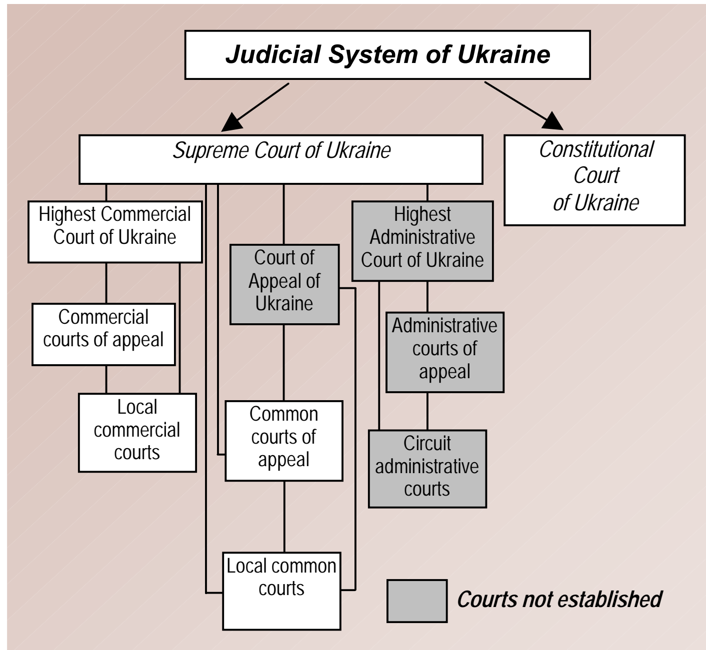
[4] See Article 75 of the Constitution of Ukraine.

While there are some exceptions, a majority of the Rada (not less than 226 votes) is required to approve a law. If the Committee assigned primary responsibility for the draft legislation fails to recommend the draft law to the Rada, only rarely will the legislation be approved. The Speaker of the Rada sends approved legislative acts to the President of Ukraine for his signature. The President, within 15 days, can sign the law into effect or veto the law and return it, with proposals, to the Rada for further consideration. If the President fails to take action within the 15 days the law is approved. This legislative process can be further extended depending on the actions taken by the Rada on the proposals made by the President.

The Verkhovna Rada, whose membership includes many wealthy businessmen, who promote their individual interests, has delayed or defeated important economic and financial sector legislation. Recently President Kuchma noted in a public statement that businessmen are trying to get into the Parliament at any cost in order to protect themselves from the law and to lobby their own interest. He noted that Rada members from large business do not place the State's interest first.[5]

> **"As for oligarchs in Parliament, they are not needed there"**
>
> *President Kuchma, March 26, 2004*

The procedure for publication and thus effectiveness of the law is cumbersome and not well coordinated leading to further issues regarding the "official" date of the law coming into force and the ability to locate the laws. The Ministry of Justice, the Rada and the President maintain records of effective legislation, however, these records are often in conflict or not necessarily maintained on a current basis leading to lack of transparency as to the effective legal framework in Ukraine. It has been stated that the best and most current source of information on legislative enactments is the mass media. This lack of transparency contributes greatly to lack of understanding of the legal framework by judges, the legal profession and ordinary citizens.

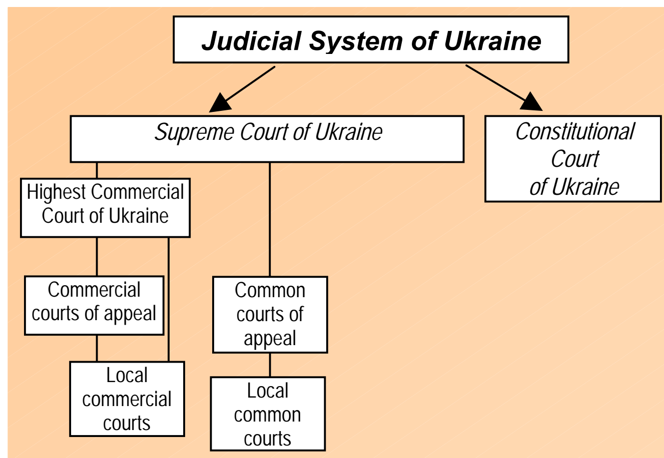


Judicial System. Under the 1996 Constitution of Ukraine, the judicial system is independent of other branches of the Government.[6] The State is required, by the Constitution, to provide financing and the proper conditions for courts to function. In 2002 the Law of Ukraine "On Judicial System" implemented

[5] Interfax News Service, March 26, 2004.

[6] See Article 125 of the Constitution which separates out judicial powers and Article 129 which establishes judicial standards based on the United Nations Basic Principles on the Independence of Judiciary.

the provisions of the Constitution and created the new court structure being established in Ukraine. The Law provided for the creation of specialized courts at the direction of the President. However, the necessary funding for the effective operation of the courts has not been budgeted.



Current Court System. Today, the Court system follows a very basic organizational structure. However, the procedures and operation of this system are quite complex and difficult to comprehend.

Constitutional Court of Ukraine. The Constitutional Court of Ukraine is to guarantee the supremacy of the Constitution of Ukraine. There are 18 judges on the Court. The President, the Verkhovna Rada and the Congress of Judges, an independent body, each have the right to appoint six judges. The Constitutional Court governs 1) interpretation of the Constitution and laws of Ukraine, 2) determining the constitutionality of the laws and legal acts of the Rada, Presidential Decrees and Resolutions of the Cabinet of Ministers, 3) consideration of compliance of international agreements of Ukraine with the Constitution, and 4) consideration of the constitutionality of investigating, dismissal and impeachment of the President of Ukraine.

Supreme Court of Ukraine. The Supreme Court is considered the highest court of general jurisdiction with final authority to consider and act on criminal, civil, economic and administrative cases. The Court has 80 judges trained under the Soviet system with some international donor supported legal training in western countries.

The Court has four sections or chambers that consider appealed cases: commercial, criminal, civil and administrative. The commercial section handles disputes between legal entities, while the civil section handles the same commercial issue if one of the parties to the action is a natural person. The criminal section handles the appeals for all criminal acts but few, if any, of the criminal acts under existing legislation involve financial crimes. The administrative section, which has not been established, is to handle all matters resulting from state institutions' sanctions imposed against legal entities or natural persons or setting aside acts of state institutions.

Under the powers granted to the Supreme Court, cases appealed to this body can result in one of five decisions. The Court can cancel the appealed case and the lower court decision stands. The Court can cancel the appeal and return the case to the lower court for a new consideration, e.g. to obtain more evidence on the case. The Court can change the lower court decision, which is binding. The Court can return the case to the lower court for new consideration with a directive to take into consideration certain issues identified by the Supreme Court, which is binding on the lower court. Anecdotal evidence strongly indicates that most decisions of the Supreme Court are returned with directives to the lower court for their consideration. Routine application

of this power results in the case usually being returned to the long, slow and expensive legal process.

Commercial Courts. Under the Soviet System the Commercial Court was the highest court in Ukraine for commercial disputes. The judicial reform in 2001 made the Supreme Court the highest court in Ukraine. In an attempt to retain its former position, the Commercial Court fought to retain its power over all commercial activities. This power struggle, to some extent, resulted in the unfortunate adoption of two competing codes, the Civil Code and the Commercial Code, more fully discussed below. The structure and legal power of the Commercial Court system in Ukraine impedes consistent and fair application of the legal norms governing a particular adjudicated issues. The Commercial Court handles the case if it involves a dispute between legal entities while the Civil Court will handle the same issue if one of the parties to the case is a natural person. This process results in different application of the law depending on the parties to the action.

The Highest Commercial Court faces an unrealistic workload with only 65 judges on the Court. For 2003 there were over 27,000 appealed cases resulting in each judge having a caseload of 416 cases for the year. To address this situation, 30 additional judges were appointed to the Court as of January 2004. The average workload of the judges in each of the four chambers of the Highest Commercial Court is equally daunting. For 2003 there were 632 cases per judge in the bankruptcy chamber, 592 cases in the tax chamber, 569 cases in the property dispute chamber, and 106 cases in the intellectual property chamber. The heavy workload on judges is further compounded by the lack of funding and low salaries of the judges. Currently, the average monthly salary of a judge is estimated at 2000 Hryvnas or $375. The actual funding of the Commercial Court for the first six months of 2004 is estimated to be only 26% of the budgeted amount, further restricting court activities. Lack of adequate court space is also a major problem.

Administrative Courts. Although the structure established by the 2002 court reform provided for creation of administrative courts, no funding or other efforts have taken place to staff and create these courts. This specialized court will serve a critical function in providing a judiciary focused on protecting the legal interest of both natural and legal entities from infringements by executive institutions and local government institutions. The establishment of this specialized court will require planning, including funding for salaries and administrative support, court space and the professional staff trained to handle these cases. In addition, work should continue on the development of the draft administrative procedural code to insure its effectiveness and that it is consistent with other recent legislation, particularly the new Civil Code, and to eliminate inconsistencies with the recently adopted Commercial Code.

State Judicial Administration. In 2001 Ukraine established the State Judicial Administration charged with the responsibility for handling the administrative issues for courts such as materials, financial support, information issues and other issues freeing the courts to focus on the primary work of hearing and deciding cases. While the concept is good, the program does not give the judiciary independence over their funding and places a bureaucratic apparatus over a judiciary struggling to be truly independent. Financial support for this additional State Administration further strains

the budget process and involves the State inappropriately in the judicial process. For example, this State body has the power to control the status of legal proceeding in all courts. This State Judicial Administration should be made accountable to the Supreme Court, which would serve as another step towards establishing a professional and independent judiciary.

The State Judicial Administration is also responsible for training of the judiciary. Steps should be taken to formalize this training program with an established curriculum, particularly in the legal concepts for a market economy, leading to certification of judges. This training should include the drafting of legal opinions that are well grounded providing for the necessary transparency in the judicial system. Establishing high quality training will lead to better and more consistent legal decisions, eliminate or reduce the opportunity for telephone justice and build the critical trust in the judiciary and the rule of law.

II. Comprehensive Legal Structure for Economic Development

Economic reform requires the passage and implementation of certain foundation legislation that promotes the development of a market economy, with necessary but limited interference from the State.

The main difference between the two codes is in their ideology. Civil Code is based on minimization of State interference in the economy. The idea of the Commercial Code is that the State should be more actively involved in the economy and restrict monopolies in the interest of all producers and consumers.

"Business" Legislation: Roundtable, December 15, 2003

Civil and Commercial Codes. The Civil Code and the Commercial Code both came into effect in January 2004, and together they establish the legal framework for contracts and other business agreements. Although these two Codes do not duplicate one another, they overlap and regulate differently the same relations and issues. Thus, two different legal standards apply to an issue, with neither Code being recognized "officially" superior to the other Code.

As a result, Ukraine has entered into an era of great uncertainty and potential legal chaos from these competing Codes. While there is pending legislation in the Verkhovna Rada to bring existing laws into compliance with the new Civil Code, e.g. the Law of Ukraine on "Business Associations," this will not address the application of the conflicting provisions of the Commercial Code governing these enterprises. A patchwork legal system based on old Soviet legal concepts and outdated laws will continue.

Ukrainian legal experts have stated that the Commercial Code specifically governs "peculiarities of commercial relations of the subjects of business activities", and that the Civil Code regulates only small everyday transactions between natural persons. This conflict will reinforce the power of the Commercial Court while promoting inconsistent decisions on substantially similar legal issues. It is clear that the existence of the Commercial Code will be a serious obstacle to Ukraine's recognition as a market economy and membership in the WTO.

One of the major legal issues is the lack of clear definition as to the meaning of "commercial relationships." In a specific case an entrepreneur, judge or official will

determine whether a particular transaction is deemed "commercial" and which Code governs. This is expected to result in the cancellation of numerous court decisions not because of judicial error but because of poor legislation. For example, in a contract the Commercial Code mandates that the price be provided as a material element of the contract while the Civil Code does not.

An even more difficult legal issue is which Code applies when a new legal entity is created. Because of the difference in the provisions of the two Codes, an entrepreneur may be forced to select one Code over the other, resulting in infringing one of the Codes.

> **"When the WTO headquarters looks at the [Commercial Code] they will send [Ukraine] behind the Antarctica and [Ukraine] will join the WTO only after the penguins."**
>
> *Anatoly Yefimenko,*
> *Kyiv Institute of International Relations,*
> *December 2003.*

The Civil Code provides for the creation of business associations and production cooperatives, with no mention of state enterprises, public utilities or closed joint stock companies. The Commercial Code creates the legal foundation for "closed" joint stock companies. These closed joint stock companies, in which most citizens of Ukraine received shares in privatization, will be regulated differently than other joint stock companies and minority shareholders will have fewer protections.

The Civil Code provides that the State can create enterprises, such as joint stock companies, with the same regulatory regime as for private sector enterprises established under the Code. However, the Commercial Code provides that the State will own the property and that the enterprise will have only the right to "operate" the property with some limitations on the right to encumber or sell the property. The two Codes are in conflict and unclear as to the legal framework governing State owned property. In addition, there is no current legislation on the procedures regulating the limitations on selling or encumbering State property that is subject to "operation" by an enterprise. There is no control or accountability for State enterprises created under the Civil Code and some Ukrainian experts argue that use of Civil Code provisions for creation of State enterprises will result in the economy of Ukraine going further into a shadow economy and criminality. Because of the lack of clarity and regulations governing the limitation on sale and encumbering State property under the Commercial Code, it appears that use of either Code for regulation of State property may have the same effect.

The existence of the two competing Codes negatively influences the business climate in Ukraine with major adverse consequences for the economic development of Ukraine. Efforts should commence immediately to resolve this conflict and to address gaps in the Civil Code.

Draft Joint Stock Company Law. The corporate governance legal framework in Ukraine is not in compliance with international standards. The European Bank for Reconstruction and Development (EBRD) Corporate Governance Sector Assessment Project Report For 2003 ranks Ukraine in the lowest category, very low compliance, because of the lack of a joint stock company law.

The Law of Ukraine on "Business Associations", effective on October 1, 1991, is the current legal framework for the establishment of legal commercial entities, including

joint stock companies. In the fourteen years since its enactment, the development of the business sector has out paced this legal framework resulting in many corporate conflicts. In addition, the Law has serious gaps that result in major abuses of the rights of 18 million small shareholders. This outdated legislation fails to include critical international norms, leading to “asset stripping”, unregulated transactions with management of the enterprise, share dilution, and concealment of profits. These flagrant violations of international norms coupled with the lack of effective enforcement and equal treatment of all shareholders has limited foreign direct investment needed for economic growth.

Despite attempts in July 2001, November 2001 and again in July 2003, the draft joint stock company failed to pass a first reading in the Verkhovna Rada. Currently there is pending in the Verkhovna Rada a draft joint stock company law submitted by the Cabinet of Ministers on December 18, 2003. This current daft is characterized as “compromise legislation” prepared by the Securities and Stock Market State Commission, at the request of the Cabinet of Ministers, to address the objections of the businessmen and others who are powerful members in the Rada. Among the “compromise” changes to the current draft joint stock company law are the following:

- Closed joint stock companies are not required to become open joint stock companies regardless of the number of shareholders. This compromise will require all shareholders of the closed joint stock company to offer to sell their shares to current shareholders based upon an independent appraised value. Given the current equity ownership of these enterprises, in which management owns the majority or control of the company, the implementation of this process will affect adversely minority shareholders, the vast majority of whom received their shares as part of the privatization process. In addition, the lack of reliable financial statements prepared in accordance with international standards coupled with the lack of appraisers well trained in valuations for a market economy will hinder establishment of a fair price for these required sales.
- The definition of “affiliated person” has been narrowed and the draft law eliminates the right of shareholders to vote on these transactions at general meetings.
- Supervisory board members terms of office are increased from one year to three years.
- Mandatory purchase of the shares of small shareholders who vote against a major transaction such as a merger has been limited.

While many of the members of the Verkhovna Rada have not publicly announced their reasons for opposition to the draft joint stock company law, much of the anecdotal evidence suggest that the reasons are not well founded. Some comments as to the reasons that the draft law has not been enacted are result from “careless attitude to ownership rights characteristic of the Soviet time,” “the current situation is more comfortable for everyone,” “the executive power is not interested in the draft Law,” and “large owners in the Verkhovna Rada do not want their rights infringed.”

The Action Plan of the Cabinet of Ministers of Ukraine for 2004, approved by the Verkhovna Rada, lists among its top priorities the enhancement of corporate governance and the adoption of the Law of Ukraine "On Joint Stock Companies." To date there has been little government support for passage of this legislation.

There have been several public events promoting the passage of the draft joint stock company law. Portfolio investors who have significant investments in Ukrainian joint stock companies but remain minority shareholders with little or no protection of their rights have been interested participants. Further educational work with the Verkhovna Rada members, representatives of the business community and others is required to inform them on the benefits of a joint stock company law in compliance with international market standards. Effective implementation of pension reform will similarly dictate adoption of the joint stock company law, since pension fund portfolio managers seek investments in Ukraine with the necessary legal framework to protect their investment.

Failure to provide the fundamental legal framework embodied in the draft joint stock company law has serious negative impact on financial sector development. Foreign direct investment will not improve as Western investors seek a more rational legal scheme, such as that existing today in Eastern European countries and Russia. These investments will naturally flow to countries where there is greater legal certainty for the investment. One major portfolio manager has stated that his company is currently selling its minority interest in Ukrainian enterprises and has established a new policy of investing only as a majority shareholder in Ukrainian companies. If Ukraine is to be integrated into the global economy, recognized as a market economy, obtain membership in WTO and the European Union, it will be necessary to pass a modern joint stock company law.

Securities Law. The capital market of Ukraine is regulated by the Securities and Stock Exchange Law dated June 18, 1991. Like the Business Association Law of the same vintage, this Law is outdated and does not provide the necessary legal framework for a well-regulated capital market. On March 25, 2004 the Cabinet of Ministers sent to the Verkhovna Rada a draft "Law on Securities and Stock Market."

The pending draft law provides for few, if any, internationally recognized norms for effective operation of the capital market. This draft law, like the current Law, suffers from major deficiencies:

- There are few definitions of terms, which establish the basic provisions of the law.
- The list of securities is narrow and thus limits the types of securities available for trading on the market. This narrow list combined with other provisions of the law permits issuance of securities that should be regulated but are not, e.g. debt instruments offered by a natural person to the public, investments in pyramid schemes, options and other derivatives, etc.
- The list also includes as securities instruments that are termed securities by other legislation but are not commonly viewed as securities thus subjecting these instruments to regulation by the law and restricting normal commercial transactions. For example, the draft law includes as a security "mortgage

letters" which are merely provisions in a mortgage contract that allow the primary bank to transfer the mortgage to another bank.

- With respect to disclosure the draft law continues the same general provisions providing for information on financial activity of enterprises, annual, quarterly and ad hoc, but lacks sufficient detail to insure that Ukraine moves to international standards of transparency.
- The draft law continues the current provision that public companies publish information in official State publications that are not readily available to the public market and adds unnecessary cost for public companies. This appears to be a continuing lack of recognition that transparency is to serve the market and not the State.
- Similarly, the draft law continues the requirement that registrars provide information on owners of 10% or more of the securities of a company to the regulator. Under international best practices, registrars should treat this information as confidential and not disclose this information to anyone, including the regulator, absent a formal investigation or court directive. The natural or legal person who is the 10% owner of the enterprise should be required by law to provide this information and be subject to liability for failure to provide accurate and timely information.
- The draft law provides that all shareholders are insiders and the regulator defines what is deemed "inside information." The draft law further provides that "insider trading" provisions apply to listed companies only and not all public companies.
- The draft law continues to provide for self-regulatory organizations, however, the law does not provide for oversight and enforcement by these entities which is a basic international norm for these organizations.
- The "Law of Ukraine "On State Regulation of Securities Market" does not provide appropriate enforcement powers tailored to the substantive abuses and violations in a capital market. For example, there are inadequate provisions governing false disclosure, insider trading violations, or market manipulation activities. The administrative penalties cover routine violations e.g. failure to obtain a license, failure to file information timely, or failure to comply with the regulators orders. The administrative penalty is small and has no deterrence effect on the behavior of the violator. For example, the penalty for failure of an individual or official to obtain a license for any securities market activity is a fine of 20 to 50 times citizen's subsistence tax-free income, or a $64 to $160 penalty.

Accounting and Auditing Law. The essence of transparency in any economic activity is based on consistent and reliable reporting of financial results. One of the five OECD principles of corporate governance is that "*Information should be prepared, audited, and disclosed in accordance with high quality, internationally recognized, standards of accounting, financial and non-financial disclosure, and audit.*" Ukrainian financial statements are prepared primarily for tax purposes and are based on National Standards of Accounting, which are viewed as "substantially" in compliance with International Standards of Accounting and International Auditing Standards.

The Government should adopt new laws that require financial reports to be prepared on the basis of International Accounting Standards and International Standards of Auditing by highly qualified accountants. Immediate transition to international standards, accompanied by reconciliation for tax purposes, will increase tax collection, provide reliable basis for tax collection, reduce off-shore transfer of cash and other assets, promote the development of the economy, and reduce unemployment as the accounting and auditing profession increases to support the growth in the economy.

Bankruptcy Law. In market economies, there will always be the need for bankruptcy legislation that provides a fair, predictable and consistently enforced process to address financial failures. The by-product of a market economy is financial failure of enterprises or their inability to meet their debt obligations when due requiring some reorganization or workout procedures with creditors to allow the enterprise, if it is financially viable, to continue to operate.

The Law of Ukraine “On the Restoration of Solvency of the Debtor or Declaring it Bankrupt”, effective in 2000, was an important step forward. There has been extensive training of judges, lawyers and others on the law but continuing work in this area is necessary for the law to be effectively implemented.

There continue to be major problems with certain provisions of the Law relating to a smooth and orderly process for the issuance of shares in reorganization such as “debt-for-equity” swaps permitting old shares to be cancelled and allowing new shares to be issued to creditors who take an equity position for some or all of their debt. The role of the bankruptcy trustee should be more clearly defined in the bankruptcy law, including enforceable fiduciary obligations, and the Law harmonized with other relevant laws such as the securities laws and the joint stock company law.

The EBRD, in its support for transition economies, has an on-going assessment of bankruptcy laws. In its 2003 assessment of the bankruptcy law of Ukraine, the following advantages and weaknesses were identified: [7]

Positive Compliance Provisions

- Speedy hearing and determination of proceedings.
- Adequate stay/suspension of action provisions on the opening of proceedings.
- Representation of creditors through a committee.
- Priority provisions.

Serious Weaknesses and Defects

- Debtor delivery of property and information to trustee.

[7] See www.ebrd.com/country/sector/law/insolve/about/main.htm

- Reorganization: no independent assessment of plan, lack of provisions for material information, lack involvement of all creditors, and no supervision of the plan.
- Barely basic provisions for avoidance of pre-bankruptcy transactions.

Additional Weaknesses

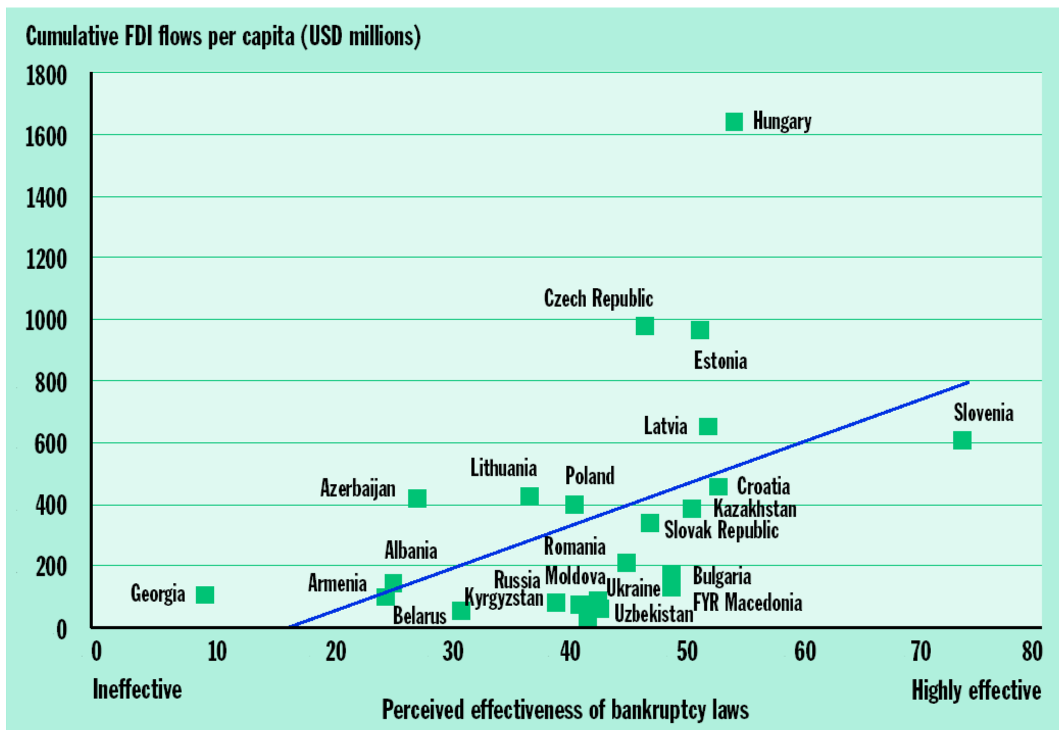
- Complicated requirements for filing application to initiate the process, including employee consultation.
- Debt must be at least 3 months overdue before commencing proceeding.
- Absence of individual notice to creditors of the proceeding.
- Qualifications required for appointment as an insolvency representative (trustee).
- Absence of set off.
- Sanctions for creditors who fail to file timely.
- Insufficient sanctions for failure to comply with the law.
- Absence of provisions dealing with recognition of cross-border insolvency.

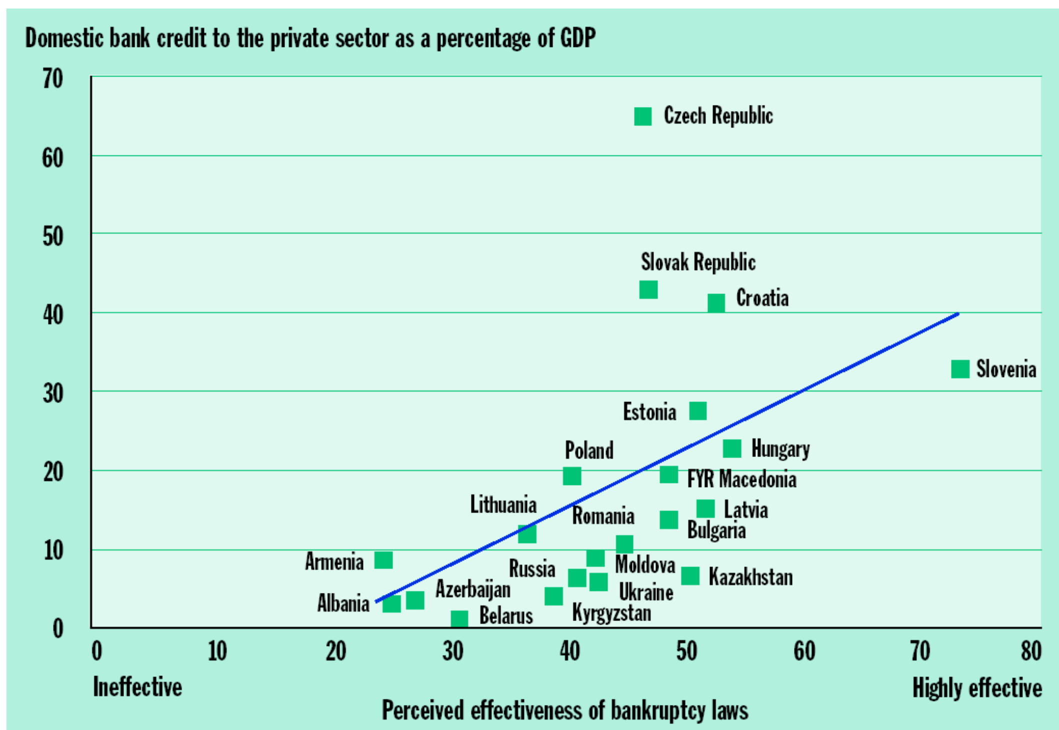
Clear and effective bankruptcy laws have a positive effect on the economic growth of a country. They provide a process for debtors and creditors to negotiate and debtors are encouraged to service their debt within the terms of the loan agreement. In addition, they avoid unnecessary liquidation of an enterprise that is facing cash flow or other short-term financial difficulties with the related community benefit of continuing operation of the enterprise and maintaining stability of employment.

The EBRD report[8] shows that effective and efficient bankruptcy laws have a positive effect on both foreign direct investment and domestic bank credit to the private sector. As seen from the charts on the following page, there is strong evidence that country scores for legal effectiveness act as significant indicators of the ratio of private sector credit to the GDP. Another positive correlation exists between country scores for insolvency effectiveness and flows of FDI. The report notes that it is the effectiveness of the legal framework and not the adequacy of the legislation that is the determining factor with respect to the relationship between the laws and FDI and domestic bank credit. Ukraine should take steps to address the recognized weaknesses in the current bankruptcy law and improve enforcement of the law to reap the benefits leading to greater growth of the domestic economy and support of the Government economic plan for 2004 to increase FDI.

[8] Ibid.

Foreign direct investment (FDI) and domestic bank credit to the private sector are highest in countries with effective insolvency laws





Ukraine can learn important lessons from the collapse of Parmalat SpA, the largest corporate scandal in Europe. The failure of Parmalat has put the Italian bankruptcy procedures under the international spotlight and has raised questions as to future investments in Italy. It is reported in the international financial press that Italian companies have found that the international debt markets are closed to them and that the cost of borrowings has increased.

III. Enhancement Legislation for Market Economy Development

Experience with economic transition and the frequent financial crises in developing and emerging market economies confirms that weak core legislation is incompatible with sustainable financial sector development. It is equally important to promote passage of other legislation that will drive economic growth and improve the living standard of the society. In 2004 Ukraine enacted two mortgage laws and a secured lending law that should promote domestic banking credits to the private sector and be the basis for new instruments on the capital market.

Enhancement Legislation

- **Mortgage Law**
- **Mortgage Registry**
- **Secured Pledge Law**
- **Secured Pledge Registry**

Mortgage Law. Availability of adequate housing was a critical problem during the Soviet period, and this situation only worsened with the collapse of the Soviet Union because private funding failed to meet demand. There was over a 70% decline in residential construction from 1985 to 2001. Even today the demand for mortgages is not being satisfied, with estimates that the demand in Kyiv alone is between US $200 and US $400 million. Ukrainian banks currently advertise 10% interest rate mortgage loans with a 30% down payment, but the reality is that most bank loans are for only 4 years with a 50% to 70% down payment.

The Law of Ukraine "On Mortgage" came into force in January 1, 2004. It establishes procedures for pledging immovable property and actions by creditors in case of default. However the draft Immovable Registry Law passed only a first reading in June 2003, resulting in a legal vacuum impeding the implementation of this critical legislation.

The Law On Mortgage provides for refinancing of the mortgage creating a "mortgage letter" as part of the initial mortgage allowing for the transfer of the mortgage by endorsement of the mortgage letter. The holder of the mortgage letter will have the same rights established by the initial mortgage. However, the Law defines the "mortgage letter" as a debt security subject to regulation by the Securities and Stock Market State Commission. In substance, this "mortgage letter" is merely a commercial contract provision and does not have any of the attributes of a "security" as that term is commonly understood. Regulation by the Commission will add another bureaucratic layer to the process and further complicate the mortgage refinancing process.

The lack of a procedure for registration of mortgages and legal conflicts with the new Civil Code has almost halted the functioning of the mortgage system in Ukraine. While the Law on Mortgage required that the Cabinet of Ministers establish, within

two months of the effective date of the Law, a temporary procedure for the mortgage registry, this was not accomplished. A lawsuit by the Kyiv Banking Union against the Government resulted in the establishment of temporary procedures for State registration of mortgages by the Ministry of Justice, which became effective March 31, 2004.

The limited public details of the temporary procedure raise questions as to the legal adequacy and effectiveness of the process. Under the temporary procedures both State notary offices and private notaries who sign agreements with the Ministry of Justice Information Center can be registrars. As registrars they will make entries based on the notice of the creditor. If the registrar refuses to make an entry to the Registry then within two business days the registrar must provide a written statement of the reasons for his refusal to the creditor. In case the registrar makes a positive decision on the application the entry must be made on the day of application. However, the procedures provide that the day and time of making an entry in the register is the day of state registration. Lack of clarity in the language of the procedure, compounded by the different timing issues and the fact that many different registrars enter the data fail to provide legal guarantees of the creditors priority. There are no clear enforcement provisions or control over this process resulting in additional uncertainties.

The Law on Mortgage is viewed by experts as a positive step forward but the existence of a second law on mortgages, the Law of Ukraine on "Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates," effective January 2004, results in inconsistent and overlapping legislation.[9] The noted problems between the two existing laws include the following:

- Different limitations on loan to value ratios;
- Conflicts in the notice and periods to cure defaults;
- Pricing of mortgaged property in foreclosure proceedings;
- Different treatment of third party interest in the mortgaged property;
- Relationship between the first and subsequent mortgages not specified and clear;
- Only one law provides for a mortgage letter.

To effectively regulate the development of mortgages it is important that Ukraine harmonize the existing Laws with other domestic legislation to insure its effectiveness and address the legal gaps in the Law. It is also important to implement recognized international norms for protection of the rights of all parties to the transaction including subsequent purchasers of mortgages in sale or refinancing transactions.

Public Offering of Mortgage-Backed Securities. The Law on Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates, effective January 1, 2004, was specifically designed to address the current lending practices of Bank

[9] International Conference, "Legal Framework for Mortgage Financing System in Ukraine, Kiev, April 22-23, 2004, sponsored by the Ministry of Finance, World Bank and OSCE. Presentation of Steven Butler, dated April 22, 2004.

Arkada. This Law appears in many respects to overlap the Law on Mortgage by establishing another but conflicting regime for granting of mortgage loans. It also creates a new regime for mortgage asset management to control pooled assets that are pledged to secure the new securities created by the Law, mortgage certificates. In addition it provides for a mortgage on "to be constructed property." The established price for the "construction mortgage" is not clear and conflicts with the Law on Mortgage, which requires the establishment of a contract with a firm price.

Enforcement procedures are only generally described. Broad powers are given to the bank to provide any provisions in the loan agreement and there is no legal framework to address the rights and obligations of the parties to the agreement. This can result in limited legal protection for the purchaser who is a party to the "construction mortgage" contract. There is no independent supervision over this risky construction contract.

Construction financing, even in developed markets, is high risk financing. Risk often results from the potential bankruptcy of the contractor, significant delays in completion of the construction, lack of necessary construction material in a timely manner, increased cost of materials and labor, poor construction leading to an impossibility to complete the construction as originally designed, without significant additional cost. Monitoring of the construction financing is usually performed in developed markets by well qualified banking specialist with expertise in the problems related to risk associated with this type of financing and the continuing control over established benchmarks for this risky loan. These risks are never transferred to the purchaser of the property, particularly the individual purchaser of a home or apartment.

The Law creates a new mortgage backed security, a mortgage certificate, that can be pooled by a creditor bank. However, the powers of the creditor bank are neither defined nor described in the legislation. There is also a provision in the Law for an inflation indexing procedure, which is to be applied against the initial mortgage. This process and procedure is not clear but appears to increase the cost of the initial mortgage to the detriment of the initial purchaser.

The process for the control over this new instrument is assigned to three regulators, the National Bank of Ukraine, the Securities and Stock Market State Commission and the Financial Services Regulator (FSR, also known as the State Commission for Financial Services Markets Regulation). However, their powers and functions are not clearly defined. Equally troubling for a fair and transparent market is that the National Depository will have control over the registration and circulation of this instrument. A license must be obtained for the issuance and circulation of these new instruments but the regulator responsible for issuing this license is not specified. The Law creates a trustee and a mortgage manager whose defined duties appear to overlap with no standards governing their conduct or enforcement remedies if they fail to act in a prudent manner.

In summary, this "special " Law raises several substantive legal issues:

- The terms and procedures of the Law are not well defined and thus the protections afforded to the initial mortgagor in this scheme are not provided.

It can be argued that under the broad provisions of the Law the "mortgages" on property subject to construction and further indexed to inflation factors increases the cost of the initial mortgage. If the natural person or legal entity cannot pay this adjusted price, he may well loose his property and the funds paid at the time of the initial contract. In some cases, the initial contract may require the purchaser to pay the full cost of the "to be constructed" property.

- The concepts in the Law fail to implement any recognized international norms for factoring transactions and regulation of pools of mortgages in such factoring transactions.
- The Law's provisions for disclosure of information are very limited and technical and provide that only banks issuing the mortgage certificates have the power to determine the additional information to be provided on these certificates. Information standards must address the risk and rewards of this new instrument permitting an investor to be fully informed and able to access the investment.
- Enforcement provisions and the method of actual implementation are limited and unclear.
- The Law does not provide how the liabilities under the mortgage certificates will effectively operate based on payment from the principal, interest and maturity of the pool of mortgages.

Efforts should commence immediately to address the problems raised by this "special" Law and reconcile its proposed operations with the Law on Mortgage, the securities law, and the powers of the three regulators. To provide for an orderly and well-regulated market the definitions of securities and the regulation of these securities should be subject to one regulatory system with the necessary powers to regulate this market in accordance with international standards. Where dual regulation is necessary, e.g. banking regulator and securities regulator, their specific powers should be well defined in the law.

Draft Law on Mortgage Securities. In February 2004, the Cabinet of Ministers submitted to the Rada a draft law on mortgage securities as the key legislation governing the public offering of mortgage backed securities. To date this draft Law has not been considered by the responsible Rada Committee. Ukrainian experts recognize that this legislation is an essential part of the legal framework for attracting long-term money from the capital market to support mortgage financing.

The draft Law addresses general provisions for the issuance and circulation of two types of mortgage securities – mortgage certificates and mortgage bonds. The draft Law specifically provides that mortgage certificates will be regulated by the "special" Law on "Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates" discussed above. Thus, in effect, it appears that the draft Law will regulate only the offering of mortgage bonds issued by banks and other financial institutions but not the issuance of mortgage bonds by public joint stock companies.

The regulatory scheme in the daft Law contains provisions for three regulators of mortgage bonds, the National Bank of Ukraine, the Securities and Stock Market State Commission, and the Financial Services Regulator, with very general provisions

regarding their powers. Because the draft law governs the public issuance of securities, the role of each of these regulators, particularly the Financial Services Regulator, needs to be more specifically described to eliminate overlapping regulation and unnecessary expense relating to the issuance of these new instruments.

The draft Law contains many good provisions for the regulation of this market. These provisions include requirements for a prospectus, prohibitions on second mortgages, and establishment of the priority claim of mortgage bondholder and grants authorities for a general meeting of bondholders with specific powers. Also, the Law creates a manager of the mortgage bond, similar to a trustee, who is not affiliated with the issuing bank or other financial institution and is to act exclusively in the interest of mortgage bondholders. The draft Law lacks specific standards as to the meaning of the requirement of the manager "to act exclusively in the best interest" of the bondholder and no meaningful enforcement powers are provided. Enforcement powers should be clear, specific, and sufficient to provide a deterrent.

There are several other provisions of the draft Law that raise questions as to whether the provisions can be effectively implemented. For example, there is a provision in the draft Law for a guarantee for mortgage securities under certain circumstances but the procedures and requirements for this guarantee are not provided. It is not clear how the guarantee will work with the pledge of the mortgage asset. There are several definitions in the draft Law, e.g. mortgage asset and mortgage coverage that are unclear and not well defined in the context of the intended purpose of the draft Law. For example, the definition of "mortgage asset" refers to the rights of the issuer under a mortgage contract and "an agreement to maintain the real value of the respective obligation, if any." It is not clear who creates the real value agreement, how it is priced and the real value determined, and how this is deemed a mortgage asset.

Mortgage financing is one of the most important capital market segments of many developing economies, particularly the development of mortgage bonds, which are highly favored debt instruments for pension funds. It is necessary to resolve the major gaps and inconsistencies in the current legal regime in Ukraine if this market is to develop.

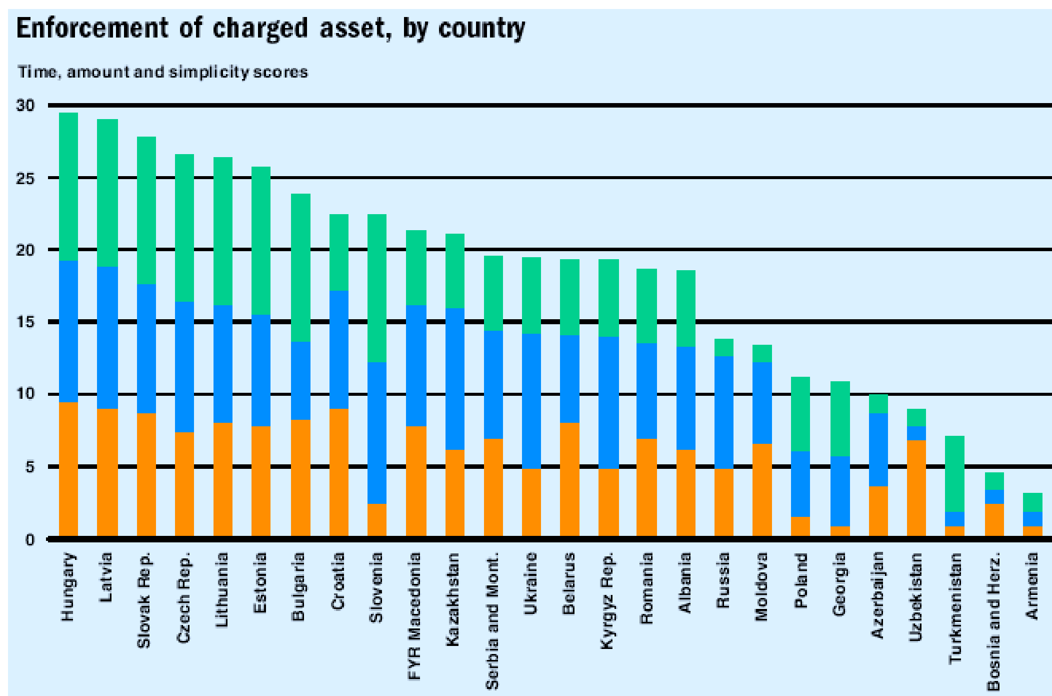
<u>Secured Pledge Law.</u> Secured transactions laws reduce the risk associated with extending credit, promote confidence that the creditor can recover the credit in the event of financial difficulties of the debtor, and promote more favorable credit terms for the debtor.

The Law of Ukraine "On Securing Creditors Claims and Registration of Encumbrances" became effective on January 1, 2004. This Law established the legal regime for creation, registration and enforcement of all categories of encumbrances on movable property including pledges, leases, sale/purchase agreements, tax liens and other private and public encumbrances. The Law provides that the registered pledge has a higher priority over non-registered pledges and that the priority is defined by order of registration. In addition the Law provides for a State registry for movable property subject to encumbrances. However, in practice, the Law's provisions governing registration raise questions as to the enforceability of the process. The Law states that the registration will be based on the day, hour and minute of making the entry to the State Registry while another provision of the Law states that entries in the

Sate Registry must be made within the same business day. To date the Cabinet of Ministers has not established the process and procedures for the State Registry.

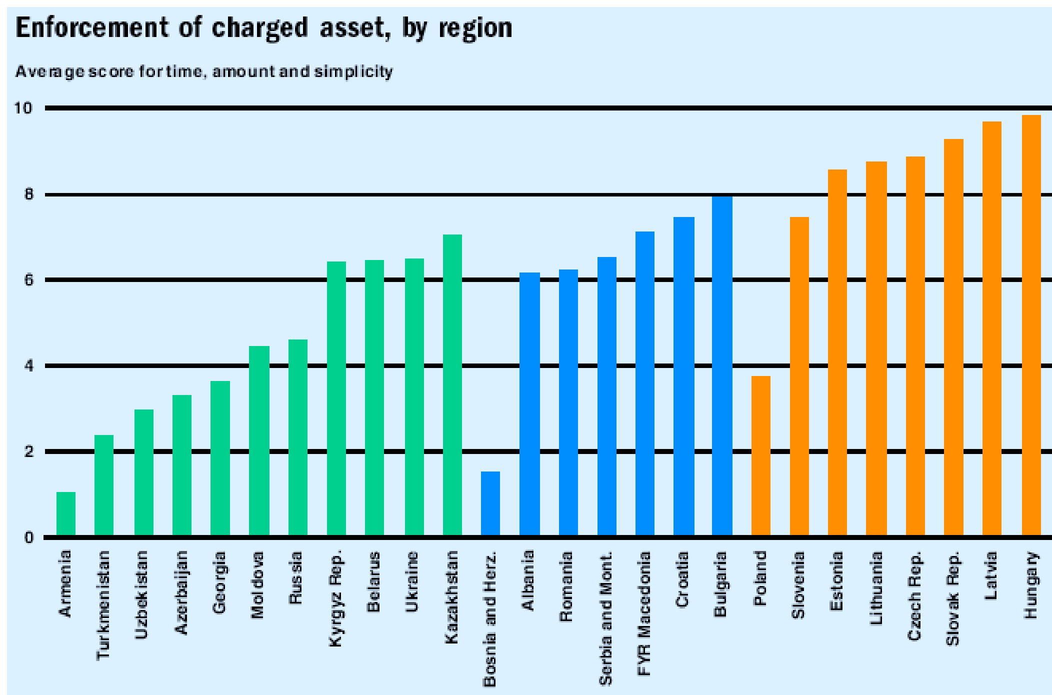
This Law, like the Law on Mortgage, does not provide for the public offering by an issuer of a bond or debt secured by its movable property such as equipment or other assets. The same issues as noted above with respect to the Mortgage Law prevent an orderly process for issuing secured public debt and effective registration and priority of debt holders.

The recent EBRD initial assessment of secured transaction laws in various countries ranked these laws, on a scale of 0 (worst) to 10 (best) as to how much a secured creditor can expect to recover (amount), how quickly (time) and how easily (simplicity). Ukraine's law received scores of 8 for amount, 5 for time and 6 for simplicity. Other countries in the region, Hungary, Latvia, Lithuania, Estonia, and Bulgaria, all scored considerably higher. Ukraine should look to the provisions of the secured transaction laws in these countries and modify its legal scheme accordingly.



Time Amount Simplicity

Source: EBRD New Legal Indicator Survey, 2003.
Note: Data for Tajikistan were not available. Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only. Ratings for each dimension range from 0 (worst) to 10 (best).



■ CIS ■ SEE ■ CEB

Source: EBRD New Legal Indicator Survey, 2003.
Note: Data for Tajikistan were not available. Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only. This graph shows the unweighted average scores for time, amount and simplicity, ranging from 0 (worst) to 10 (best).

IV. Summary and Recommended Actions

In spite of the passage of numerous laws over the past two years important to developing an effective financial sector, much remains to be accomplished. Ukraine's laws and regulations governing financial markets activities are frequently internally inconsistent, lacking in clear, workable definitions, and not harmonized with international standards. Further, Ukraine's laws frequently conflict one with the other, or permit overlapping jurisdictions, such as with the new Civil and Commercial Codes. And even if the laws were model statutes, enforcement would remain problematical because of weaknesses in the judicial and regulatory systems.

Several priority steps must be taken to strengthen the legal and regulatory framework for financial sector development and to establish an independent, competent judiciary. The key actions required include:

- Establish a program, with the Minister of Justice’s Interdepartmental Coordination Council and the Verkhovna Rada Committee of European Integration, to improve legislative drafting, eliminate internal inconsistencies in the existing legislation and insure financial sector concepts are adequately addressed in the legislation implementing the Civil Code, with adequate remedies and enforcement provisions.
- Develop program for formal and transparent lawmaking mechanism including private sector input leading to a self-sustaining system for lawmaking based on consensus and private sector understanding and need.

- Amend the Civil Code to eliminate gaps and provisions not in conformity with economic norms for a free market economy.
- Eliminate the Commercial Code.
- Passage of new laws for the securities market, especially a joint stock company law consistent with international corporate governance standards.
- Develop a coordination council among the international donor community to work on activities and technical assistance to the Government of Ukraine relating to the drafting and technical advice on legislative initiatives to insure not only compliance with European Directives and WTO requirements but international norms for an effective legal framework and adequate enforcement provisions.
- The international donor community should establish a working group in coordination with the National Bank of Ukraine as the lead regulator, in cooperation with other regulators, to address the significant problems with the current legislative regime governing mortgages to permit this market to develop based on sound legal and financial concepts leading to real growth for the economy.
- Develop the Pledge Registries for both movable and immovable property to insure their legal effectiveness, eliminating possibilities for corruption of this system with effective civil and criminal liability for improper operation of the system.
- Foster an investor friendly lending program that addresses the need for court reform, bankruptcy and enforcement practices.
- Provide extensive practical training and certification of the judiciary in the legal concepts underpinning a free market economy.
- Establish a training center under the Supreme Court that will provide in-depth training, manuals and other materials for effective performance of the judiciary.
- Support and promote publication and transparency of judicial decisions governing the economic sphere of Ukraine.

Review and Analysis of the Ukrainian Banking Sector

By

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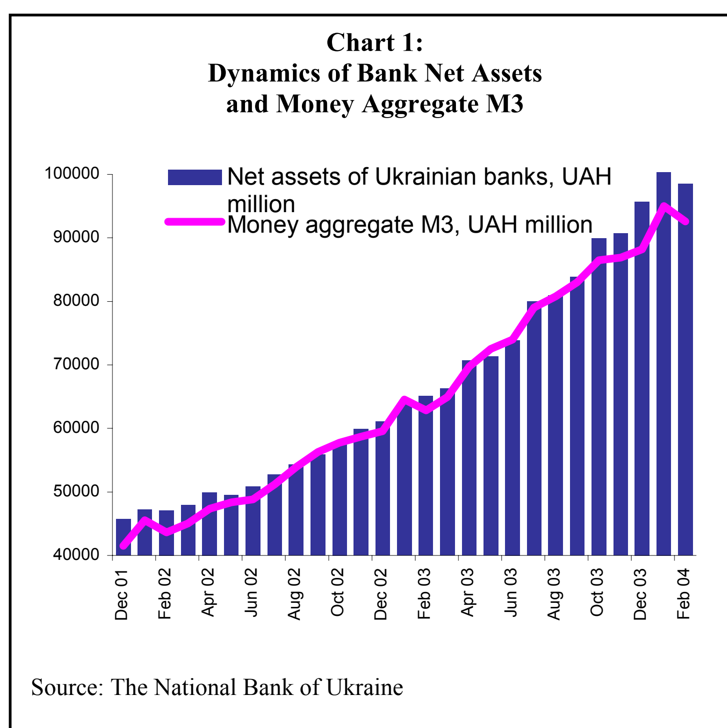
May 3, 2004

I. Overview of the Ukrainian Banking Sector

The Ukrainian banking sector began with five state-owned banks that are commonly referred to as 'Legacy Banks', inherited from the Soviet system.[1] The financial condition of these institutions was weak and they had only limited resources available to support the real sector. Consequently, the initial growth in the establishment of new privately-owned commercial banks was dominated by the major industrialists who needed to create channels for funding their various enterprises. Noteworthy development in the banking sector first began with the economic turnaround in 2000, with the first positive growth in GDP since independence, a 6 percent decline in inflation, a stable exchange rate for the Hryvnia, and a strengthened budgetary situation.

The Ukrainian banking system has grown very rapidly over the past few years, reflecting an improving operating environment and strong rise in public confidence in the commercial bank sector. Nevertheless, the sector remains small in size with total assets in the system of less than US$ 20 billion and low ratios of total bank capital to GDP of < 5%. The overall level of intermediation within the economy for the banking sector is considered low, representing approximately 35 percent of 2003 GDP, while average bank deposits total approximately 20% of GDP.

Chart 1:
Dynamics of Bank Net Assets and Money Aggregate M3



Source: The National Bank of Ukraine

The importance of Ukraine's banking system as a component of the economy increased considerably in 2003. A key indicator – the ratio of total net assets of banks to country's GDP – rose by almost 10 percent during the last year. The main reason for this was the government's loose monetary policies, the ratio of money supply to GDP to rise. Traditionally the total volume of commercial bank' net assets has corresponded closely to the volume of the broad money aggregate M3. However, since September 2003, net assets of the banks have started to grow faster than the money supply, a sign that corresponds with international economic trends where overall economic development is measured by a larger share of bank net assets in GDP than that of the money aggregate M3.[2] In general, the more economically

[1] The 5 legacy banks were: Prominvestbank, Bank Ukraina, Ukrsotsbank, UkrEximbank and Oschadny Bank (savings bank). Today only Oschadbank and UkrEximbank remain state-owned and Bank Ukraina is under liquidation due to its high level of NPLs and extreme undercapitalization.

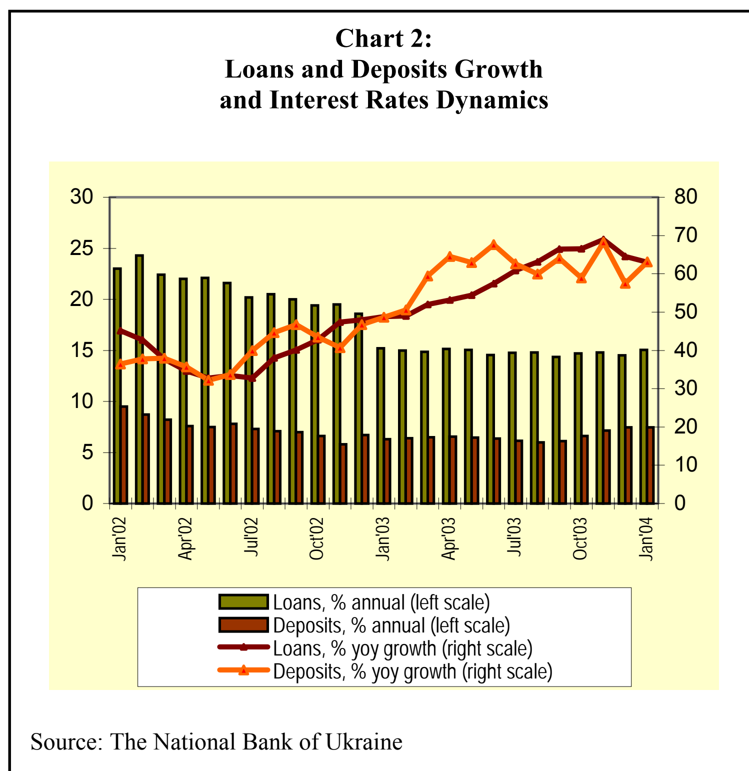
[2] The M3 to GDP ratio is a benchmark measure of financial sector depth and liquidity.

developed a country, the greater the spread between the ratios of net assets of banks to GDP and money supply to GDP.

Financial markets in Ukraine are extremely shallow[3] and the linkage between central bank monetary policy and bank lending is very strong. In fact, NBU's active policy for curbing inflation by limiting money supply growth rate has not been supported by the banks. They have actively continued lending to businesses and households despite a lessening of the money inflow into the banking system. As a result, interest rates began to rise in the later half of 2003. This trend culminated in December when about UAH 7.5 billion (US$1.4 bn.) moved out of the banking system into accounts of the state treasury. Judging by recent data, Ukrainian banks have now begun to limit the previously excessive rate of loan growth and are accumulating liabilities on their balance sheets.

Despite some improvements in balance sheet structure and high growth in certain accounts, the operating environment for commercial banks remains challenging. The banking system continues to be characterized by a number of significant weaknesses including: (i) weak capitalization, (ii) low profitability and, (iii) an overly rapid growth in risk assets, primarily commercial loans. Retail banking operations have expanded exponentially in the last two years but credit to individuals still accounts for less than 15% of total loans outstanding. The banking sector remains both highly concentrated and selectively over-banked within the large urban areas, and there is still a high concentration of related party loan transactions.[4] Lastly, the current regulatory environment in Ukraine is not consistent with the high risk operations exhibited by the banks, nor are the existing NBU regulations strongly enforced.

Chart 2: Loans and Deposits Growth and Interest Rates Dynamics



Source: The National Bank of Ukraine

Both loan and deposit interest rates show a downward trend over the past two years while both loan and deposit balances have increased dramatically (see Chart 2). However, average lending rates, when combined with collateral requirements, are still prohibitively expensive for most small to medium enterprises. The recent rapid

[3] The Ukrainian banking sector constitutes over 95% of the total volume of financial assets in the economy.
[4] There are a number of definitional problems central to current legislation and NBU regulations concerning insider and related party transactions. These issues are discussed in more detail further in this paper.

growth in banking sector assets (primarily loans) has raised concerns about a deterioration in asset quality and weak risk management systems and practices in many banks. The current drive for high loan growth has placed further pressure on banks' capital positions, raising concerns about the ability of a number of institutions to absorb a sharp deterioration in asset quality, whilst also restricting opportunities for further growth. Additionally, it would appear that earnings are vulnerable, due to the falling interest rate environment, and loan concentration levels. Under such conditions even a relatively small number of problem loans could have a very material impact on net interest income and provisions.

Most of the larger commercial banks have begun an active program of diversifying into new and often higher margin, lines of business such as retail lending. However, most banks have limited experience, untested underwriting skills, and weak IT infrastructures to support this new business. Diversification of revenue streams is important, but such a program may prove difficult for many banks to achieve or sustain in the current operating environment.

Progress has been made in recent years in terms of the implementation of new banking legislation and the laying of the foundations for a more effective supervisory and regulatory framework. The banking supervision department of the NBU is developing a new risk-based supervision methodology which, if properly implemented and enforced, will prove an important benchmark in the future development and maturity of the Ukrainian banking sector. Much work still remains to be done in terms of filling gaps in enabling legislation (e.g. joint-stock company law, bankruptcy law and, corporate governance regulations) and the NBU must continue the tightening of certain existing prudential regulations.

Structure of the Banking Sector

The Ukrainian banking system is a two-tier structure consisting of a broad base of 'universal' commercial banks and the national central bank (NBU). At the beginning of 2004, 179 commercial banks were registered to operate in Ukraine, of which 158 banks have been granted licenses by the NBU to perform general banking transactions. Ukrainian banks are incorporated under various legal structures with the majority operating as 'open joint-stock' companies which allows for unrestricted sale of shares and periodic increases in authorized capital.

The 158 operating commercial banks are divided by the NBU into four groups according to their size and performance data. Ten major banks with total assets of UAH 1.4 to UAH 8 billion have been classified in the first group. This group of banks controls over 70% of the total assets in the system and has an approximate market share in excess of 80%. The second group consists of 12 banks with total assets of UAH 500 million to UAH 1.4 billion. The gap between the second group of banks and the first group has been widening over the past two years. The third group consists of 34 banks with total assets of UAH 170 million to UAH 670 million, and the fourth group consists of 101 banks with total assets of UAH 30 million to UAH 300 million. Many of these smaller institutions do not carry out normal bank intermediation functions in the economy and could best be considered as 'pocket banks' for their primary shareholders and their industrial groups. See Table 1 below for a more detailed profile of these bank groupings by size.

Table 1:
Profile of Banking System Structure (% of Total)[5]

		1st Tier Banks	2nd Tier Banks	Total top 20 Banks	3rd Tier Banks	4th Tier Banks
Total Assets	2000	46.8	16.4	63.3	16.7	20.0
	2001	47.7	19.8	67.5	19.6	12.9
	2002	54.1	14.7	68.8	17.4	13.8
	2003	53.7	17.1	70.8	17.1	12.1
Gross Loans	2000	46.6	18.0	64.6	15.9	19.5
	2001	44.2	21.1	65.2	21.2	13.6
	2002	52.9	15.7	68.6	17.6	13.8
	2003	54.9	17.2	72.1	16.5	11.4
Total Deposits	2000	54.5	14.2	68.7	17.3	14.0
	2001	55.9	17.5	73.4	17.7	8.9
	2002	59.8	14.5	74.3	15.2	10.5
	2003	59.0	15.8	74.8	15.2	10.0
Balance Capital	2000	34.4	13.5	47.9	20.1	32.0
	2001	33.4	13.7	47.1	24.7	28.2
	2002	39.2	11.2	50.4	21.8	27.8
	2003	38.5	14.9	53.4	19.8	26.8
Net Income	2000	----	----	----	----	----
	2001	----	----	----	----	----
	2002	46.2	12.7	58.9	29.9	11.2
	2003	46.2	17.7	63.9	29.2	6.9

Source: NBU Statistics

According to the National Bank of Ukraine (NBU), net banking assets of the banking system have now increased to a total of UAH 100bn (c.USD19bn), a 56.7 percent increase over the 2002 year end level. Although this growth rate is impressive and can be considered a sign of positive development for the depth and level of intermediation of the banking sector, this is still the equivalent of approximately 35 percent of the preliminary GDP figures reported for 2003.[6] By comparison net assets of the banking sectors in most transition economies now account for an average of 63% of GDP. In the United States and most advanced European countries this ratio exceeds 100%.

Two of the largest banks in Ukraine, UkrEximbank (Export-Import Bank) and Oschadny (Savings) Bank, are still 100 percent state-owned institutions and collectively account for 9.4 percent of total net bank assets in the system.

While the Ukrainian Export Bank has assumed some of the role of a traditional state export agency, it continues to operate primarily as a government-directed commercial bank. Following an international diagnostic and restructuring which included significant forbearance of non-performing credits to government-owned enterprises

[5] Tier 1 banks are the 7 largest banks in terms of total assets for 2000, 2001 and 10 banks in 2002, 2003.
Tier 2 banks are the next 13 banks in 200, 2001 and 10 banks in 2002, 2003.
Tier 3 banks are remaining banks with total assets > UAH 150 million
Tier 4 banks are all remaining banks (total assets < UAH 150 million)

[6] This ratio is considered to be overly influenced by the very high rate of loan growth in the past 2 years—averaging in excess of 50%/yr. As the level of bank capital is the fundamental measure of bank soundness as well as the primary mechanism controlling growth in banking assets; a more realistic determinate would be **Capital / GDP**. In this respect the structural weaknesses of the Ukrainian banking sector are even more pronounced as this ratio is still < 5% as of year-end 2003.

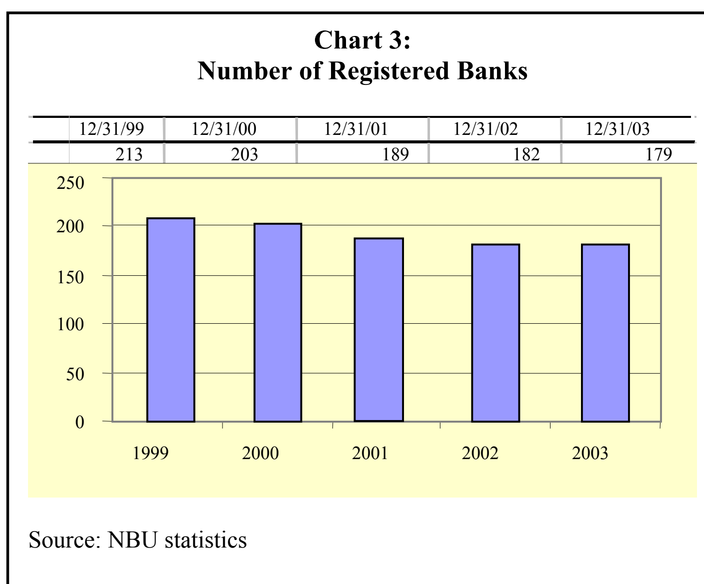
and projects, UkrEximbank now appears to be a fairly well-managed and sustainable (if not very profitable) operation as currently organized.

The government-owned savings bank (Oschadny Bank) is known to be in severe financial difficulty and is currently limited in its operations. Since mid-2003 the bank has been under close supervision from the NBU. The bank is now being managed under the direction of a joint World Bank, NBU, and Cabinet of Ministers Memorandum of Understanding which outlines a number of risk management actions and operational changes that are aimed at restoring its capital base and the eventual restructuring of this institution into a competitive and stand-alone commercial bank.

Size of Banking Sector

The change in the number of registered commercial banks in Ukraine is illustrated in Chart 3.

The number of operating banks (always fewer than the total of registered institutions) has actually increased slightly last year due to the opening of 3 new institutions. The number of commercial banks physically operating in Ukraine totaled 158 institutions as of year-end 2003.



Twenty banks in Ukraine have foreign investment capital to some degree and seven such banks are fully foreign-owned. Banks with foreign capital comprise approximately one-fifth of the total capital of banks in Ukraine, whereas their assets make up one-sixth of total assets in the system. One foreign-owned institution (Raiffeisen) has recently expanded its business scope into retail operations and is expanding its branch network throughout the country. The remaining 100% foreign-owned banks continue to specialize in servicing their established corporate clients and market their international investment programs.

As of January 2004, the top ten banks (two of which are state-owned) accounted for 54% of total banking sector assets, with over half of these in the three largest banks alone. Conversely, at year-end 2003, a total of 120 banks, or 76% of the total number of banks in the system, had total combined assets of less than UAH570m (US$ 107m). This dispersion of the banking system may in part be attributable to the status of many small banks as "pocket banks" of large enterprise groups. These institutions are used primarily for the internal treasury operations of their parent enterprise groups and as consistent sources of cheap liquidity and equity investment. Connected and insider dealing between banks, enterprises and major entrepreneurial groups is

difficult to monitor because clear and meaningful information on ownership structures has been difficult to obtain, especially where ownership has been "layered" through several off-shore corporations.

Given the high concentration levels and overall small size of the banking sector, consolidation within the industry (be it through mergers and acquisitions or closure) is desirable. To date, this has been a fairly slow process, largely reflecting the ownership culture in Ukraine, but also a lack of impetus on the part of the NBU. Financial industrial groups have typically been reluctant to relinquish control over their banks, since these frequently fulfill important roles within their groups.

The recent NBU imposed increase in the minimum capital adequacy requirement for all commercial banks to 10% could stimulate increased consolidation within the banking sector. However, this will largely depend on the extent to which this new requirement is actually enforced and a shift in the prevailing rationale for owning 'pocket banks'. Although there have been no recent significant mergers/acquisitions, the pattern of consolidation in Ukraine will most likely follow that of Russia whereby larger banks acquired significantly smaller banks, often purely as a means to widen their branch networks. Currently there appears to be little interest among foreign banks to enter or expand in the Ukrainian market via the acquisition of any of these small privately-held banks.

According to preliminary data the book capital of the Ukrainian banks increased by 29% during the course of the year and amounted to UAH 12.9 billion. This total included an authorized (paid-in) capital level of UAH 8.1 billion and various reserves and retained earnings amounts totaling UAH 4.8 billion. Unfortunately the NBU still allows the banks to include such items and revaluation reserves, specific loan loss reserves, and an excess of subordinated debt into the total capital account. Adjusted for the proper classification as per the Basel standards, the capitalization of the Ukrainian banking system would be 10-15% lower.

While loan growth and reported interest income were positive in 2003, the net effect of operations on the balance sheet was a decrease in the regulatory capital adequacy ratio for the system—from 18.1% in 2002 to 15.1% at the end of 2003. This was due mainly to the fact that asset growth greatly outstripped the capacity of the system for internal capital generation. Consequently, the banking system continues exhibit a very high ROE of 7.6% in combination with a relatively low ROA of slightly under 1%; this despite a pure spread margin of almost 6%.

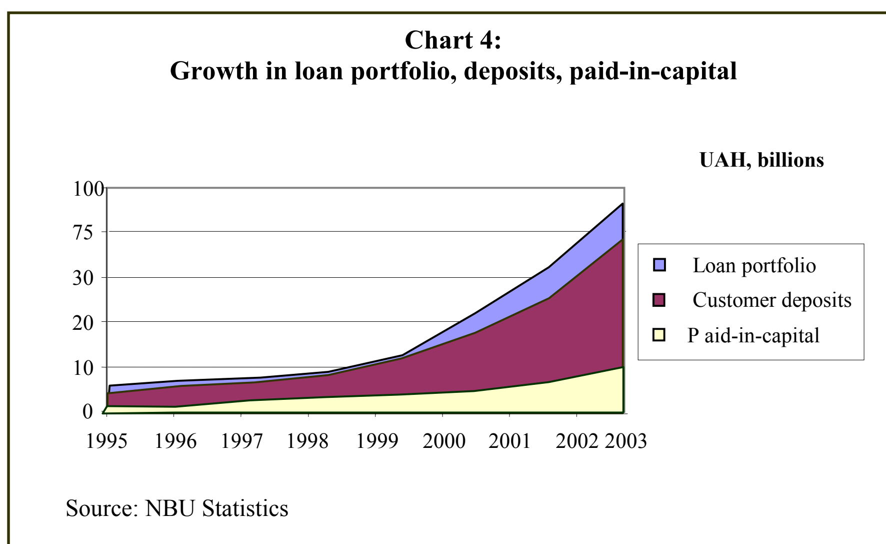
Unaudited financial reports as of 12/31/03 provide the following basic operating and performance data on the banking sector:

- Total assets (adjusted for reserves) of all commercial banks in Ukraine amounted to UAH 100.2 billion (US$18.8 billion);
- The total credit portfolio amounted to UAH 73.4 billion (US$13.7 billion);
- Deposits received from corporate customers amounted to UAH 27.9 billion (US$ 5.2 billion);
- Deposits of individuals amounted to UAH 32.1 billion (US$ 6.0 billion);
- Reported balance capital was UAH 12.9 billion (US$ 2.4 billion), and;

- Net profits for the system totaled UAH 827 million (US$ 155 million) which indicates an approximate ROA of 0.9%--(based on average assets).

All of these indicators exhibit significant growth over 2002 year-end levels although the increase in capitalization of the system still lags significantly behind the rate of loan and deposit growth. The profitability of the system only increased by 21% in 2003, while loan assets grew by 57%. This is another indicator of the continued structural weaknesses and high level of operational inefficiencies inherent in the system. Chart 4 illustrates the phenomenal growth rate experienced in the three major account categories of the commercial banks in Ukraine since 1995.

Chart 4:
Growth in loan portfolio, deposits, paid-in-capital



Source: NBU Statistics

The consolidated balance sheet and income statement for Ukraine's commercial bank sector indicates that the banks continue to show a profit (collectively) and that loan assets and customers deposits have shown strong growth rates since 1998. Since late 2000, these accounts have expanded at an extraordinary and possibly unsustainable pace. However, it is also clear that increases in bank capitalization have been lagging over the past three years. Overall the disparity in growth rates among each of these fundamental balance sheet accounts has contributed to the continued fragility and high risk nature of the Ukrainian banking sector.

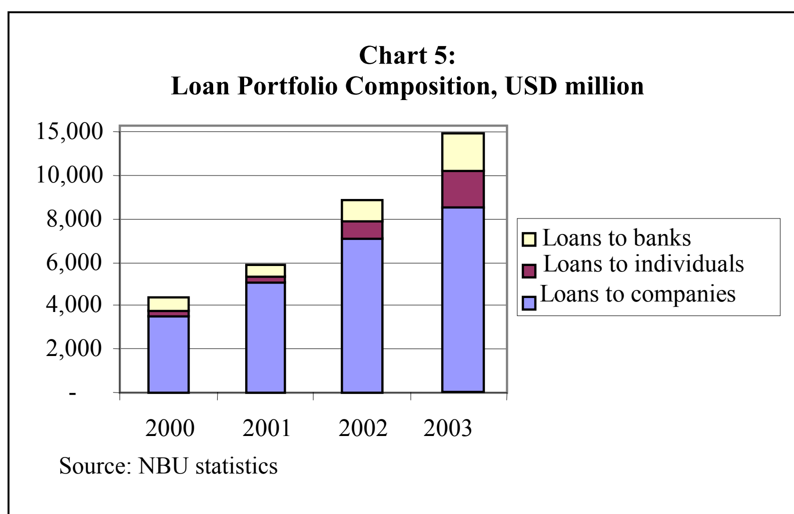
Lending Practices

Notwithstanding the improvements noted over the recent past, the financial intermediation effort of Ukraine's financial sector remains very limited. Although rising by 31% in nominal terms during 2003, the total capitalization of the banking sector is still less than US$ 2.5 billion; equivalent to less than the capitalization of a single medium-sized European bank. By any measure the banking sector in Ukraine must be considered undercapitalized. Consequently, the ability of individual banks to effectively intermediate in the economy and provide the financing required to stimulate growth is severely limited.

Despite the recent increases in corporate loans, most small and medium enterprises still have only limited access to credit. In addition to limitations on leverage due to low capitalization, this phenomenon is also partly a consequence of the high interest rate environment and partially due to the interrelationship between banks and industrial groups under common ownership.

Even with a slight percentage decrease from 2002 levels, loans to corporate entities continue to dominate at 76% of the loan portfolio of the sector. Lending to individuals has increased dramatically in the past 2 years, now up to 15% of the total. However, most of these credits are short-term and for highly priced and somewhat inflation sensitive consumer-based goods and services which include car loans and credit cards.

Chart 5 illustrates the profile of loans to the corporate sector and to individuals over the past four years.



The share of long-term loans (over 1 year) has increased substantially over the past two years and now account for 12% of the local currency loans and almost 60% of the credit extended in foreign currency. Combined, long term credits granted to corporate entities total approximately 72% of the total loan portfolio as of year-end 2003. However there is anecdotal evidence that a number of credits that are classified by the banks as long-term are in reality rolled-over and extended short-terms debts. Non-performing loans continue to represent some 25% of the system's credit extensions and the practice of extending past-due loans to avoid additional charges to reserves is still wide-spread.[7]

The average interest rates on UAH denominated loans to entities ranged from 22% for short-term loans to 25% on long-term loans. (USD 14-16%). The share of bank borrowings denominated in foreign currency has increased during 2003 and averages approximately 25% of total bank funding sources. This figure does not include the two recent Eurodollar long-term loan placements (bonds) sold on behalf of two of the larger commercial banks—each for US$ 100 million and a term of three years.

Although the NBU has followed policies which are designed to exert downward pressure on bank interest rates[8], the weighted average of annual lending rates of the commercial banks averaged 18.5% for 2003. While this represents a decline from previous levels any significant downward movement continues to be impeded by high rates on short-term deposits, increased credit risk, and excessive operational costs within the banks themselves.

[7] The Ukrainian system has its own, more liberal, definition of non-performing credits which is not in total agreement with international best practices, particularly in the areas of collateral valuation and the allowance of credit against normal provision requirements.

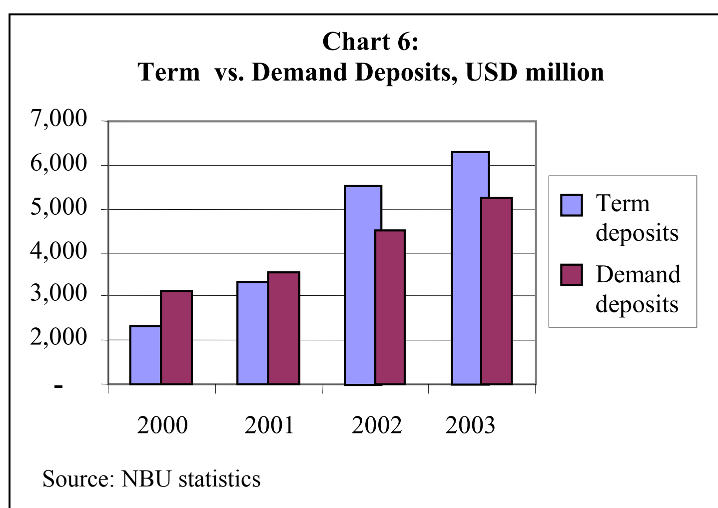
[8] The monetary policy of the NBU has traditionally been more concerned with exchange rate stability than with direct measures to control of interest rates.

The banks appear to have lent a disproportionate amount of their funds in foreign currency. The apparently widespread disregard (by both banks and borrowers) of borrowers' exposure to foreign exchange risk, and the still relatively high level of dollarization of bank deposits, could potentially harm individual banks, the banking system, and economy if economic circumstances worsen. Often the borrowing in foreign currency is performed due to the lower interest rates charged versus rates for loans in hryvnia. While the exchange rates have been very stable over the past 3 years, such lending practices can entail a dangerous level of currency risk. A large share of Ukrainian enterprises and households do not generate earnings in the foreign currencies, which leads to a significant exposure for both the borrowers and the banks to foreign exchange risks, especially in the event of crisis.

Deposit Base

Total deposit balances in the system also expanded in 2003 with the most dramatic increase coming from new individual deposits, primarily in the form of short-term time deposits and savings accounts. Total deposits grew by almost 45% during 2002 with deposits from individuals increasing a remarkable 71% and the corporate deposit base rising by 25.9%. It is reported that personal deposits in the banking system have increased annually from approximately 3 billion UAH in 1998 with the most significant increases coming in the last two years. With this enormous increase in individual deposits, the structure of bank deposits in the system is now fairly balanced between the two main sources.

The total amount of deposits in commercial banks has risen sharply with individuals' deposits rising by more then two-thirds in real terms in 2002 alone. The deposits growth ratio is expected to decrease to 50-60% on y-o-y basis in 2003 and 2004, which is still very high. As of 1 July 2003 the total deposits and balances on current accounts attracted by the 15 largest banks exceeded USD 6.7 billion, which represents over 70% of total funds attracted by the industry. The increased confidence in the banking sector and no personal income tax on interest income has fuelled the deposits growth.



As shown in Chart 6, total term deposits in the banks exceeded demand deposits for the first time since Ukraine's independence in 2002. However, the maturity of term deposits is very short, ranging from 6 months to 1 year and actually averaging approximately 90 days. This leads to the issue of volatility in the deposit base versus the level of core deposits that the system can depend on. Short-term corporate deposits tend to be working capital accounts of businesses and their volume can fluctuate wildly for a variety of reasons beyond the internal control of the banks. Conversely, fund flow statistics strongly indicate that a significant level

of ‘core’ deposits is evolving within the individual deposit base which the banks should be able to depend on for stability. The banks need to develop a wider range of customer products with a range of interest rates and tenor in order to develop a large and stable funding base. A further increase in volumes and maturity of term deposits is vital to provide stable long-term financing to banks, which, in turn, will support long-term lending.

There also continues to be a notable difference in interest rates offered on hryvnia accounts versus foreign currency deposits which strongly influences both the choice of deposit denomination and the mix of time vs. demand accounts. Table 2 provides a monthly breakdown of the currency split in deposit denominations as well as the mix between current and time deposits. Currently almost 70% of all accounts are in Hryvnia with the remainder denominated primarily in US Dollars.

Table 2:
Breakdown of funds held by enterprises, organisations, and households on accounts in Ukrainian banks

Period	Total	In national currency		In foreign currency		Current deposits		Term deposits	
	UAH mln	UAH mln	Share of total, %	UAH mln	Share of total, %	UAH mln	Share of total, %	UAH mln	Share of total, %
Jan ‘03	37,829	25,287	66.8	12,542	33.2	17,335	45.8	20,493	54.2
Feb ‘03	39,243	25,988	66.2	13255	33.8	17,980	45.8	21,263	54.2
Mar ‘03	43,503	28,881	66.4	14,622	33.6	20,868	48.0	22,635	52.0
Apr ‘03	44,155	29,161	66.0	14,993	34.0	20,616	46.7	23,540	53.3
May 03	45,382	30,226	66.6	15,156	33.4	21,086	46.5	24,296	53.5
Jun ‘03	49,017	33,174	67.7	15,843	32.3	23,216	47.4	25,802	52.6
Jul ‘03	49,969	33,482	67.0	16,487	33.0	23,045	46.1	26,925	53.9
Aug ‘03	51,262	34,333	67.0	16,930	33.0	23,068	45.0	28,195	55.0
Sep ‘03	54,946	37,326	67.9	17,620	32.1	25,336	46.1	29,610	53.9
Oct ‘03	54,675	36,649	67.0	18,026	33.0	23,491	43.0	31,185	57.0
Nov ‘03	56,291	37,912	67.4	18,379	32.6	23,612	41.9	32,679	58.1
Dec ‘03	**60,100**	**40,988**	**68.2**	**19,111**	**31.8**	**25,482**	**42.4**	**34,618**	**57.6**

Source: National Bank of Ukraine.

As stated earlier, the Ukrainian banking sector continues to exhibit a number of structural weaknesses, not the least of which are its high levels of concentration and fragmented market distribution. The banking sector is dominated by a few large (by Ukrainian standards) institutions with a large number of closely-held small institutions. While there has been some repositioning among certain banking groupings over the past three years, the main movement has been the rapid growth of the top 10 institutions and a widening of the market share gap between the first and second tier banks. The banking sector has not demonstrated any real consolidation through the mergers or acquisitions among the smaller banks and in fact has developed an overall riskier profile. An increasing number of the smaller banks have become more uncompetitive and marginalized over the years and should, because of their weak financial structure and inability to intermediate effectively in the economy, be considered for closure by the NBU.

Recent Developments in the Banking Sector

Despite continued improvement over the past two years, the Ukrainian banking sector continues to suffer from a number of fundamental structural and operational weaknesses including: (i) under capitalization, (ii) weak corporate governance and management, (iii) poor asset quality, (iv) excessive connected lending and, (v) excessive political intervention in some banks.

In addition to the 57% annual increase in loan risk assets, there was also a notable (48%) increase in the level of investments in securities on the balance sheet of the commercial banks. This phenomenon is the result of a very rapid increase in the issuance of corporate bonds that have been purchased by the banking sector. It is estimated that of the 3.6 billion Hryvnia worth of new corporate bond issues in 2003, the commercial banks purchased and now hold approximately 3.25 billion or 90% of these debt securities in their portfolios. At the same time the composition of the banks' investment portfolios significantly changed from over 80% invested in government securities to approximately 50% in unsecured private debt.

This rapid increase in the purchase of a new and high risk debt instrument sets a dangerous precedent for the banking sector since these bonds are illiquid, have not been rated by any competent authority, and in many cases represent excessive exposure to marginal, and sometime related party, enterprises. There is a fear that a even a minor payment default in one or more of these instruments could lead to a systemic liquidity problem for the banks. Consequently the NBU is in the process of restructuring its accounting regulations and provisioning procedures for the treatment of these instruments when held by a commercial bank.

Analysis of 2003 Financial Performance of Banks

The following section is an attempt to analyze the financial structure and performance of the Ukrainian commercial banking sector on a consolidated basis. The analysis performed below is based on various financial reports provided by the National Bank of Ukraine (NBU) and the Association of Ukrainian Banks (AUB) and the results are very much dependent on the accuracy of the submitted data. It is noted that there are a number of inconsistencies and discrepancies in the data when separate sources are compared. In those cases where the totals are in question, the analyst has relied primarily on the figures provided in the monthly statistical bulletin published by the NBU.

As cited earlier, the Ukrainian banking system banking sector began to expand strongly in 2000 and has been strengthened by a considerable drop in interest rates and an easing of the minimum reserve requirement. Lending to the real sector also increased sharply, following the decrease in profitability in trading of state securities, increased currency confidence and greater liquidity. Nevertheless, the level of banking sector involvement in the real economy remains low in comparative terms. The ratio of net loans to the economy as a percentage of GDP is reached a low 28% or US$13.4 billion by the end of the 2003.

Assets

A large, and increasing, proportion of the earning assets of Ukrainian banks consist of standard loans to customers, mainly short and medium term credits to large enterprises. Due to the lack of alternative earning assets in Ukraine, customer lending typically accounts for over two-thirds of the balance sheets of the largest Ukrainian banks. Loan concentration levels by sector and by individual customer remain high in many banks, to a large extent reflecting a lack of suitable borrowers in Ukraine[9]. Due to the less than transparent nature of many organizations operating in Ukraine, customer concentration levels (included related party) could be higher than actually reported. The lack of transparency in financial reporting also contributes to the inability to accurately measure banking sector performance by the common international standard of: domestic credit to the private sector as a percentage of GDP. Based on historical data and trends it is estimated that this ratio has risen into the range of 12-14% as of year-end 2003.[10]

Loans

Total loan assets to the economy increased by a notable 61.4% during 2003 to a total of 67.8 billion Hryvnia (US$ 12.7 billion).[11] The ratio of loans extended in foreign currencies has remained basically the same as 2002 levels and has averaged 42.5% of total loans extended for the past three years. While there was a notable increase in new loans to individuals during the year; this sub-sector must still be considered underserved in terms of total loan extensions as credits to corporate entities still represent almost 87% of total loans. Table 3 illustrates the growth in credits through the commercial banking system from 2001 to the end of 2003.

Table 3:
Volume of loans from Ukraine Banks*
(in millions of UAH)

Period	**Corporate Credits**		**Loans to Individuals**		**% of FX loans to total loans**
	In Hryvnias	In Foreign Currency	In Hryvnias	In Foreign Currency	
12/3/01	14,858	12,098	987	431	44.1%
12/31/02	22,490	16,231	1,972	1,341	41.8%
12/31/03	35,559	23,290	4,004	4,982	41.7%

Source: NBU Statistics
* Total loan statistics—excluding interbank credits and loans to banks

Based on NBU figures from 12/31/03 on the primary balance sheet for the banking system, the general structure and composition (% of total) for net assets was as follows: (i) total loan portfolio (74.4%), (ii) funds due from NBU and correspondent

[9] (e.g. First Ukrainian International Bank's (FUIB) top 20 borrowers accounted for 73% of the loan book, or 136% of equity; at end-October 2003, Privatbank's top 20 borrowers accounted for 21% of the gross loan portfolio, or 320% of equity).
[10] This is still a very low result despite some increases in the numerator. By comparison this ratio was an average 27% for 10 similar transition countries during 2002.
[11] This growth in new loans comes after a similar high rate of expansion—48% in 2002, raising a number of questions regarding a possible deterioration in asset quality and insufficient capital adequacy and provisioning amongst the more aggressive banks.

accounts (6.6%), (iii) securities portfolio (6.5%), (iv) fixed assets and intangibles (7.7%) and, (v) other assets (.2%). It is noted that as of 12/31/03, the banking sector, as a whole, held an extremely high 18.9 billion Hryvnia in 'highly liquid assets' (cash, due form NBU and government securities) which equaled 19% total assets. This measurement indicates an overly liquid position in the system, despite record loan growth during the year.[12]

Asset quality, as discussed further below, remains weak with many loans constituting what in most systems would be considered as problem or non-performing credits. Based on NBU statistics, Non-Perfuming Loans (NPLs) at the end of 2003 accounted for 2.5%-11% of the loan books of the top ten banks. Based on the detailed data provided by the NBU and shown in Table 10 below, these figures appear to be unrealistically low. As the NBU definition of a non-performing loan is restricted to only those credits which are past due >90 days, it is obvious that many loans have been rolled-over or rescheduled. This action causes the NPL statistics to be artificially low and the overall quality of the portfolio to be overstated.

Recent rapid loan growth and expansion into potentially more risky lines of business (e.g. retail and long-term investment loans) could cause further asset quality problems as these loans mature. Although most lending is collateralized, continued weaknesses in the realization laws on collateral and property rights mean that full and timely realization of collateral is not always possible.

The limited number of stable and financially sound corporate clients and increasing competition among banks has led the major banks to develop programs for consumer lending and to develop branches. Some banks have expressed confidence that consumer lending will double by the end of this year. The average interest rates for UAH denominated loans to individuals remain high at 15-35% with a notable difference on US Dollar-based credits at 11-20%.

The relative position of Government and NBU securities as an investment vehicle has become less significant for the banks due to low yields of government bonds and the recent explosion in corporate bond issues. The commercial banks have shifted their securities portfolios noticeably and now hold government paper mainly to maintain their required liquidity reserves with the NBU.

Investment Portfolio

Bank investments in corporate bonds increased significantly during 2003 to total in excess of UAH 3.9 billion (US$ 736 million). A total of 63 percent of all securities are held by the first tier banks, with virtually 100 percent of these new corporate bond instruments held in the portfolios of just six institutions. Although the emergence of this alternative financial instrument can be considered an encouraging sign and the total outstanding in the investment portfolios of the commercial banks is not large in relation to total risk assets, the acute structural weaknesses in capital markets

[12] High balances in the NBU account are only partially indicative of the liquidity reserve requirements on deposits. The average mandatory provisioning requirements on deposits were decreased significantly in2002, dropping from 13 to 7.9% of short-term deposits. The reserve requirements remained untouched during 2003. The liquidity reserve requirement on long-term funds was cut to zero.

regulations and operations as well as the financial weaknesses intrinsic to many of the issuers, make an investment in these bonds a high risk proposition.[13]

Detailed balance sheet data published by the NBU allows for the creation of the following tables which illustrate the rapid growth in new corporate bond issues, the changes in the profile of bank securities portfolios and the concentration of risk for these instruments among the few large banks in the system.

Table 4:
Changes in Profile of Securities Portfolio (all banks)
(UAH millions)

Indicators	DATE			Growth rate, %	
	31.12.2001	31.12.2002	31.12.2003	2002	2003
Investments in securities	4,397	4,401	6,534	0.3	48.4
including:					
T-bills and debt securities issued and refinanced by NBU	2,975	2,314	2,423	-22.2	4.7
other securities for sale and investments in corporate bonds	1,269	1,947	3,936	53.4	102.2
Investments in affiliated and associated companies	153	140	175	-8.5	24.9

Source: NBU Statistics

This table shows the rapid increase–almost 50% over this past year, in the total securities portfolio held by the banking system and the fact that virtually all of this growth was realized with purchases of newly issued corporate bonds. The national T-bill and NBU securities market grew only slightly in 2003 after a considerable decrease in 2002. It appears that the primary rationale for this switch in investment instruments was pricing with a minimal regard for the risk factors involved. Interest rates on government securities have decreased significantly over the past two years as a result of government monetary policies. As interest rates on standard loan instruments also began to decline, the availability of higher yields on corporate bonds has become an increasingly attractive alternative earning asset for banks.

The primary problem with this expansion into the corporate bond market, at this stage of the development of the Ukrainian financial markets, is the excessively high risks levels intrinsic to these particular instruments. The normal capital market controls are simply non-existent in the Ukrainian market, and when combined with the weak creditworthiness of many of the bond issuers, cause many of these bonds to be unacceptable as risk assets on the balance sheet of any properly regulated financial institution. These bonds are high risk, illiquid and held by an exceptionally concentrated (10-15 large commercial banks) group of inter-related investors.

Currently, none of these bond issues would be considered an acceptable investment instrument for a bank operating in either the United States or the EU member countries. This problem of excessive risk is acerbated by the fact that most Ukrainian

[13] Details of the specific issues regarding the risks of corporate bonds in the Ukrainian market can be found in Ukrainian Debt Markets: Analysis and Recommendations for Development a paper prepared for USAID by Robert Strahoda of the US Securities and Exchange Commission, June 2003.

banks have failed to fund any semblance of a specific loss reserves or 'mark to market' calculation against this risk.[14]

Table 5:
Securities Portfolio of Top Ten Ukrainian Banks

	12/31/2003			**12/31/2002**			**Change**	
	UAH million	**Rank**	**Market Share, %**	**Volume, UAH million**	**Rank**	**Market share, %**	**UAH million**	**%**
All banks	**6 534.0**	**-**	**100.0**	**4 400.7**	**-**	**100.0**	**2 133.3**	**48.5**
Top 10	**4 138.5**	**-**	**63.3**	**2 981.9**	**-**	**67.8**	**1 156.6**	**38.8**
Aval	317.1	6	4.9	328.0	3	7.5	-10.9	-3.4
Privatbank	198.2	7	3.0	155.0	6	3.5	43.2	27.8
Prominvestbank	62.8	10	1.0	88.0	8	2.0	-25.1	-28.6
Oschadbank	1,655.5*	1	25.3	1,358.6*	1	30.9	296.9	21.9
Ukrsotsbank	592.6	2	9.1	639.7	2	14.5	-47.1	-7.4
UkrEximbank	423.6	4	6.5	184.4	4	4.2	239.1	129.7
UkrSibbank	444.4	3	6.8	162.1	5	3.7	282.3	174.1
Raiffeisenbank	20.2	12	0.3	0.0	12	0.2	20.2	---
Nadra	90.7	9	1.4	35.4	10	0.8	55.3	156.2
Brokbiznesbank	333.4	5	5.1	30.6	11	0.7	302.8	988.7
Finance & Credit	138.0	8	2.1	105.6	7	2.4	32.4	30.7
Pravex	25.1	11	0.4	51.0	9	1.2	-26.0	-50.9

Source: NBU statistics
* By regulation, 100% of investments in securities by Oschadbank (savings bank) are Government instruments

Table 5 provides a further indication of the highly concentrated nature of the nascent bond market in Ukraine. The top ten banks hold 63.3% of all security issues in the country. This is a slight decrease in the percentage totals from 2002 levels but all the difference is accounted for in the drop in government securities in their portfolio mix. More importantly, by extrapolation[15], this table also indicates that these few large banks also hold a disproportionate percentage of the new corporate bond issues. During 2003 the investment portfolio of 7 of the top 12 banks detailed in the above table reported an amazing 218% average increase in their risk exposure through investments in new non-government (e.g. corporate bond) securities.

Liabilities

As of year-end 2003, the total aggregate liabilities of the banking sector were UAH 87.4 billion indicating a significant increase of UAH 33.4 billion, or 62% over year-end 2002 levels. The majority of this growth is reflected the substantial increase in customer deposits during the year. During 2003 there was a 42.0% growth in corporate deposits and a remarkable 68.25% increase in the level of deposits from individuals. This represents a compound growth rate of over 68 percent for deposit mobilization for the third straight year and should be considered a very positive sign of increased pubic trust in the banking sector.

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[14] Currently the NBU is addressing this issue with revisions to Regulation 629, which sets forth the procedures for classifying investments by type (for trade, for sale, or held to maturity) and the mechanisms necessary for accounting for the market value or loss risk in each type. However, these adjustments have yet to become required actions for the affected banks.
[15] Deducting Oschadbank's government portfolio form the total leaves UAH 2.5 billion or 64% of the total corporate bonds outstanding divided among 9 banks.

Financial resources attracted from corporate and individual bank customers represent around 71% of banks' total liabilities as of the end of 2003. Accounts of individuals have exceeded those of legal entities since late 2003 and now comprise 37% of total bank liabilities. While the deposit structure is getting stronger the banks are, in general, beginning to actively seek alternative funding sources to finance their rapid asset expansion.

Deposit Structure

The structure of the deposit liabilities in the Ukraine banking system demonstrates the dynamic nature of the banking system's deposit mobilization efforts over the past three years as well as the continued strong growth in new deposits from individuals. As of the end of 2003, the mix between corporate and individual deposits remained basically equal to previous years, yet on a much larger base. 79% of corporate deposits are denominated in Hryvnias, while individual deposits in foreign currencies have increased steadily to equal 42 % of this sub-sector. The maturity profile of the overall deposit base remains distinctly short-term at 68% of total deposits.

The following table provides a profile of the deposit structure for the last 3 years:

Table 6
Customer Deposits in Banking Sector
(in millions of UAH)

Date	Total Hryvnias Deposits	Total Foreign Currency Deposits	Maturity Profile of Total Deposits (%)		Including:			
					Corporate*		Individual*	
			S/T	L/T	UAH	CFC	UAH	CFC
12/31/01	17,393	8,281	86%	14%	10,827	3,509	6,566	4,772
12/31/02	25,636	12,079	76%	24%	14,035	4,378	11,601	7,701
12/31/03	41,794	19,571	68%	32%	22,977	6,079	18,817	13,492
%Δ yoy	63%	62%	-10.5%	33.3%	63.7%	38.9%	62.2%	75.2%

Source: NBU Statistical Bulletin CFC = Convertible Foreign Currency

The overall structure of customer deposits in the Ukraine banking system continues to favor the corporate sector, despite the remarkable growth in individual deposits over the past 2 years. The maturity of corporate deposits has lengthened somewhat but its still (68%) short term in nature. This leads to the issue of volatility in the deposit base versus the level of core deposits that the system can depend on. If the commercial banks are to continue in their aggressive expansionary mode for both credits and deposit mobilization, it is highly recommended that their risk management practices and business plans be further monitored to ensure that they have conducted an in-depth analysis of their funding profile under standard liquidity risk management and asset/liability management techniques.

There were also increases in the combined growth of new bank borrowings through interbank credits and funds obtained from international agencies. There was a marked increase in funding through subordinated debt issues (31%) while new debt securities (bonds) issues by the banks themselves remained flat after a 59 percent increase in 2002. Other forms of funding remain limited. According to the NBU, promissory notes or bonds issued by commercial banks, accounted for less than 1% of bank's liabilities at end-2003.

However, it is important to note that in late 2003 and early 2004 two banks[16] successfully issued Loan Participation Notes (a form of Eurobond) as an alternative source of funding. Both of these issues are highly controversial given the financial condition of these two institutions, the very limited financial disclosures provided in their offering memorandums, and the fundamental credit and market risks intrinsic in such investments in transition countries. Despite the high growth in total liabilities during the year, the share of total deposits attracted by the banks remained near 2002 levels at approximately 70% of total bank liabilities.

Capital

Despite several years of strong asset growth and steady but mediocre earnings, the level of capitalization for commercial banks operating in Ukraine remains dangerously low. The current minimum statutory capital requirement of the NBU necessary to obtain a general license for nationwide banking activities is set at very low € 5 million.[17] This minimum capital requirement is even lower for the many smaller institutions which operate only on a limited regional basis.

For operating banks the major current source of capitalization remains retained earnings–which are not increasing at the same pace as loan growth. Over the past two years, earnings of the banking system has shown positive increases, but the ROA ratio has decreased significantly due to lower interest rates on loans, continued high levels of NPLs, high overheads, and operating inefficiencies.

Capital adequacy remains one of the most problematical issues affected the Ukrainian banking system today. The quality of a bank's capital is also important. Contrary to existing Ukrainian practices, only certain accounts can be considered as 'real' equity in a bank, with actual paid-in capital from investors being the most critical component of tier 1 capital. The habit of Ukrainian banks to include current earnings, specific loan loss reserves and, fixed asset revaluations into the primary capital account is misleading, structurally incorrect and, against Basel standards.

The NBU has recently ruled that the local banks should be required to increase their minimum CAR from 8 percent to 10 percent.[18] However, this will be done without raising the minimum level of level of equity capital required. Given the unstable macroeconomic conditions, the increasing market and related credit risk factors, combined with some of the structural and management weaknesses inherent with the Ukrainian banks, many analysts consider that a 10% CAR is still too low.

The management of many Ukrainian banks still fails to understand the basic purpose or function of bank capital. Management also fails to recognize that loan quality and

[16] Privat Bank and UkrSibbank have each raised $100 million in 3 year promissory notes on the Euromarket. Several additional banks (Aval, Ukrosotsbank, and UkrEximbank) have announced their intentions to issue similar debt instruments during 2004.

[17] Although the capital is to be paid-in in Euros, the NBU has recently yielded to pressure from the local Bankers Association to allow capital adequacy to be accounted for in Hryvnia, avoiding any negative adjustments that might be necessary due to exchange rate fluctuations.

[18] This new requirement came into effect in March 2004 and the NBU has reported that only a few 'small' banks have failed to meet these criteria to date. Further, the NBU has announced that they will grant a period of forbearance (unspecified) before taking any action against banks which have failed to meet this new minimum CAR.

strong borrower performance have an integral relationship to the proper level of bank capital as well as the ultimate solvency of a financial institution. Overall the system demonstrates a very weak capacity for self-capitalization with high loan growth, a lower but steady rate of growth in net profits but a lagging indicator of capital account expansion.

Of particular concern to the proper analysis of capital adequacy for Ukrainian banks is the lack of accounting consistency in the treatment of various accounts which make up the capital account itself. Despite requirements to maintain CAR levels using Basel Accord measurements and to initiate international accounting standards (IAS), most financial data released by the banks, and presented in NBU statistics, continue to incorrectly include fixed-asset revaluation reserves and current year earnings as Tier 1 capital. Additionally, the lack of transparency in the beneficial ownership of offshore bank shares raises serious questions about the true value of the equity accounts of certain banks.

II. Analysis of Income Statements and Balance Sheets

The following two pages present the main balance sheet and income statement spread sheets as indicators for the financial movements in the Ukrainian banking system from 2001 through 2003:

	Main Indicators of Ukraine Banking Activity 2000—2003 (thousand UAH)									
Indicators	**Date**				**Absolute growth**			**Growth rate, %**		
	31.12.2000	**31.12.2001**	**31.12.2002**	**31.12.2003**	**2001**	**2002**	**2003**	**2001**	**2002**	**2003**
ASSETS										
Total assets	39,866,128	50,784,568	67,773,519	105,539,413	10,918,440	16,988,951	37,765,894	27.4	33.5	55.7
Highly liquid assets	8,270,328	7,744,355	9,043,430	16,042,889	-525,973	1,299,075	6,999,459	-6.4	16.8	77.4
Loan portfolio	23,637,257	32,096,673	46,735,598	73,441,978	8,459,416	14,638,925	26,706,380	35.8	45.6	57.1
Investments in securities	2,174,692	4,389,875	4,401,955	6,533,614	2,215,183	12,080	2,131,659	101.9	0.3	48.4
Accounts receivable	1,924,456	2,081,012	1,410,112	1,194,152	156,556	-670,900	-215,960	8.1	-32.2	-15.3
Fixed assets and intangibles	3,196,658	3,599,186	4,926,289	6,532,723	402,528	1,327,103	1,606,434	12.6	36.9	32.6
Accrued income	605,069	712,086	936,897	1,270,796	107,017	224,811	333,899	17.7	31.6	35.6
Other assets	52,118	151,177	306,949	523,261	99,059	155,772	216,312	190.1	103.0	70.5
Provision for ‘active operations’	2,737,245	3,193,290	3,877,474	5,305,052	456,045	684,184	1,427,578	16.7	21.4	36.8
Net assets	37,128,883	47,591,278	63,896,045	100,234,361	10,462,395	16,304,767	36,338,316	28.2	34.3	56.9
TOTAL LIABILITIES	30,622,131	39,676,021	53,912,619	87,352,483	9,053,890	14,236,598	33,439,864	29.6	35.9	62
including:										
NBU funds	1,399,005	1,114,747	1,302,187	2,374,185	-284,258	187,440	1,071,998	-20.3	16.8	82.3
Budget and extra-budgetary funds	1,349,904	1,533,805	1,749,399	1,113,641	183,901	215,594	-635,758	13.6	14.1	-36.3
Correspondent accounts of other banks	1,035,761	1,702,239	1,090,320	3,117,978	666,478	-611,919	2,027,658	64.3	-35.9	186.0
Interbank credits and deposits	3,398,836	4,313,418	6,404,784	10,824,984	914,582	2,091,366	4,420,200	26.9	48.5	69.0
Credits received from Intl. and other financial entities	0	447,162	817,030	901,348	x	369,868	84,318	x	82.7	10.3
Corporate deposits, total	13,071,195	15,653,110	19,702,916	27,987,111	2,581,915	4,049,806	8,284,195	19.8	25.9	42.0
Individual deposits	6,648,684	11,164,891	19,092,370	32,113,288	4,516,207	7,927,479	13,020,918	67.9	71.0	68.2
Funds of non-banking financial institutions	x	x	x	3,287,981						
Issued debt securities	629,898	468,255	743,300	799,447	-161,643	275,045	56,147	-25.7	58.7	7.6
Subordinated debt	912,121	809,832	857,977	1,126,603	-102,289	48,145	268,626	-11.2	5.9	31.3
Accrued expenses payable	447,233	268,349	399,160	633,904	-178,884	130,811	234,744	-40.0	48.7	58.8
Other liabilities	1,729,494	2,200,213	1,753,176	3,072,013	470,719	-447,037	1,318,837	27.2	-20.3	75.2

CAPITAL ACCOUNT	31.12.2000	31.12.2001	31.12.2002	31.12.2003	Absolute growth			Growth rate, %		
Book capital	6,506,752	7,915,257	9,983,426	12,881,878	1,408,505	2,068,169	2,898,452	21.6	26.1	29.0
authorized capital	3,670,912	4,573,189	5,998,120	8,115,581	902,277	1,424,931	2,117,461	24.6	31.2	35.3
paid-in registered authorized capital	3,664,523	4,575,176	6,003,202	8,116,111	910,653	1,428,026	2,112,909	24.9	31.2	35.2
treasury stock	17,317	37,361	41,750	26,530	20,044	4,389	-15,220	115.7	11.7	-36.5
dividends reserved for authorized capital increase	23,706	35,374	36,668	26,000	11,668	1,294	-10,668	49.2	3.7	-29.1
issuing difference	189,847	186,663	264,850	285,951	-3,184	78,187	21,101	-1.7	41.9	8.0
general reserves	42,733	78,342	82,927	36,879	35,609	4,585	-46,048	83.3	5.9	-55.5
reserve fund	366,097	488,783	602,531	604,327	122,686	113,748	1,796	33.5	23.3	0.3
other funds	x	x	x	726,137	x	x	x	x	x	x
results of past years	1,589,178	1,525,354	1,560,198	1,062,053	-63,824	34,844	-498,145	-4.0	2.3	-31.9
Result of current year	-27,329	531,706	684,515	826,943	559,035	152,809	142,428	-2,045.6	28.7	20.8
revaluation of fixed assets and intangibles	675,314	531,220	790,285	1,224,007	-144,094	259,065	433,722	-21.3	48.8	54.9
INCOME AND EXPENSES										
Income	7,527,934	8,582,958	10,469,575	13,948,930	1,055,024	1,886,617	3,479,355	14	22	33
interest income	4,439,132	5,706,011	6,900,696	9,492,833	1,266,879	1,194,685	2,592,137	29	21	38
fee income	2,006,664	2,290,888	2,598,924	3,463,443	284,224	308,036	864,519	14	13	33
Net trading income	616,165	360,728	668,749	740,385	-255,437	308,021	71,636	-41	85	11
other operational income	306,555	98,784	180,315	155,311	-207,771	81,531	-25,004	-68	83	-14
other income	45,688	37,554	62,999	39,987	-8,134	25,445	-23,012	-18	68	-37
recoveries on loan write-offs	110,087	76,521	55,076	55,175	-33,566	-21,445	99	-30	-28	0
unexpected income	3,643	12,472	2,817	1,796	8,829	-9,655	-1,021	242	-77	-36
Expenses	7,555,263	8,051,252	9,785,060	13,121,987	495,989	1,733,808	3,336,927	7	22	34
interest expenses	2,386,162	2,799,796	3,660,756	4,916,480	413,634	860,960	1,255,724	17	31	34
fee expenses	543,379	324,855	301,606	384,205	-218,524	-23,249	82,599	-40	-7	27
other operational expenses	409,536	481,077	597,117	802,248	71,541	116,040	205,131	17	24	34
general administrative expenses	2,523,567	3,131,550	4,024,733	4,842,264	607,983	893,183	817,531	24	29	20
deduction to reserves	1,446,398	1,056,907	926,401	1,725,268	-389,491	-130,506	798,867	-27	-12	86
unexpected expenses	20,471	7,823	976	1,732	-12,648	-6,847	756	-62	-88	77
income tax	225,750	249,244	273,472	449,790	23,494	24,228	176,318	10	10	64
Net profit (loss)	-27,329	531,706	684,515	826,943	559,035	152,809	142,428	-2,046	29	21

Income Statement Profile

Net interest income, earned primarily on corporate loans, is the largest single contributor to the income stream of Ukrainian banks, reflective of the importance of lending on banks' balance sheets. Some larger banks have managed to help offset corporate margin pressure, resulting mainly from the falling interest rate environment, through higher lending volumes and diversification into higher-margin business (e.g. retail lending). Fee and commission income is not very significant for most banks, largely reflecting weak demand for, but also a general lack of, fee-paying products and services in Ukraine to date. However, some of the larger domestic banks have successfully developed this revenue source on the back of an expanded range of fee-paying products and services (e.g. plastic cards, fees on retail loans, documentary operations, etc.), and volume growth.

As competition grows, fee and commission tariffs are likely to fall. FX income, most of which is earned through customer-driven operations, is not a significant contributor to banks' earnings, mainly due to NBU restrictions on speculative UAH/USD trading. Securities trading gains, a potentially volatile source of income, have historically formed only a small part of bank income, due to the under-development of the capital markets.

As banks' loan books are typically highly concentrated by customer, their earnings are potentially very vulnerable, with even a relatively small number of problem loans able to have a very material impact on net interest income and provisions. Most importantly, the already thin margins of profitability would be immediately impacted by a deterioration of loan performance. System-wide profitability is already being affected by the adverse impact of the banks' very high operating costs (e.g. averaging 78% of gross operating income for the top ten banks), despite only modest branch networks in most cases. Cost efficiency needs to be addressed as a priority, particularly as margins on corporate lending (i.e. the main contributor to banks' earnings) continue to fall.

Table 7:
Interest Income & Interest Expense detail (in thousands UAH)

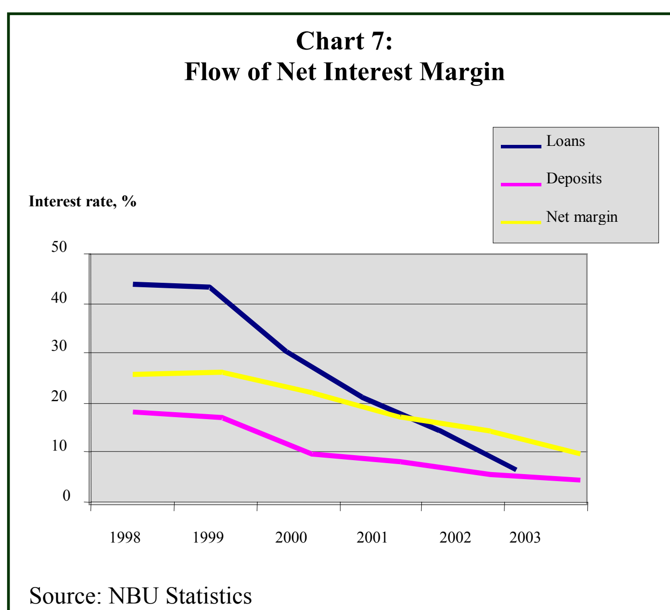
	12/31/01	**12/31/02**	**12/31/03**
Interest from loans to corporations	4,575,419	5,789,900	7,540,595
Interest from Loans to individuals	189,761	334,406	902,340
Interest from Loans to State enterprises	30,858	45,400	22,058
Interest earned on securities portfolio	272,962	261,858	404,103
Interest on funds placed with NBU	17,566	4,015	1,154
Interest on funds with other banks	546,220	369,749	544,169
Other interest income	73,225	95,368	78,415
Subtotal interest income	**5,706,011**	**6,900,696**	**9,492,834**
Interest paid on individual deposits (demand & time)	1,173,691	2,022,360	2,793,253
Interest paid on corporate deposits (demand)	612,195	791,575	1,061,907
Interest paid on lines with international organizations	19,735	22,337	27,737
Interest paid to NBU	47,787	46,984	93,412
Interest paid to other banks	460,081	369,309	583,732
Interest paid to NBFIs	----	---	72,264
Interest paid on budget funds	170,822	96,193	60,471
Interest paid on own debt securities	175,498	166,108	122,232
Other interest expense	139,987	145,889	102,472
Subtotal interest expense	**2,799,796**	**3,660,755**	**4,917,480**

Interest Rate Environment

Beginning in 1999 there has been a steady overall decline in interest rates for bank loans. Moreover, the spread between interest rates on granted loans and deposits attracted from customers has also been declining to an average of 8.3% for 2003. However, this margin remains high in comparison to other transition countries in Eastern and Central Europe. Financial results clearly demonstrate that while Ukrainian banks, as a whole, still operate with high net interest margins, they remain operationally inefficient with very low net profit and ROA results.

Recent statistics from the EBRD indicate that the average net interest margins for all commercial banks that are in operation in the transition economies of Eastern Europe and the CIS have declined. Since 1998 this figure had decreased to an average of 4.2% by year-end 2003. Despite fairly regular declines in these margins since late 1999, Ukraine continues to lag noticeably in this internationally accepted measurement of banking efficiency. By year-end 2003 the net interest margins of the commercial banks had declined to approximately 8% which is considered as very high in an efficient market. It is apparent from the 2003 performance of the commercial banks that due to their operational inefficiencies, they require high net interest margins to cover equally high interest expenses and internal expenses.

Chart 7:
Flow of Net Interest Margin



Source: NBU Statistics

Profitability

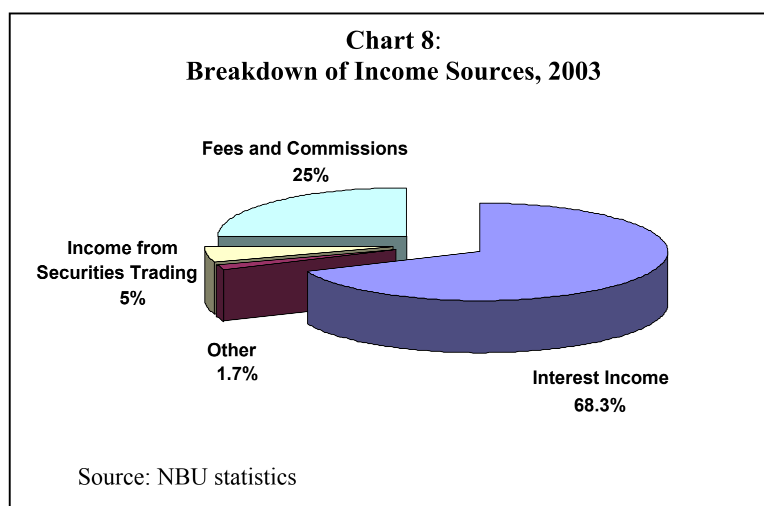
On the surface it appears that the profitability of the Ukraine banking sector is adequate and continues its strong improvement from its wide-spread loss position of 1998. While all of the group 1 and 2 banks were profitable in 2003, 10 smaller institutions reported losses and 14 had net earnings in the dangerously low range of 7 to 99 thousand Hryvnias. Although not clearly disclosed in the available financial reports, a number of banks (including the state-owned savings bank) would have reported losses if their capital had been properly adjusted for the additional loan loss reserves required by the NBU or if properly calculated under IAS rules. On a system-wide basis the banks reported net profits of UAH 827million for 2003 (US$ 155 million). This represents a 20.8% increase over 2002 net earnings but also indicates further deterioration in the average return on assets. Due to a continuing inefficient operating structure, high levels of NPLs and increased expenses in the areas of IT infrastructure and investments into retail network development, the profitability of the largest Ukrainian banks remains far below Eastern and Central European averages.

As can be determined from Chart 8 below, the major sources of income for the Ukrainian banks during 2003 included interest income from loans (68%) and income from fees and commissions (25%).

Notwithstanding the high net interest margins and a growing level of income during 2003, the average ROE of the 15 largest banks stood at a relatively low 6.4%. At the same time, the return on net assets stands at a very low .83%. A significant spread between these two indicators proves low profitability of Ukrainian banks. When despite a low profitability the ROE is relatively high, this is a strong indication of the low level of capitalization in the system.

A review of the structure of the income stream for the banking sector confirms that most banks are still heavily dependent on interest income from loans as their primary source on revenue. Gross interest income constituted 68.3% of total income with fee and commission income the second highest source at 24.8%; up by 33% over 2002. While argument can be made that the banks are not active enough, these figures strongly indicate that on the whole, they are performing their main intermediation function of providing credit into the economy.

Chart 8:
Breakdown of Income Sources, 2003



Source: NBU statistics

The following table provides a profitability profile for the banking system over the past 3 years:

Table 8:
Commercial Bank Profitability
(as a percentage of total assets).

Account	2001	2002	2003	% Δ yoy
Net interest income	6.1	5.1	4.6	-9.8
Non-interest income	4.6	4.6	3.5	-23.9
Total income	11.3	10.1	8.4	-16.8
Provision for loan losses	2.2	1.4	1.5	7.1
Operating expenses	7.3	6.3	5.1	-19.1
Net operating income	10.9	9.7	7.7	-20.6
Net income before taxes	1.6	1.5	1.3	-13.3
Income taxes paid	.52	.43	.45	4.7
Net income after tax	1.1	1.1	.83	-24.5
Return of average assets	1.3	1.2	1.0	-16.7
Return on equity	6.7	6.9	6.4	-7.2

Source: Calculations from NBU Statistics

While an annual return on average assets of 1 percent would be considered acceptable in a mature banking system, it is very low for Ukraine when one considers the state of

the economy, the high level of credit risks existent due to the poor financial condition of many corporate borrowers, and the very high net interest margin (5.6%) enjoyed by the local banks. More disturbing is the continued downward trend in this ratio which reflects the fact that expenses are continuing to grow at a faster rate than income. The year-on-year changes calculated in the above table indicate a positive reduction in operating expenses as a percentage of net assets. However, net operating income has also decreased significantly. This reflects the very high growth rate in new loan assets, tighter interest margins and a major reduction in the contribution of non-interest income.[19]

The first tier group of the top ten banks (based on total assets and as listed by the NBU) all reported profits for 2003, totaling UAH 382 billion (US$ 72 million) and representing 46.2% of the net income of the entire system. For this group of banks the combined ROA on net assets at year-end 2003 was only 0.7%[20] and their ROE (based on adjustments to the capital account) was 7.4%.

The following table presents a series of ratios commonly used to analyze the operational performance of a commercial bank over time. In general these ratios measure a bank's operating income and expense figures against total assets and interest and other key expense information. In this manner a profile of the bank's operating efficiencies and return on assets employed in banking activities can be measured.

Table 9:
Selected Performance Ratios of the Banking Sector

Annualized Ratios	2001	2002	2003
Interest income / Average Earning Assets	18.3%	16.3%	11.6%
Net Interest Income / Average Total Assets	6.8%	5.8%	5.6%
Non-interest Fee Income / Average Total Assets	5.4%	5.3%	4.2%
Non-interest Fee Income / Operating Income	44.5%	47.8%	45.6%
Interest Expense on Deposits / Average Total Deposits	7.4%	8.3%	9.9%
Interest Expense / Average Total Assets	11.6%	10.8%	6.0%
Annualized Intermediation spread (2-6)	-4.8%	-5.0%	-0.4%
Net interest Income / Gross Operating Income	55.5%	52.2%	60.3%
Operating Expenses / Gross Operating Income	66.6%	72.6%	74.2%
Other Operating Income / Gross Operating Income	1.9%	2.9%	2.6%
Other Operating Expenses / Average Total Assets	1.4%	1.3%	.98%
Staff costs / Gross operating Income	30.1%	33.7%	32.9%

Source: Calculations from NBU statistics

The standard financial performance ratios calculated in the above table further point to operational vulnerabilities of the Ukrainian banking system. Although improving statistically (due primarily to the rapid increase in assets in 2003) the intermediation spread for the banking sector is still negative. This negative number indicates a fundamental structural inefficiency in the system as the growth rate of interest expenses has exceeded that of interest income, when measured as a percentage of average assets. This is a disturbing indicator as, despite recent declines in both loan

[19] While the ratio of operating expenses to net assets declined in 2003 this is very much the result of the extraordinary increase in the denominator (57%). The actual amount of general administrative expenses in 2003 increased by UAH 817 million (20%) over 2002 levels.

[20] It is noted that the ROA for the top ten banks is below industry average, which given concentration of assets in this group, is a further indication of the operational inefficiencies of these institutions.

and deposit interest rates, the banks continue to enjoy a significantly positive interest rate margin. A negative intermediation figure strongly implies that a number of bank credits are not earning interest income at the originally rates contracted.

The table above also points out certain operating inefficiencies in the banking system due to the high (and increasing) levels of operating expenses to income (74.2%); a high ratio of staff expenses against operating income (personnel costs consume over 32.9% of gross operating income); and a strong dependency on non-interest income items to support overall earnings. Fee income accounted for almost 46% of operating income in 2003 leading to questions of sustainability for this source of income in an increasingly competitive retail market.

Bank Funding Sources and Liquidity

An analysis of the consolidated position of the Ukraine banking system discloses an increasing dependence on funding from sources other than traditional customer deposits. These include interbank loans at 10.8 billion Hryvnia, issued debt securities at 799 million Hryvnia, and subordinated debt of an additional 1.1 billion Hryvnia. Together these total slightly more than 12.7 billion Hryvnia (US$2.4 billion) and represent almost 15% of total system liabilities. It should be recognized that these fund sources, which under certain circumstances could be considered a sign of banking system maturity, are an expensive alternative to more traditional deposits.

Many of the Group 1 & 2 (top 22 institutions by assets size) Ukrainian banks have already issued debt securities (bonds) on the local market and several have begun contracting international debt through correspondent banks and syndicated loans. As of year end 2003 the banking system reports total debt securities issued at 799 billion Hryvnia (US$ 151million), which, while still only representing less than 1 % of total bank liabilities, is a form of debt that increased by 7.5% during the past year in parallel with a 31.5% increase in subordinated debt issues.

There are almost daily reports announcing similar new debt issues by the larger banks in the system, reflecting their growing dependence this source of funding. Research reveals that on average these debt instruments are issued for a period of two to three years, due in full at maturity with an annual interest rate in the 15-17% range.

Table 10 presents a set of liquidity and funding ratios for the last three years:

Table 10:
Selected Liquidity and Funding Ratios

Annualized Ratios	2001	2002	2003
Liquid Assets / Total Assets	16.3%	14.2%	16.0%
Volatile Liabilities / Total Liabilities	35.4%	32.8%	36.5%
Total Loans / Total Deposits	120%	121%	122%
Net Loans /Total Deposits	108%	110%	115%
Inter-bank borrowings / Total Liabilities	10.9%	11.9%	12.4%
Inter-bank debt / Total Deposits	16.1%	16.5%	18.1%
Demand Deposits / Total Deposits	53.9%	45.6%	41.9%
Term Deposits (≤ 90 days) / Total Deposits	32.3%	30.2%	40.3%
Term Deposits (≥ 90 days) / Total Deposits	13.8%	24.2%	17.8%
Total Term Deposits / Total Deposits	46.1%	54.4%	58.1%
Total debt securities issued/ Corporate Deposits	2.9%	3.8%	2.9%
Subordinated Debt / Total Deposits	3.0%	2.2%	1.9%

Source: Calculations from NBU statistics

The above table also reveals some troubling movements in the profile of bank funding, much of which can be traced to the unusually high loan to deposit ratio in the system. While the level of term deposits increased to equal 58% of total deposits over the year, a detailed breakdown reveals that most of this growth was in short-term individual savings accounts and that the percentage of deposits with maturities over 90 days declined. Volatile demand deposits remain at almost ½ of the funding base. Additionally, the nominal value as well as percentage composition of bank debt securities issued, subordinated debt and particularly, interbank borrowings, increased as the banks continued to 'over lend' against the internationally accepted limits on the traditional deposit base.

The level of subordinated debt issues in the banking system rose by a notable 31.5% during 2003, possibly reflecting a shift towards domestic bonds for pricing considerations as well as the need for banks to increase their CAR to a minimum of 10% in early 2004. As of 12/31/03 subordinated debt issues still represented less than 2% of total deposits but had risen rapidly to almost 12% of Tier 1 capital of the system. Subordinated debt is found in varying percentages of the capital base throughout the banking system and was reportedly the primary instrument used to raise capital (particularly among the smaller institutions) and to meet NBU requirements several years ago. Most disturbingly, the NBU has recently announced its intentions to further encourage the Ukrainian banks to increase their capital base through the issuance of new subordinated debt (structured as limited circulation bonds) under some terms and conditions which appear to be overly liberal for market conditions.

It is widely recognized that an overdependence on subordinated debt by a commercial bank to bolster is capital base is a dangerous precedent as it simply does not resolve the fundamental issue of undercapitalization of the institution. The Basel Committee has established a number of guidelines which severely restrict the use and structure of subordinated debt as a source of regulatory capital. Under Basel Guidelines subordinated debt is considered as Tier 2 capital only and is limited to a maximum amount of 50% of the Tier 1 capital base. It should be clearly understood by the banking authorities in Ukraine that this type of funding is expensive[21], tends to force the continuation of a high interest rate environment and does not provide a long-term solution to systemic capital adequacy requirements.

In several of the more developed financial markets there have been attempts to require commercial banks to issue and maintain a certain level of subordinated debt on the theory that the market will price these instruments according to differences in individual bank risk. While there are merits to this approach, it is much too early to consider such a requirement (or opportunity) for the Ukrainian banks due to the lack of a functioning capital market combined with the dearth of reliable and publicly available financial data on which a reasonable investment decision can be made. Investments in Ukrainian commercial banks should be considered as still in the high risk 'venture capital stage'. The Ukrainian banks need to increase their capitalization

[21] The NBU has proposed raising the minimum interest rate standards for subordinated debt (which its sets) in order to make the limited circulation debt bonds a more attractive investment. Nonetheless, the proposed rate structure still amounts to a subsidy as there is no *real* market or benchmark market rate for this type debt. A properly functioning debt market which priced subordinated debt of commercial banks efficiently would certainly price these issues above the rate for Ukrainian sovereign debt, as currently proposed by the NBU.

with 'real money' and not with the short-term and temporary fix that subordinated debt offers.

There is also concern about a possible repeat of the previous pattern of capitalization in which the NBU allowed a number of small commercial banks to remain in business primarily because of artificial recapitalization based on new subordinated debt issues. Previously much of this debt was created through a series of cross-lending operations among the owners of these weak institutions and there is little indication that controls are now in place to prevent a repeat of this questionable practice. Under the Basel Guidelines, only direct bank holding companies are allowed to hold subordinated debt in other financial institutions and the NBU also has a regulation which requires that such cross-borrowings be deducted from regulatory capital calculations. It will become increasingly important over the next year that the bank supervision operation of the NBU analyze the source of new capital funds and strictly enforce its existing regulations on subordinated debt issues.

International Debt Issues

As mentioned above, there is a recent phenomenon of the larger commercial banks assuming significant amounts of international debt in the form of syndicated loan participation notes.[22] In late 2003 and early 2004 Privatbank and UkrSibbank each raised US$100 million in 3 year promissory notes through agreements with two large European banks. Several additional Ukrainian banks (Aval, UkrSotsbank, and UkrEximbank) have announced their intentions to issue similar debt instruments during the first half of 2004.

However, there are numerous dangers in this trend that that should elicit further analysis and careful policy reconsideration by the NBU. Experience from a number of countries has shown that international bond borrowings as a primary source of funding for financially vulnerable commercial banks, operating under the constraints of a transition economy such as Ukraine, must be recognized for the double-edged sword that it is.[23] It appears that the Ukrainian banking sector is the most recent target of some very heavy marketing efforts from international investment banking firms which have convinced them that of their ability to raise large sums of money for them on the 'prestigious' international markets. It should not be forgotten however, that there is always a market for 'risk at a price',

The possible problems and increased risks from uncontrolled borrowings in the international markets by the commercial banking include the following:

1. The true financial condition and soundness of the Ukrainian borrowing institution. Both of the banks which have borrowed through this mechanism to date exhibit numerous structural and operational weaknesses.

[22] By law Ukrainian banks can not access the international markets through direct bond issues. The Loan Participation Note is merely a mechanism structured to circumvent this restriction. Because of the limited recourse to the Underwriters acting as an issuing bank, the market and credit risk to the investor for these notes remains basically the same as for a standard bond instrument.

[23] The most recent examples of where excessive foreign currency exposures in the international bond markets which have contributed to the financial collapse of commercial banks would include Indonesia and Argentina.

2. Increased credit and currency risk exposures for the banking system. There are very few Ukrainian enterprises which earn significant amounts of foreign exchange on a regular basis. There also appears to have been minimal analysis of the full impact or effect of a default if the bank is unable to repay or renew this large debt.

3. The high cost of such borrowings which reflect both the direct credit risk of the borrower and country risk factors. The high price paid for this debt will force continued high lending rates as the banks seek a positive margin on the use of these funds.

4. Minimal involvement or control from the regulatory authorities in analyzing the complex consequences of such large foreign currency exposures to both the borrowing commercial banks and their loan customers. The macroeconomic impact of this amount of new money in circulation, including a possible increase in inflation, also does not appear to have been adequately considered.

5. The lack of 'absorption capacity' in the economy for large amounts of new loan funds. The inability to use these funds effectively in the market by lending to viable, creditworthy, foreign currency earning enterprises could lead to a possible increase in related party lending and further concentrations of credit.

Lastly, this new phenomenon of accessing the international markets has created a growing market for the rating agencies in Ukraine. In order to issue debt on the Euromarkets, the banks have been required to announce a 'rating' from an international ratings agency such as Moody's or Fitch International. Several banks now have debt and individual financial soundness ratings and several more have recently contracted with these firms to conduct their due diligence studies on their operations for the same purpose.

There seems to be not only considerable misunderstanding and misinterpretation as to what these ratings are really saying about these banks and their debt issue, but a false sense of accomplishment by the institution from the mere fact of 'being rated' at all. The fact is that the bank and debt ratings received to date are very poor. It needs to be understood that the rating grade given for the debt instrument itself is the result of the same analysis as conducted on the bank. Individual bank ratings are an assessment of the intrinsic strength of the bank and the level of support it can be expected to receive from its owners or the government in times of difficulty. The rating for the debt issue reflects the likelihood of default under current market conditions. These ratings have a major impact on the pricing of the debt instrument being sold.

The ratings which have been awarded on each of the two large loan participation debt issues for Privatbank and UkrSibbank are B and B-, which are not considered as investment grade in most countries and are only slightly above what has traditionally been awarded for junk bonds**.** Each bank has been awarded a Support rating of 5, which is the lowest classification and means that investors can expect very little, if any, additional financial support to assist these institutions if they are in financial difficulty.

Most telling and despite some encouraging analytical comments which speak of recent improvements in bank management, market share, and loan quality, is the fact that both banks received abysmal individual ratings of D/E - the bottom grade that would cause most international investors to avoid any long-term credit exposure to these institutions. The unfortunate reality is that neither of these banks is truly qualified to enter the international debt markets at this time and doing so has only ensured that any funds they are able to raise will come at an extremely high price.[24]

The NBU has an obligation to become more engaged in this issue and develop more stringent financial guidelines and rules regarding the eligibility of commercial banks under their supervision to enter the international debt markets, particularly for such large amounts.

Loan Portfolio Quality and Provisioning

Most banks have reported that the quality of their loan portfolios improved during 2003, with the average share of so-called ‘bad loans’ for the top 10 banks dropping to an average of 6% in comparison with 13% at the end of 2002. The Association of Ukrainian Banks, citing general numbers from NBU statistics, states that *“Problem loans declined from 4.5% of loan portfolio to 3.4%”* – a statement and ratio which is open to wide interpretation and does not correspond to the more detailed financial data presented below.

The issues of proper asset classifications and the creation of sufficient loan loss provisions have been long standing problems for the Ukrainian banking system. Asset classifications are theoretically performed and updated on a regular basis by bank management. They are further adjusted and verified each year at the time of the annual on-site examination conducted by the NBU and in preparation of audited financial statements. Often these results are not representative of the true level of loans which would normally be adversely classified under prudent bank accounting procedures due to the infrequency of such exams. While the absolute level of performing loans appears to have improved statistically, it should be noted that these percentages are on a rapidly increasingly loan base which by definition includes loans that are too new to rate as only minimal time has elapsed in which to monitor performance.[25] Meanwhile the percentage of adversely classified loans has increased over 2002 levels. Historically, the commercial banks have greatly overestimated the overall quality of their loan portfolio and often do not report substandard or prolonged loans in their general rubric of bad loans.[26]

[24] The announced interest rates for these debt instruments of 10.875% and 10.5% are well above current market rates for quality investment risk and do not reflect the additional 4-5% of the borrowed amount that was paid by the banks in loan and placement fees to the underwriters.

[25] There is sufficient empirical evidence from banking sectors worldwide that indicates that in such a rapidly expanding credit environment, the actual level of loans which should be adversely classified should be higher than normally reported. Consequently, the required level of loan loss provisions should also be increased.

[26] One of the problems embedded in the Ukrainian system of loan classifications is the over-weighting of collateral held against loans, the stated value of which Ukrainian banks are allowed to deduct from the required loss reserve calculations. This is the consequence of the fallacy of overdependence on secured lending practices vs. basing credit on cash flow repayment capacity.

The following table presents the trend in loan asset classifications as a percentage of total loans, over the last 3 years:

Table 11:
Changes in Aggregate Asset Classifications
(as a % of total loans)

Classification of loans	As of 12/31/01	As of 12/31/02	As of 12/31/03	Average % Δ yoy**
Standard (performing)	39.1	37.7	66.6	36.5%
Watch (performing but weak)	36.6	40.4	5.0	-38.4%
Sub-standard (prolonged)	14.8	14.7	21.1	21.5%
Doubtful (past due)	3.6	3.1	4.6	17.3%
Loss	5.9	4.1	2.7	-35.3%
Loan Loss Reserves				**Absolute change**
LLR required by NBU*	3,714	4,678	5,452	16.5%
Actual LLR reserved*	3,194	3,878	5,355	38.0%
Actual as % of required	86%	83%	98%	9.3%
Charge to LLR for year	1,057	926	1,725	86.3%

Source: National Bank of Ukraine
*this reserve account is titled: Provision for Active Operations of which LLR constitutes an average of 98% of the total: Hence the total figure has been used.
** calculated as (% Δ 2001/2002 + %Δ 2002/2003) / 2

The level of the reported 'shortfall' in required loan loss reserves (LLR) has continued to decline notably from 2001 levels but it is unclear exactly how this achievement has been realized since: i) the level of loans which NBU regulations state require classification reserves has risen at a much greater rate over the past year, than the profile of classified assets; ii) the actual amount of loan loss provisions created by the banks is well below the level that the rapid rate of loan expansion would normally imply, and; iii) the actual figures do not appear to include the increase in the reserves against risk assets of 2% required on all new and performing credits, although this amount may very well be hidden in the general reserves category which is included in the capital base.

In 2003 the banks made a major adjustment in their loan classification methodology by shifting a number of credits from the Watch category into a more liberally defined Standard or performing category. There does not appear to be any documented rationale for this move and as a result the overall internal classification system as practiced by the Ukrainian banks remains suspect. This shift is also a reflection of the banks' aggressive lending practices and the non-classification of any of the new credits extended during 2003. Historical evidence clearly demonstrates that under such growth environments a more predictive and forward-looking provisioning policy, as opposed to the after-the-fact methodology currently employed should be followed.

More specifically, despite announced collection efforts by the banks, the trend of loans classified as substandard and doubtful continues to deteriorate as a percentage of total loans. NBU statistics indicate that, at a minimum, the level of NPLs was 28.4% of total loans as of year end-2003, which represent an almost 30% increase

over the level reported for 2002.[27] The NBU reports that as of year end 2003 the total of adversely classified loan assets was 24.1 billion hryvnia (US$ 4.5 billion) of which 6,2 billion hryvnia (US$ 1.2 billion) was classified as Loss. This is very damaging empirical evidence of the continued poor risk management controls and weak credit administration skills evident in the Ukrainian banks and is particularly disturbing in light of the rapidly expanding credit extensions noted during 2003.

The reported 98% 'coverage ratio' of funded reserves to the level of provisions required by NBU regulations is a misleading statistic because of the overly liberal classifications definitions in effect combined with the allowance to deduct questionable collateral values from required reserves. A more proactive risk-based supervision system should correct this shortfall.

Changes in Bank Capitalization

During 2003 the total level of shareholder's equity investment (book capital) in the banking sector increased by 2.4 billion Hryvnias (29%). While still well below the growth rate of both loans and deposits, this must be considered a positive development for the banking sector as a whole. Increases in the capital account can be attributed primarily to a sizeable increase in paid-in authorized capital which made up 88% of the increase amount. Aggregate current profits and increases in accumulated reserve funds from retained earnings accounted for the balance of this growth. These figures were adjusted to remove the impact of another increase (55% above the 2002 balance) in revaluation reserves on fixed assets which has been incorrectly included (100%) as part of the capital base.

A recent independent banking study conducted by the Oxford Policy Management Group has raised a number of interesting questions regarding the soundness and sustainability of the Ukraine banking system in terms of its capital adequacy. This study introduces the concept of capital creation and capital consumption in the course of bank operations. This is a dynamic measurement tool which states that for a period of time banks can consume capital and expand their operations internally with the expectation of future profits, only to the degree that they have adequate levels of surplus capital to begin with.[28] As a bank increases the size of its risk asset portfolio it concurrently requires the inclusion of a percentage of its capital base to support this growth—in order to maintain a minimum capital adequacy ratio (CAR). Continued rapid growth in loan assets consumes capital and requires the bank to either re-invest earnings or approach shareholders for new capital funds.

This study clearly demonstrates that in the case of Ukraine virtually all of the banks which have achieved the largest market share have no better capital adequacy than smaller institutions and are characterized by significantly negative self-capitalization capacity levels. They are rapidly consuming their unused capital. The fastest growing banks demonstrate higher internal costs, higher customer prices and poorer asset deployment than the slower growing banks.

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[27] Non Performing Loans (NPL) are defined as the total of loans adversely classified as substandard, doubtful and loss.

[28] This is the theory of 'self-capitalization capacity'

Table 12 provides comparative illustration of this lag in growth in capital formation during periods of rapid asset expansion as well as the lagging indicator of concurrent earnings growth.

Table 12:
Growth Rate of Book Capital vs. Loans
(Percentage growth y-o-y)

	2001	2002	2003
Capital Growth Rate	21.6	26.1	29.0
Loan Growth Rate	35.6	45.6	57.1
Earnings Growth Rate	-20.5	28.7	20.8

Source: Calculations from NBU statistics

The wide disparity in these critical growth rates is even more pronounced when the compounded average growth rates for the period of 2001 through 2003 in each category are compared:

a) The loan portfolio has expanded an average of 46.1 % annually since 2001;
b) The capital account has grown by an annual average of 25.6 % since 2001, and;
c) The net profitability of the banks have exhibited an average annual growth of 9.7%

This means that the banks have expanded their loan portfolios almost twice as fast as they have increased their capital position and have done so with only a marginal average net profit performance. While the Ukrainian banks have generally complied with the minimum 8% capital adequacy ratio recommended by the Basel Committee, this static ratio method for measuring bank soundness is not adequate for the current market conditions and risks found in Ukraine.

A proper calculation of the capital of the banking sector, under the Basel 1 Guidelines, would exclude both the fixed asset revaluation reserves and the current period earnings from the Tier 1 capital base. This would reduce the aggregate capital base of the system by 18.5% to 10.5 billion Hryvnias. Of this total the paid-in authorized capital (referred to by the NBU as regulatory capital) equaled 77.1% or 8.1 billion Hryvnias.

Table 13 below, illustrates that as risk assets have grown—the overall capital adequacy measurements of the banking sector have remained weak or continued to decrease.

Table 13:
Ratios characterizing the capitalization level of the banking sector

Ratio	12/31/01	12/31/02	12/31/03	% Δ yoy
Tier one capital to aggregate assets	14.4%	13.3%	9.5%	-28.6
Regulatory capital to risk-weighted assets	11.7%	11.1%	12.3%	10.8
Regulatory capital to total assets at risk	10.6	10.8%	11.2%	3.70
Funded provisions to regulatory capital	69.5%	65.0%	49.1%	-24.6
Regulatory capital to total loan portfolio	14.3%	12.8%	14.8%	13.3
Regulatory capital to loss credits ratio	7.15 times	7.13 times	7.0 times	-1.8

Source: Calculations from NBU statistics

The continued undercapitalization of the Ukrainian banks and their inability to 'grow out of it' from internally generated earnings is creating an unsustainable situation. The amount of fresh capital required to support the system-wide expansion experienced in 2002 and 2003, is now significant and is placing a high burden on many current shareholders. This situation is acerbated by the new cash investments necessary to meet increased NBU regulatory requirements and capital adequacy ratios. Despite this required increase in capitalization, there remains a high degree of systemic risk in the Ukrainian banking sector as any failure of the larger banks to increase their capital base with new equity capital could very well portent a future collapse of the banking sector as currently structured.[29]

As a part of its transition towards risk-based supervision practices amore dynamic approach to measuring bank capital adequacy has been introduced to the NBU. A new tool that is being tested in the bank supervision department is the matrix presented in Table 14 below. This table puts forward a listing of the myriad of external and internal topics and issues that should be addressed and considered in calculating and maintaining bank capital above a basic regulatory minimum.

Table 14:
MATRIX FOR ADJUSTMENTS TO CAPITAL ADEQUACY RATIO

CIRCUMSTANCE OR RISK AREA	POSSIBLE SCORES (basis points)	
CAPITAL ALLOCATION		
I. ECONOMIC CONDITIONS IN HOST COUNTRY:		
Annual inflation < 10% per annum	0	min. score = 0
Annual inflation > 10% and < 25% per annum	10	max. score = 25
Annual inflation > 25% per annum	25	
II. a. NEWLY LICENSED BANK:		
Over five years old	0	min. score = 0
Less than five years old, but greater than one year old	25	max. score = 50
Less than one year old	50	
II. b. BANK OR PARENT COMPANY PUBLICLY TRADED:		min. score = 0
Yes No	0 10	max. score = 10
II. c.		
BANK HAS BORROWED IN THE FORM OF SYNDICATED LOAN FROM A LARGE BANK WITH ITS HEADQUARTERS LOCATED IN AN OECD COUNTRY		
Yes No	(10) 0	
BANK HAS ISSUED DEBT THROUGH AN EXCHANGE LOCATED IN AN OECD COUNTRY		min. score = (25) max. score = 0
Yes No	(25) 0	
II. d. STRUCTURE OF CAPITAL:		
Tier I capital > 90% of total risk-based capital	0	min. score = 0
Tier I capital > 75% of total risk-based capital < 90% of total risk-based capital	10	max. score = 25
Tier I capital < 75% of total risk-based capital	25	
II. e. POTENTIAL FOR A CAPITAL INFUSION:		
Can raise Tier I capital by 10% in less than 6 months	0	min. score = 0
Can raise Tier I capital by 10% in less than one year	10	max. score = 25
Can raise Tier I capital by 10% in more than one year	25	
II. f. PARENT COMPANY SOURCE OF STRENGTH:		
The bank has no parent company or affiliates	0	min. score = 0
Parent company and affiliates are a clear source of strength	0	max. score = 100
Parent company and affiliates are a neutral source of strength	25	
Parent company and affiliates are a threat to bank capital	100	
III. a. STRATEGIC RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	10, 5	max. score = 35
Aggregate Level of Risk High, Direction of Risk Increasing	25, 10	

[29] It is particularly important that any increase in bank capital consist primarily of Tier 1 eligible assets as many of the larger banks have reached prudent limits to the level of Tier 2 quasi-capital instruments that can counted in the regulatory capital base for CAR purposes.

III. b. LEGAL RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	5, 5	max. score = 20
Aggregate Level of Risk High, Direction of Risk Increasing	10, 10	
III. c. REPUTATION RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	5, 5	max. score = 20
Aggregate Level of Risk High, Direction of Risk Increasing	10, 10	
III. d. OPERATIONAL RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	25, 5	max. score = 60
Aggregate Level of Risk High, Direction of Risk Increasing	50, 10	
III. d. 1. INTERNAL AUDIT:		
Risk-based audit AND full-scope audit coverage	0	min. score = 0
Not risk-based OR not full-scope audit coverage	5	max. score = 20
Neither risk-based NOR full-scope audit coverage	10	
Internal audit department reports to the supervisory board	0	
Internal audit department reports to the bank president	5	
Internal audit reports to any other group or person	10	
III. d. 2. EXTERNAL AUDIT:		
Most recent external audit opinion is unqualified. Adjustments <10% from previous	0	min. score = 0
Most recent external audit opinion is qualified. Adjustments >10% from previous	50, 25	max. score = 250
Most recent external audit opinion is adverse, raising questions of the bank as a going concern. Adjustments > 25% from previous audit.	200, 50	
III. d. 3. INTERNAL LOAN REVIEW:		
Independent of lending function	0	min. score = 0
Not independent of lending function	25	max. score = 25
III. e. CREDIT RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	25, 10	max. score = 125
Aggregate Level of Risk High, Direction of Risk Increasing	100, 25	
III. e. 1. PROBLEM CREDITS ADD-ON FOR CREDIT RISK:		
Adversely classified assets to tier one capital < 50%	0 – 25	min. score = 0
Adversely classified assets to tier one capital > 50% < 100%	25 – 50	max. score = 150
Adversely classified assets to tier one capital > 100% < 200%	50 – 100	
Adversely classified assets to tier one capital > 200%	100 – 200	
III. e. 2. LARGE EXPOSURES ADD-ON FOR CREDIT RISK:		
Large exposures are less than 400% of tier one capital. Management of risk adequate	0	min. score = 0
Large exposures are 400-600% of tier one capital. Management of risk raises concerns	5, 5	max. score = 25
Total of large exposures is 600-800% of tier one capital. Management of risk insufficient	10, 15	
III. e. 3. ASSET GROWTH RATE:		
Risk-based asset growth minus inflation < 10% per year	0	min. score = 0
Risk-based asset growth minus inflation 10-20 % per year	10	max. score = 50
Risk-based asset growth minus inflation 20-30% per year	25	
Risk-based asset growth minus inflation > 30% per year	50	
III. f. LIQUIDITY RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	25, 5	max. score = 85
Aggregate Level of Risk High, Direction of Risk Increasing	75, 10	
III. g. INTEREST RATE RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	10, 5	max. score = 35
Aggregate Level of Risk High, Direction of Risk Increasing	25, 10	
III. h. FOREIGN EXCHANGE RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	10, 5	max. score = 35
Aggregate Level of Risk High, Direction of Risk Increasing	25, 10	
III. i. MARKET (PRICE) RISK RATING AND DIRECTION:		
Aggregate Level of Risk Low, Direction of Risk Decreasing	0	min. score = 0
Aggregate Level of Risk Moderate, Direction of Risk Stable	10, 5	max. score = 35
Aggregate Level of Risk High. Direction of Risk Increasing	25, 10	
RISK ADJUSTED SCORE TOTAL		min. score = 0 max. score = **1205**
PLUS MINIMUM INTERNATIONAL REQUIREMENT		**800**
TOTAL RISK-BASED CAPITAL NEEDED (This figure can not fall below 1000, even if the risk-adjusted score is –0-, showing capital needed of 800.)		min. score = 1000 max. score = **2,205**

Source: B. Stirewalt, BearingPoint. Inc.

This matrix - which must be recognized primarily a as *a tool for supervisors* and not as a firm regulation, provides positive incentives for a bank to maintain strong risk management systems and adequate levels of capitalization. This concept has been designed to assist the off-site analyst and bank examiner in the determination of a general range of capital investment that would be considered sufficient to ensure bank soundness. This amount of capital can be used to show a methodical and less arbitrary approach to determining the level of capital a bank needs. While the capital allocations are numerical in nature, considerable judgment is still necessary on the part of the analyst or inspector to ensure the capital allocation matches the bank risk profile and risk management systems.

The capital allocation matrix follows three basic areas of risk to a bank.

1. The first area is macroeconomic conditions in the host country. When the local economic environment is unstable, a bank needs more capital;
2. The second major area is the legal and organizational structure of the bank or banking group, and the level of capital support that is provided from the parent company and affiliates, if applicable, and;
3. The third area of consideration, where the largest amount of capital should be allocated, is the current financial condition of the bank and the bank's risk management systems.

Ownership Structure and Transparency

The concerns regarding insider transactions and transparency in ownership remain paramount in the current structure of the Ukrainian banking sector. Beyond the many corporate governance issues which affect the financial institutions in general[30], the historical ownership structure found in most Ukrainian commercial banks has led to a higher than normal incidence of related party lending and insider transactions. Contrary to normal international standards and best practices, there are only minimal limitations or restrictions on the ownership structure of a bank which has led to a number of banks, including several of the largest, to be almost wholly-owned by single individuals, family groups and multi-layered and closely held corporate conglomerates.[31]

The issue of transparency and full disclosure of the information regarding the ultimate beneficial ownership of financial institutions is also at the forefront of the current corporate governance debate. Historically, a primary rationale for forming a bank in Ukraine was tax avoidance which in turn led to hiding the ultimate ownership of the institution. This was often accomplished through the creation of a network of inter-linked corporate fronts which protected the ultimate beneficiaries from scrutiny from both tax and bank supervision authorities. This structure has allowed the creation of a number of so called pocket banks whose main purpose has been to serve the financial

[30] The myriad corporate governance problems inherent throughout all sectors of the Ukrainian financial markets are discussed in greater detail in a separate section of this paper.
[31] Ukrainian corporate law and NBU regulations require that there be at least 2 separate registered shareholders for an open joint stock corporation. In fact there are several banks that are effectively 100% owned by a single individual through their cross holdings in off-shore corporations and 'third-party' companies in which they also own the majority of shares.

needs of the owner. It has also led to significant abuses of the public trust over the years, ultimately resulting in several bank failures.

Partially as a result of work begun during Ukraine's the recent anti-money laundering program, the NBU has embarked on a concerted effort to require, under threat of stronger enforcement measures, the banks to provide full and complete disclosure of their ownership and related party structures. There is increased realization that one of the fundamental weaknesses in the financial safety and soundness of the Ukrainian banking sector is the high level of insider and related-party transactions. The NBU will be requiring more complete ownership disclosure in order to properly calculate compliance with its concentration of credit regulations as well as to better evaluate risk management and corporate governance procedures.

It is doubtful that there will be any substantial reduction in the number of established pocket banks in the near term, as this area is a political minefield. However, it is safe to forecast a gradual reduction of their weight and influence in the Ukrainian banking industry, firstly due to further growth of the largest private banks which have been forced to become more public in their actions and, secondly, due to increased competition for market share led primarily by the more efficient operational procedures of the foreign-owned or controlled banks. An increase in foreign investment as well as a liberalization of the NBU regulations regarding entry rules for foreign banks could subsequently lead to an increase in the number of large international banks operating in Ukraine. Foreign competition will unambiguously lead to (and in some cases, force) an increase in the efficiency of Ukrainian banks, their profitability and product diversification.

Dollarization of the Banking Sector

Currency substitution, in which the financial sector shifts from the use of local currency towards convertible foreign currencies, commonly called 'dollarization', has been on the rise in most transitional economies for a number of years. In the case of Ukraine, this phenomenon was pronounced in the early 1990's but appears to have decreased as the economy has somewhat stabilized and the populace has regained confidence in the Hryvnia.

The introduction of an open foreign exchange market invariably led to a very rapid increase in the share of foreign currency denominated assets and liabilities in the banking system. Permitting foreign currency deposits has commonly served as a vehicle to foster financial intermediation and financial deepening at a time when the local banking systems were still considered fragile. Dollarization of the financial sector has also made it possible for domestic financial intermediation to be conducted in both domestic and foreign currencies, with residents being able to denominate and settle domestic contracts in either currency, as well as arbitrage freely between onshore and offshore accounts.

The NBU regulates the country's foreign exchange and currency markets and continues to monitor all transactions closely. While the foreign exchange markets are open and the Hryvnia readily convertible (locally), the exchange rate is closely managed through a 'dirty float' which requires the regular intervention of the central bank. Additionally, the NBU has established regulations covering acceptable limits on the net open currency position of a bank to control the degree and risk of excessive

currency mismatch in the system. The NBU has set a general normative limit of 35 % on a bank's total net open position for all currencies and it appears (subject to the negative effects of averaging the data) that the banks are in compliance with this operational regulation.[32]

As in other transition economies, domestic and foreign currencies compete in deposit and loan markets of the banking sector. In Ukraine there continues to exist a notable interest rate differential between the Hryvnia and foreign currencies reflecting the myriad of economic factors that determine the relative strength of a currency and the movements of the foreign exchange rate markets. The degree of currency substitution is usually measured by the ratio of foreign currency deposits to total deposits in the banking system. In Ukraine, while the total volume of deposits has increased substantially; the ratio of total foreign currency deposits to total deposits has remained basically flat at 47% over the past three years. As of year-end 2003, foreign currency denominated deposits totaled 19.6 billion hryvnia (US$ 3.7 bn.).

It is also important to recognize that the trend in new deposits from individuals, which expanded dramatically in 2003, has shown a notable preference for foreign currencies. As of 12/31/03, 42% of total deposits held by individuals were placed in foreign currencies, as compared to only 21% of total corporate deposits. While this could be interpreted as a negative trend and a weakening of public trust in the Hryvnia, it is more likely an affirmation of the belief that the NBU will maintain currency stability and that the foreign exchange markets will remain open and active. Total foreign currency denominated bank deposits are still well below the total volume of loans extended in foreign currencies, however, this gap is closing slightly due to the growth in individual deposits cited above.

The banks appear to have lent a disproportionate level of their funds in foreign currency and are, highly exposed to unhedged foreign currency risks. As of 12/31/03 bank foreign exchange exposure in total corporate and individual credits totaled of 28.3 billion hryvnia against total foreign currency deposits from both sources of only 19.6 billion hryvnia—a long position of 9.2 billion hryvnia or 33% of FX loan exposures. For historical reasons there has been a degree of dollarization in the Ukrainian loan market with total credits issued and repayable in foreign currency representing 42.3% of the sector's loan portfolio as of year-end 2003. Thus the banking system is operating their credit portfolios with an increasing currency mismatch in which the loans denominated in foreign currency exceed the bank's foreign currency deposits.

Because there is very little trend data on bank management practices in the area of currency risk management available, there is concern that the banks may not be monitoring this type of risk sufficiently. It may be that many banks are lending in foreign currency to enterprises that do not generate sufficient foreign currency income to service their debt without an over-dependency on volatile foreign exchange markets. This is an area where the new risk-based supervision program being adopted by the NBU can be useful in properly measuring the net open positions of the banks

[32] The obvious exception to this statement would be the effect of the recent large offshore borrowings of 2 major banks which while not in technical violation as foreign currency cash should equal (or exceed) these foreign currency liabilities—have not completed converting these funds into earning assets (loans) which may or may not be denominated in foreign currency.

as well as their vulnerability in operating with a significant deposit/loan currency mismatch.

III. Summary and Recommendations

As a result of the research conducted, the most recent IMF FSAP mission and the financial performance analysis performed for the 2003 banking operations, a number of common structural weaknesses and restraints currently impacting further development of the Ukrainian banking system have been noted. The joint IMF/World Bank program for periodic financial sector appraisals (FSAP) has proven to provide a particularly thorough analysis and is an effective measurement tool for addressing the structural and operational shortfalls of national banking systems.

The primary findings of the IMF report on the latest FSAP review (2002) concluded that the Ukraine banking system is:

- a highly concentrated, high cost and inefficient banking system dominated by a very few state-owned or the larger politically connected institutions;
- only marginally profitable with below industry standards for net profits vs. high gross margins and only minimally acceptable returns on average assets;
- well behind the development of other banking systems in similar transition economies in consolidating the banking sector through the closure of failing institutions or forcing operational changes in the less efficient and/or politically connected institutions;
- fundamentally undercapitalized while experiencing a period of very rapid and probably unsustainable expansion in both credit extension and deposit mobilization. Most banks are consuming capital at an alarming rate;
- inconsistent in the transparency of its financial reporting and a high degrees of as well as a very strong aversion to transparency in its operations;
- operating under a noted lack of good corporate governance practices, and;
- extremely weak in the implementation of the most common risk management categories of: Credit Risk, Liquidity Risk, Interest Rate Risk and Operational Risk.

While some of the above cited issues have been effectively addressed by the NBU over the past year, the analysis of the 2003 financial data for the banking system and research for this study shows that many of the fundamental problems revealed by the IMF remain. At this stage in the development of the Ukrainian financial markets, and particularly the banking sector, many of the outstanding issues and obstacles to further progress can be characterized as ‘intrinsic impediments’. They were created at the inception, have taken on a life of their own, are now well entrenched in common business practices, and will require a high degree of political will and time to make

the changes in cultural behavior required for resolutions which will allow the sector to evolve in a positive and sustainable manner.

The main recommendations for promoting the stability and sound development of the Ukrainian financial system can be divided between those of immediate importance which are either already in motion or readily implementable, and those requiring more preparation.[33]

Short term, rapidly implementable:

- Continue the program of closely monitoring bank capitalization and requiring periodic increases. Emphasis should be on Tier 1 eligible instruments and calculations of minimums set through risk-based criteria. For most banks this would be well above the minimum 10 percent CAR recently set by the NBU.
- Require banks through prudential supervision to limit foreign currency-denominated credits to borrowers without a reliable source of foreign currency earnings.
- Further strengthen supervisory controls on insider and connected lending; implement consolidated supervision regulations.
- Maintain requirement that banks take prompt corrective action to rectify any prudential deficiency, and strictly avoid forbearance.
- Clarify to the public the prioritization of the central banks domestic and external monetary policy targets.
- Continue phase out the NBU's longer-term refinancing facility and strictly limit refinancing provided to short-term liquidity driven operations. Require that only high-quality collateral of matching maturity be accepted for rediscounts.
- Make operational the new regulatory agency for non-bank financial institutions.
- Implement some approval and monitoring controls over the size and concentration of the issues of bank debt in both the local and international markets, particularly when they involve excessive currency risk exposure.
- Continue, with increased vigor, the current program for the rehabilitation and restructuring of the Savings Bank.

Medium term, possibly requiring amendments to laws and regulations, or other extensive preparations:

- Review and revise loan loss provisioning regulations and shift emphasis to a forward looking rate system based on empirical evidence of actual NPL levels and losses.
- Tighten regulations on allowable instruments and ownership percentage for bank equity investment.
- Require banks to prepare accounts fully in compliance with IAS on an ongoing basis throughout the operating year.
- Integrate the insurance of deposits at the Savings Bank into the FGDNP system.

[33] This list of recommendations closely follows those put forth by a recent IMF / World Bank FSAP report.

- Appropriately limit the conditions under which central bank management can be replaced; and determine central bank profit transfers to government on the basis of realized profits.
- Update and extend regulation for non-bank financial institutions, notably for leasing companies, pension funds and credit unions.
- Consolidate securities exchanges, registrars, and depositories; increase disclosure requirements.
- Further update, standardize and modernize the mortgage law, land and building titling, and the law on secured transactions.
- Strengthen shareholder rights by increasing access to corporate information, moving towards international standards in corporate accounting and audit, facilitating shareholder control of management, and reinforcing supervisory boards (including of banks).

In order to strengthen the financial soundness of the banking system and ensure its transparency, the following actions steps are recommended:

- Improve the quality of corporate governance and internal audit at banks by:

    - Strengthening the requirements to the qualifications and business reputation of the members of the Supervisory Council of the bank;
    - Increasing the responsibility of the owners of the bank for its activities;
    - Broadening the functions of the Supervisory Council with regard to the determination of the bank's development and operating strategy, its organizational structure, comprehensive risk management system, risk limits, approval of internal policies, etc.;
    - Raising the status and role of internal audit and risk management functions;
    - Improving the procedure for reviewing the business reputation, education and work experience of the managers of the bank and its structural units, when they are appointed to their positions and in the process of their work. (a fit and proper test)

- Strengthen the role and quality of external audit based on the implementation of International Standards on Auditing and toughen the qualification requirements for firms allowed to conduct bank audits.

- Take actions aimed at avoiding conflicts of corporate interests.

- Implementation in banks of efficient risk management systems, including:

    - procedures for identification, monitoring and control of banking risks, in particular, credit, operational, interest rate and market risks;
    - models for measuring risks;
    - contingency planning;

- work aimed at training qualified experts in the risk management area.

- Ensure transparency in banks' activities by means of:

  - Strengthening requirements to the content and format of publications of annual and interim financial reports, including to their re-publication of reports where material deficiencies were disclosed. Banks must publish profound and detailed information on their financial condition, owners, management structure, major investments and volumes of reserves, sources of income, risks taken by the bank and the quality of their management;
  - Strengthening responsibility of bank management for accuracy and timeliness of reports, as well as accuracy of commercials;
  - Continuing the work on the implementation of International Financial Reporting Standards, including those concerning recognition of financial instruments, and International Standards on Auditing;
  - Implementing Basle Committee requirements to the disclosure of quantitative and qualitative information on the condition and performance of banks;
  - Educating on approaches to the interpretation of financial reports;
  - Expansion of the network of rating agencies as independent experts in risk assessment.

- To increase the level of capitalization of banks by means of:

  - Ensuring an inflow of capital to the banking system;
  - Improving assets quality, more active problem debt collection efforts;
  - Profitability growth, including through the growth in the range of risk free commission operations;

- More optimum structure of expenses, in particular, more reasonable approach to operating and administrative costs;

- Strengthening NBU control over bank's compliance with capital adequacy requirements.

- Redefine the nature of those transactions and financial data that are to be included in bank secrecy regulations and increase normal transparency in operations while also increasing individual responsibility for illegal disclosure of confidential information.

- Address at the legislative level the protection of the rights of creditors by means of:

  - Creation and maintenance of a register of titles to real estate as tied to the land plot;

  - Establishment of priority title of the first creditor to the property pledged by means of the registration of property liens;
  - Establishment of credit history bureaus in order to accumulate and exchange information on the creditworthiness of bank borrowers;
  - Simplification of formal collateral procedures and the sale of collateral;
  - Determining various conditions and ways of the sale of collateral;
  - Allow for the sale of collateral, when the borrower is bankrupt, before other creditor claims;
  - Restrictions on the use by the debtor in his/her benefit of the moratorium on meeting legitimate claims of creditors.

- Address at the legislative level the protection of depositors' rights, including:

  - improving the bank liquidation procedure;
  - improving the system of individual deposits insurance, and;
  - ensure that banks, whose activity threatens the interests of depositors or creditors, exit the market on a timely basis.

- Enhance the professional level of management and key owners of banks.

Corporate Governance in Ukraine

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I. Regional Developments

> **"The governance of the corporation is now as important in the world economy as the government of countries."**
>
> *James Wolfensohn, President, The World Bank*

In Ukraine, as in all other countries in the FSU, capital markets were created in order to provide a trading outlet for company shares, following voucher privatization of state-owned enterprises. A securities commission was established in 1996 to provide the regulatory oversight and support for the further development of the capital markets. The much anticipated evolution of Ukraine's capital markets into becoming the repository of securities have yet to materialize. The lack of progress in this area can be explained by factors ranging from infrastructure and the legal and regulatory frameworks, to the general environment for business in the country.

In some countries such as the Czech Republic, capital markets were initially created as support institutions to implement massive voucher privatization programs. In such cases, capital markets were established even before sound regulatory frameworks and competent market regulators were in place. Other countries such as Poland, followed a more traditional approach and legal institutions were created before trading practices were established. Yet other countries in the region still have under-developed capital markets due to unfavorable economic conditions.

After more than ten years of transition, the development of capital markets and the degree of sophistication of legal and regulatory frameworks varies from country to country. While countries endeavor to establish modern and efficient capital markets, world financial markets are not standing still and the global economic environment is rapidly changing.

Strong globalization and consolidation trends in world financial markets raise concerns about whether transition country capital markets will ever achieve the necessary economies of scale to compete internationally by becoming a vibrant mechanism for price discovery as a repository for securities.

Most importantly, the weakness in corporate governance has been a large impediment to attracting financial capital to these countries. These considerations gave way to questions as to whether it is worthwhile for international donors to invest time and resources to establish individual capital markets.

II. Background

Corporate governance is generally defined in the context of issues and problems that result from separation of ownership and control in organizations. Corporate governance sets up a system of institutions that govern the relationship between investors, the company boards and creditors on the one side, and managers on the other side. What it does is very important for companies trying to succeed not only in domestic markets, but also in markets abroad – it provides for competition that is based on fair, transparent and responsible practices. An important aspect of corporate governance is the fact that much attention is being paid to relationship between managers and other stakeholders, protection of shareholder rights and independent

supervision over activities of a business entity. Corporate governance sets up a system where rules are reinforced by written regulations, and also by moral standards of business ethics and by responsible corporate behavior.

Corporate governance strongly depends on the institutional development of a country. This is because a system cannot be set up under a weak or non-existent framework of rules and regulations. In this context, establishing these mechanisms in developing economies is a much greater challenge. In many cases, developing and transition countries lack strong and sound institutions that are vital to the development of such mechanisms.

Transition economies generally experience three types of corporate governance abuses:

1. *Asset stripping* – the sale or transfer of a company's assets at below-market prices to companies that are owned or controlled by company managers or controlling shareholders;
2. *Transfer pricing* – the sale of a company's products at below-market prices to an affiliated company, and;
3. *Share dilution* – the issuance of capital to a targeted group of shareholders without protection of the pre-emptive rights of existing shareholders to participate in the capital increase.

Corporate governance principles rest on the fundamental recognition that there exist a set of relationships between shareholders, board, management and other constituencies in the governance of a company.

These relationships promote four values of good corporate governance: transparency, accountability and responsibility of the management, and the fair and equitable treatment of all shareholders.

These issues have been widely discussed in various fora in the region and around the globe, and remedies for improvements have been recommended. As long as these infractions occur, corporate governance practices will be weak.

Good corporate governance practice will rely on the combination of external and internal systems of corporate governance. The objective of a good ***internal governance*** system is to ensure sound corporate decision-making, reflecting the interests of both majority and minority shareholders of the company, and the relationships between the shareholders, the board and the management. It is important to stress that decision-making should also reflect the interests of minority shareholders, to avoid situations where the majority shareholder uses its position of influence and control to extract personal gains, jeopardizing the financial viability of the enterprise and the interests of minority shareholders and creditors. The objective of ***external governance*** system is to provide a framework of reference for the discipline in which insiders such as managers or shareholders of entities deal with issues of mergers and take-overs; creditor monitoring; collateral and foreclosure rules; bankruptcy framework, and enterprise restructuring.

These rules are expected to provide a level playing field, which will strengthen the internal mechanism of governance and provide a discipline for the relationships between an enterprise and its stakeholders. While the adoption of legal and regulatory frameworks similar to those in developed countries is not difficult, the key to

developing and maintaining sound capital markets in the long term lies in strong supervision of market activities and rigorous legislation enforcement.

III. Overview of Corporate Governance in Ukraine

The importance of good corporate governance has increasingly become a part of the public debate and has seemingly entered the social conscience in Ukraine.[1] Unfortunately, however, Ukraine's corporate governance framework is considered to be among the weakest in transition countries. Based on the OECD corporate governance principles, the World Bank/IMF ROSCs and EBRD assessments place Ukraine's corporate governance framework behind not only the EU-accession countries of Latvia and Bulgaria, but also behind Croatia, Russia and Georgia, as shown in the summary matrix in Table 1.[2] EBRD assigned Ukraine the lowest ranking along with Azerbaijan, Belarus and Tajikistan.[3] It appears that Ukraine needs to spend much more effort in order to achieve the necessary corporate governance reforms prior to negotiations for accession into the European Union.[4]

Table 1:
EBRD 2003 Corporate Governance Ratings

A Very High Compliance	B High Compliance	C Medium Compliance	D Low Compliance	E Very Low Compliance
	Armenia Hungary Latvia Kazakhstan Lithuania Macedonia Moldova Poland Russia	Albania Bulgaria Croatia Czech Republic Estonia Kyrgyz Republic Serbia and Montenegro Slovakia Slovenia Uzbekistan	Bosnia Georgia Romania Turkmenistan	Azerbaijan Belarus Tajikistan Ukraine

Source: EBRD Corporate Governance Sector Assessment Project: Report on 2003 Assessment Results. January 2004.

Ukraine has come to a critical point in the development of its corporate governance framework. The privatization programs of the mid-1990s resulted in a private sector that represents over 60 percent of GDP, but the programs also created a corporate sector in need of substantial restructuring. For such restructuring to take hold and to result in improved efficiencies of Ukraine's businesses, the corporate sector needs a

[1] President Kuchma issued a decree on March 2002 outlining the improvements to be sought in legal and regulatory frameworks on corporate governance that is aimed at improving the efficiency and productivity of the Ukrainian private sector joint stock companies. This was followed by the corporate governance recommendations of the SSMSC on June 2002, which was drafted by FMI. This resolution was followed by the decree of the Ukraine Cabinet of Ministers in January 2003 on the Approval of Measures for Implementation of Priority Directions for Corporate Governance Development in the Joint Stock Companies.

[2] The Corporate Governance Reports on Observance of Standards and Codes (ROSCs) are publicly available at http://www.worldbank.org/ifa/rosc_cg.html

[3] EBRD Corporate Governance Sector Assessment Project: Report on 2003 Assessment Results. January 2004.

[4] As of October 2002, the timetable for EU-accession negotiations has been set for Latvia for 2004 and for Bulgaria in 2007. No date for negotiations have been set for Croatia or Russia and none is immediately expected for Georgia. Ukraine has a target date of 2011 to join the EU.

far stronger corporate governance framework than the one that is currently in place. The privatization programs also created a class of 18 million small shareholders holding shares of joint stock companies, with very few shareholder rights.

Weak corporate governance and the lack of commitment to contractual responsibilities has impeded financial sector development in Ukraine. The banking sector needs to have transparency in operations and adequate disclosure in order to provide credit to established and emerging businesses alike. Similarly, in the capital markets, bond buyers need a corporate sector that operates with transparency and a level playing field where the rules are clear to all market participants. Minority shareholders prefer to invest in companies that follow international standards of corporate governance in order to protect their rights, and pension funds are required by law to make prudent investments where their portfolio risks can be measurable so that their actuarially determined target rates of returns can be achieved.

OECD
PRINCIPLES OF CORPORATE GOVERNANCE

1. The rights of shareholders
The corporate governance framework should protect shareholders' rights.

2. Equitable treatment of shareholders
The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders.

3. The role of stakeholders
The corporate governance framework should recognize the rights of stakeholders and encourage active co-operation between corporations and stakeholders.

4. Disclosure and transparency
The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation.

5. Responsibilities of the board
The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

In recent years, various Ukrainian organizations and interest groups as well as a number of government bodies, have been promoting corporate governance standards. Some domestic institutional investors have been promoting a corporate governance model focused on the interests of shareholders. These efforts were mainly directed at strengthening influence and control of management action. Other constituencies have stressed the broader responsibilities of enterprises towards their various stakeholders in addition to shareholders, including employees, suppliers, the community in which they operate, as well as local and national governments.

In Ukraine as well as in all other countries in the region, awareness of improved corporate governance has entered the public consciousness, as well as the public-private sector institutions and the boards of these institutions. However, a major breeding grounds for corruption can be found in the area of governmental applications of laws and regulations including, but not limited to, labor law, tax rules, customs and currency regulations, and health and safety laws. One cannot get at the root causes of corruption by merely weeding out corrupt individuals, be they public procurement officers, politicians, or business people. Corruption thrives in markets where legal systems are ambiguous, the rule of law is not embedded within cultural norms, and where laws and the judiciary allow employees opportunities to exert discretionary authority throughout various levels of government.

Promoting Corporate Governance: Legal and Regulatory Frameworks and Institutions

At this point, with major support of USAID and other international donors, there is an active, ongoing dialogue between the Government of Ukraine (GOU) and the private sector. A significant number of seminars and training sessions have been held since the beginning of the decade, with the active participation of the government and business sector. The state agencies actively collaborate with the private sector and international donors in order to improve corporate governance in Ukraine. In addition, the Ukraine Bankers Association, Ukraine League of Insurers and others organize corporate governance round tables and seminar discussions.[5]

Richest Man Steps out of the Shadows

"After years of operating his concerns from the sidelines, Ukraine's wealthiest man, Mr. Rinat Akhmetov (37), was made the President of the Systems Capital Management Holding company at the general shareholders meeting on March 1. Mr. Akhmedov owns a 90 percent interest in SCM, which is a diversified holding company that manages minority to majority shares in various metallurgical and industrial plants, mobile phone services, brewery, hotel, a major confectioner, newspaper and media company. This move could make his businesses more attractive to foreign investors. The reclusive businessman from Donetsk appears ready to take a more public role as the owner of his businesses in an effort to increase their transparency and boost investor confidence. In a statement, Mr. Akhmedov said: "Our goal is to build an effective corporate management structure which will be on par with world requirements. We have achieved major strides towards this goal, though we still have much to accomplish. I candidly believe that by increasing the corporate culture of businesses in Ukraine we will move closer to integration with global economic structures." Mr. Akhmedov is rated as the eighth wealthiest businessman in Eastern Europe, with personal wealth of $1.9 billion. Other Ukrainians include Mr. Viktor Pinchuk (Ukraine Parliamentary Deputy) in the tenth place with $1.3 billion, and Mr Viktor Medvechuk (Presidential Chief of Staff) in the eighteenth place with under $1 billion of wealth…."

Roman Olearchuk,
Kyiv Post, March 11, 2004.

Recent activities show an increasing interest in promoting good corporate governance by GOU and private sector organizations. The Securities and Stock Market State Commission (SSMSC) and the State Commission for Regulation of Financial Services Markets in Ukraine (the Financial Services Regulator - FSR) plan to promote and support better corporate governance through frequently held training programs and seminars with private sector in design of relevant corporate governance legislation. Several leading Universities and Colleges have begun graduate level educational programs in corporate governance.

At the national level, there is strong support for the corporate governance process by the Cabinet of Ministers of Ukraine, the Administration of the President of Ukraine,

[5] USAID/FMI Project International Business Standards: Corporate Governance has conducted a series of programs since 2002, such as Seminars for Judicial and Regulators, ranging from such topical areas as "Problems of Corporate Governance and Activities of Joint Stock Companies," to "Protection of Investor Rights in Corporate Legal Relations," followed by "Corporate Governance in the Light of the New Civil and Commercial Codes." These seminars were conducted in a number of locations around Ukraine in partnership with local institutions. The seminars and workshops attracted legal leaders consisting of judges, regulators, and academics. During all of the events, several materials that were prepared were distributed to the participants. In addition to the above programs, Directors' Training Seminars targeting corporate directors and managers were also designed, developed and delivered. Separately, FMI organized corporate governance seminars and training programs for banks, targeting the members of "Bank Supervisory Councils," relevant literature and materials that were developed for this purpose were distributed. FMI also leads a "Working Group on Implementation of the Corporate Governance Courses" offered by various institutions of higher learning in Ukraine. The FMI programs assisted these universities in course design and curriculum development methods for corporate governance.

the State Property Fund of Ukraine, profile committees of the Verkhovna Rada, the SSMSC, and the FSR as well as other public and private organizations. At the regional and local levels, efforts continue to promote good corporate governance activities in close cooperation with corporate and business leaders, local deputies and privatization authorities. These efforts include providing legal, methodological and consulting support, as well as training assistance to the enterprise sector and the regulatory agencies.

The IFC in 1999 published a Ukraine Corporate Governance Manual based on OECD Principles of Corporate Governance.[6] This manual has been adopted by the SSMSC as the reference text for all corporate governance applications in Ukraine, however, the document is strongly "recommended" while its implementation is entirely voluntary and not binding in any way.[7]

The overall implication of all these activities and actions by the GOU and the international donors has not been very effective: regulatory and judicial enforcement continues to be very weak, and the practice of good corporate governance, especially the rights of minority shareholders is persistently violated in Ukrainian joint stock companies.

The GOU has announced plans to update and strengthen the legal and court system; the corporate tax system; the educational system for business and legal professions and the application of international accounting and auditing standards. The outcome of these plans have been that the legal and court system has been put under a process of a general restructuring, albeit without any major changes occurring as yet.

Many crucial issues awaiting GOU action have been taken care of, even though some very important issues remain. A tax code has been passed by the Rada and was adopted as of January 2004. This has improved the applications of tax regime significantly, and brought in the flat tax system into effect in Ukraine. Time will show how this will affect the overall enterprise system.

The Ukrainian private sector, especially the larger companies, are beginning to play a very active role in educational process for business and legal professions. Various private companies and educational centers organize seminars and training programs. However the training programs that seems to have more impact are the ones sponsored by international donor organizations.

Amendments to the Business Law have been made, while the draft new Joint Stock Company Law (JSC) still awaits adoption at the Rada, after four years. The new Civil and Commercial Codes were adopted and came in force as of January 1, 2004. However, it is argued that there are many overlaps and contradictions between these two laws. The detailed list of main laws and regulations addressing corporate governance are shown in Annex 1.

[6] IFC had developed and published Corporate Governance Manual with financial support from the British Know How Fund in 1999.
[7] The new corporate governance manual outlines the goals of the company; shareholders rights; the supervisory board and the executive board; information disclosure and transparency; overseeing the financial and business activities of the company; and stakeholders. The development of this manual was initiated by USAID and other international donor organizations.

The existing Law on “Business Associations,” regulating the joint stock companies was passed in 1991. This law can no longer provide proper protection for investors, whether they are majority or minority shareholders. This is due to the many changes that took place in the system as it evolved by the transformation of state ownership into private hands over time since 1991. Furthermore, the existing law is considered ineffective because it fails to regulate many areas that are more specific to the governance of a modern joint stock company. Delays in the passage of the new draft Law on Joint Stock Companies have had major implications on effective corporate governance and attracting capital into the financial markets in Ukraine.

The passing of the new law will be beneficial in a number of ways, but it will especially be important in the following areas:

- When enacted, the law will help prevent the potential for corporate fraud and abuses. It’s presence will help in eliminating the risks of such abuses from resurfacing in the future. There were several well known corporate conflicts and abuses in Ukraine that have had a negative effect on the overall financial position and productivity of many companies. The existence of this law would have significantly reduced, if not completely prevented the abuses from happening.

- The rights of the State as a large shareholder will be better protected in some of the most productive Ukrainian companies. This law will shield the State better against rampant asset stripping and profit skimming that causes loss of value of its holdings, thereby protecting national interests as well.

- The new law will enhance the potential for collecting larger amounts of privatization proceeds to the budget, because it will help increase investor confidence and improve the image of the country in both the domestic and global arena.

- The new law will facilitate a larger flow of domestic investments into the financial sector, helping increase economic growth to reach its full potential.

Shareholders Rights, Equitable Treatment, the Board

Many of the difficulties faced by the Ukrainian financial system are a reflection of institutional shortcomings in financial relationships that are pervasive in all sectors of the economy. Hindrances to the speedy and economical enforcement of contracts and property rights affect commercial banks, NBFIs, enterprises, and households alike. The sometimes obscure and collusive ownership relationships and the weaknesses in governance that are found in some banks are considered to be prevalent in the enterprise sector as well.

The overall framework for creditors’ rights and insolvency in Ukraine has improved in recent years, but is still weak. There is a Law on Pledge. The Bankruptcy Law that came into effect in 2000 offers major improvements in this area. The Bankruptcy Law places stronger emphasis on creditors’ rights and enterprise rehabilitation, and recognition of their improved rights has resulted in a wider use of the process by creditors to collect debts. However, the applicability of the Bankruptcy Law to certain

types of enterprises, particularly state-owned enterprises, is limited, and time delays can be excessive.

The Law of Ukraine "On Mortgage" came into force in January 1, 2004 which establishes procedures for pledging immovable property and actions by creditors in case of default. However the draft Immovable Registry Law passed only a first reading in June 2003 resulting in a legal vacuum impeding the implementation of this critical legislation. The Law on Mortgage is viewed by experts as a positive step forward but the existence of a second law on mortgages, the Law of Ukraine on "Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates," effective January 2004, results in inconsistent and overlapping legislation.[8] Land and building titling problems persist.

With respect to movable assets, a new law on secured transactions has been passed and should benefit from the state-of-the-art pledge registry created in 1999. The court system is widely viewed as slow, unpredictable, and its familiarity with the new commercial law is inadequate. Thus, while most loans tend to be collateralized, lenders do not regard these instruments as reducing the risks of non-performance. This in turn, limits the flow of bank credit in the economy.

Capital Markets

There are approximately 9000 open joint stock companies in Ukraine. However, only about 300 companies are listed on the primary stock exchange, First Securities Trading System (PFTS). Most trading occurs outside of any organized stock exchange. An estimated 80-85 percent of all share trading of joint stock companies is conducted on the parallel market. As a result, no information on the pricing of most share trades is available to other market participants, and no market price discovery mechanism is established for purchases and sales of shares where shareholders might wish to sell their shares to the company. Further complicating the scene is the fragmentation of the capital markets, with 9 licensed securities exchanges, more than 370 registrars, and three depositories in Ukraine.

The fragmentation of the capital markets prevents adequate market share price discovery mechanism, which hurts the small shareholders rights the most. The many small shareholders of Ukrainian companies can not sell their shares freely since most companies' shares are not traded in an organized market. The only way small shareholders can sell their shares is back to the company, which usually offers to buy those shares at the nominal value.

For instance, the lack of price transparency on share trading effectively violates an important shareholder right. Where minority shareholders disagree with an important company decision, they should have the right to sell their shares to the company at a market-determined price.

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[8] International Conference, "Legal Framework for Mortgage Financing System in Ukraine, Kiev, April 22-23, 2004, sponsored by the Ministry of Finance, World Bank and OSCE. Presentation of Steven Butler, dated April 22, 2004.

Due to the weak corporate governance environment, the citizens who acquired shares by converting their privatization certificates into shares under the Ukrainian privatization program, are now being prevented from exercising their right to trade those shares in an open market as minority shareholders. The current corporate governance framework provides no opportunity to sell shares at a market-based price.

In addition, both the large and small shareholders have little ability to exercise minimum shareholder rights. Except for occasional situations, the shareholders are unable to influence a company's decisions, obtain proportional representation on supervisory boards, vote at shareholders' meetings, or obtain reliable and current financial information on the company.

Under the current corporate governance framework, only controlling shareholders holding 60 percent plus one share can influence the decisions of company management. If they hold 40 percent plus one share, smaller investors can boycott the shareholders' meeting and thus prevent the meeting from taking the minimal decisions falling under the exclusive authority of the shareholders' meeting, even though they cannot act as effective owners of the company.

According to market participants in Ukraine, asset stripping and share dilution continue, despite recent efforts by the SSMSC to issue additional regulations regarding the procedures on share dilution.

Transfer pricing may also be seen in the oil and gas sector, but due to the current high level of government shareholdings in the Ukraine energy companies (particularly the power generating companies), the impact of transfer pricing is likely to be felt most directly by the government, both in reduced taxes paid to the budget and in low levels of dividends paid by the companies to the government as shareholder.

Transparency and Investment Environment: Specific Recommendations

One of the major impediments to the effectiveness of corporate governance in Ukraine is the persistent lack of transparency in both the private and public sector institutions. This seems to emanate mainly from the underlying legal structure of the corporate sectors, even though culture has some impact. While the companies have public responsibilities to their large shareholder base, the capital markets provide little liquidity and still less potential for market appreciation. It should be noted, however, that it is important to differentiate between companies with large numbers of shareholders and those with just a few owners.

Reorganizing the Corporate Sector. An estimated 1,700 closed joint stock companies have at least 100 shareholders. It is also estimated that 58 closed joint stock companies have more than 5,000 shareholders. Similar to the actions taken by the Kazakhstan Financial Services Authority (the new financial sector regulatory body), these closed joint stock companies can be required to either choose to be limited liability companies or open joint stock companies, to make a clear distinction, within a given period of time.

At the end of defined period of time, such as two years, closed joint stock companies that fail to convert to limited liability companies would automatically be converted

into open joint stock companies. They would then become subject to the disclosure and shareholder protection measures required for publicly traded companies that may have thousands, or hundreds of thousands of shareholders. Small shareholders should be bought out and thus receive some form of cash compensation from the controlling shareholders as the company converts itself into a limited liability company.

Companies with large numbers of shareholders could be legally obligated to be provide full disclosure and other shareholder rights. Companies with few shareholders could be held to a lower disclosure requirement. This is a difficult issue, however it is recognized as being fundamentally important and needs to be addressed as soon as possible.

Transparency. For the open joint stock companies a high level of transparency must be required. In the transition economies transparency is considered as being the most critical in improving governance practices. Transparency relates to four areas:

(1) The ability of a shareholder to verify his own shareholding in a company;

(2) The ability of other shareholders (and stakeholders) to know who owns and controls the company;

(3) Public availability of reliable financial reports on the company, and;

(4) Accessibility to copies of the company's corporate legal documents that affect a shareholder's voting rights.

Verification of Ownership Record. According to the OECD Principles of Corporate Governance, being able to verify ownership is considered to be the most important basic shareholders' right. The current framework relative to the functioning of registrars and depository is inadequate. There are a number of issues that contribute to this. Following the regulatory practices of the SSMSC, corporations with a few shareholders can keep records of their own shareholders privately. Experience in Russia, and elsewhere suggest that when there is a single record of share ownership without independent backups, manipulations could occur, leaving the minority shareholders records to be removed from the register. This necessitates the existence of independent registrars.

Registrars. Currently there are about 375 share registries in Ukraine. Some of these are considered to be "pocket registrars" meaning that they are actually owned by companies for which they hold share registers. While these registrars do perform an important task, there have been cases of abuses as were experienced in Russia before. Licensed registrars in Ukraine must be merged and their numbers be reduced to increase their efficiency, and their independence from interested companies be increased.

Depositories. There is no single centralized depository that keeps the records of all shareholders records. This issue is compounded by the fact that there are also too many depositories. The most prominent one of these is the MFS system, performing

depository in material and de-material forms, clearing and settlement functions.[9] The second one, National Depository of Ukraine (NDU), provides a numbering system for all listed securities. This effectively dominates the MFS activities, because no share can be deposited without a number. The MFS and NDU must be merged so that there is a single share depository system in Ukraine. The third depository is the one operated by the National Bank for its own securities.

Access to Shareholder Information. A major issue about transparency and disclosure is the access to shareholder list. All shareholders, including the minority shareholders have the right to access to information to the full list of shareholders. This information is especially important in mergers and acquisition process an essential ingredient of corporate governance in action. The shareholder information at this time is not readily made available to shareholding public in Ukraine, and held as confidential by the registrars, or banks. This verification process is especially difficult because of the lack of integration between the records of the numerous registrars. These obstacles must be eliminated, and access to this information should be easily available to all legitimate shareholders.

At least, a threshold can be established by the regulatory authorities that will require that if for example a shareholder has 3 percent ownership of the shares of a company, that investor should have access to full information disclosure. But this is against the fair and equitable treatment of all shareholders recommendations, therefore we recommend that the rule be passed to allow access to all shareholders. This information should be made available by registrars to all shareholders for a reasonable fee.

Full Disclosure of Controlling Shareholders. Another issue is the full disclosure of all major shareholders. Shareholders need to know the other shareholders with controlling interest in the company. Russia and Cyprus are listed among the top two FDI investors in Ukraine. However, there is no clear information about who the names of any of these owners are in companies with publicly traded shares. This information is not only important for shareholders, but to the company managers as well. As was the case in many Asian companies before the 1997 financial crisis, the complex ownership structures had misled investors and management of the companies alike. Disclosure on this aspect must be mandatory. Enforcement of this issue would be under the jurisdiction of the SSMSC.

Financial Statements. Currently there is a long lag (such as a year) between the end of the fiscal year and the time the financial statements become available to all shareholders. All open joint stock companies must have IAS based financial statements, audited under the ISA rules, available to the shareholders by the end of the first quarter of each year for the previous year. Furthermore, the financial information must also be required to be publicly disseminated through internet and other media where applicable, under the supervision of the SSMSC. Ukrainian National

[9] MFS was formed by several market participants ranging from the Central Bank to commercial banks and investment companies, PFTS and the Ukrainian Interbank Currency Exchange. The MFS clients include 950 issuers, 117 custodians, 9 trading partners. NDU is a government owned entity. It's only function so far has been to issue an ID number for all shares.

Accounting Standards must also be fully converted into IAS/ISA and applied to all Open Joint Stock Company financial disclosure documents.

Access to Legal Documents. All corporate legal documents must be accessible to all investors through the SSMSC. This means all financial and non-financial information, including the list of founders, minutes of corporate board meetings, resolutions of general shareholders meetings, and the like.

Shareholders Voting Rights. At the shareholders general meetings, two main issues arise relative to the scope of the meetings: (1) authorities of the general shareholders meetings in the election of the supervisory board, the approval process for large asset transfers, and strategic issues such as the creation of subsidiaries and joint ventures; (2) the voting procedures such as achieving the quorum at 50 percent plus 1, independent verification of vote counting, and purchase and sale of voting shares in exchange for real estate, write off of debt, payment of a debt, outside the bankruptcy process can cause corporate governance abuses.

Proxy voting is another area of concern: The issue here is whether to allow the shareholders to authorize the representatives to vote on their behalf. Proxies provide much flexibility in achieving quorum, but they may also be abused. This issue is covered under the JSC Law in the Rada.

Requesting Extraordinary Shareholders' Meetings. Shareholders with more than 10 percent of the shares ought to be allowed to have the right to request extraordinary meeting, even if management refuses to honor this demand, the law should be on the side of the investor, and the SSMSC must be prepared to act on behalf of the shareholders and convene this meeting.

Functions of the Supervisory Board. A number of factors must be considered:

(1) The supervisory board should have the authority to select the management, the compensation board, monitoring the performance and replacing the management, with the final authority to lie with the general shareholders meeting. Supervisory board must be held accountable and responsible for the approval of major asset transfers (limited by the authority of the general shareholders meetings). The supervisory board may have the authority to approve of investment decisions that constitute between 25-50 percent of company assets;

(2) Election of the supervisory board members should be through cumulative voting if the company has over 1000 shareholders;

(3) The Legal liability of the supervisory board members must be clarified. The member of the board must act in the best interests of the shareholders of the company and with due diligence. But given the business environment in Ukraine, board members must actively be involved in the monitoring the application of the capital in order to ensure efficient utilization of the scarce resource. The new JSC law has provisions in this area, but it is our understanding that this is still not very clear as to how much legal liability will a member of a supervisory board assume;

(4) The pending new JSC Law has provisioned that supervisory boards should meet minimum four times a year. The recently adopted Ukraine corporate governance handbook provides adequate guidance in the conduct of supervisory board meetings and other operational efficiencies, and;

(5) One more item is to develop company secretary systems similar to the ones in the US-UK models. Company secretary ensures that the supervisory boards follow procedures that comply with the law, and secondly that the company's internal documents are correctly prepared and approved by the board. It may be useful to prepare a company secretary code of conduct in order to provide the benchmark guidance.

Regulatory Bodies. There are two bodies that provide supervisory oversight to securities markets and the non-bank financial institutions in Ukraine. There are several important aspects that will increase the effectiveness of the regulatory bodies: (1) The authority to fine market participants that are violators of corporate governance best practices adopted by the SSMSC and the FSR; (2) Convergence of the fragmented securities markets, and elimination of the off-exchange trading so that transparency is increased and market price discovery mechanism is enhanced.

The functions of the securities markets and the non-bank financial institutions regulators (SSMSC and FSR) must be streamlined and well coordinated in order to ensure the successful development of a healthy financial sector in Ukraine. In the case of overlaps in regulatory oversight, a joint resolution would need to be made that is relevant to all of the market participants. Both the NBFIs and securities markets institutions have a direct interest in investing in the securities markets as equity and bond investors, and they are equally interested in good corporate governance practices. The regulatory authorities ought to have the legal authority to impose fines for specific violations and be able to enforce them in a timely manner.

In order for the regulatory authorities to have the effectiveness and the confidence of the market the respective Commissions' own transparency practices must be improved. The Commissions could publish year end results with the decisions reached and actions taken during the year, cases on hand and the most hard pressing issues of the financial sector that impede its further development.

Elimination of Off-exchange Trading. Fragmentation of the Ukrainian securities markets, and the fact that 80-85 percent of all trading takes place off the exchange is a major impediment to the further development of capital markets and a major cause for concern relative to corporate governance. Consolidation of the exchanges and elimination of the off-exchange trading will improve the price discovery process, increase transparency significantly, and reduce the level of market risk on the stock price determination process. This can be achieved initially by combining the activities of the 377 registrars down to more manageable numbers, and by requiring them to report all transactions through the stock exchange.

Elimination of Asset Stripping and Share Dilution.

(1) Asset stripping: The draft Law on JSC has provisions for prevention of asset stripping by management. General shareholders' are responsible for any sale

of asset that constitutes more than 50 percent of the company's asset structure, while the supervisory boards are responsible for 25-50 percent of the market value of company assets. The SSMSC must require that prior to sale of any company assets, an expert valuation must be performed to determine the intrinsic, fair market or investment value of these assets by certified valuation professionals. Regulations must be promulgated, similar to the Russian experience, that the fair market value estimates of all real property, machinery and equipment or any part of the business as a going concern must be determined based on discounted cash flow methods that are representative of the actual financial viability of each entity. These professionals must be certified by professional SROs with the backing of the two Commissions. The existence of these professionals will be useful for banks that are in the mortgage lending business, and for insurance, leasing and pension funds in making investment decisions as well as in performing financial analysis of securities market investment opportunities, and;

(2) Share dilution: In order to prevent actions by unscrupulous managers that will lead to share dilution, and deterioration of corporate governance, existing shareholders must be given "rights offering" as a right of first refusal in the case of new share issues. However, while it is nice to have these prudent regulations in place, it is important to have a regulation that will enable the shareholders to sell their shares to the company at a fair market value, that is determined by an independent certified valuation expert. This will prevent the habit of repurchasing the shares of small investors at nominal value or par value.

Judiciary Capacity. The judiciary plays a very important role in corporate governance, by setting precedents and creating important benchmarks for corporate actions, that are the foundations for regulatory actions. The judiciary's capacity must be increased to cope with the ever changing market environment, and a data base can be developed to provide the judges a library of case references, and improving the efficiency of the court system by assigning only one type of court to deal with matters relating to corporate governance issues.

IV. Conclusions and Recommendations

The effectiveness of corporate governance is significantly affected by the relationship between the existing business culture and the legal traditions. The desired level of sophistication and innovation in the company law and the compatibility of the legislation with that of the country's major trading partners and foreign investors also have an additional overarching implication on the level of good corporate governance observed in a country. For Ukraine, it is considered important to review the process under which laws are interpreted and applied. Ukraine is now at a crossroads in its reform and market development efforts, as it begins to integrate with the rest of the world and especially with its targeted accession into WTO, NATO and the EU.

Following a decade of economic reform and shifting paradigms, there remain hard pressing issues and lessons learned in the establishment of effective corporate governance practice in Ukraine in the following areas:

1. Corporate governance is a public policy concern that is critical to economic growth. This has been recognized by the president on down. Operationalizing the emerging international principles and standards of business conduct in the global economy is a matter of national development strategy for the countries in the region as much as it is for Ukraine, and requires continued development assistance.

2. In Ukraine, the legal and regulatory institutions and frameworks surrounding property ownership and control, securities and financial markets are weak, and enforcement skills and judicial capacity requires upgrading so that rule of law is firmly established.

3. In addition to the government, private sector must also take action to remedy the issues within the context of the market economy. Eliminating the weaknesses in the enterprise sector due to incomplete privatization, restructuring and issues of competitiveness, liberating the enterprise sector from the shadow economy, increasing transparency, enhancement of managerial capacity and improvements in the overall management culture are essential ingredients for success in strengthening corporate governance.

4. Public education is a major component of creating effective corporate governance in a given country. In order to get investors, issuers and financial intermediary institutions to interact effectively, the participants must understand the rights and responsibilities of property ownership. For this, management education must be enhanced, civil society organizations, NGOs and SROs must be formed, and professional associations to be empowered for effective influence on corporate agendas, and to provide duality in the governance processes.

In light of these circumstances there are opportunities for USAID intervention. USAID has the unique opportunity to be at the forefront of providing technical assistance to Ukraine with significant deliverables. The challenges of establishing a strong corporate governance culture, and assisting the global integration of Ukraine would require close cooperation among the donor community, while working to achieve the USAID strategic objectives of “accelerated growth and development of private enterprise” and “a more competitive and market responsive private sector.” The main USAID intervention in this area ought to be the operationalization of the five OECD principles of Corporate Governance.

Annex 1.

Legal and Regulatory Framework Affecting Corporate Governance

1. The Law of Ukraine "On Business Associations" (the "Business Law") of 1991 with many amendments.
2. The Civil Code. 1 January 2004.
3. The Commercial Code, 1 January 2004.
4. The Law of Ukraine "On the National Depository System and Peculiarities of Electronic Circulation of Securities" (the "Depository Law") of 1998. There are no changes so far.
5. The Law of Ukraine "On Securities and Stock Exchange" (the "Securities Law") of 1991. This Law was changed and amended a number of times.
6. The Law of Ukraine "On Accounting and Financial Reporting in Ukraine" (the "Accounting Law") of 2000. Several changes took place over time.
7. The Law of Ukraine "On Renewal of Solvency of Debtor or Recognition It as a Bankrupt" (the "Bankruptcy Law") of 2000.
8. The Law of Ukraine "On Tax on Profit of Enterprises" (the "Profit Tax Law") of July 2002.
9. The Regulation "On Procedure of Maintenance of Registers of Owners of Registered Securities" (the "Registrar Regulation"), of 2001.
10. The Regulation "On Depository Activity" (the "Depository Regulation") approved by the SC of 20 November 2001.
11. The Cabinet of Ministers of Ukraine Resolution № 765 "On the Introduction of the Mechanism for Prevention of Monopolization of the Commodities Market" (the "Antimonopoly Resolution") of 2002
12. The Antimonopoly Committee's Regulation "On Control over Economic Concentration" (the "Antimonopoly Regulation") as amended in 2002.
13. The Regulation "On Procedure of Registration of the Issuance of Shares of Open Joint Stock Companies and Bonds of Enterprises" (the "Shares Issuance Procedure") of 2001.
14. Ukrainian National Auditing Standard (the "Auditing Standard") of 1999.
15. Code of Professional Ethics of Ukrainian Auditors (the Auditors Code) of 1999.
16. The Disciplinary Code of Professional Association of Registrars and Depositors of 1999 at the VIII General Meeting of Professional Association of Registrars and Depositors.

Ukrainian Debt Markets:
Analysis and Recommendations for Development*

By

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* This is an abridged version of a paper written for USAID in June 2003. For example, the original document had several technical appendices, which have been omitted.

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PROLOGUE

Since my June 30, 2003 report, Ukrainian debt markets have continued to grow significantly. The volume of public debt offerings registered with the SSMSC, which some predicted as 3 billion Hryvnia for 2003, actually was 4.24 billion Hryvnia. In addition to the increase in corporate offerings, five municipal offerings were announced and two of these (Kyiv and Donetsk) were completed. As noted in FMI's report, Privatbank and UkrSibbank each raised US$100 million by placing three-year notes with European banks and several additional Ukrainian banks have announced similar offerings for 2004. As a consequence of this activity, the volume of bond trading on the PFTS Exchange has continued to outpace equities trading, despite an approximate 85% increase in share prices during the first four months of 2004. Apart from some lengthening of maturities, the fundamental character of the corporate debt offerings remains largely unchanged; they are essentially registered private placements to institutional investors with limited secondary market liquidity because many of the buyers plan to hold to maturity.

Effective January 1, 2004, the restriction that limited joint stock company borrowing to 25% of statutory capital was changed to 100% of statutory capital. Many corporate borrowers continue to avoid this arbitrary and unnecessary restriction by borrowing through a subsidiary limited liability company or through use of third party guarantees.

There have been changes in mortgage and commercial laws since June 30, 2003. However, as noted in FMI's report, these laws do not address some of the basic obstacles to secured debt issuance or asset-backed financing. The legal shortcomings in these areas as well as the uncertainties surrounding a debt servicing by municipalities (Kyiv being a special case) that is not dependent on transfer payments from the national government remain essentially unchanged from the description of these problems in my report.

RDS
May 22, 2004

I. Executive Summary and List of Recommendations

A. Executive Summary

1. Corporate and Asset-Backed Debt Securities

A promising primary market in short-term (1-3-year) corporate debt securities has begun to emerge in the Ukraine. Despite macroeconomic, legal and political uncertainties, there is significant potential for building upon this beginning to develop a medium to longer term corporate debt market, and to introduce debt instruments such as mortgage-backed securities and securities backed by loans to small and medium-size enterprises (SMEs) whose borrowings are too small to warrant individual access to public capital markets.

For the foreseeable future, the corporate debt market will remain primarily an institutional market for several reasons. First, under the current tax law, interest income on individuals' savings deposits is not subject to tax. Under tax reform legislation (yet to be signed by the President), effective January 1, 2005, interest on individuals' savings deposits would be subject to a 5% tax rate. Under the current tax law, individuals' interest income on corporate debt is taxable at rates beginning at 10% and rapidly increasing to 40%. Under the pending tax reform legislation, effective January 1, 2004, the tax rate would become a flat 13%. Even if the pending tax legislation is adopted, the interest rates paid on Ukrainian bank savings are slightly in excess of current yields on corporate debt securities,[1] so there would be no after-tax incentives for individuals to shift to investments in corporate debt securities.

Second, even if steps are taken to equalize tax treatment, Ukrainian citizens' disposable income available for securities market investment is not that substantial. For 2002, GDP per capita in the Ukraine was only $829.

Third, both the incentive and capacity for Ukrainian brokers[2] to underwrite retail distributions of debt securities is limited.[3]

Fourth, many market participants characterized the current corporate market as a sellers' market whereby investors (primarily commercial banks) are more than willing to buy up issues quickly as they come to market and, in most cases, hold the securities to maturity or earlier redemption. As other Ukrainian institutions, such as privatized pension funds, mutual funds that are not privatization funds, and insurance companies, enter the debt market as purchasers, there is a good possibility that

[1] Savings rates offered by foreign banks licensed to business in the Ukraine are significantly less (by at least 50%) than Ukrainian bank rates and rates in the Ukraine on US dollar and EURO deposits are about two-thirds of Ukrainian rates.

[2] I use the term "broker" for simplicity and consistency. Ukrainian law and regulations generally refer to licensed persons who purchase, sell or underwrite securities as securities traders.

[3] I have not been able to obtain information on the number individual investors who have accounts with brokers in the Ukraine, but other Ukrainian market statistics suggest that the number is likely to be a very small percentage of the total population. The accounts reported by other former CIS and CEE countries are astoundingly low. Even in Poland, the most developed market in the region, the estimated 1.08 million retail brokerage accounts represent less than 2.8% of the country's population.

demand for corporate instruments will continue to exceed supply.[4] As long as issuers are able to place corporate debt issues at relatively low costs with a limited number of institutional investors, there is no reason for them to attempt to seek retail distribution to individual investors, which can be a more costly process even when the necessary distribution infrastructure is in place.[5]

In many markets, including the United States, the current Ukrainian corporate debt market would be considered a private placement market, since the offering terms are negotiated and there are almost always less than ten purchasers of an issue. There appear to be two reasons that the market is not considered a private placement market in the Ukraine. First, the Ukrainian securities laws do not include a private placement or limited or nonpublic offering exemption that makes it more expedient not to publicly register the offering. Whether an issue is likely to involve less than ten purchasers or more than ten thousand, the issuer and its representatives have to go through essentially the same registration procedures with the SSMSC.[6] This being the case, it makes sense for the issuer and its representatives to list the bonds for public trading on the PFTS market. Even though there is limited secondary trading, there is no downside to having available a potential liquidity option in addition to the put options and similar early redemption features that have been adopted to address both lack of market liquidity and the need to hedge repayment risk.

A second reason that the current market functions as a private placement market with listed securities, is that banks, the principal purchasers of corporate debt, are not required by banking regulations to establish any reserve against listed debt securities whereas a 25% reserve requirement applies to bank loans. As long as this situation prevails, banks are likely to eschew a private placement exemption for debt securities if it precludes listing of the debt securities.[7]

As I point out below, there are significant differences in the types of securities regulation that should apply in institutional vs. retail markets. SSMSC's regulations are far from optimal. International best practices, such as the International Organization of Securities Commission (IOSCO) Objectives and Principles of Securities Regulation, recognize that securities regulation in any country should be tailored to the type of market it is intended to regulate.[8] The SSMSC regulations that

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[4] See generally the table below, comparing potential institutional investment available for debt securities investments in Kazakhstan and the Ukraine.

[5] This observation is buttressed in the Ukraine by the reluctance of most issuers of securities to make their financial and other information publicly available.

[6] This situation would not change significantly if the SSMSC's May 30 draft regulation were adopted.

[7] There is nothing inherently wrong with the use of listing to satisfy or mitigate the effect of legal investment restrictions. For example, most Eurobond offerings are listed on Luxembourg or United Kingdom markets to avoid legal constraints that apply to institutional investors purchases of unlisted securities, but the Eurobonds trade OTC notwithstanding the listing. Moreover, most of the Eurobond market is regulated by established contractual and disclosure practices developed by the primary and secondary dealers associations in these markets. EU securities directives have been drafted to respect and largely exempt from regulation the institutional character of Eurobond market.

[8] For example, the current (and near final) June draft of IOSCO's Methodology designed to assess implementation of the IOSCO Objectives and Principles, provides at p. 12:
Markets with a single or a few issuers, that are totally domestic in nature, or that are predominantly institutional, will pose different questions and issues as to the sufficiency of application of the Principles, and as to the potential vulnerabilities likely to arise from their non-application, than jurisdictions where there are substantial numbers of retail participants, intermediaries frequently are part of complex groups, issuers are established in other jurisdictions, or the markets have other international or cross-border components.

affect debt securities should be changed per my recommendations below. The regulatory problem is further exacerbated because the type of information that the SSMSC currently requires in offering documents and periodic reports from corporate issuers bears little relationship to the information that would be of importance to investors in either retail or institutional markets.

The above observations are not particularly encouraging in terms of prospects for development of liquid secondary trading markets in corporate debt securities on the PFTS exchange or elsewhere in the Ukraine. Nevertheless, PFTS should be commended for adapting its market place to encourage both primary offerings of corporate debt, for example, through Dutch auction procedures, and by making available a dealer market for secondary trading in debt securities, which is usually the structure of choice for secondary debt markets. Overall, PFTS has demonstrated leadership, initiative and the institutional capacity to adapt itself to Ukrainian market users' needs. Hopefully, PFTS may look forward to better days ahead. It is important to remember, however, that secondary securities markets exist to provide liquidity and facilitate capital formation. Capital formation does not exist, and should not be adapted, to facilitate the needs of secondary securities markets.

The problems that need to be addressed in order to lengthen the maturities of corporate debt securities and to introduce mortgage and other asset-backed securities in the Ukraine fall into two categories: (i) macroeconomic-political; and (ii) legal infrastructure. It is not within my competence to address the macroeconomic-political issues other than to note that my interviews with many market participants confirmed the obvious. The Ukraine is enjoying a current period of macroeconomic stability that is very encouraging, but the period is still relatively short-lived and it is taking place under the same national governmental administration that presided over 25%+ annual inflation only a few years ago. Clearly, it will take a longer period of economic growth and stability to establish greater credibility and investor confidence in Ukrainian capital markets.

The legal infrastructure situation is more encouraging. A law on mortgages has been adopted recently and reasonably acceptable versions of a Law on Joint Stock Companies and Law on Security of Creditors' Claims and Registration of Encumbrances are under consideration for adoption. Both the current (1991) securities law and the July 23, 2002 draft law on Emissive Securities and Stock Market are disappointments,[9] as is the performance of the SSMSC. While the securities law and SSMSC's shortcomings need to be addressed, they are not as important to the infrastructure necessary to support the current type of debt markets that exist in the Ukraine as are the joint stock company and collateral laws.[10] Also,

[9] Work on the draft law is in the capable hands of FMI and detailed commentary on my part is unnecessary. (My general views on the essential elements of a securities law, as it relates to debt securities, are included in Appendix H.) Suffice to say that the problem is not the quality of the advice. It is the current SSMSC leadership and their inability and perhaps unwillingness as the securities regulator to understand and convince the Rada of what changes in the law are necessary to establish a sound system of securities regulation for debt and equity markets. Only one example is necessary to illustrate this problem. Both the 1991 securities law (Article 22) and the July 23 draft law (Article 29) focus only on failure to comply with formalities as grounds for refusing registration of a securities issue when the grounds should be whether the information required to be disclosed as necessary for informed investment decisions is materially incomplete or materially false or misleading.

[10] Several of my recommendations address improvements or clarifications that would be desirable in the collateral laws. I am not commenting on the proposed Law on Joint Stock Companies since this project is also in FMI's

accounting and auditing standards are probably more important than the securities law to debt market development and, despite Ukrainian claims to the contrary, there is little evidence to suggest that the development of high quality, internationally acceptable auditing and accounting standards, particularly their enforcement, has progressed significantly in the Ukraine.

I place more importance on corporate, collateral, accounting and auditing laws than on the securities law in the Ukraine because the former are more important to dealings among private parties and also tend to be relied upon and enforced more by private parties in most countries.[11] Securities laws work very well and are extremely important in jurisdictions, such as the United States because of the presence of a strong regulator and private rights of action to enforce the laws. In the Ukraine there is an ineffective securities regulator and it is unrealistic to expect private rights of action to develop under the Ukrainian civil law system of jurisprudence.

Laws and regulations, if properly drafted and implemented, can facilitate the development of sound bond and other capital markets. However, they should complement, rather than replace, private sector market forces. The final arbiter of debt securities issuance should be the investor – in this case, the institutions that allocate capital and price risk.

The good news in the Ukraine is that if the improvements in macroeconomic-political stability can be sustained, and the necessary additional legal infrastructure can be put into place, both the institutions having a need to offer debt securities with longer maturities and asset-backed features, and institutions having a need to invest in these products already exist. For these reasons, my recommendations regarding market development are limited primarily to the key infrastructure needs.

One of the most encouraging aspects of my interviews with private sector participants in the corporate debt market is that these persons have a very good understanding of corporate finance and deal structures that will work, given current macroeconomic and legal infrastructure constraints. The comments of representatives of the institutions that are placing debt issues and those that are purchasing them suggest that there is an active due diligence process and concern for reputational integrity involved in the placement of debt issues. Even though the quantity and quality of publicly available information about debt issues may be limited, it should be borne in mind that the market is essentially a negotiated, institutional market. The Ukrainian debt market has significant potential to grow and develop, but it is likely to remain an institutional market and should be regulated as such for the foreseeable future.

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capable hands, alternative versions of the law are now before the Rada, and I provided input regarding the law when it was being conceived several years ago.

[11] It is true that in the United States, the US SEC and the new Public Company Accounting Oversight Board have played and will continue to play a leading role in accounting and auditing enforcement, but it is simply unrealistic to expect the near-term development of comparable Ukrainian institutions. It is more likely that the effective forces pressing for adherence to accounting and auditing standards in the Ukraine will be institutional investors, contractually for their own protection, and hopefully, the PFTS, through improved listing standards to protect the integrity of its market.

2. Sub-Sovereign (Municipal) Securities

My view with respect to development of a market for sub-sovereign (municipal securities) in the Ukraine is not as optimistic as my view regarding the development of corporate debt markets.[12] I must caveat that I am not an expert in municipal government or municipal finance, that most of my discussions with market participants pertained to corporate debt markets, and that I have relied significantly on The Urban Institute's work product.

While I agree with much of The Urban Institute's analysis, I have significant reservations about what appears to be one of their most fundamental assumptions, whether the current legal infrastructure assures that municipalities will have sufficient ongoing revenue sources, year after year, to provide sufficient assurance that they can pay debt service on municipal debt issues. I do not see anything in The Urban Institute's documentation or in the Ukrainian municipal legal infrastructure, including the Budget Code of 2001,[13] that provides other than annual, year-by-year assurance of national sources of revenue being made available to municipalities.[14] Also, it is not clear to what extent the procedures under the Budget Code are being implemented. Since The Urban Institute acknowledges that, other than the property tax, municipalities in the Ukraine currently have no significant taxing authority of their own, such as the ability to establish local taxes or tax rates, and little authority over most fees and charges,[15] this leaves the very basic question: **What assurance is there of an ongoing municipal revenue base for debt service on municipal bonds?**

The answers that I was able to find to this question are that the Law On Local Self-Government recognizes that the national government has a fundamental obligation to provide sufficient revenues to local governments so that they may meet certain basic social obligations to their citizens, that traditionally this obligation has resulted in a relatively stable percentage of the local government's budget revenues coming from the national government, and that it would be politically difficult for the national government to attempt to alter this process.

If I were a prospective investor in the general obligation bonds of a Ukrainian municipality, I would not find these answers very comforting. If the national government were to change, or a macroeconomic crisis were to occur, what law **requires** the national government to provide sufficient funds to municipalities to satisfy debt service on their obligations?

For these reasons, the current system whereby municipal debt issuance may not be undertaken without approval of the Ministry of Finance (MOF) seems quite sound.[16]

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[12] Corporate and municipal markets are not entirely mutually exclusive. For example, it may be possible to have both corporate and municipal sponsored organizations involved in mortgage financing and SME financing.

[13] For example, Article 7(3) of the Budget Code provides that the State Budget of the Ukraine and budgets of local self-governments are autonomous. No one budget in the Ukraine incurs liability for commitments of other budgets.

[14] Article 9(5) of the Budget Code provides:

> "Transfers shall be understood as non-redeemable, non-repayable, and discretionary revenues received from other bodies of State power, local self-government or international organizations."[emphasis added]

[15] Urban Institute Report, p. 4.

[16] Cabinet of Ministers Resolution No. 207 (February 24, 2003) On Approval of the Procedure of Local Budget Borrowings.

The MOF is in the best position from a fiscal standpoint to determine from its responsibilities with respect to the budgets of the national government and local self-government bodies whether a municipality should be floating municipal debt securities.

With respect to the potential moral hazard that a national government guarantee may be implicit in any MOF approval of municipal debt issues, the problem may be addressed through inclusion of specific disclaimers in any such debt issues. Indeed, current law and resolutions already make it clear that no such guarantee exists.

I agree with The Urban Institute's observations that the SSMSC need not to be involved in specifying the formalities required for issuance of municipal debt securities, such as the content of a municipal council's resolution, because these requirements are already addressed by other Ukrainian laws that are not the SSMSC's responsibility. As discussed below, however, I suggest that it would be preferable to have the MOF rather than the SSMSC involved in addressing the content of municipal disclosure documents because the MOF has greater familiarity with the unique aspects of information about local self-government operations, budgets and financial reporting that are critical to such disclosure. Accordingly, I have suggested below that the SSMSC adopt a municipal disclosure regulation that recognizes the necessity of deferring to the MOF on municipal registration, reporting and disclosure issues.

Of course, the SSMSC should be responsible for regulating brokers that offer and trade municipal debt securities and in regulating markets and clearing and settlement institutions that handle these securities. Ideally, the SSMSC should have the same enforcement authority to address fraud in municipal securities transactions that it should have with respect corporate securities transactions. The problem, of course, is that to date the SSMSC has demonstrated very little enforcement capacity. If a law on municipal finance is introduced, as suggested by The Urban Institute, it may be advisable to include enforcement provisions in such law that enable the MOF as well as the SSMSC to take action against fraud in municipal debt securities.

Apart from the issue regarding the uncertain municipal revenue base for municipal debt service, there is no question that lingering concerns about the 1998 Odessa debt default have made the establishment of investor confidence in municipal debt issues a much greater challenge than building investor confidence in corporate debt issues. Quite frankly, the perception may be that the risk of fraud, corrupt behavior, and consequent defaults is greater in the case of municipal securities than in the case of the corporate debt securities that have come to market to date. The perception may be correct.

B. List of Recommendations

Recommendation No. 1. The restriction currently embodied in Article 11 of the Law on Securities and Stock Exchange, that prevents joint stock companies from issuing debt in principal amount in excess of 25% of the company's authorized fund, should be eliminated. The amendment to the Commercial Code that would change the 25% limitation to 100% effective January 1, 2004 is also inadvisable, as is what I am told is a National Bank of the Ukraine (NBU) proposal to base the 100% limitation on stockholders' equity, including retained earnings. There is no reason that any

limitation of this nature is necessary for investor protection or other purposes. Furthermore, there is no reason to include any version of this limitation in the bond issue regulations proposed by SSMSC.

Recommendation No. 2. The current practices of the SSMSC regarding public availability of information of issuers of debt (and equity) securities need to be improved substantially. If the SSMSC remains uncooperative by withholding information that should be available to the public, there are alternative means of addressing this problem.

Recommendation No. 3. The information that the SSMSC's regulations require to be filed with the SSMSC in connection with public offerings of corporate debt (and equity) securities should be refocused on information that would be material to investment decisions so that this information would be the same as the offering document that an issuer should be required to use to offer and sell the securities.

Recommendation No. 4. The May 30 draft regulation should be amended in response to FMI's annotations thereon.

Recommendation No. 5. Amendments to the Civil Code, effective January 1, 2004, and the Draft Law on Security Interests, if enacted, would appear to be a positive step forward in addressing the collateral problems described above. However, neither of these amendments appears to address a rather complex series of problems that arise in markets for investment securities (both debt and equity). These problems arise primarily when securities intermediaries wish to use securities as collateral to finance the intermediaries' operations, and when individuals or legal entities that are the ultimate economic or beneficial owners of securities wish to use their securities as collateral for loans, but such persons do not own their securities directly because, for example, the securities are held by the persons' brokers, banks other custodians, or in a central securities depository. These problems also should be addressed.

Recommendation No. 6. The SSMSC's regulation on bond issuance should not require collateral security as a condition for registration or exemption of debt securities.

Recommendation No. 7. Even though the current securities law provides the SSMSC with authority to regulate Eurobond and other foreign offerings by Ukrainian corporate issuers, because these issues are placed outside of the Ukraine, the SSMSC has nothing to add to this process from an investor protection standpoint and would best be advised not to become involved.

Recommendation No. 8. Subject to exceptions for issues unquestionable quality, the SSMSC should adhere to a policy of national treatment and require foreign issuers that propose to sell their securities in the Ukraine, and brokers who propose to effect transactions in such securities in the Ukraine, to adhere to essentially the same disclosure and other requirements that would apply to a comparable offering of securities (debt or equity) by Ukrainian issuers.

<u>Recommendation No. 9</u>. USAID might consider two pilot projects that would support: (i) the development of a market for collateralized mortgage obligation securities; and the development of a debt security backed by loans to SMEs.

<u>Recommendation No. 10</u>. The possibility of using specialized collective investment institutions, organized under the Law On Collective Investment Institutions, to invest in mortgages and SME loans, thereby providing liquidity and additional funding to the originators of these instruments, also merits consideration.

<u>Recommendation No. 11</u>. The current state-municipal budgetary situation requires that the MOF retain oversight and approval authority over the ability to borrow and the terms and conditions of borrowing by Ukrainian municipalities, recognizing, of course, that limited exceptions are appropriate for unique, high quality credits, such as the city of Kiev. Subject to a few suggested changes, Cabinet of Ministers Resolution No. 207 (February 24, 2003) On Approval of the Procedure of Local Government Borrowings provides a workable framework for the MOF oversight process.

<u>Recommendation No 12</u>. While the SSMSC has a role to play in the regulation of municipal debt securities, that role should not extend to substantive registration of municipal offerings or to establishment of municipal disclosure and financial reporting standards. The lead regulator in these areas should be the MOF consistent with Resolution 207.

<u>Recommendation No. 13</u>. Until it is established that the SSMSC is under new leadership that is committed to principles of sound securities regulation, including, among other things, transparent public information policies, it is recommended that USAID and its contractors work a more limited, selective basis with the SSMSC, generally, and particularly on matters of debt market development and regulation. More emphasis should be placed on consensus building within the private sector and among other government institutions that have more commitment to reforms and a better vision of market development.

II. Analysis and Explanation of the Recommendations

A. Corporate Debt Securities

1. Unsecured Debt Securities

a. Analysis of the Market

Prior to 2000, all issues of Ukrainian corporate bonds were private placements. Private placements declined from $18 million in 2000 to $8 million in 2001 to zero in 2002. Even now, however, while all corporate issues are registered with the SSMSC, there are usually less than ten purchasers per issue. Although many of the 47 outstanding corporate debt issues have been listed on the PFTS Exchange, trading is limited because of the limited number of initial purchasers and their inclination to hold the bonds to maturity.

In 2002, government issued debt accounted for 82% of the total bond market in the Ukraine, down from 100% in 1997-2000. Corporate bonds accounted for

approximately 9% of PFTS' total trading volume with Kyiv Star bonds accounting for approximately 40% of the total corporate bond volume. Other Ukrainian securities markets are largely irrelevant since PFTS accounts for 97% of total secondary market trading. However, it would be possible for PFTS-listed issues to be traded OTC.

Banks account for most of corporate bond purchases in the primary market and for most of the secondary market trading volume. There appear to be 5-6 major bank participants in the market. Foreign investors have yet to enter the market.

Insurance companies are not significant participants in the primary or secondary market, although there are no legal or other reasons for them not to be participants.

Not all of the corporate bond issues have been for the purpose of raising new capital. In some cases, a Ukrainian parent company may issue bonds to its subsidiaries as a means of transferring subsidiary profits to the parent company without taxation. Where a bank effectively controls a company, it has been suggested that the bank also might use high yield corporate bonds as a means of taking money out of the company. In some cases, bond issues have been used to finance repurchase of companies' own shares.

At present, the primary market for Ukrainian debt is a sellers' market. While it is possible to use the facilities of PFTS to auction a new issue of bonds, e.g. through Dutch auction procedures, underwriters often are able to negotiate the price of an issue at lower cost with a limited number of bank purchasers. To date, all but one of the primary issues have been underwritten on a best efforts basis, meaning that the underwriter is not buying the bonds as principal, assuming resale risk or guaranteeing that the entire issue will be sold. The only firm commitment underwriting has been an issue placed by ITT-Invest for Darnytsky SBK, a reinforced concrete construction plant.

Most maturities of corporate debt are in the 1-3-year range. The potential duration of many of the issues is even shorter since the purchasers are given an option to "put" the bonds back to the issuer or underwriter at a specified price after six months or one year. One reason for such a feature, of course, is that investors are concerned that there would be limited or no liquidity if they were to attempt to sell the bonds in the secondary market.

Ukrainian corporate bonds are issued in local currency, often with minimum yields in dollars to provide the perception of a built-in hedge factor against the exchange rate. However, the hedge factor is not really meaningful to sophisticated institutional investors (who account for most purchases) because, for example, the principal amount of the bonds is not adjusted. While participants I interviewed indicated that currency protection has some benefit, it does not address all problems related to macroeconomic-political uncertainties.

Underwriting fees on corporate bond issues range from 3-5%. This may include fees for preparing the issue (approximately 1%) and fees for serving as payment agent (approximately 2%). Additional compensation may be paid to an underwriter that undertakes to maintain liquidity. Underwriters' compensation generally has not been

disclosed in domestic bond offerings, although it has been disclosed in international issues. Disclosure should be required.

Approximately 90% of all cash settlements of securities transactions in the Ukrainian market are conducted offshore, which effectively prevents delivery vs. payment (DVP). Notwithstanding the uncertainties that market participants foresee regarding settlement of securities transactions in the Ukraine, participants at a March 2002 conference on formation of a debt market in the Ukraine cited the absence of a DVP procedure between trading systems and depositories as one of infrastructure problems that should be addressed.

All corporate debt issues now use a securities depositary. The main depository for corporate issues is the MFS (Inter-regional Securities Union). Both physical certificates and dematerialized issues are permitted, as well as registered and bearer certificates, although almost all publicly offered bonds are issued in book entry form. MFS can settle but not clear transactions because it does not have a license from the SSMSC. The National Depository Union (NDU) requires an ISN code for each series of each bond issue at a cost of US $300 per code.

A 0.01% state duty is payable on Ukrainian corporate debt issues.

None of the Ukrainian bond issues to date have been rated by credit rating agencies.[17] However, participants at a 2002 bond market conference in Kiev suggested that ratings would enhance development of the Ukrainian market.

Generally, the board of directors of a Ukrainian joint stock company may authorize a non-convertible bond issue unless the corporate charter requires shareholder approval. This is the correct result. Shareholder approval of corporate debt issuance (as well as equity securities) causes unnecessary financing delays. Article 31.2(4) of the Reg. 3059-1 version of the Law on Joint Stock Companies under consideration by the Rada is potentially troubling in this regard because it provides that the general meeting of shareholders has authority to pass upon "establishing the number of announced securities." It is not clear whether "securities" in this context includes non-convertible debt securities. Hopefully, it does not. Article 49.2(6) of the same draft indicates that it is within the competency of the Supervisory Board to make a decision on the placement of non-convertible debt securities. Nevertheless, it would be preferable <u>not</u> to require in the law a decision by shareholders taken at a General Meeting, which might limit the amount of non-convertible debt securities that may be issued.

Convertible debt is not strictly prohibited but, to date, there have been no convertible issues. Under the present company law, it is believed that shareholders would have preemptive rights if a company were to propose a publicly-offered convertible issue. Accordingly, most issue documents include a statement that conversion into shares is not permitted.

[17] While issues of bonds have not received credit ratings, there have been a few instances where credit ratings have been assigned to governmental borrowers. For example, in December 2002, Standard & Poor's assigned a 'B' rating to the city of Kiev.

Use of debt with options and warrants also is not prohibited, but the amount of options is limited under current law and warrants are not specifically addressed.

Both versions of the draft Law on Joint Stock Companies now under consideration by the Rada envision that the authority of the Supervisory Board of a joint stock company to issue debt securities does not include securities convertible into shares and options to acquire shares.[18] Accordingly, shareholder approval would be required for issuance of debt securities with conversion features or options or warrants attached, presumably to protect the preemptive rights of shareholders, which can only be waived by shareholders.[19] This is an unfortunate result, as is the overall premise that preemptive rights are necessary to protect shareholders. However, the shareholder approval requirement is not so serious a problem as to warrant my recommending changes in the draft Law on Joint Stock Companies. These issues have already been debated and a new law is so badly needed for other reasons, it probably would be counterproductive to raise the authorization issue at this stage.

In terms of defaults and creditors' rights, market participants view the Ukrainian bankruptcy process as untested. It also was pointed out that if the state has ownership of 25% or more of an enterprise, the bankruptcy process is unavailable.

With respect to the ability of SMEs to access the bond market, market participants suggested that a bond issue would not be cost effective for the corporate borrower if the amount of the offering were less than US $1 million.

Market participants also cited the SSMSC's current policy of requiring issuers that do not have a three-year history of earnings to secure bond issues as a significant limitation. (As noted below, there has been only one issuer of secured corporate debt, Arkada Fund.) Also, the statutory restriction on borrowed capital (discussed below) and the inability of many small issuers to produce reliable financial information affects their ability to access the bond market.

b. Potential for Market Development

One participant estimated that the volume of primary offerings of corporate debt offerings would be US $1 billion in 2003. As of June 30th, this goal appears within reach.

An Oxford Analytica report points out that of the 150+ Ukrainian listed companies, only 30 are regularly traded, with the five most actively traded stocks accounting for more than 60% of PFTS transactions. However, most of the country's 900 strategically important enterprises are not traded at all[20]. These enterprises alone would be able to support a domestic bond market. Because of concerns about not relinquishing control, their managements should be more receptive to issuance of non-convertible debt securities than stock.

[18] Article 47.2(5) of Reg. #3059 and Article 49.2(6) of Reg. #3059-1.
[19] Article 29.2(17 of Reg. # 3059 and Article 31.2(22 of Reg. #3059-1
[20] "Ukraine: Securities Market Ripe for Reform," Oxford Analytica Daily Brief (Nov. 14, 2002), p. 8.

Banks. On the demand side, banks should continue to be the primary source of investment interest in corporate bonds. One market participant indicated that banks currently have excess liquidity but face credit quotas and reserve requirements on lending, so they find investing in corporate bonds to be an attractive use of funds.

Investment funds. Development of the Ukrainian bond market has been further limited by the fact that there are no investment funds to invest in corporate bonds. The only funds are privatization investment funds. Privatization investment funds have been operating since 1995 under a Presidential Decree that expires in 2003 at which time all investment funds will have to comply with the Law on Collective Investment Institutions. The Law on Collective Investment Institutions permits a corporate mutual fund to raise funds by issuing investment certificates, both to legal entities and natural persons. However, this will require registration with the SSMSC. One securities firm, Kinto, already has reorganized two of its funds to comply with the new law and has applied to the SSMSC for an asset management license.

Pension funds. Privatized pension funds have yet to emerge in the Ukraine. The state pension fund limits its bond investments to Ukrainian government bonds. PFTS representatives believe that privatization of pensions should increase trading interest in corporate bonds.

Individuals. It is estimated that Ukrainians have approximately $2.5 billion in saving accounts. When this amount is divided by the Ukrainian adult population, however, average savings are well under annual GDP per capita, which was $829 in 2002.

Tax structure. In addition to relatively low savings and GDP per capital, income taxation is probably the most significant factor discouraging individual investors from participating in the corporate bond market. At present, there is no tax on savings deposits in the Ukraine but interest on corporate bonds is subject to tax at progressive rates ranging form 10-40%. The 40% maximum rate applies to person with a monthly income as low as US $330. Within the past month, tax law changes have proposed a 5% tax on individuals' interest income from savings deposits effective January 1, 2005, and a 13% flat tax rate applicable to individual income, including interest on corporate bonds, effective Janaury1, 2004. As pointed out in above, however, the President has not signed the tax reform legislation into law and even if the changes are enacted, the individual income tax structure would remain skewed in favor of savings instead of investment in debt securities.

A 30% tax rate applies to interest on corporate debt held by legal entities.

There may also be tax uncertainties associated with the manner in which interest is paid on corporate debt. The two alternatives are coupon interest, which is addressed in the tax law and issuing bonds at a discount, which is addressed by special law for government bonds, but not for corporate bonds. Thus, according to one market participant, there may be some uncertainty how corporate bonds bought at a discount in the secondary market are taxed when they are paid at maturity, and how bonds originally issued as a discount are taxed with respect to the interest element inherent in the discount.

Introduction of Commercial Paper. PFTS also has proposed to the SSMSC that the PFTS might be used as a primary auction and secondary trading market for short-term prime commercial paper.

c. Ukraine vs. Kazakhstan.

For purposes of identifying factors that are important to the development of a corporate bond market, it is useful to compare in the following table the situation in the Ukraine with that of Kazakhstan, a country generally regarded to have had significant success to date among CIS countries in developing a corporate bond market. Much of the data below comes from "Corporate Bond Market Developments: A Look at Four Transition Economies," Deloitte Touche & Tohmatsu, submitted to USAID under SEGIR Financial Services IQC (May 2003).

Factor	Kazakhstan	Ukraine
Corporate bond volume as a % of GDP, 2001	2.58%	0.38%
Debt market as a % of total capital market, 2002	59%	22%
Corporate debt as a % of total debt, 2002	21.5%	16%
Outstanding corporate note and bond issues, 2002	$448 million (34 issues)	$109 million (47 issues)
Sub-sovereign debt, 2002	$80 million (9 issues)	None
Banking assets, 2002	$5.9 billion	$9.7 billion
Inflation rate, 2002	6.0%	-0.6%
Net spreads on bank rates, 2002	6.7%	15.88%
Interest rate on bank savings deposits, June 2003	[%]	14-16% domestic;* 7% foreign
Interest rate on government treasury bills, June 2003	5.2%	14-16%*
Estimated pension funds available for investment in corporate bonds, 2002	$1.2 billion	$3.3 billion
Establishment of private pension funds	Yes, since 1998	Not yet
Estimated insurance funds available for investment in corporate bonds, 2002	$1.7 billion	$2.6 billion
Tax regime	0% for main types of investors (e.g., pension funds) and flexible limits for other institutions	30% for legal entities and 10-40% progressive rates for individuals with a proposal to reduce individual rates to 13%
Modern law on secured transactions	Yes	Pending
Credit rating agencies	Yes	Not yet
GDP per capita, 2002	$1648	$829

* Individuals cannot buy treasury bills directly in the Ukraine, but they may request a bank to buy bills on their behalf. Foreign banks licensed to do business in the Ukraine offer a significantly lower rate on savings deposits than domestic banks.

On the positive side, in the case of banking, insurance and pension fund assets, it is estimated that the Ukraine has more funds than Kazakhstan available for investment in corporate debt markets. It should also be pointed out that the 15.88% net spread on bank rates in the Ukraine has recently come down from in excess of 20% but it is still the highest rate in CIS and Central and Eastern European countries. As this rate comes down more, banks should have an even greater interest in investments in corporate debt securities.

On the negative side, while the current inflation rate in the Ukraine is encouraging, it should be noted that as recently as [2000], the rate was in excess of 20%. It may take several years for investors to be convinced that macroeconomic stability is a reality.

d. Securities Regulation Issues

Under the present securities registration scheme for corporate debt, the SSMSC is given 30 days within which to register an issue. Market participants described the SSMSC registration process as essentially a "box checking" exercise with no substantive review.

The current process for registration of debt (and equity) issues also is not properly focused. The official document that is required to be filed with the SSMSC and to comply with the SSMSC's disclosure requirements is usually not the same as the prospectus or offering memorandum used to offer and sell the securities. Unlike US practice, which permits offers but not sales to commence when offering documents are filed with the securities regulator, Ukrainian law does not permit offers of the securities until the SSMSC has approved the offering.

During my meetings with SSMSC officials, which included FMI representatives, they expressed support for improving the disclosure process for debt issues. However, they also indicated that disclosure doesn't solve all investment risks in the Ukraine because of lack of sophistication among market participants, including investment bankers. They suggested that the procedure for redemption of bonds is one area that is not adequately addressed in the prospectus. They also expressed concern that if defaults were to occur, investor confidence would be undermined. They suggested that security for bonds was important and suggested that perhaps guarantees of insurance companies might be used. Finally, they expressed some concern with current practices whereby the buyers of bond issues are pre-determined.

SSMSC representatives invited comments on SSMSC's draft bond disclosure regulations from FMI. Since October 2003, when the draft regulation was first proposed, FMI's efforts have produced improvements in the draft. However, as discussed below, in FMI's annotations on the May 30 Draft Regulation significant problems remain.

Ukrainian issuers are required to make annual financial information available but by law are given up to nine months after the fiscal year end to do so and to publish such information and to distribute it to shareholders. The SSMSC, by resolution, has required the annual financial information to be filed with it not later than 120 days after the close of the fiscal year. However, the resolution was challenged and subsequently invalidated by a court with respect to issuers that are closed joint stock

companies.[21] Recently, SSMSC has begun to require quarterly reports form joint stock companies with at least 10% state ownership interest (approximately 2000 companies) to be filed with the SSMSC within 25 days of the close of each quarter, including the fourth quarter.[22] Surprisingly, however, SSMSC does not make this information publicly available.

PFTS requires listed companies, including bond issuers, to file quarterly financial information within 90 days after the close of a quarter. Bank issuers also are required to make financial information available quarterly.

Market participants indicated that financial statement requirements often were a problem because many Ukrainian companies lack sophisticated financial and accounting personnel and have some apprehension about making public financial disclosures. Despite claims to the contrary, Ukrainian national accounting and auditing standards fall substantially short of high quality international accounting and auditing standards. Enforcement of any standards is a major problem.

All of the commercial banks currently placing corporate debt are subject to SSMSC regulation, although general standards of broker-dealer regulation administered by the SSMSC are not particularly demanding.

It was suggested by some market participants that a private offering exemption from SSMSC registration would benefit issuers. Other participants indicated that since the current market is largely driven by commercial banks, the banks' reaction to such a proposal would be important. Current SSMSC regulations do not contain such an exemption. The May 30 draft regulation includes such an exemption, but the procedures are no less cumbersome or time consuming than registration of a debt issue with the SSMSC. For these reasons, most corporate issuers of debt should be expected to continue to register such issues so that they may continue to list the issues on the PFTS exchange and have available a liquidity option should a more liquid secondary market develop. Similarly, as discussed above, banking regulations are structured so that it is to a bank's advantage to invest in listed securities.

Recommendation No. 1. The restriction currently embodied in Article 11 of the Law on Securities and Stock Exchange, that prevents joint stock companies from issuing debt in principal amount in excess of 25% of the company's authorized fund, should be eliminated. The amendment to the Commercial Code that would change the 25% limitation to 100% effective January 1, 2004 is also inadvisable, as is what I am told is the National Bank of the Ukraine (NBU) proposal to base the 100% limitation on stockholders' equity, including retained earnings. There is no reason that any limitation of this nature is necessary for investor protection or other purposes. Furthermore, there is no reason to include any version of this limitation in the bond issue regulations proposed by SSMSC.

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[21] I am advised by FMI that it is possible for Ukrainian closed joint stock companies to have substantial numbers of shareholders.

[22] There appears to be no logical explanation for the SSMSC's decision to focus on this class of approximately 2000 issuers rather than on the issuers representing less than 20% of this number whose securities are publicly traded.

The most significant legal constraint on the ability of Ukrainian joint stock companies to issue bonds is the limitation in Article 11 of the 1991 Law on Securities and Stock Exchange:

> "A stock company may issue bonds for not more than 25 per cent of its authorized fund and only after all issued shares have been paid in full."

Authorized fund means the nominal or par value of the company's capital stock plus any amounts paid in excess of nominal value. Accordingly, a company receives no credit against this limitation for retained earnings or for the possibility, in many cases, that the company's net asset value on a fair value basis exceeds its stockholders' equity determined in accordance with generally accepted accounting principles.

It has been suggested that this limitation might be liberalized so that the limitation is based upon a percentage of stockholders' equity, including retained earnings, or possibly even total capital, including indebtedness. However, in reality, there is no logical reason for any such limitation. The ability of an issuer of debt securities to service such obligations does not depend upon arbitrary ratios or constraints. It depends on future cash flow. The most constructive step that may be taken to safeguard against future defaults on corporate debt is to improve the quality of financial information that corporate debt issuers are required to provide, including a statement of cash flow prepared in accordance with International Accounting Standard No. 7.[23]

Also, for issuers of debt securities that also have publicly traded equity securities, a determination of an issuer's weighted average cost of capital might readily support an issue of debt securities that substantially exceeds the issuer's stockholders' equity.

Some Ukrainian companies have avoided the 25% limitation by setting up limited liability companies (LLCs) to issue bonds since the limitation does not apply to LLCs. In these cases, the parent joint stock company guarantees the LLC's debt securities. This raises a question of what financial information is required to be disclosed by the guarantor joint stock company. Ideally, consolidated financial statements of the joint stock company guarantor, which include the LLC subsidiary, should be included in offering documents and annual reports. If current Ukrainian accounting standards do not require consolidation,[24] separate financial statements should be required for both the LLC and the parent company guarantor.

It also would be possible for a Ukrainian joint stock company to revalue its assets upward,[25] but in order to get credit for the increase as paid-in capital, it would be necessary for shareholders to approve an increase in the company's par value.

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[23] A cash flow statement is not required at present by SSMSC regulation, but it would be required by the May 30 Draft Regulation. It is quite possible that underwriters and institutional investors have access to cash flow information, given the negotiated nature of the primary market.

[24] The definition of "consolidated financial report" in the Law On Accounting and Financial Reporting refers to such a report including financial information regarding the legal entity and its branches (affiliates). It is not clear that this would include all subsidiaries of an issuer.

[25] In some cases, this is permitted under international accounting standards adopted by the International Accounting Standards Board, although it would not be permitted under generally accepted accounting principles in the United States.

<u>Recommendation No. 2</u>. The current practices of the SSMSC regarding public availability of information of issuers of debt (and equity) securities need be improved substantially. If the SSMSC remains uncooperative by withholding information that should be available to the public, there are alternative means of addressing this problem.

First, any disclosure document filed with the SSMSC, whether it is a prospectus or information memorandum that will be reviewed by the SSMSC, or an annual or periodic report that may not require review, should be made publicly available free of charge as soon as it is filed. Failure to adhere to a policy of immediate public availability is a disservice to investors and significantly increases the possibility that nonpublic information will be used for purposes of insider trading or corruptly for other purposes by persons having selective access to this information. This includes both persons having access to the information through the issuer and staff of the SSMSC having selective access to the information.

Second, the concern that information requires review by the SSMSC before it is made publicly available is fallacious. Even in the United States, where the staff of the securities regulator has sufficient experience and training to identify shortcomings in disclosure documents, in many cases, it is the private sector, including the financial media, securities professionals, rating agencies, and others, that often identify problems with issuer disclosures. It is a serious mistake to deny the public immediate access to issuer disclosures.

Third, the excuses that have been offered by the SSMSC for not making information immediately available to the public are highly circumspect.[26] Even if the SSMSC's web site is being redesigned or repaired, there are not so many Ukrainian issuers of corporate equity and debt securities that are publicly traded that would prevent the SSMSC from providing a public reference room where information on the issuers of publicly listed or publicly traded debt and equity securities may be accessed.[27] If the SSMSC continues to be unresponsive in making issuer information publicly available, consideration should be given to providing a web site administered by a private sector body, such as the PFTS, to make such information available.

For example, PFTS might simply require as a listing condition that issuers of debt and equity securities post their prospectuses, annual and quarterly reports on their web sites on a timely basis and disclose the availability of the web site information in the prospectus. The 5-6 banks that are currently placing substantially all of the debt issues might be approached by FMI and encouraged to adopt as a common underwriting condition, the requirement that any issuer making a public offering of debt securities must agree to make timely annual and quarterly financial information

[26] The SSMSC appears to have breached the July 9, 2002 Agreement on Disclosure of Information that it entered into with PFTS and the Stock Market Development Infrastructure Agency to make publicly available issuer and other information required to be filed with the SSMSC.

[27] Even though current reporting requirements may apply to thousands of Ukrainian issuers as a legacy of mass privatization, if these issuers are not publicly traded (many may be insolvent or too small to warrant any public trading interest), the SSMSC's focus should be on the no more than 300 issuers of debt and equity securities where there is public trading and/or listing on the PFTS. Information on the non-publicly traded issuers is at best of secondary importance to information regarding publicly traded issuers.

available on its own web site and/or on a commonly agreed web site.[28] As part of its corporate governance project mandate, FMI might encourage a voluntary association of publicly owned issuers of debt and equity securities who agree to best governance practices that include timely public release of annual and quarterly results on their own and/or a common web site. Indeed, if it is not possible to convince issuers to disclose basic corporate information, which is a fundamental precondition to corporate governance, there may be little point in attempting to introduce a more civilized governance environment that cannot be achieved without such information.[29]

The notion that there is a large universe of publicly owned Ukrainian companies that warrant the SSMSC requiring enhanced information technology to manage and make such data publicly available data regarding these companies is simply fallacious. Poland, a country with a population of 39 million, a substantially greater success story regarding economic progress, and the most significant securities market in the NIS/CEE region, still has less than 500 publicly traded companies for which timely disclosure of public information is necessary. Even under the best of circumstances, the Ukraine should not be expected to approach 500 publicly-traded companies for at least another decade.

Going forward, if the SSMSC demonstrates a willingness to act responsibly under new leadership, in addition to developing a web site that provides for free access to public fillings by issuers, the SSMSC should require issuers to establish and identify in their filings with the SSMSC their own web sites, which should contain all information required to be filed with the SSMSC. Filing with the SSMSC and publication on the issuer's web site should be accepted as a satisfactory alternative to the more costly procedure of distributing information to shareholders.

Recommendation No. 3. The information that the SSMSC's regulations require to be filed with the SSMSC in connection with public offerings of debt (and equity) securities should be refocused on information that would be material to investment decisions so that this information would be the same as the offering document that an issuer should be required to use to offer and sell the securities.

The SSMSC's current registration regulation, the 1991 securities law and the May 30 draft regulation all focus on largely irrelevant legal formalities rather than information that is essential for investment decision. In this regard, I agree with the observations of market participants cited above, that registration of a securities issue with the SSMSC appears to be a "box checking" exercise with no focus on informational disclosure that is essential for investment decisions. This raises a very serious questions whether the SSMSC has developed any institutional capability to serve an investor protection function, including the ability to identify by regulation information that is essential to investor decisions, and to pass upon the adequacy of the information provided with respect to specific offerings.

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[28] FMI points out, for example, that some issuers of debt securities already voluntarily place the information they use to sell their bonds on a private web site, www.cbonds.com.ua. This practice is commendable and might be built upon to establish a broader private data base for issuers of debt securities.

[29] See generally OECD Principles of Corporate Governance (1999) Section IV, explaining the fundamental role that corporate information plays in corporate governance.

Recommendation No. 4. The May 30 draft regulation should be amended in response to FMI's annotations thereon.

2. Secured Debt Securities

a. Legal Infrastructure.

The Law on Pledge currently limits the types of assets that a Ukrainian corporation may use as security for debt. A most significant problem is that the collateral used as security may be viewed as personal pledge that is not transferable with the debt securities. For example, it is not possible under the current law to pledge a machine as collateral for a series of transferable bonds and to have the security interest in the machine transfer with the bonds. I was informed by several persons I interviewed that these problems would be resolved under the proposed Law on Security of the Creditor's Claims and Registration of Encumbrances (hereinafter, Draft Law on Security Interests). However, FMI representatives and I have reviewed the Draft Law on Security Interests and do not find any provision in the draft that solves the above-mentioned transferability problem.

In 2002, the EBRD Regional Survey of Secured Transactions Law conducted an analysis of the current secured transactions regime in the Ukraine. The most significant problems identified in this survey were that with respect to both possessory and non-possessory charges [liens], it is not permitted to describe property generally, and in the case of possessory liens it is not possible for the collateral to constitute a fluctuating pool of assets. Also, it was pointed out that in the case of non-possessory liens a third party acquiring property in the ordinary course or business without notice of the lien is not protected, and in the case of both possessory and non-possessory liens a bona fide purchaser without notice of the lien is not protected.

On June 13, 2003, Ann Wallace of FMI and I met with Professor Roderick A. MacDonald of the McGill University Law School, who is working on the Draft Law on Security Interests as a consultant to The World Bank. Professor MacDonald explained that because the Ukraine is a civil law country, it made more sense to look to a civil law jurisdiction, such as Quebec, as precedent for the Draft Law on Security Interests rather than Article 9 of the US Uniform Commercial Code. He indicated that the problem of assuring that a security interest transfers with the transfer of the debt security it secures would be solved under the Draft Law by inclusion of a provision borrowed from Article 2692 of the Civil Code of Quebec, which provides:

> "A hypothec securing payment of bonds or other titles of indebtedness issued by a trustee, a limited partnership or a legal person authorized to do so by law shall, on pain of absolute nullity, be granted by notarial act *en minute* in favour of the person holding the power of attorney of the creditors."

Professor MacDonald explained that the effect of this provision is to create a bond deed which is held by a nominee on behalf of all creditors (holders of secured debt). In response to Ann Wallace's question regarding what provisions are included in the bond deed and what law governs this, Professor MacDonald indicated that this is essentially a matter of contract between the parties, but he recognized that in the context of a public securities issue, it also would be possible to address required

content of the bond deed by securities regulation.[30] Finally; Professor MacDonald indicated his view that inclusion of the provisions he described would be sufficient to permit securitizations and transactions in asset-backed securities.

At present, however, even with a perfectible security interest, creditors' rights still may not be that well protected under the Bankruptcy Law, which permits a stay of enforcement of a security interest during reorganization proceedings, requires secured lenders to appear in the bankruptcy process to preserve their security interest, and it allows the bankruptcy trustee, not the secured lender, to administer the sale of the collateral.[31] The effect of such requirements is to deny secured lenders an expeditious remedy in realizing upon their collateral security in the event of a default. Such requirements can only have the effect restricting secured lending practices and increasing the cost of borrowing when secured lending is use or unsecured lending is the only alternative. It is not clear whether these shortcomings have been or are proposed to be addressed through the recent changes in the Civil Code or the proposed Draft Law on Security Interests.[32]

b. Are Guarantees Legally Enforceable under Ukrainian Law?

As noted above, in order to avoid the 25% of authorized fund limitation on debt securities issued by joint stock companies, parent joint stock companies have guaranteed subsidiary LLC issues because the 25% limitation.[33] The guarantee, which is also used in Russia to deal with a similar limitation, has been described as "embedded" in the prospectus or offering documents. Normally a prospectus is a descriptive document. In most countries, a guarantee might be described in a prospectus, but a separate legal document evidencing the guarantee would be executed in order to create a legally binding obligation of the guarantor. Some Ukrainian market participants have described the guarantee as more of moral than a legal obligation. Some experts, including FMI, believe that even if a separate legal document evidencing the guarantee were executed, it would not be legally binding because the obligation to third party investors under the debt securities may not have been in place before the guarantee was executed. It would appear possible to address this problem through "good lawyering" in connection with the primary placement of a guaranteed debt issue, but if the guarantee does not transfer automatically in connection with secondary trading in the debt securities, then a problem exists.

There appears to be a consensus that the new Civil Code provisions, effective January 1, 2004, will provide a legal foundation for guarantees, so the above concerns may be moot by that date. Ann Wallace and I also asked Professor MacDonald about the

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[30] In the United States, in the case of a registered public offering of corporate debt securities, the Trust Indenture Act of 1939 requires that certain debt security holders' rights must be included in a trust indenture qualified and administered by independent trustee under the Act. However, the specific terms of the security interest, events of default, issuer covenants and other provisions are essentially negotiated between the issuer and the underwriters for the debt offering.

[31] Paul Holden, "Using Real Estate as Collateral in Ukraine: Issues and Options," The Enterprise Research Institute, Washington, DC, (undated), p. 17.

[32] As of the date of this report, none of these changes had been adopted.

[33] There is nothing inherently wrong with the practice of using newly-formed subsidiaries to borrow on behalf of parent companies. Indeed, it is a widely accepted practice in the Eurobond market. Thus, the legal issues that may need to be addressed in connection with the effectiveness of guarantees should not be addressed by preventing the use of subsidiary LLCs to borrow on behalf of parent joint stock companies.

guarantee issue. He indicated that there are three types of guarantees under civil law: (i) Surety ship; (ii) Enforceable collateral guarantees; and (iii) Letters of Comfort, which are essentially moral obligations. It would appear that the current guarantees used for Ukrainian debt issues may fall into the Letter of Comfort category. However, Professor MacDonald indicated that under Article 583(1) of the Civil Code, effective January 1, 2004, it will be possible to have pledges based upon a third person's surety, so that the types of guarantees currently used by parent companies to guarantee subsidiary debt would be legally enforceable if issued after January 1, 2004.

There is also what I consider a more troubling aspect of current Ukrainian guarantee practices, which may not be solved by the new Civil Code. Two of the market participants I interviewed indicated that in some cases issuers or banks placing corporate bonds had negotiated separate guarantees with purchasers, though not necessarily uniformly with each purchaser in the same issue. One purchaser is unlikely to know what terms were agreed to with other purchasers. This, of course, raises not only a fundamental problem of fair dealing and lack of disclosure, but also the prospect that all bonds of the same issue are not fungible.

Mortgage-backed securities, including the Arkada Fund secured bonds, are discussed in Section C below.

Recommendation No. 5. The amendments to the Civil Code, effective January 1, 2004, and the Draft Law on Security Interests, if enacted, would appear to be a positive step forward in addressing the collateral problems described above. [34] However, there is no indication that either of these laws addresses a rather complex series of problems that arise in markets for investment securities (both debt and equity). These problems arise primarily when securities intermediaries wish to use securities as collateral to finance the intermediaries' operations, and when individuals or legal entities that are the ultimate economic or beneficial owners of securities wish to use their securities as collateral for loans, but such persons do not own their securities directly because, for example, the securities are held by the persons' brokers, banks other custodians, or in a central securities depository. These problems also should be addressed.

When the world was a much simpler place and markets for investment securities used physical certificates, a broker or an individual owning investment securities and wishing to use them as collateral for a loan would simply pledge such securities by delivering the physical certificate to the creditor along with a stock power. Indeed, if the physical certificates were in bearer form, physical delivery was the only means of pledging the collateral.

Nowadays, even in the Ukraine's fledgling markets for investment securities, most Ukrainian debt securities are not evidenced by physical certificates. Instead, they are issued in book entry form and the registered owner of the certificate is reflected in the records of a central securities depository. The registered owner often is not the same as the ultimate economic or beneficial owner. To facilitate secondary trading, including clearance and settlement of transactions, the economic or beneficial owner

[34] I must caveat that I am not an expert in collateral law or in the specialized collateral issues associated with investment securities that I am describing.

often elects have the securities registered in the name of the owner's broker or bank or another custodian. In some instances, there is a chain of intermediary custodians with only the top custodian reflected in the records of the depository.[35]

If an economic or beneficial owner of securities held in a Ukrainian central securities depository wishes to use the securities as collateral for a loan, how is the collateral secured in favor of the creditor? Clearly, if securities in the depository are in book-entry form, the owner does not have a separate piece of paper to pledge as collateral. Perhaps the owner's creditor will attempt to rely on the Law on Pledge or, when enacted, the Law on Security Interests by registering a security interest in the owner's securities. But where does the creditor do this? In the pledge registry along with other personal property, such as inventory and intangibles, such as trademarks? However, if there is a default and the creditor walks into the central securities depository with the piece of paper purporting to be a perfected security interest in the owner's investment securities, the creditor is likely to be in for quite a surprise when the depository tells him they have never heard of the owner, and "Oh yes, we do have some XYZ debt securities but your security interest says your debtor held these securities through ABC broker. Unfortunately our records show that ABC broker sold all of its XYZ debt securities over six months ago. Sorry, it is not possible to determine what happened."

In the United States, a rather complex set of amendments to Articles 8 and 9 of the Uniform Commercial Code was required to address collateral problems that arise in connection with use of indirect holdings of physical and book entry securities as collateral. There does not appear to be anything in the earlier version I reviewed of the Draft Law on Security Interests, the Law On the National Depository System and Special Features of Electronic Circulation of Securities in Ukraine, or the other Ukrainian laws and regulations I have reviewed that either acknowledges or addresses such problems. The problems will need to be resolved.

Recommendation No. 6. The SSMSC's regulation on bond issuance should not require collateral security as a condition for registration or exemption of debt securities.

Security, in the form of collateral, guarantees, insurance or other credit enhancements, all have associated costs and do not compensate for lack of transparency (full disclosure) or lack of credit worthiness. The market place, not the SSMSC, is in the best position to assess credit worthiness, to price risk and to determine whether collateral is necessary.

One significant exception to this recommendation is the situation where, for example, a joint stock company uses a subsidiary organized as an LLC to issue debt securities and the proceeds are loaned upstream to the parent joint stock company. In these circumstances, it would be advisable (whether the guarantee is a moral obligation or is legally enforceable) to require the parent company guarantee of the debt securities and disclosure of the parent company's financial statements, preferably on a consolidated basis, including the LLC subsidiary.

[35] Not all securities depositories are the same. Same permit only securities professionals to be reflected as registered owners. Others may maintain sub-registries of indirect holders.

3. Ukrainian Corporate Debt Securities Sold Outside of the Ukraine

One potential constraint for Ukrainian issuers considering the Eurobond alternative is that few issuers would be eligible because the minimum issue threshold for such issues is usually $100-150 million. Market participants I interviewed believed that no more than 5-6 Ukrainian corporations might be candidates to access international debt market over the next few years. Among constraints cited were the fact that the Ukrainian central depository has no clearance and settlement linkages with Eurobond depositories. In my opinion, however, the depository issue should not be a limitation unless it were also desired to have a Ukrainian Eurobond issue traded domestically. Otherwise, the Ukrainian depository should be irrelevant to the process.

Kyivstar placed a $100 million Eurobond issue with a three-year maturity. It was not possible for Kyivstar to do a straight bond issue because of the Ukrainian limitation on debt not exceeding 25% of it authorized fund and the requirement that Ukrainian issuers bonds must be denominated in local currency. Accordingly, the underwriters, Dresdner, Kleinwort Wasserstein made a $100 million loan to Kyiv Star and then sold the underwriters' bonds which are payable only out of the debt service on the loan. The loan agreement is governed by United Kingdom law, but it had to be registered with the NBU. The NBU also imposes a ceiling on interest payments, which was 13% at the time of this issue. The bonds were placed just under the ceiling at 12.75%. Moody's and S&P provided credit ratings. Kyivstar has been preparing financial statements in accordance with US GAAP for the past three years. The bonds were listed on the Luxembourg Exchange so that they would be legal investments for many institutional investors but, like other Eurobonds, secondary trading is OTC.

PFTS and market participants indicated that they favor permitting Ukrainian investors to buy Eurobonds. At present, a license for each transaction in Eurobonds would be required from the NBU. It should be expected that investor demand for such issues should develop in the Ukraine as it has in Russian and Kazakhstan. There is no reason not to permit such issues to be traded in the Ukraine without NBU licensing. Also, there should be no reason to prevent Ukrainian investors from purchasing these securities directly or through intermediaries in overseas markets. These issues are most likely to be the Ukraine's "blue chip" issuers. Impediments to their purchase by Ukrainian individuals and institutions, either domestically or overseas, in domestic or foreign currency, should be removed.

Recommendation No. 7. Even though the current securities law provides the SSMSC with authority to regulate Eurobond and other foreign offerings by Ukrainian corporate issuers, because these issues are placed outside of the Ukraine, the SSMSC has nothing to add to this process from an investor protection standpoint and would best be advised not to become involved.

In the United States, the US SEC does not require registration of a domestic issuer's securities that are sold overseas, including US issuers' Eurobond issues. Procedures are in place, however, to restrict the ability of these securities to "flow back" into the United States without registration until the securities have come to rest overseas and, a certain period of time has elapsed.

If there were Ukrainian issuers that attempted to evade Ukrainian securities laws by placing securities overseas primarily with a view to avoiding SSMSC registration, then the SSMSC should have a legitimate interest in regulating this process to assure that its registration and disclosure requirements are not compromised. In the case of access to the Eurobond market, however, as pointed out above, the $100 million minimum offering threshold to access this market effectively limits access to 5-6 Ukrainian issuers and the disclosure standards for Eurobond debt issues, which are largely self-enforcing, have the effect of assuring that Ukrainian issuers are not selling Eurobonds to avoid registration and disclosure requirements imposed by the SSMSC. Indeed, a comparison of the high quality disclosure that was required in the Kyivstar Eurobond issue with the minimalist disclosure required in Kyivstar's SSMSC-registered domestic debt issues demonstrates that subjecting a Ukrainian Eurobond issuer to SSMSC registration and disclosure requirements for the same issue would add nothing substantively to the information about the issue available in the Ukrainian market place.

For these reasons, I recommend that a Ukrainian Eurobond issuer should not be required to register such issue with the SSMSC. I also recommend that PFTS should be permitted to list a Ukrainian issuer's Eurobonds for trading in the Ukraine without SSMSC approval, and that NBU licensing obstacles should be removed. However, for purposes of satisfying disclosure and financial reporting requirements for Ukrainian secondary trading, the Ukrainian Eurobond issuer should be required to comply with PFTS listing requirements and SSMSC reporting requirements for issuers of publicly traded securities.

From a disclosure standpoint, my recommendation is the same for Eurobond issues of Ukrainian municipal issuers. However, I recognize that from the standpoint of controlling the level of Ukrainian public sector borrowing, the Ukrainian Ministry of Finance may wish to pass upon such issues.[36] Nevertheless, there is no reason for any SSMSC involvement in this process.

4. Foreign Issuers' Securities Sold In the Ukraine

Recommendation No. 8. Subject to exceptions for issues unquestionable quality, the SSMSC should adhere to a policy of national treatment and require foreign issuers that propose to sell their securities in the Ukraine, and brokers who propose to effect transactions in such securities in the Ukraine, to adhere to essentially the same disclosure and other requirements that would apply to a comparable offering of securities (debt or equity) by Ukrainian issuers.

The SSMSC is authorized under the current securities law to register such issues. It may be appropriate, however, to exempt certain international financial institution (IFI) issues, as well as other issues of unquestionable quality from registration and other SSMSC requirements. The likelihood of primary offerings of such issues being

[36] Since a Ukrainian municipality must have a population of more than 800,000 to borrow internationally, I was informed that there are only three municipalities that would be eligible for Eurobond or other foreign borrowings.

directed into the Ukraine appears remote.[37] However, there may be Ukrainian individual and institutional investor interested in secondary market purchases of these securities.

Even if the Ukrainian debt market develops substantially, there is likely to be significant future demand for quality fixed income securities as pension funds are privatized and assets of other Ukrainian institutional investors continue to grow (See Kazakhstan v. Ukraine table above). Accordingly, it would be advisable for the Government of the Ukraine to put currency controls aside in order to accommodate the needs of Ukrainian institutions with Ukrainian constituents for safe, fixed income investments, which cannot be satisfied entirely by Ukrainian issuers of fixed income securities. Purchases of these securities should be permitted in overseas markets, but it would also facilitate growth of Ukrainian capital markets if purchases of the securities could be made domestically as well.

It should not be expected that foreign issuers of quality fixed income securities, such as IFIs, German Euros, UK Gilts, or US Treasuries, will have any incentive to deal with Ukrainian regulations in order to make their securities eligible for purchase by Ukrainian investors. Accordingly, SSMSC registration and reporting requirements should not apply to those issues. Of course, the SSMSC should have regulatory authority over Ukrainian brokers and markets that effect transactions in such securities.

For similar reasons, there should be no requirements that transactions in such securities must be effected in Ukrainian currency.

With respect to foreign issues in the Ukraine that do not fall within the limited category of issues of unquestionable quality, the SSMSC should continue to have the authority it currently has to register these issues, but in doing so, it should follow a policy of national treatment. It should be borne in mind that national treatment does not mean absolutely identical offering terms and disclosure standards. For example, foreign tax consequences and foreign country political and economic risks of investing in a foreign debt issue should be required offering disclosure.

B. Asset-Backed Securities

1. Mortgage-Backed Securities

a. Current Mortgage Lending Activity

Arkada Fund Secured Bonds. At present, the only Ukrainian issuer purporting to offer a secured debt obligation, other than a parent company guaranteed obligation, is Arkada Bank, which uses Arkada Fund, an LLC, to issue a so called "secured bond." Arkada Fund purchases from Arkada Bank the bank's default rights on 20-30-year

[37] In the United States, public offerings of securities by foreign private issuers and public offerings of foreign governmental issuers' debt securities are required to be registered with the US SEC. However, over the years, exemptions from registration have been provided for IFI offerings of, e.g., The World Bank, International Finance Corporation, Asia Development Bank, InterAmerican Development Bank, and European Bank for Reconstruction and Development.

loans given for apartment housing construction with a 35% down payment requirement. The builder is a bank affiliate, Kiev Municipal Building Construction Co. The loans and related collateral, consisting of controlled apartments, remain on the bank's books. Accordingly, the Arkada Fund bonds cannot legally be called secured mortgage bonds. The Arkada Fund secured bonds have a maturity of two years. When the loans are repaid to Arkada Bank, a portion of the proceeds are transferred to Arkada Fund. If there is a default, the collateral consisting of the apartments may be accessed and it should have significant equity in light of the 35% down payment requirement. Principal and interest on the Arkada Bank loans are paid monthly. To date, loan delinquencies are only about 0.5% . In contrast to US practice and experience, prepayments are unusual and would not be used to reduce the principal amount of the secured bonds.

Arkada regularly recalculates the value of the borrowing unit, factoring in inflation and currency changes, and adjusts the redemption terms of the long-term loan and the bonds so that all risk is passed through to the borrowers. There are five series of the Arkada Fund secured bonds outstanding. The yields have decreased from 21-23% initially on the first series initially to just over 10% on the third series. Purchasers of the secured bonds are primarily commercial banks, insurance companies, and some individuals who would still find the after-tax yields attractive. There are no foreign buyers participating in these issues, primarily because of the difficulties they would face under NBU currency regulations, including a separate license requirement that apply to each redemption.

At present, if mortgage loans are made on residential buildings that are being constructed, when extending a loan, the bank uses the borrower's apartment as collateral. Title is given to the borrower only after he pays back 100% of the loan, but the borrower is granted a temporary residence right. If the borrower were given a permanent residence right, there is a risk that he or she would add other occupants to the title and, therefore, be in a position to frustrate enforcement of the collateral. Typically, a 20-30% down payment is required on these types of loans with a 15-17% interest rate. The effect of this arrangement is to transfer all risk to the borrower.

Other Mortgage Lenders. UkrSots Bank indicated that it is currently making individual mortgage loans through its affiliate I-S Mortgage Bank, and that as soon as they had assembled a sufficient portfolio, they would like to offer a collateralized mortgage bond issue.[38] The bank acknowledged that there were legal questions that would have to be addressed, but it also indicated that it would prefer not to follow the model used in Kazakhstan because of concerns about state intervention.[39]

It is encouraging to learn that lenders such as Arkada Bank and UkrSots Bank have a good grasp of mortgage financing issues and are attempting to develop mortgage financing procedures that will work in the face of current problems with the legal infrastructure for secured lending.[40]

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[38] Under Article 133(4) of the Land Code, only certain banking institutions are entitled to be a mortgagee.

[39] Presumably, this remark was intended to refer to the Kazakhstan mortgage agency being under state control.

[40] I am not an expert in Ukrainian law and I have not reviewed the special legislation under which the Arkada financing plan is authorized; accordingly, I express no opinion on the enforceability of the secured obligations created under of the plan. Suffice to say that since the plan is based upon special legislation, it does provide a

One of the most critical problems that needs to be addressed for purposes of facilitating a secondary mortgage market or other secured lending is to find ways of transferring secured debt securities so that the purchasers will acquire the collateral security interest along with the debt securities. In this regard, it does not follow that a mortgage itself should have to be transferred or re-recorded every time that a purchase and sale of a mortgage security takes place. The Arkada financing plan recognizes this point as does the solution described by Professor MacDonald that is proposed to be included in the Draft Law on Security Interests.

b. Analysis of Conditions Necessary for Securitized Mortgage Financing

Assuming that the problem of transferable security interests is resolved under the Draft Law on Security Interests, or by other means, the general problems of securing corporate debt discussed above are further exacerbated in the case of mortgage financing. For mortgage financing to work effectively, in order to facilitate both primary and secondary mortgage markets, a number of infrastructure requirements ideally should be in place. These include: a land title system; efficient centralized registries for titles and mortgages, low transaction and recording costs; an efficient system for realizing on the collateral in the event of default; and competent professionals, including lenders, title insurers, appraisers and government officials who are capable of making the processes work. One commentator has pointed out that it can take years to develop this infrastructure.[41]

Nevertheless, recent experience in Kazakhstan, the first CIS country to place a mortgage-backed debt issues, suggests that these problems are not insurmountable and that a pilot project may be the best way to demonstrate this point. In the remainder of this section, I set forth four important issues that need to be addressed in designing a pilot project for mortgage-backed financing in the Ukraine. This is not intended to be an all-inclusive list, nor is my commentary on these issues intended to prejudge how they should be resolved ultimately. My objective is simply to provide some guidance regarding the scope and design of the pilot project.

What special purpose entity (SPE) should be used to hold and issue or pass through cash flows from economic ownership rights in the underlying portfolio of mortgage securities? It is essential that the SPE achieve three basic objectives. First, the manner in which the SPE holds underlying mortgages or an ownership interest in such mortgages must be sufficient to assure that investors are the persons assured of receiving the cash flow from interest and principal payments and that creditors of the original mortgage lender[s],[42] or other third persons, including the government, are not in a position to assert adverse claims. Second, the manner in which interest and

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universal solution to the Ukrainian legal problems associated with secured lending, although it may suggest a legislative approach that warrants further study towards a more universal solution.

[41] Paul Holden, supra.

[42] In the United States, it is usually established that creditors of a mortgage lender have no claim on securitized mortgages by satisfying the conditions necessary to establish a "true sale" of the mortgages to an SPE under circumstances that would not render the lender insolvent. However, this is not a universal requirement. I am informed that in some European countries that it may be possible to isolate the mortgages from the claims of the mortgage lender's creditors even though the mortgages may remain on the lender's books.

principal payments are passed through should be non-discretionary so that the person administering the SPE is not in a position to delay or divert the cash flow. Third, in order to make the investment attractive, interest and any other taxable elements of the cash flow stream taxable to the investor must not also be subject to taxation at the SPE level, or to the originator of the mortgages or any other intermediary involved in the process, such a broker buying the mortgaged-backed securities for a customer and holding them as the customer's nominee or custodian.

In the United States, the most frequently used SPE is a business trust. However, I am advised that an equivalent concept of trust does not exist under Ukrainian law. Several market participants suggested that the best choice for a SPE may be a limited liability company; this is the alternative used under the Arkada financing plan. While an LLC certainly merits consideration, it should be studied carefully, as part of the pilot project undertaking, to make sure that the above three objectives of a SPE are achieved if the LLC is used. Certainly, the bond deed alternative, discussed above, would merit strong consideration if the concept finds its way into the Draft Law on Security Interests.

Should a mortgage-backed pilot program make use of a government-sponsored enterprise or SPE? In Kazakhstan, a government-sponsored mortgage financing agency was established. I can see some arguments in favor of such an enterprise being established in the Ukraine (primarily promotion of uniform underwriting standards). However, I can see potentially greater disadvantages, including the delay and legislation likely to be required to establish a government enterprise, assuming the remaining legal infrastructure is substantially in place, and the belief that given a choice between the government and the private sector, the private sector will always do a better job of allocating capital. There is also the question of whether the Government of the Ukraine's participation in such an undertaking would add to or detract from investor confidence in the mortgage-backed securities to be offered. Because several Ukrainian banks, including Arkada Bank and UkrSots Bank, have already built up significant portfolios of mortgage loans that are candidates for securitization, my view is that it would be preferable to establish a pilot project with a private sector bank rather than a government-sponsored enterprise.

Should uniform underwriting standards be established for the mortgages included in securitized pool? For reasons similar to those discussed in the preceding paragraph, including avoidance of delay and introduction of rigidity by regulation that frustrates market development, I would tend to disfavor an attempt to establish uniform underwriting standards. It is significant in this respect that while the United States does include some uniformity in underwriting standards for Ginnie Mae, Fannie Mae and Freddie Mac securitized mortgages, the US government also provides certain federal guarantees or assurances regarding such mortgage programs. What would the Government of the Ukraine be bringing to the table in order to justify the need for government established underwriting standards?

On balance, I think it would be preferable to establish mortgage pools where the mortgages come from an individual lender or lenders that used common underwriting standards. Involvement of a pilot mortgage-backed securities lending project in establishment of its own underwriting standards is likely to involve delay without necessarily introducing additional safeguards. The focus of the pilot might better be

directed toward finding an existing mortgage lender whose underwriting standards and mortgage loan portfolio are financially acceptable for securitization purposes.

Should USAID's Development Credit Authority (DCA) Guarantee All or A Portion of the Mortgage-Backed Securities Issued Under the Pilot Program? In Kazakhstan a 50% DCA guarantee was used for the initial placement of mortgage-backed securities. This initiative appears to have contributed to "jump starting" the market and warrants consideration in the Ukraine as well.

2. SME Loan-Backed Securities

a. Current SME Lending Activity

There are currently several SME lending programs in the Ukraine funded by USAID and the EBRD.

Western NIS Enterprise Fund is a USAID-supported venture capital lender and investor in private sector enterprises in the Ukraine, Belarus and Moldova.

The EBRD has SME financing and micro-lending programs, which its representatives characterized as very successful. Under these programs, the EBRD lends to either the NBU or local Ukrainian banks meeting established criteria, who in turn lend to SMEs. Approximately $150 million has been disbursed. EBRD is working on a third tranche loan under the SME program that would not require a sovereign guarantee.

There are also individual banks in the Ukraine, some of them with foreign ownership, that have their own SME lending programs.

b. Analysis of Conditions Necessary for SME Loan-Backed Securities

The four issues discussed above with respect to a pilot project for a mortgage-backed securities issues are also applicable with respect to a pilot project for SME loan-backed securities and, generally, my comments and recommendations above apply equally to an SME pilot project. However, some additional explanation is warranted with respect to differences between mortgage lending underwriting practices and SME loan underwriting criteria.

There are substantial differences in risk associated with mortgage lending and SME or venture capital lending, and it follows that there may be substantial differences in the risks and required disclosures associated with securitized issues of mortgage-backed and SME loan-backed securities. The latter clearly involve more risk and may require more disclosure unless the greater SME-loan risk can be mitigated by other means.

The reason for these differences, of course, are that mortgage loans are by definition always secured and always underwritten with a requirement that there be some equity in the collateral exceeding the principal amount of the loan. SME loans, on the other hand, are often not secured. SME lenders who are venture capitalists may compensate for the greater risk by having a right to equity ownership of the borrower, thereby providing greater reward potential to compensate for the risk. Generally, it should not

be anticipated that a SME lender who is a venture capital lender will wish to securitize the lender's venture capital portfolio (unless the lender determined it was not performing well) because the lender would be sacrificing too much equity or upside potential by selling or transferring the portfolio to a SPE for purposes of securitization. Unlike the mortgage lender, which is a fixed income claimant, a venture capital lender has much more to lose and, therefore, much less incentive to securitize.

However, as noted above, there are also SME lenders who are not venture capital lenders and who do not structure their loans to SMEs with a view to payback or an exit strategy that involves equity participation. SME micro-lenders fall into this second category. They mitigate risk of SME lending, often on an unsecured basis, by limiting the amount and term of loans to SMEs so that individual defaults are unlikely to affect the success of the overall micro-lending program.

The reason I point out the above distinctions is that at a June 12, 2003 meeting at USAID Kiev, attended by representatives of Alfa Bank, USAID, FMI and myself, the possibility of structuring an SME loan-backed pilot issue involving as few as five underlying SME loans was discussed. In my view, this would be a serious mistake. For the reasons explained above, this strategy would provide insufficient risk diversification. Indeed, each of the five loans would be so significant to the success of the pilot issue that individual information would be required for each of the five borrowers, including financial statements. The purpose of pursuing a securitization pilot backed by SME loans is to provide liquidity from the market place to the lenders who have loaned funds to SMEs that otherwise would not be in a position to access the capital market. If the securitization were not sufficiently diversified so that each of the SME borrowers were required to provide its own business and financial information for the securitization issue, then nothing has been accomplished in terms of reducing these borrowers' capital market access burdens.

For these reasons, the strategy that I recommend for an SME loan-backed securitization pilot is one that securitizes a significant number of micro-loans to SMEs where no individual loan is so significant as to require individual information on the borrower. I also recommend that rather than attempting to set up a new micro-lender, which would add cost and delay to implementation of the pilot, the pilot should select an existing micro-lender in the Ukraine, such as one of the EBRD tranches, and securitize outstanding loans acquired from that micro-lender.[43]

Recommendation No. 9. The terms of reference included in Appendix F might be used by USAID for two pilot projects that would support: (i) the development of a market for collateralized mortgage obligation securities; and the development of a debt security backed by loans to SMEs.

Recommendation No. 10. The possibility of using specialized collective investment institutions, organized under the Law On Collective Investment Institutions, to invest

[43] Using micro-loans to support securitization is a viable strategy for providing additional liquidity to the SME loan market. As pointed out at the Budapest Workshop, one of the most difficult challenges faced by micro-lenders is obtaining additional funding in local currency that is necessary to "grow" their micro-lending programs.

in mortgages and SME loans, thereby providing liquidity and additional funding to the originators of these instruments, also merits consideration.

Securitization is not the only way to provide liquidity to mortgage and SME lending activities and it may not always be the most efficient or expedient way to do so. Essentially, all that securitization does is to acquire from a lender a bundle of cash flows associated with illiquid financial instruments (e.g. mortgage loans), repackage the cash flows into a security backed by the cash flows and sell that security in the public market place, using the proceeds of sale to pay the lender for the original bundle of cash flows, thereby permitting the lender may make additional loans.

It may be possible to accomplish the same objective by using a collective investment institution. In this connection, the Ukrainian Law On Collective Investment Institutions provides for several forms of collective investment vehicles, including the joint stock company model popular in the United States and the UCITS or contractual model preferred in Europe. The Law also provides for open-end and closed-end funds.

At present, the Law is largely untested in the Ukraine but the same can be said of securitization. I respectfully suggest that if it would be possible to pool a number of illiquid mortgage loans or SME loans for purposes of a public securitization issue, it would be just as easy, if not easier, to pool these loans into a collective investment vehicle in which interests are offered publicly. If this alternative were pursued, the most logical vehicle would appear to be a closed-end, non-managed UCITS.[44] The UCITS would appear preferable to the joint stock company model for the very reasons that it is preferred in Europe, lower administration expenses and avoidance of double taxation of income and gains at the entity and investor levels. The UCITS is a contract and does not involve a separate entity. The loans in the UCITS portfolio might be held in exactly the same manner as Professor MacDonald suggests in the Draft Law on Security Interests, in a bond deed held by a nominee.[45]

Clearly, there are other questions that would have to be addressed, such as the certainty of avoiding double taxation and safeguards against self-dealing and unreasonable sales and administration expenses. However all of these issues also must be addressed under the securitization alternative.

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[44] The UCITS would have to be closed-end because there would be no market for the loans in its portfolio. Accordingly, the UCITS would not be in a position to redeem investors' interests. Investors would have the choice of holding the UCITS until all principal and interest on the loans held by the UCITS was paid at which point the UCITS would terminate, or selling their interests in the UCITS in a secondary trading market. The UCITS would be non-managed because once the initial portfolio of loans were placed in the UCITS, there would be not need for portfolio changes. Of course, a custodian or administrator for the UCITS would be required to see that interest and principal payments on the loans were passed through to UCITS investors. The comparable US investment vehicle is a unit investment trust. Unit investment trusts are used extensively in the US and other jurisdictions to permit investors to invest in diversified portfolios of government, municipal and corporate bonds.

[45] One respect in which the UCITS procedure might be less complicated than a securitization is that the ownership interests in the UCITS would not have to be directly secured as is the case with securitized mortgage obligations. Instead the bond deed would be held for the benefit of the UCITS.

c. Sub-Sovereign (Municipal) Securities[46]

Odessa Default. In 1998, the City Council of Odessa issued bonds for infrastructure development with the Council guaranteeing the timely repayment of debt service. The bond proceeds, which were to be invested in infrastructure projects, were invested on an interim basis in the Ukrainian interbank market at negative arbitrage. Many of the proceeds were unaccounted for, and the projects were not completed. Those that were did not generate the expected revenues. The debt service on the bonds was not provided for the city's budget and Odessa defaulted on the first payment date for the bonds.

The infamous Odessa municipal issue was not registered with the SSMSC. Since 1998, both the SSMSC and Ministry of Finance (MOF) have in place requirements that would apply to municipal debt issues. A Presidential Decree was issued immediately, which effectively prohibits the issuance of municipal debt securities without MOF approval and registration of the issue with the SSMSC.[47]

Market participants indicated that many municipalities that would benefit from municipal bond financing tend to think only of short-term needs and fail to understand the benefits of a debt issue. Also, in light of the Odessa problem, questions remain as to the boundaries of municipal authority. Significant legal questions are likely to arise regarding sources of debt service, collateral and set-off with respect to state-owned assets, and available remedies in the event of default. In this regard, the Ukrainian Law on Bankruptcy does not cover a municipal insolvency.[48]

With respect to debt service sources, municipalities generally have authority to levy local property taxes; however VAT and profit taxes are shared by ratios established between the municipal and national governments under the Budget Code.

Current Limitations on the Issuance of Municipal Debt. These limitations exist under the Budget Code and under MOF and SSMSC regulations.

The Budget Code requires the maximum amount of debt and guarantees must be set forth in a municipality's budget for each budget period. All municipalities are permitted to borrow short-term for not more than three-months for cash flow financing that must be paid within the budget period. Debt service may not exceed 10 percent of the general budget fund expenditures in any budget period in which debt is to be serviced. The failure to pay timely principal and interest on municipal borrowings prohibits a municipal borrower from borrowing for five years.

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[46] In addition to my interviews and laws reviewed, much of the information in this section is drawn from Michael A. DeAngelis, Eugene Komiychuk and Yaroslav Gregircak, "Legal and Regulatory Framework for Sub-National Borrowing," Prepared by the Urban Institute for Ukrainian Municipal Development Loan Fund Project, The Ministry of Finance of the Ukraine (June 2002) (Urban Institute Report). As used in my report, the term "municipal securities" includes any securities that might be issued by a Ukrainian oblast, rayon, city, village or town, or by any special legal entity that these governmental units might be authorized to organize for the purpose of issuing securities.

[47] Presidential Decree No. 655/98.

[48] This is due to the definition of "debtor " in Article 1 of the law as a "business entity."

MOF Directive 19 provides that (i) the maximum amount of a municipality's internal borrowings may not exceed 15 percent of applicable local budget revenues, excluding state budget subsidies and subventions, as well as loans and credits received from banks; and (ii) the maximum total value of all of a municipality's bonds may not exceed 30 percent of the revenue part of the issuer's budget for the preceding year. An MOF official indicated that municipal debt service may exceed 10% of municipal revenues each year, and that the proceeds of municipal borrowing must be placed in a special fund for investment projects. For example, municipal wages may not be paid from this fund.

Some market participants indicated that if a municipal bond market were to be developed it would necessarily have to be a domestic market because Kiev is the only municipality that might be considered a realistic candidate for a Eurobond issue.[49] This view was based upon the underwriting criteria that would likely apply to such an issue, including size of issue, municipal tax base and debt service costs as a percentage of municipal budget. It was also indicated that the MOF would have to approve such an issue under its regulations. If such a Eurobond issue were made, the maturity would likely be no longer than five years, and could be as short as two years.

Apart from the practical limitations on Ukrainian municipalities being able to access international markets, the Budget Code provides that only the Verkhovna Rada of the Autonomous Republic of Crimea and Radas of cities with a population over 800,000 may borrow internationally. Only three cities meet the 800,000 population test.

Each of the Budget Code, MOF regulations and SSMSC regulations require a resolution of a municipal council to issue debt securities. The Law on Local Self-Government provides that a municipality may act as a guarantor of loans to third parties that are entities belonging to the municipal communal property. However, the Budget Code indicates that only executive bodies of city councils have authority to issue guarantees.

Law On Local Self-Government. The Law On Local Self-Government in Ukraine provides a constructive basis for municipal governance. For example, it should be possible for a person performing due diligence regarding a possible debt offering (or other borrowing) by a Ukrainian municipality to look to this law and obtain objective answers regarding the municipal governing bodies' authority with respect to issues related to budgets, use of funds, construction programs and communal property rights, including the alienation of such rights.

In the area of budget revenue sources, however, the law is less helpful. For example, while there is authority to establish by legislation fees for household, communal, transportation and other services provided by enterprises and organizations that are the communal property,[50] the law lacks specificity with respect to municipal taxing authority. For example, Article 63 provides that local budget revenues shall be taken

[49] It now appears that Kiev plans a bond issue in September 2003. Since special laws apply to the municipal governance of the cities of Kiev and Sebastopol, debt issues placed by these cities are probably not indicative of municipal financing issues affecting other Ukrainian municipalities. However, in light of continuing effect of the 1998 Odessa municipal scandal, it is encouraging that Kiev will be the first city since 1998 to place municipal debt.
[50] Law on Local Self-Government in Ukraine, Article 28(a)(3).

from their own sources, as determined by law, [e.g., What are they?] and also from national taxes, fees and other mandatory payments embodied in the procedure encouraged by law. Similarly, Article 69 provides that local self-government bodies may establish local taxes and fees in accordance with the law [e.g., What is the law?]. Neither of these provisions resolves whether there is a local tax base. Indeed, Article 62 provides:

> The State shall financially support local self-government, participate in the formation of local budget revenues, exercise control over the lawful, expedient, economical and effective expenditure of funds, an their appropriate accounting. The State shall guarantee a revenue basis to local self-government bodies, needs. In cases where the revenues from national taxes and fees, earmarked in local budgets, exceed the minimum amount of the local budget, the State shall assume part of the difference from the local budget to the state budget, in the procedure.

Based upon this Article, it appears that municipalities are largely dependent on the national government for revenue sources and that the state is in a position to affect the use of any municipal budget surplus. See also Articles 66 and 67 regarding balancing of local budgets and the requirement that funds required for the exercise of powers by local self-government shall be annually stipulated in the Law of the Ukraine on the State Budget of the Ukraine.

It has been suggested that the Budget Code includes the introduction of formula-based intergovernmental transfers which provide for predictable revenue streams which can be used to fund debt service on municipal bonds. However, it appears that the critical question is whether the Budget Code is sufficient to assure an adequate stream of revenues for debt service over the life of a municipal bond issue. The above articles from the Law of Local Self-Government suggest that a municipality may still not be in a position to plan its revenue sources from the state other than annually.

In general, the greater the financial autonomy of sub-sovereign units of government, the greater the likelihood that a sub-sovereign securities market may develop.[51] The dependency of Ukrainian municipalities on national revenue sources is not encouraging in this respect.

<u>Taxation</u>. Interest on municipal debt is included in the gross taxable income of the recipient.[52]

<u>MOF Views</u>. An MOF official responsible for internal and external debt issues indicated that the Budget Code was intended to address municipal bond financing but to date municipalities have preferred loans to bond issuances. The official attributed the absence of municipal bond issues to:

- The securities law;

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[51] Thomas Glaessner and Jeppe Ladekarl, "Issues in Development of Government Bond Markets," [Draft] (March 2001) included in materials of Fifth Annual OECD-World Bank Bond Market Forum, Washington, DC, June 2-3, 2003.

[52] Urban Institute Report at note 114, citing several tax law authorities.

- Interest rates being too high for many municipalities to access the market;
- Inadequate qualifications of municipal officials;
- Banks' preferences to make loans to municipalities rather than purchase their bonds; and
- The unavailability of long-term financing for municipalities in either the lending or capital markets in order to fund infrastructure projects.

The official also indicated that MOF's own proposals would provide for greater regulation of the debt market. He indicated the need for greater control was due to the fact that the municipalities are a negative on the national government's budget.

Recommendation No. 11. The current state-municipal budgetary situation requires that the MOF retain oversight and approval authority over the ability to borrow and the terms and conditions of borrowing by Ukrainian municipalities, recognizing, of course, that limited exceptions are appropriate for unique, high quality credits, such as the city of Kiev. Subject to a few suggested changes, Cabinet of Ministers Resolution No. 207 (February 24, 2003) On Approval of the Procedure of Local Government Borrowings provides a workable framework for the MOF oversight process.

The Urban Institute Report indicates that the new Budget Code appears to make a clearer assignment of taxation and expenditure responsibilities between the state and municipalities. However, I do not believe that the Budget Code completely accomplishes this objective. Moreover, there is little experience to date with implementation of the Budget Code provisions. In my opinion, as long as the ability to pay debt service on municipal securities appears to remain dependent on transfers from the national government, it would seem both prudent and logical that the MOF should continue to have more control over the issuance of municipal debt securities.

Further support for my argument in favor of specific MOF pre-approval of municipal debt offerings is found in the Urban Institute Report itself. For example, the report points out that the Budget Code provides for the State Treasury to execute municipal budgets, resulting in the transfer of municipal accounts from commercial bank deposits to the State Treasury. As a result of the State Treasury's possession of municipal funds, the report indicates that any enforcement of a pledge of municipal revenues will necessarily require execution by the State Treasury. Finally, the report questions whether, at this time, the Treasury system being put in place for municipal accounts will be able to segregate identifiable revenues that have been pledged to municipal creditors and permit enforcement by the creditor of its security interest in such funds. Until issues such as this are clarified by law, I respectfully suggest that it would be very imprudent to undertake a municipal debt issue without specific approval from the MOF that addresses such issues.

The Urban Institute Report also comes out against the national government's prior approval of municipal borrowing because of concerns that national government approval might raise a moral hazard in connection with an implicit national guarantee of the municipal debt. I disagree with this analysis because I believe that there is a

greater risk of imprudent municipal borrowing at this stage in the Ukraine than of any moral hazard risk of an implicit national government guarantee. The implicit guarantee issue may be easily addressed by simply putting a bold face legend on municipal bonds and offering circulars that there is no national government guarantee. Moreover, the Budget Code, Article 76(2), provides that the national government is not liable for municipal debt.

In any event, Cabinet of Ministers Resolution No. 207 (February 24, 2003), On Approval of the Procedure of Local Budget Borrowings (hereinafter "Resolution 207"), now resolves the issues debated in the Urban Institute Report in favor of continued MOF oversight of municipal borrowing, through bank loans or possible issuance of debt securities. Among other things, Resolution 207:

- Provides the MOF with explicit authority to approve municipal borrowings and specifies the process for doing so, including the documents that must be submitted.

- Establishes a registry for municipal borrowings to be maintained in the MOF. This is where the registry belongs.

- Tends to document what the Law on Local Self-Government suggested, that the source of funds for the special-purpose fund may include income from non-agricultural land and business associations owned by the municipality. This is encouraging support for revenue bonds, and possibly, bonds issued by entities other than the municipality itself.

- Recognizes that there is a need to submit ongoing information to the MOF, although clarification of content is required.

- Indicates that the MOF must bring its regulations into compliance with Resolution No. 207.

There are two areas in which I recommend that USAID suggest to the Ukrainian government that Resolution No. 207 be changed or clarified.

First, Paragraph 6 of the Resolution requires as a condition of MOF approval that a credit rating must be provided from a duly recognized credit rating agency that addresses the ability of the municipal borrower "to make payments under debt obligations timely and fully." I question the requirement that the World Bank, IMF or EBRD should pass upon the qualifications of the credit rating agency. Unless one of these IFIs is bringing economic support of their own to a transaction, why should they have any right to address the qualifications of a rating agency? None of them is a source of expertise on credit rating agency qualifications. Finally, is there value to having a requirement for a credit rating when the rating might be "C-"? Is it intended that Resolution 207 provide the MOF with authority to refuse approval of municipal borrowing if the rating is below a certain rating threshold? If so, it would be advisable to state the requirement in the Resolution or an MOF regulation adopted consistent with the resolution.

Securities law experts do not have uniform opinions regarding the value of securities ratings. My view is that ratings are of little value unless a creditor insists on them as a financing condition at which point they become a necessity for a specific transaction. Therefore, I usually recommend that ratings not be included as a legal requirement in emerging market countries, and instead, that they be left to the decision of borrower and lender. There are three reasons for my view. (1) Financial information available to make a ratings judgment is often of such poor quality in an emerging market that the rating agency is not in a position to make an informed judgment, but doing so via the rating provides false confidence for investors. (2) Even in developed markets with high quality financial information, rating agencies are usually "behind the curve." E.g., the Enron case in the United States. (3) Compared to the professionals and economics of commercial and investment banks, the economics of credit ratings is such that rating agency personnel often are not that well-qualified, especially those that are assigned to emerging market countries.

Despite these reservations, I can appreciate arguments contrary to mine in favor of required credit ratings for public offerings of municipal debt securities in the Ukraine, if the above comments and suggested clarifications are addressed. However, I would not recommend regulations that require credit ratings for corporate debt offerings. The issue is best left for private sector decision on a case-by-case basis.

My second comment on Resolution 207 is that it is correct and commendable that financial information should be required from municipal borrowers initially and on an ongoing basis, and that such information should be maintained in a general registry under the administration of the MOF. Resolution 207 does not address whether the registry information will be publicly available free of charge as soon as it is filed. MOF regulations adopted to implement Resolution 207 should confirm public availability upon filing free of charge. Otherwise, the MOF process may be subject to criticism for lack of transparency and the general registry may be abused in the same manner that public company filings with the SSMSC are now being withheld from the public and distributed selectively.

Finally, MOF regulations also should clarify the types of ongoing information that will be required of municipal borrowers, and the regulations should take into consideration that this information may be different for municipalities that simply borrow from banks compared to municipalities that publicly issue debt securities. Public issuance of municipal debt securities warrants the filing of more comprehensive financial information on an ongoing basis.

Recommendation No. 12. While the SSMSC has a role to play in the regulation of municipal debt securities, that role should not extend to registration of municipal offerings or to establishment of municipal disclosure and financial reporting standards. The lead regulator in these areas should be the MOF consistent with Resolution 207.

Who should regulate municipal securities? If a market in municipal securities were to develop, it is likely that the securities would be traded by many of the same brokers and dealers that trade corporate securities and quite possibly on the same type of markets for corporate debt securities with the same types of clearance and settlement procedures. This would suggest that the securities regulator, the SSMSC, has a role to

play in the regulatory process. There is certainly no reason, for example, why broker-dealer already trading corporate debt securities should be subject to a separate licensing regime if the broker-dealer wished to trade municipal securities. The same is true with respect to secondary market oversight, including clearance and settlement.

Municipal Disclosure Regulation. On the other hand, the disclosures that would normally be expected of a municipal issuer are quiet different than the disclosures that are made by issuers of corporate debt securities. There is clearly some commonality in that one of the most basic questions whether disclosure addresses is the ability of the issuer to pay debt service on the securities. However, municipalities are not organized and do not operate in the same manner as for-profit corporations. Their source of funds to service municipal debt is not generated in the same manner as corporate debt service. Different legal questions pertain to municipal vs. corporate authority to borrow and to apply the proceeds of borrowing. Accepted municipal accounting practices, if any, are quite different from generally accepted accounting principles applicable to for-profit corporations. In many respects, municipal issuers' disclosures bear a closer relationship to sovereign issuers, although the risks are usually, but not always, greater in the case of municipal issuers.[53]

For these reasons, it does not follow logically that the SSMSC, instead of another body such as the MOF, is in the best position to regulate municipal issuers' disclosure. The Cabinet of Ministers should be commended for recognizing the importance of the MOF's role under Resolution 207.

There is the question of enforcement. Clearly, laws and regulations that prohibit fraud, insider trading and market manipulation in connection with securities transactions should extend to transactions in municipal securities, including primary distributions and secondary trading. Since the SSMSC is largely responsible for administration and implementation of these laws, its jurisdiction with respect to the laws should extend to municipal securities transactions.

But who is in the best position to enforce compliance with disclosure requirements by municipal issuers? For example, at present, there is no requirement that municipal issuers receive independent audits of their financial statements. Many Ukrainian municipalities may have such poor internal accounting controls that it would be impossible for an independent auditor to express anything but "no opinion" on the municipalities' financial statements.[54] Even if the SSMSC were to introduce such a requirement by regulation, it is doubtful that it would be able to enforce it. There is also a risk that any attempt by the SSMSC to prescribe disclosure and financial reporting by municipal issuers will conflict with the MOF's administration and implementation inter-governmental financing and Resolution 207.

Because of its responsibilities with respect to the Ukraine's national finances and the potential effect that imprudent municipal borrowing could have on such finances, the MOF is the governmental agency that would appear to have the strongest incentive to

[53] Kiev's planned September 2003 municipal debt offering may prove to be an exception to the general rule.
[54] This is not a problem unique to the Ukraine or to emerging market countries. Several years ago, the US General Accounting Office indicated that it was impossible to prepare financial statements for the District of Columbia in accordance with accepted accounting principles because of inadequate internal accounting controls.

determine that municipal issuers have the legal authority to issue debt securities for proper purposes. In circumstances where the debt securities will be offered and sold to the public, the MOF also should be able to do a better job than the SSMSC to assure that necessary information regarding the offering is disclosed to investors. Clearly, the fact that the MOF is already involved with municipalities in connection with governmental transfers (one of the more likely sources of debt service on municipal obligations) and that the MOF already has an understanding of municipal budgeting, legal authorization and accounting requirements, should put the MOF in a much better position than the SSMSC to pass upon municipal disclosure issues.

Finally, if problems were to arise in connection with municipal offering disclosures, it is likely that these disclosure problems often may turn on questions regarding the legality of a municipal issuer's actions; for example, authority to borrow, use of proceeds, ability to use certain funding sources for debt service; proper presentation of municipal finances. It also would appear that a governmental agency with ministerial status, such as the MOF, is likely to have more political clout than the SSMSC to take or recommend appropriate legal action with respect to the municipality.

d. A Strategy for the Future

Recommendation No. 13. Until it is established that the SSMSC is under new leadership that is committed to principles of sound securities regulation, including, among other things, transparent public information policies, it is recommended that USAID and its contractors work on a selective basis with the SSMSC, generally, and particularly on matters of debt market development and regulation. More emphasis should be placed on consensus building within the private sector and among other government institutions that are committed to reform and market development.

Neither I nor others at the SEC have been involved in day-to-day interaction with the SSMSC, but we have had ample opportunity to work on a number of Ukrainian capital markets assistance issues beginning before the SSMSC was formed and continuing throughout the tenure of the SSMSC's current leadership.[55]

In my opinion, under the current chairmanship of the SSMSC, there appears to be little commitment to meaningful securities regulation in the Ukraine. Indeed, some of USAID's significant capital markets accomplishments, such as the central depository, have been accomplished over the SSMSC's resistance. The alternative draft law on joint stock companies that the SSMSC is supporting in the Rada is clearly the less satisfactory alternative. The SSMSC has failed to secure passage of revisions to the 1991 securities law even though a draft law was ready for introduction several years ago.

[55] For example, immediately after the original SSMSC commissioners were nominated, the SEC provided a special training program at its Washington, DC headquarters for the Chairman and three of the Commissioners. The SEC has conducted special training programs in the Ukraine on enforcement and clearance and settlement for the benefit of SSMSC staff. Fifty-nine SSMSC staff have attended one or two-week securities regulation training programs in the United States. SEC staff members, including myself, have reviewed and recommended changes in Ukrainian securities law, company law and clearing and settlement laws as well as a number of securities regulations. About three years ago I provided input and helped FMI present to the SSMSC a proposed five-year plan for market development and regulation. These ongoing, albeit periodic, efforts are, of course in addition to years of day-to-day assistance that FMI and other USAID contractors have provided on site for the benefit of the SSMSC.

Concerning municipal bond regulation, the appropriate strategy would be to press my recommendation for the SSMSC's municipal bond regulation first with the MOF and the President's Administration as well as with other donors and contractors working on municipal finance before it is presented to the SSMSC. The objective should be to develop a coalition in favor of MOF having the dominant regulatory role over municipal bond issuance and then to present this position to the SSMSC.

Finally, even if there is hope for the SSMSC under new leadership, significant time will be required to replace the poor regulatory culture and indifference that currently pervades the agency. It may not be possible for some time under Ukrainian civil service salary impediments and a government that looks more to politics than merit in making appointments to develop a competent securities regulator. For these reasons and because of the largely institutional character of Ukrainian capital markets, USAID's strategy should focus more on working with private sector market participants, such as PFTS and groups of bond issuers and underwriters, to encourage responsible debt market practices.

LIST OF PERSONS/ORGANIZATIONS INTERVIEWED

#	NAME	POSITION	ADDRESS
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2	Oleynik Andrey	Fixed Income Department	4/6 Desyatinna Str., Kyiv, 01025
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