Diversified Investment Alternatives and New Financial Instruments:

The Challenge for Ukraine's Pension Reform

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EXECUTIVE SUMMARY

With the implementation of pension reform in Ukraine, it is imperative that pension fund assets be invested prudently using sound risk/return criteria so that capital is preserved and earns a real (i.e., above inflation) rate of return. This is necessary to ensure that the long term needs of pensioners will be met, which should be the primary objective of asset managers in managing pension assets, and indeed the primary objective of regulators in administering pension reform.

The asset pool to be invested will soon be very considerable. Pillar III voluntary pension funds which began operations in 2005 are still small ($23.6 million of assets as of October 1, 2006). However, the Pillar II Mandatory Accumulation System, funded by mandatory contributions by individuals and employees, expected to commence within two years, is projected to have inflows of assets of US $600 million in year one and to accumulate to US $9.7 billion by 2014.[1]

The purpose of this paper is to examine whether prudent asset diversification with quality assets, reasonable liquidity, and appropriate durations can in practical terms be achieved for the large projected flow of funds in the Pillar II and Pillar III pension systems given 1) the existing legislative and regulatory parameters governing asset allocation by pension funds, and 2) the investment instruments currently available on the Ukrainian capital market. The conclusion of this paper is that under current circumstances, prudent asset diversification is not achievable due to overly restrictive investment parameters for pension funds, an inadequate supply of quality domestic investment instruments, and the practical inability of pension funds to invest in foreign assets.

A real solution to the problem of too few investment alternatives must be multi-pronged, focusing on issues that relate to the regulation of pension funds, as well as more general issues that relate to development of financial markets in Ukraine. In selecting primary and secondary priorities for action by Ukraine and the USAID/CMP, several important criteria were used. The most important criteria was whether a proposal supported the project's overall goals -- developing a robust financial sector which supports economic growth <u>and</u> establishment of a sound pension system, which work together in a virtuous circle, wherein properly functioning capital markets provide vehicles for pension investments which in turn fuel market growth, create pools of investment capital, and support transparency, good corporate governance, and economic growth. Other important criteria included potential impact (as will be seen below, pension proposals include tangible rule changes that can result in an immediate effect on pension fund investments) and achievability (feasability to generate support within the private or public sector for proposed reforms or technical assistance; level of potential political will and/or opposition which will effect the speed and effectiveness of technical assistance), as well as resource and partner requirements, and the presence of leverage opportunities with other USAID projects, donor funded initiatives, or Ukrainian efforts to promote pension system and financial markets reforms.

This paper outlines Specific Recommendations which are high priority items for implementation as part of technical assistance to the pension fund industry and financial markets, based on the criteria outlined above and the strategic objectives of the Capital Markets Project. These include actions targeted to:

1) facilitate access to foreign investments through changes to the NBU foreign currency licensing regime;
2) increase the number of investment alternatives allowed under the Investment Parameters, both for domestic investments and foreign investments through revisions to the legal/regulatory framework;

[1] .

3) implement a professional, open tender process for selection of Pilar II asset managers which builds pensioner, investor and market confidence in the professionalism/integrity of the mandatory pension system; and
4) increase the supply of traded domestic equity shares through privatizations conducted through the PFTS exchange.

In addition, this paper identifies a number of secondary tasks (several of which are underway via USAID or other donors) which need to be completed for financial market development to fully benefit from expanded pension fund investment activities. It is recommended that the work in these second tier areas be accelerated on a parallel basis, with the following four issues made a priority given that progress will expand the impact of the Specific Recommendations made above:

- Further implement fundamental reforms to the country's financial markets infrastructure in order to improve transparency, reduce "grey market" trading, increase liquidity, and protect shareholders and investors;
- Further implement municipal financing reform which will provide a sound basis for expanding credit provision to municipalities and infrastructure projects, thereby generating more investment opportunities;
- Design and implement a range of additional general (non-municipal) infrastructure projects which will provide opportunities for pension fund investments and further grow the market;
- Promote passage of a much needed Asset Securitization Law which will provide the legal and regulatory foundation needed for further expansion of investment instruments in the Ukrainian market.

Implementing these primary and secondary recommendations in an integrated fashion with expert technical assistance and support from public and private sector Ukrainian partners is critical for successful capital markets development. Carried out correctly and in a timely fashion, they will result in a less risky portfolio of pension assets, with a better real rate of return, with a greater likelihood of meeting the needs of future pensioners. Moreover, implementing these recommendations will enhance the positive impact of pension funds on financial markets in myriad ways**.** Failure to implement these recommended reforms as soon as possible – *before* the large funds start flowing into Pillar II funds—will ultimately imperil the ability of pension funds to meet their solemn obligations to workers, and may diminish the many positive benefits that could accrue from capital markets development.

INTRODUCTION

With the implementation of pension reform in Ukraine, it is imperative that the pension fund assets be invested prudently using sound risk/return criteria so that capital is preserved and earns a real (i.e., above inflation) rate of return. This is necessary to ensure that the long term needs of pensioners will be met, which should be the primary objective of asset managers in managing pension assets and indeed the primary objective of regulators in administering pension reform.

The asset pool to be invested will soon be considerable. Pillar III voluntary pension funds which began operations in 2005 are still small ($23.6 million in assets as of October 1, 2006). However, the Pillar II Mandatory Accumulation System, funded by mandatory contributions by individuals and employees, expected to commence within two years, is projected to have inflows of assets of US $600 million in year one and to accumulate to US $9.7 billion by 2014.[2]

To preserve capital and achieve an appropriate real rate of return, pension assets must be invested following sound investment principles. This paper is not intended as an academic review of portfolio investment theory, but certain principles are basic to achieving the goals of pension fund

[2] .

managers. Overall *asset quality* should be achieved through diversification of investments among different asset classes, and prudent asset selection within each asset class. *Asset liquidity* (ability to sell in volume) is important to allow ease of entry/exit from investments to adjust investment positions and meet obligations, ensure fair prices, and lower trading costs in terms of bid/offer spreads. *Asset durations* are important because longer term assets are more appropriate given the long term nature of the pension fund obligations. *Asset currency* denomination is important since the fund obligations are ultimately in hyrna.[3]

Diversification – among bonds, equities, and other instruments, including both foreign and domestic assets -- is the most important issue to be discussed here. Failure to diversify the portfolio quite simply means imprudent risk of losing money due to concentration in a class of assets. No single asset class is risk free. Sovereign, sub-sovereign or corporate bond issuers can default, currencies can devalue, inflation can exceed expectations priced into fixed income yields, banking systems can have severe problems, equity markets can have severe downturns, and so on. The way to manage these risks is not to expect perfect foresight as to what problem will occur at what time in what asset class, but rather to have a diversified portfolio of investments that will perform well despite the inevitable problems may occur in one asset class or another from time to time. Prudent diversification also has the benefit of allowing inclusion in the portfolio of assets such as real estate or venture capital funds that would be considered too risky if looked at in isolation.

The purpose of this paper is to examine whether prudent asset diversification with quality assets, reasonable liquidity, and appropriate durations can in practical terms be achieved for the large projected flow of funds in the Pillar II and Pillar III pension systems given 1) the existing legislative and regulatory parameters governing asset allocation by pension funds, and 2) the investment instruments currently available on the Ukrainian capital market.

The conclusion of this paper is that under current circumstances, prudent asset diversification is not achievable and that in order to address this a number of priority actions must be taken both with respect to reforming the regulation of pension funds, and accelerating reforms related to development of financial markets in Ukraine. This paper does not recommend specific investments or portfolio allocations, rather the focus of this paper is on insuring sufficient investment alternatives will be available for the asset managers to make prudent, dynamic investment decisions. Failure to implement these recommended reforms as soon as possible – *before* the large funds start flowing into Pillar II funds—will ultimately imperil the ability of pension funds to meet their solemn obligations to workers, and may diminish the many positive benefits that could accrue from capital markets development.

This paper does not discuss a) costs and fees of pension funds, which can be a significant factor effecting returns; b) investment mark-to-market methodology or reporting, which can be important issues in evaluating investments; or c) projected investment returns versus actuarial projections of contributions and payouts, which will be an element of investment decision making by asset managers. [put this paragraph in footnote if you think this looks odd as final paragraph]

I. OVERVIEW OF UKRAINE PENSION REFORM

a. Background

Prior to 2004, Ukraine had a pay-as-you-go pension system, founded on the former Soviet system, under which pensions were established based on the official cost of living and the length of employment service, and not on the individual's labor activities and pension contributions.

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[3] These investment principles are similar to those stated in the OECD "Insurance and Private Pensions Compendium", Book 2, Part 1:1, "Selected Principles For The Regulation Of Investments By Insurance Companies And Pension Funds" (2000).

Effective January 1, 2004, Ukraine implemented a comprehensive pension reform program, based on international standards, which established a three-pillar system: Pillar I, a solidarity state pension system, under which retirement payments are determined on the basis of the individuals's labor records and contributions; Pillar II, a mandatory accumulation system with individual worker accounts that will gradually supplement the Pillar I system for workers below a certain age; and Pillar III, a voluntary private pension system.

The worker benefits ultimately paid under Pillar I do not depend on pension fund investment performance, so Pillar I is not the focus of this paper. This paper focuses on the investment regulatory framework and policies of the Pilar II funds and Pilar III funds. The legislative background and current status of the Pilar II and Pillar III systems are summarized below.

b. Pillar II System

Pillar II, the mandatory accumulation system set forth in the Law of Ukraine on Mandatory State Pension Insurance ("Pillar II Law") passed in 2003, is to be funded by pension contributions made by individuals and employers. Each worker has an individual account. The Pillar II Law provided that Pillar II would be introduced only if certain conditions were met:

- stable economic growth of at least 2% of GDP per annum for two consecutive years;
- the Pension Fund of Ukraine budget is balanced;
- experience with the operation of private pension funds
- certain accounting capabilities in place

The first three conditions are met, and the fourth is underway. The key remaining step is passage of the draft "Law on Introduction of Accumulation System of the Mandatory State Pension Insurance" ("Draft Pillar II Law") which was adopted by the Cabinet of Ministers of Ukraine and sent to the Verkhovna Rada in early 2007, where it passed first reading in April 2007. The status of the draft law is uncertain due to the current political crisis which may result in new Rada elections.

The draft law provides for a gradual phase-in of employee contributions starting with 2% in 2009 and increasing by 1% per year reaching the maximum 7% in 2014. According to projections (see table below) funds will total US$ 0.6 billion in 2009, and reach approximately US$ 9.6 billion by 2014, or 7.86 % of projected GDP. [V?- check these figures]

Prospective Pension Accumulations – Pillar II

Year	Mandatory accumulation system ($bl) (2)	GDP ($bl) (3)	Pension assets as % of GDP
2005	0.0	84.11	0.01
2006	0.0	88.31	0.05
2007	0.0	92.73	0.20
2008	0.0	97.36	0.22
2009	0.66	102.23	0.87
2010	1.66	107.34	1.78
2011	2.96	112.70	2.87
2012	4.61	118.35	4.14
2013	6.60	124.26	5.56
2014	9.60	130.48	7.86
2015	12.60	137.00	9.45
2016	15.60	143.85	11.10

Source: Demographic and Social Research Institute, Kyiv, Ukraine, Capital Markets Project.

The Ukraine Pillar II system does not initially provide for separate pension funds managed by private asset managers who compete for the affiliation of workers, which is the model used in Chile and many other countries. Instead, for the first eleven years there is one central Accumulation Fund, from which all workers receive the same return on their pension assets. The Accumulation Fund is administered by a fourteen member board, seven appointed by the President (which are designated to be representatives of various government entities, including the FSR and SSMSC) and seven appointed by the Verhovna Rada (including one representative each for the covered workers, employers, and the NBU respectively). The board will divide fund assets among two or more asset managers to be selected by tender for five year contracts (extendable up to two years). The asset managers will act pursuant to instructions set forth by the board in annual Investment Policies, which shall be public, and Investment Standards, which shall be confidential and contain more specific investment guidelines, including investment selection criteria with regard to ratings of specific investments.

The law also allows for the board to contract an Investment Advisor to assist in setting Investment Policies and Investment Standards. The asset managers may be given specialized investment instructions, such as investing exclusively in domestic equities or bonds or foreign assets, or could be given similar overall instructions. The on-going key role played by the politically appointed board obviously increases the risk of political interference, compared to a system where, within regulatory parameters, asset managers compete for the allegiance of workers by seeking and demonstrating the best return with the lowest costs.

c. Pillar III System

Voluntary private pension funds (Pillar III) began operations in 2005 and have grown rapidly in terms of numbers of funds, numbers of participants, and assets. Per FSR data which includes new pension funds and those reorganized from the old system, as of October 1, 2006 there were 75 registered private pension funds (59 open general funds, 10 corporate funds and 6 professional funds), approximately 138,398 participants (up from 88,363 at the start of the year), and assets of approximately US$ $23.6 million, more than double the amount at the start of the year (US$ 9.2 million). Continued growth depends on many factors but it is expected to continue at its current pace, or accelerate if some large employers start to participate, with Pillar III fund assets potentially reaching several hundred million dollars within a few years.

It should be noted that the growth of Pillar III funds to date has been considerably below initial estimates for a number of reasons, including several political crises, which distracted workers and businesses, lingering public mistrust of financial institutions after bad experiences in the 1990s, and insufficient public information campaigns. There is a need to educate employers and employees about the role of private pension funds in financial planning and generally increase financial literacy. On a positive note, the demographics of the participants reflects substantial participation by young wage earners (46% of participants are under age 40), who are taking an active role in planning for their retirement, which was a key goal of the Ukrainian pension reform.

Assets of private pension funds have so far been invested primarily in bank deposits in the aggregate (according to FSR data, 47% as of October 1, 2006). However, this is misleading because there are many start-up pension funds that have not yet achieved sufficient funds to make capital markets investments. The Pillar II Law restricts bank deposits to a maximum of 40% of assets, but this requirement is waived during the first 18 months of operation. For those funds in operation over 18 months, according to informal figures provided by the Ukrainian Association of Investment Business (UAIB), funds are invested 73% in securities (in order of magnitude: corporate bonds; equity shares with more than half in PFTS tier one and tier two “blue chip” shares; municipal bonds), 22% in deposits, and a small percentage in bank metals.

[get figures from UAIB, and insert chart of the figures]

II. PENSION FUND INVESTMENT PARAMETERS

The rules governing investment of pension fund assets for Pillar II and Pillar II funds are contained in their respective laws, and also in regulations issued by the SSMSC. Although the FSR is considered the principal pension fund regulator, the key government body responsible for interpreting and implementing Investment Parameters is the SSMSC. In this paper the rules contained in the laws will be referred to collectively as the "Investment Parameters", although in some cases it will be specified that the discussion refers only to the rules applicable to Pillar II or Pillar III funds.

The Investment Parameters are summarized in the table below:

Asset Categories (% **total assets)**	**Pillar II (Accumulation)**	**Pillar III (Private)**
Bank deposits and savings certificates	**< 50% and < 10% in one bank spread over 3 banks**	**< 40% and <10% in one bank**
Government Debt (guaranteed)	**< 50%**	**< 50%**
Municipal bonds	**<10%**	**< 20%**
Domestic Corporate Bonds	**<20%**	**<40%**
Single Domestic Issuer limit	**< 5%**	**< 5%**
Domestic Issuers Shares	**< 40%**	**< 40%**
Foreign government debt	**<20 % <10 % one govt**	**See "Foreign Issuers"**
Foreign Issuers (shares or bonds)	**<20%**	**<20%**
Domestic mortgage instruments	**See Other Assets**	**< 40%**
Bank metals	**See Other Assets**	**< 10%**
Other Assets (not specified or prohibited by law)	**<5%**	**< 5%**
Real Estate	**See Other Assets**	**< 10%**
National rating	**Not required**	**Required**

Source : Data from Article 88 of the Law "On Mandatory State Pension Insurance" governing the Mandatory Accumulation System and Article 49 of the Law "On Non-State Pension Provisions" governing private pension funds.

The Investment Parameters allow for diversification among bonds and equities, and foreign and domestic investments. There are very substantial amounts permitted to be invested in government bonds and bank deposits. In general terms these restrictions are similar to those in many other countries. However, as discussed in the following sections of the paper, there are a number of important types of assets that are currently not permitted (for example, real estate for Pillar II funds, mutual funds, private equity, and others), which, if allowed, would facilitate better diversification. Also, as further discussed below, in practice foreign investments cannot currently be made to the extent permitted by the Investment Parameters.

III. CURRENTLY ALLOWED DOMESTIC MARKET INVESTMENTS

a. Overview

This section reviews the domestic market investments currently permitted under the Investment Parameters, taking into account both availability (volume outstanding, liquidity) and asset quality issues (credit issues, transparency issues).

In reviewing investment alternatives for Ukrainian investors, two important factors should be taken into account. First, the high rate of inflation in Ukraine -- 10% in 2006 -- is a critical benchmark against which investors must measure fixed income returns to ensure that a real return is earned.

Second, foreign investors have at times been very active in the domestic financial markets, in effect competing with domestic investors for assets. In the fixed income market, foreign investors are sometimes said to have been a contributing factor pushing down yields on government bonds to below inflation. Foreign investors do not look at the real return in UAH, but rather at the all-in return in foreign currency after converting the UAH investment back into foreign currency. In the equity market, foreign investors have contributed to prices increases.

As a broad overview, the table below shows the overall outstanding amounts of various categories of domestic investments. For purposes of contrast, the amount of outstanding internationally traded instruments is also shown, and in all cases it substantially exceeds the size of the domestic market counterpart. However, it should be noted that the number of corporate Eurobond issuers is small, and Kiev is the only municipal Eurobond issuer. Precise figures for trading or market capitalization of depository receipts of Ukrainian companies is not available. However, many Ukrainian companies have issued depository receipts traded outside Ukraine. According to a report in Investigazeta Magazine (April 16-22, 2007), *PWC IPO Watch* estimates that initial public offerings of Ukrainian companies for trading abroad are tentatively planned through 2008 in a total of $3.1 billion.

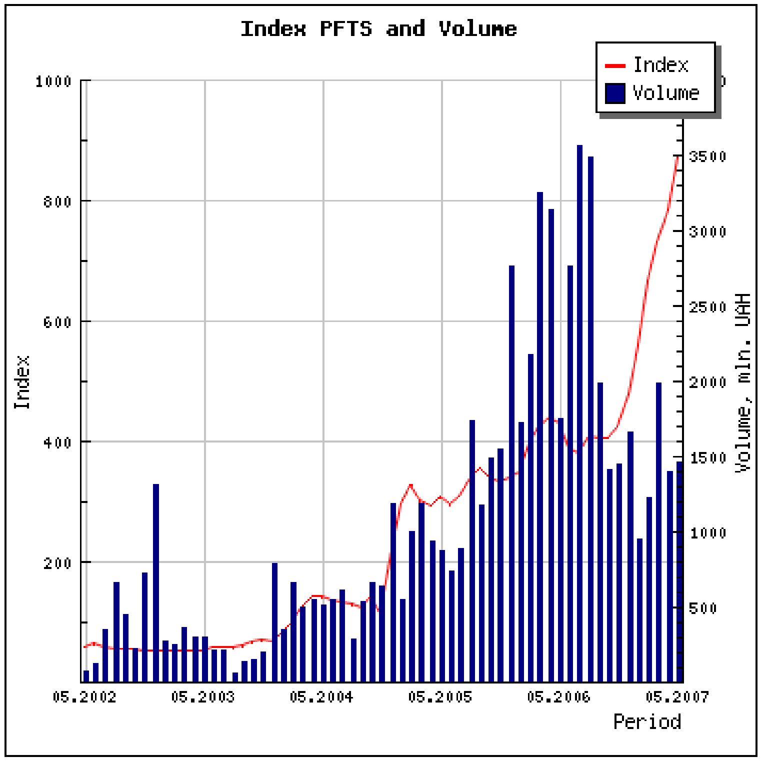
Ukrainian Issuer Capital Markets Instruments Outstanding (May 3 2007)

Instruments	**Amount ($)**
Government Bonds - Domestic	1.44 bln
- Eurobonds	4.5 bln
Corporate/ Bank Bonds - Domestic	4.8 bln
- Eurobonds	6.0bln
Municipal Bonds - Domestic	115mln
- Eurobonds	600mln
Domestic Shares Freefloat (est. 5% of PFTS market cap)	3.17 bln
Depository Receipts of Ukrainian Companies	NA

Source: Cbonds (bonds), PFTS (total market cap)

b. Domestic Equity Market

Market Description: The equity market has grown tremendously in recent years. Market capitalization of PFTS, the main trading platform which is usually estimated to account for approximately 90% of exchange trading, stood at $61.8 billion on April 26, 2007, or __% of GDP, (up from $___ billion at year end 2001), and there are in excess of 300 companies listed on PFTS. **[need to say volume of what, over what period ???]**



However, these impressive numbers do not translate into a robust, secondary trading market:

- Market liquidity at PFTS is very limited. On a typical day equity trades are only a few million dollars and active trading is concentrated in a few companies (for example, as reported by Kinto securities website, on April 26, 2007 trading totalled $__ million, over half of which came from four companies). Even taking a broader look, trading is mostly in the top twenty companies, with sporadic trading in one or more of these companies accounting on any given day for a large proportion of share trading. An even broader look would capture perhaps forty or fifty companies that occasionally trade.
- An estimated 90% of trading occurs OTC (although volumes are reported with a five day delay only to the SSMSC), which obviously makes price discovery – an assessment of trading prices and volumes by market participants - and valuation - problematic.
- PFTS market capitalization is concentrated, with the top ten companies accounting for almost half of market capitalization on April 26, 2007.
- In most cases the free float of shares – those not held by the government and/or a strategic investor or financial industrial group – accounts for a small percentage of outstanding shares. This is difficult to quantify but is usually estimated at around 4% on average.

There is limited primary market activity, although precise volumes are not easily available. In most cases the sales of government shares (partial or full privatizations) have been in auctions to strategic investors or through opaque sales through minor exchanges, in neither case contributing to the development of the domestic equity market. The financial industrial groups that control much of the Ukrainian economy have rarely spun off companies through the capital markets.

Assessment: The limited volume of exchange trading for a limited range of issuers poses a problem for pension asset managers seeking to invest large sums. Even when shares are available, there are serious problems which cast a shadow over the market and should cause asset managers to proceed cautiously. One key issue is the lack of price transparency mentioned above which complicates trading at fair prices, as well as mark-to-market of assets. Other trading infrastructure issues relate to problems with registry integrity, slow trade settlement, and infrequent use of delivery-versus-payment settlement, all of which increase the risks to market participants. Owning shares carries others risks since minority shareholders in Ukraine have insufficient legal protection against abusive practices (dilution, insider trading, related party transactions). Ownership of companies is often unclear, and disclosure is inadequate in terms of quantity, quality, and timing.

Despite all these potential obstacles, equity markets in Ukraine have shown resiliency and have a strong potential for growth and investments by pension funds, should the reforms outlined in this paper be implemented successfully. As can be seen in the above chart, over the last 5 years, the PFTS index has risen steadily, providing consistent returns to investors. Trading volume has also increased, although it must be noted that like many emerging markets it is highly sensitive to domestic and international disruptions. An improved Ukrainian environment for equity investors with transparency in price and ownership, order-driven trading, good corporate governance, and shareholder rights will be needed if this market growth is to be sustained and beneficial to pension investors. The CMP and its partner projects continue to work on these issues, but the GOU and private sector need to be further engaged so that the pace of reform accelerates along with the growth of the market. Otherwise, this will not be sustainable.

c. Bank Deposits

Market Description: The total size of the bank deposits in the banking system was ___$ billion as of ___. The duration of these deposits is generally short term, with over ___ % less than ___ days. [**this is enough info – deposits market is pretty basic probably].**

Assessment: Bank deposits, while relatively high yielding, are very short term and not in line with the long-term actuarial nature of pension liabilities. Although a review of the banking sector is beyond the scope of this paper, there are obvious cautionary factors which underscore the point that bank deposits do not represent a safe haven investment appropriate for large asset concentration. For example, the banking system has expanded tremendously in recent years, with massive growth in credit portfolios, both commercial and consumer, including exposure to the booming real estate sector through mortgages. Such rapid expansion obviously carries risks regarding underwriting standards, operations, and sometimes asset-liability management.

d. Domestic Government Securities

Market Description: The domestic government bond market has been small for a number of years, and has even decreased in the last two years. As of April __, 2007 outstanding issues totalled only UAH__, Bn., (US$1.44Bn.), or 2% of GDP, down from a total of UAH_10.3 Bn., (US$2.0Bn) at the end of 2005. Tenors are short, not exceeding three years. A sporadic auction schedule has led to a fragmented, illiquid market without "benchmark" issues forming a reliable yield curve. Secondary market trading totalled UAH 17bln (US$3.4bln) in 2005, but liquidity fluctuates widely and prices are unknown for OTC trades which account for a large portion of trading and are reported to the NBU in volume terms only. For example, the week of April 2-6, 2007 weekly trading volume on PFTS was only UAH ___ (US$___) and was only UAH ___ (US$___) for reported OTC trades. Yields in recent years have been frequently below or barely exceeding inflation, resulting in a negative or flat real return, Yields as of April __, 2007 for the three year issue ___ stood at ___%. Inflation in 2006 was __% per annum. That is not an attractive yield for any domestic investor, given that bank deposit rates are several percentage points higher (11% to 14% in UAH). As mentioned above, foreign investors are at times investors in the domestic government bond market, and may be willing to accept yields below inflation due to a view regarding stability or appreciation of the UAH. **[update/verify all these figures]**

Assessment: Under current market conditions, government bonds are not an appropriate investment given the negative real yield, which essentially means that pension fund assets will be eroded in real terms. In the event that there are positive real yields, the limited trading volume and liquidity, and the lack of a reliable yield curve, would still make government securities a problematic investment.

e. Municipal Bonds

Market Description: The domestic municipal bond market is now growing rapidly, but it remains quite small. In the last two years issuers have included small, medium and large cities (Cherkassi, Vinnitsa, Ivano-frankovsk, Zaporozhie, Donetsk, Kkarhiv, Kiev). Total issues outstanding are still only UAH ____ ($115million) as of May 3, 2007, with issues often completely bought by the underwriter for private placement. Given the small number of issues outstanding, secondary market trading is obviously limited and some takes place OTC. For example, based on figures from Kinto Securities, during the week of April 2-6, 2007 weekly trading volume on PFTS was only UAH 1.9million ($480,000), which was concentrated in two issues. The small supply of municipal bonds relative to demand in the market, means that it would be relatively easy to exit a position in these bonds, so from this perspective they are liquid. Spreads over government bonds are generally in the range of 150-250 basis points (bps) but, as noted above, there is no liquid government benchmark yield curve. Spreads on corporate bonds tend to be another 200 or so bps higher. Foreign investors have been reported to be investors in the domestic municipal bond market. The sovereign does not guarantee sub-sovereign debt, and indeed in 1998 did not step in when Odessa defaulted on a domestic bond. A major issue related to the municipal bonds market is the massive infrastructure financing needs of the Communal Services Enterprises which provide sewer, water, and other services for municipalities. To date, none of these entities have issued bonds.

Assessment: Due to the limited market size, municipal bonds cannot be a major component of pension fund assets. In any case, there are serious credit quality issues with municipal bonds and pension fund managers should proceed cautiously. Municipalities have limited fiscal autonomy, and there are deficiencies in the legal and regulatory framework for municipal borrowing. Municipal finance reform is the subject of several donor initiatives and an in-depth discussion is beyond the scope of this paper. If properly structured, long term financing for Communal Services Enterprises would be an ideal investment for pension funds: long term, local currency, secured. However, these entities have generally poor financial profiles and financing for these entities is wound up in the same issues generally involved in municipal finance reform

f. Corporate Bonds

Market Description: The domestic corporate bond market has grown tremendously since 2001 with issuers from all sectors of the economy, including banks. Total corporate bond issues were $___bln in 2006, up from $2.5bln in 2005. (source: SSMSC). Outstanding bonds total $4.8bln (source: Cbonds) as of May 3, 2007. The main issuers are well known corporates and banks, but there are several hundred bonds listed at PFTS, so many smaller companies are issuers as well. While these figures reflect genuine growth in the market, it should be noted that a substantial number of issues are so-called “technical” issues, issued for regulatory, tax or other non-market reasons and do not reflect genuine capital markets activity. **FOR EXAMPLE – GIVE 1 OR 2 EXAMPLES – up to viktor to cite one if we wish.**

Secondary market trading is limited, but more extensive than with municipal bonds or equities. Some trading takes place OTC and is only reported to the SSMSC in terms of volume, so the market data is somewhat obscured. For example, for the week of April 2-6, 2007 weekly trading volume on PFTS was UAH ____million ($40 million). As with municipal bonds, for major issues there is probably an ability to sell if desired, so limited secondary volumes do not imply inability to exit. Overall, initial placement and secondary market trading on PFTS totalled 6.5bln UAH in 2005, or 45% of all PFTS trading volume. Spreads over government bonds are generally in the range of 350-400bps but, as noted above, there is no reliable government benchmark yield curve.

Assessment: Corporate bonds represent a sensible component of the pension fund portfolios but the funds should proceed cautiously in the corporate bond market. The corporate bond market is affected by many of the same negative factors as mentioned regarding the domestic equity market, such as weak corporate governance, accounting standards issues, and inadequate disclosure and transparency. The market issuer quality is uneven and it should be noted that major banks are some of the largest bond issuers, so that purchasing these bonds would entail yet more exposure to the banking sector.

g. Mortgage Backed Securities

Market Description: The mortgage backed securities market in Ukraine is just beginning, but the potential is large. The Law on Mortgage Bonds adopted in December 2006, created the legal framework for issuance of both mortgage bonds (on balance sheet obligations of issuers, secured by a pool of mortgages) and mortgage backed securities (off-balance sheet obligations, secured by a pool of mortgages). The first pilot mortgage bond issue – a three year $10mln (UAH50mln) by Ukrgazbank -- was issued in February 2007 with the assistance of the USAID Access to Credit Initiative. The coupon was 10.5%, but there is too little market experience to say what spreads over government yields will ultimately be required to place these bonds. Further bond issues may be delayed until certain technical amendments regarding some bankruptcy issues are made to the enabling legislation.

Assessment: This represents an appropriate class of securities for pension funds due to the enhanced credit quality provided by the security and the potentially longer durations that should be expected to occur as the market develops. Rapid development of this new asset class should be encouraged so that these assets are available when the Pillar II system starts having significant assets. However, mortgage bonds alone would not resolve the issue of where to place pension asset investments. There are cautionary factors regarding these bonds, including: 1) uncertainties regarding the underlying collateral asset quality, with little data history on residential mortgages defaults; 2) uncertainties and little experience in Ukraine with mortgage foreclosure; 3) banks have increased portfolios rapidly which raises operational and borrower quality issues; 4) by all accounts the Ukraine real estate market has been increasing in price rapidly, posing some risk of a downturn; 5) mortgage bonds, and even more so mortgage backed securities, represent complex legal structures that have not been tested in Ukraine; and 6) on balance sheet mortgage bonds are essentially bank corporate bonds and in the first instance, before turning to the security, represent additional exposure to the banking system. The Pillar II Law needs to be amended to allow investment in mortgage bonds, as is allowed under the Pillar III Law.

IV. ANALYSIS AND OVERVIEW OF RECOMMENDATIONS

Although the existing Investment Parameters would appear to permit substantial portfolio diversification, the above assessment of domestic investment alternatives illustrates that there is a gap between the large volume of funds to be invested and the availability of prudent, quality investments. Under current conditions asset managers face one or more of the following problems:

- Fixed income returns that are flat or negative in real terms (government bonds).
- Lack of long term fixed income instruments, leading to reliance on short term investments (bank deposits and all bonds), thereby failing to reflect the long-term objectives of pension funds.
- Low liquidity (all securities categories), limited number of quality investment opportunities, or issuers, within the asset category (corporate and municipal bonds, and equities), and possible overexposure to certain sectors of the economy (particularly banking).
- Lack of transparent asset pricing, inadequate minority investor rights, lack of transparency of issuers, lack of reliable and consistent information (equities and corporate bonds).

Moreover, the large volume of Pillar II funds creates the additional risk that high demand chasing limited supply will result in unrealistic prices for domestic assets. This would make the pension funds almost captive buyers of whatever new issues come to market, thereby reducing the market pressure to have good quality issuers with well structured transactions. Finally, although foreign investments are in theory allowed up to a maximum of 40% of assets for Pillar II funds, and 20% for Pillar III funds, in practice Pillar III funds have not been allowed to make such investments due to NBU currency restrictions[4]. Under applicable currency control legislation and various NBU currency regulations, pension funds must obtain a specific license to carry out the foreign exchange transactions needed to make a specified foreign investment. This effectively precludes pension funds from making fast market-based investment decisions.

The experience so far of the Pillar III funds illustrates the inadequacies of the current investment alternatives facing asset managers. For those funds which have been in operation over 18 months, investments are primarily in domestic equities, domestic bonds (corporate bonds and some municipal bonds, none of which are available in long term maturities), and bank deposits (also short term).[5] The diversifying benefit of foreign investments is simply missing, both due to asset managers' focus on high-yielding domestic investments, and practical impediments to making the foreign investments. Commodity positions, which represent a diversification away from the domestic market, are less than 3% of assets overall. If pension assets were invested with this type of portfolio profile at the time of a financial crisis – for example, bond defaults, devaluation, and bank failures similar to the 1998 Russia crisis – the pension system would be severely undermined, causing further financial, economic and even political stress. The point is not that a banking or financial crisis is likely, but rather that the risk to pension funds could be reduced through further diversification.

It may be tempting for regulators or policy makers to view increased issuance of government bonds for placement with pension funds as a potential solution to the problem of where to invest pension assets. That would be unwise for several reasons. First, such a policy would result in an imprudent risk concentration – even government bonds default. Second, currently real yields on government bonds are negative or flat (and yields could possibly decrease even further if there were suddenly large demand for such bonds from Pillar II funds), so such a policy would result in erosion of the capital value of invested assets. Third, such a potential policy would violate the basic idea behind Pillar II pension reform to allow workers' savings to go into private sector investments and instead would again make pensioners wealth dependent on government payments, in this case debt interest rates. Fourth, such an outcome, where funds substantially ended up back with the government, would not justify the social and fiscal cost – and investment manager fees -- related to the creation and management of mandatory pension funds.

A real solution to the problem of too few investment alternatives must be multi-pronged, focusing on issues that relate to the regulation of pension funds, as well as more general issues that relate to development of financial markets in Ukraine. In selecting primary and secondary priorities for action by Ukraine and the USAID/CMP, several important criteria were used. The most important criteria was whether a proposal supported the project's overall goals -- developing a robust financial sector which supports economic growth and establishment of a sound pension system, which work together in a virtuous circle, wherein properly functioning capital markets provide vehicles for pension investments which in turn fuel market growth, create pools of investment capital, and

[4] The Decree of the Cabinet of Ministers of Ukraine "On the System of Currency Regulation and Currency Control" (the "Currency Control Decree") is the principal legislative act regulating the issues of currency regulation and control. The Decree establishes the regime of currency transactions and determines the general principles of currency regulation, the authority of state agencies, the functions of banks in regulation of currency transactions, the rights and obligations of subjects of currency relations, and the procedure for currency control. The Law of Ukraine "On Procedure of Settling Foreign Currency Accounts" establishes rules for export and import operations payment. There are a number of resolutions of the National Bank of Ukraine regarding currency operations. The principal state body responsible for currency control and regulations in Ukraine is the National Bank of Ukraine (the "NBU"). The NBU issues individual and general licences to conduct currency operations which fall within the scope of the licensing requirements of the Currency Control Decree.

[5] SOURCE THIS INFORMATION

support transparency, good corporate governance, and economic growth. Other important criteria included potential impact (as will be seen below, pension proposals include tangible rule changes that can result in an immediate effect on pension fund investments) and achievability (feasability to generate support within the private or public sector for proposed reforms or technical assistance; level of potential political will and/or opposition which will effect the speed and effectiveness of technical assistance), as well as resource and partner requirements, and the presence of leverage opportunities with other USAID projects, donor funded initiatives, or Ukrainian efforts to promote pension system and financial markets reforms.

In the following section this paper outlines Specific Recommendations which are high priority items for implementation as part of technical assistance to the pension fund industry and financial markets, based on the criteria outlined earlier and the strategic objectives of the Capital Markets Project. These include actions targeted to:

1) facilitate access to foreign investments through changes to the NBU foreign currency licensing regime;
2) increase the number of investment alternatives allowed under the Investment Parameters, both for domestic investments and foreign investments through revisions to the legal/regulatory framework;
3) implement a professional, open tender process for selection of Pilar II asset managers which builds pensioner, investor and market confidence in the professionalism/integrity of the mandatory pension system; and
4) increase the supply of traded domestic equity shares through privatizations conducted through the PFTS exchange.

In addition, this paper identifies a number of secondary tasks (several of which are underway via USAID or other donors) which need to be completed for financial market development to fully benefit from expanded pension fund investment activities. It is recommended that the work in these second tier areas be accelerated on a parallel basis, with the following four issues made a priority given that progress will expand the impact of the Specific Recommendations made above:

- Further implement fundamental reforms to the country's financial markets infrastructure in order to improve transparency, reduce "grey market" trading, increase liquidity, and protect shareholders and investors;
- Further implement municipal financing reform which will provide a sound basis for expanding credit provision to municipalities and infrastructure projects, thereby generating more investment opportunities;
- Design and implement a range of additional general (non-municipal) infrastructure projects which will provide opportunities for pension fund investments and further grow the market;
- Promote passage of a much needed Asset Securitization Law which will provide the legal and regulatory foundation needed for further expansion of investment instruments in the Ukrainian market.

Implementing these primary and secondary recommendations in an integrated fashion with expert technical assistance and support from public and private sector Ukrainian partners is critical for successful capital markets development. Carried out correctly and in a timely fashion, they will result in a less risky portfolio of pension assets, with a better real rate of return, with a greater likelihood of meeting the needs of future pensioners. Moreover, implementing these recommendations will enhance the positive impact of pension funds on financial markets in myriad ways:

- providing greater depth and liquidity to financial markets;

- fostering development of new financial instruments, such as asset backed securities and infrastructure bonds;
- providing longer-term capital which is sorely needed in many sectors of the economy; and,
- providing finance to sectors of the economy such as infrastructure that currently receive little private sector financing.

V. PRIMARY RECOMMENDATIONS: ACTIONABLE ITEMS FOR PENSION REFORM

1) Facilitate Foreign Investment Per Existing Limits

For pension funds to actually be able to invest abroad, as is theoretically allowed per the existing Investment Parameters, a number of hurdles must be overcome, as outlined below.

NBU should facilitate foreign exchange transactions for foreign investment

Recommendation:
Under applicable currency control legislation and various NBU currency regulations **[footnote two],** pension funds must obtain a specific license to carry out the foreign exchange transactions needed to make a specified foreign investment. This effectively precludes pension funds from making fast market-based investment decisions. It is recommended that the NBU remove the license requirement (and support legislative changes if required) or grant a new type general license to Pillar II funds to allow for foreign exchange transactions in connection with any transactions permitted under the applicable Investment Parameters. It is recommended that similar action be taken with regard to Pillar III funds. However, in the case of Pilar III funds, which are numerous with uneven professionalism and opaque ownership, the NBU may wish to take a slightly more restrictive stance. For example, it could grant Pilar III funds a license with a specified cap (to be used in any way allowed by the Investment Parameters), or informally indicate on an annual basis the quantity and timing of individual licenses that will be expeditiously granted upon application. In the absence of serious doubts about a Pillar III fund, it should be expected that all such funds will be treated the same by the NBU.

Rationale:
The case for pension funds to have a substantial portion of their portfolio invested abroad is compelling. Foreign investment allows access to the world's largest capital markets, so the investment objectives of diversification, liquidity, and long durations are all achievable. Most importantly, foreign investment represents a diversification away from Ukraine risk that cannot be achieved in any other manner. To follow up on the example mentioned above, in a financial crisis similar to the Russia crisis of 1998, foreign assets would act as a significant stabilizing force for the pension fund assets. In the OECD "Survey of Investment Regulations of Pension Funds" (June 2006), all countries surveyed allow investments to some degree in foreign assets

It is recognized that foreign investments involve taking currency risk. The returns earned in the foreign currency asset, upon conversion back into UAH, can be either eroded due to appreciation of the UAH against the foreign currency, or enhanced due to depreciation of the UAH. This currency risk should be evaluated in light of the following: a substantial portion of fund assets will still be in UAH (i.e., there will be currency diversification); many costs in Ukraine are indexed formally or *de facto* to foreign currencies; and finally, the foreign currency exposure can be adjusted overtime as conditions warrant. It is also recognized that under current market conditions investing in foreign fixed income instruments will be problematic. The UAH exchange rate has been quite stable, which means that the nominal yield earned in a foreign currency investment translates back into a similar nominal yield in UAH. Given that inflation in Ukraine is currently around10% per annum which is well in excess of the interest rate on most foreign fixed income bonds (e.g., long term US government bond yields under 5%), the all-in return in UAH from such investments is negative in real terms. Nevertheless, such investments should still be considered for diversification purposes.

It is beyond the scope of this paper to discuss the potential macroeconomic impact of significant foreign investment flows. However, successful implementation of pension reform is so important, and has so many financial markets, economic, social, and political benefits, that facilitating foreign investment should be considered a policy priority.

Strategy:
ADD 1-2 SENTENCES ON WHAT NBU IS CURRENTLY DOING, WHY, and HOW OUR APPROACH TIES IN—viktor input. USAID should 1) approach bank officials at the NBU and identify key decision makers regarding this issue in order to present the merits of the case for the importance of diversification; 2) marshal the support of regulators (FSR and SSMSC) as well as possibly other government policy makers; and 3) marshal the support of market participants such as existing Pilar III Pension Fund Administrators Association and Association of Investment Businesses (UAIB, which represents most asset managers). This is likely to be a contentious issue, given the potential macroeconomic and political implications, and the NBU has so far shown little cooperation with the Pilar III funds. However, given how critical this issue is to the pension funds, this issue must remain a top priority.

General approval of use of foreign investments per existing parameters

Recommendation:
The Pillar II Law provides in section 80.3 that the Accumulation Fund may make the permitted foreign investments "provided that foreign investment of the Accumulation Fund will not have an adverse impact on the balance of payments of Ukraine, its exchange reserves, and the stability of its currency". The same section further provides that the possibility of foreign investment requires a positive decision from the Council for National Security and Defense of Ukraine. The Council should issue a general positive declaration on this issue.

Rationale:
This issue should be resolved to provide Pilar II funds with certainty regarding their ability to invest in foreign assets.

Strategy:
It is not clear whether this decision is likely to constitute a mere formality or will present a substantive approval hurdle. Given that Pilar II will not be operational for another two years, and the draft law is not yet enacted, it may be difficult to get a serious assessment of this issue at this time, so this is noted for now as a potential hurdle.

2) Expand Permitted Investments Under the Pillar II and Pillar III Laws

Recommendation:
It is recommended that the list of permitted domestic investments should be expanded to include commercial real estate (a classic diversifying asset, which is already allowed for Pilar III funds, but not Pilar II funds), private equity (another diversifying asset), mutual funds (potentially more efficient form of investment), and mortgage bonds (another diversifying asset, which is already allowed for Pilar III funds, but not Pilar II funds). The list of permitted foreign investments should be expanded to include common investment vehicles and instruments (mutual funds, derivatives, principal protected notes, and others), rather than just direct share and bond ownership as currently allowed. It should also be clarified that instruments which trade abroad but which relate to underlying Ukrainian investments (for example, Eurobonds issued by a Ukrainian bank or Ukrainian ADRs/GDRs that are traded overseas) should be considered domestic investments under the Investment Parameters, and not count against the foreign investment limits. In addition, given

the dynamic nature of financial markets and the many variations of financial products and investment vehicles, in some instances it is recommended that the SSMSC be able to approve new investment types (or issue regulatory guidelines regarding approved investment types) and to clarify what is allowed under existing investment categories. These recommendations are explained in greater detail in Annex A.

Rationale:
Although in very broad terms the existing Investment Parameters allow for diversification, important modifications to the law are needed because several important asset classes are not allowed and some of the allowed asset classes are too narrowly defined. As explained in the introduction to this paper, diversification is a key element of prudent portfolio management. The OECD "Survey of Investment Regulations of Pension Funds" (June 2006), demonstrates that numerous countries allow investments in assets such as private equity, hedge funds, real estate, and mutual funds.

Strategy:
USAID should present these recommendations to the regulators (FSR and SSMSC), and to the Pilar II Draft Law working group. Given that the draft law passed first reading, and is still pending final passage, this should be done as soon as possible, although the status of the law is unclear due to pending parliamentary elections. There is a reasonable chance of adoption of some of the recommendations, and indeed the Pillar II Draft Law contains some amendments similar to the recommendations made here (for example, mortgage bonds allowed for Pillar II funds). Since the essential point of the recommendations is that the pension funds ought to have further investment alternatives, and since it is hard to anticipate which particular recommendations will be well received, it is best to present the entire list contained in Annex A, and see which are accepted. Regarding Pilar III Law changes, the most likely strategy will be to at a minimum to seek changes similar to those ultimately adopted for Pilar II.

3) Tender Process for Asset Managers – Transparent, Professional, Open

Recommendation:
The regulators and the Accumulation Board should ensure that the tender process for selection of asset managers is conducted in a transparent, professional manner including selection of at least one foreign manager or Ukrainian affiliate of a major foreign financial institution.

Rationale:
This will send a strong signal early on to the market and workers and politicians that the Pillar II funds will be professionally managed, and help ensure that funds are managed using best international practices and expertise.

Strategy:
USAID should approach the regulators (FSR, SSMSC, and the Pension Fund of Ukraine) with an offer to provide advice and counsel on the tender process. This could possibly include assistance in preparing qualifications requirements, issuing public notices, and the services of an international specialist in asset management to review potential candidates for selection. This recommendation may be well received in general terms, although given that the tender process is sometime in the future, and the Accumulation Board does not yet exist, it may be difficult to get firm commitments.

4) Accelerate Privatizations of Key State Holdings and Place At Least a Portion of Shares Over the PFTS Securities Exchange

Recommendation:

Privatization of the government's still substantial holdings in selected key enterprises – held through the State Property Fund and through other agencies – should be accelerated and conducted along the following guidelines which will help spur the pension system and capital markets:

- To ensure that privatizations actually stimulate domestic market trading, the government should conduct privatization sales (or partial privatizations) through PFTS using open, transparent IPOs. The government should cease selling shares through opaque procedures at minor exchanges where little or no trading occurs on a regular basis. Even in the case of major privatization sales, conducted either through auctions to strategic investors or IPOs abroad, a portion of the shares to be sold should be allocated for sale through the domestic market on PFTS.
- To make shares available for pension funds, the government should sell additional share positions in major state-owned-enterprises already traded on PFTS, including the following (State ownership position shown in parenthesis): Ukrtelecom (92.8%); Centerenergo (78.3%); Kyivenergo (50.0%); Donbasenergo (85.7%); Dniproenergo (76.0%); Zakhidenergo (70.1%); Ukrnafta (50.0%).
- Additionally, the government should consider selling some portion of what are deemed "strategic" holdings to Pillar II funds (at a price referenced to trading market prices for free float shares) with some restrictions on subsequent transfer to reflect the strategic nature of the holdings. Additionally, a similar transfer restriction mechanism could be used to allow the Pillar II pension funds to purchase the state's share of rights issues by partially state-owned companies. Given the long term investment perspective of the Pillar II funds the transfer restriction would not be a critical problem, and in any case overtime it could be relaxed as the government redefines what is deemed strategic.

Rationale:
Acceleration of privatization of these holdings could constitute a major potential source of equity investment instruments for pension funds and help stimulate development of the domestic equity market. It would also increase the free float in the market, provide fiscal benefits and increase economic productivity of these assets.

Strategy:
Given that there have been other donor advisory efforts regarding privatization in the past, it is important to emphasize that this effort is specifically linked to developing investment alternatives for pension funds. USAID CMP will need to establish a multi-sectoral Task Force to promote this process, marshalling the support of regulators (FSR and SSMSC), and approaching the key decision makers at the State Property Fund, as well as possibly other government policy makers. It is worth noting that recent court decisions concerning potential privatization of Ukrtelecom demonstrates the importance of a strategy which incorporates all key stakeholders and potential complexities in implementing this critical task.

***Discrete Supporting Activities:* Convene Roundtable Conference, Establish "Task Force on Pension Fund Investment Alternatives," and Promote Portfolio Management Training**

In addition to the priority actions outlined above, several discrete activities were identified for implementation as a result of discussions with local counterparts and a review of ongoing CMP and partner project activities.

- CMP should organize a Roundtable on the topic "Diversified Investment Alternatives and New Investment Instruments For Ukrainian Pension Funds" . This should bring together Ukrainian market participants, asset fund managers, pension fund administrators and regulators (FSR, SSMSC, NBU), and also bring in international perspective with regulators and fund managers from one or two other markets.

- Following the Roundtable, CMP should be the catalyst for formation of a "Task Force on Pension Fund Investment Alternatives" which on an on-going basis will monitor actual investment profiles (of Pillar III funds, and later Pillar II funds) and advocate needed changes in Investment Parameters, market reforms, and development of new investment products. The task force would have subcommittees providing serious technical support for initiative such as drafting new legislation. The difference between this task force and others pushing similar issues will be the practical, concrete orientation it will bring to bear regarding the actual investment needs of pension funds.

- CMP should also implement a series of programs for training regulators and a selection of asset managers and market participants regarding international asset management practices and common international financial products, such as indexes and derivatives.

VII. SECONDARY AND GENERAL RECOMMENDATIONS FOR MARKET DEVELOPMENT

a. Continue and Complete Domestic "Infrastructure" Improvements

Recommendation:
Significant market infrastructure improvements are underway and need to be completed for the impact of pension reform and diversified investment instruments to be sustainable and deep. The Capital Markets Project and several partner USAID programs continue to advance these issues, but priority should be placed on the following:

- passage of a Joint Stock Company law to protect minority shareholders,
- accounting reform (conformity to International Financial Reporting Standards)
- market infrastructure reform (integrated DVP settlement, registrar integrity, price disclosure, eliminate fragmentation among numerous exchanges, centralized depository)
- enhanced financial reporting to the SSMSC (including the Electronic Disclosure System being developed with assistance from USAID CMP)

Rationale:
Implementing these reforms will create conditions for new investment opportunities and securities issues. This is critical given the large volume of Pillar II funds that will need to be invested. Moreover, Pilar II pension funds potential asset size and frequency of presence in the financial markets can reinforce positive aspects of such reforms, contributing to market improvements such as development of local rating capacity, innovations in securities trading and custody, better market practices regarding disclosure, and a stronger shareholder voice for good corporate governance.

Strategy:
Implementation of these reforms are ongoing initiatives of USAID and its partner implemented programs, including the CMP.

b. Implement Expanded Municipal Finance Reform

Recommendation:
Although it is beyond the scope of this paper to review all aspects of municipal finance reform – many of which are underway via USAID and other donor funded initiatives - one key issue which needs to be prioritized is passage of a *revised legislative framework for municipal borrowing*.

Rationale:
Implementation of municipal financing reform that will provide a sound basis for expanding credit provision to municipalities and infrastructure projects for Community Services Enterprises is a key

issue for pension fund reform because it would generate more investment opportunities. In particular, soundly structured long-term investments in infrastructure projects would be an appropriate investment for pension funds given their long-term perspective.

Strategy:
Implementation of municipal finance reforms is an ongoing initiative of the USAID ATCI.

c. Facilitate Expanded General (Non-municipal) Infrastructure Financing

Recommendation:
It is beyond the scope of this paper to review the various legal and regulatory issues to be resolved, and the possible roles to be played by the government and perhaps international donors, in order to facilitate development of general (non-municipal) infrastructure projects. The structures typically used for providing private sector finance for infrastructure are very complex and may involve many different players. The main elements of the structure may include the following: a legal concession is granted from a government entity to a special purpose corporation which will develop and receive revenues from the project (user fees such as road tolls, airport user fees, clean water or sanitation fees, etc.); the concession runs for a finite period; a sponsor firm, such as an international construction firm, is responsible for development and operation of the project; finance providers purchase bonds or make loans that provide most of the funding. The finance instruments could be a general project bond issued by a special purpose company, a securitized bond backed by the revenue stream, equity shares in the special purpose company, or a pool of such assets.

Rationale:
The infrastructure needs of Ukraine are enormous in virtually all types of infrastructure including highways, airports, ports, pipelines, sewage treatment, and others. Infrastructure finance, if properly structured, represents a potentially very attractive investment alternative for Ukraine pension funds due to the diversification it gives versus other assets, longer term nature of the asset, potentially attractive fixed income yield and local currency return. The projects would also provide tremendous external benefits fostering productivity and economic growth. It should be noted that the liquidity of an infrastructure investment may not be high, depending on factors such as the nature of the investment instrument, rating, issue size, listing, and simply whether there are other potential investors with such a long term perspective. Key risks are project execution and operation risk, and the risk of political interference (e.g., changing the user fee agreement). Infrastructure finance has been invested in by pension funds in other developing countries, such as Chile, where funds have purchased long term infrastructure bonds.

Strategy:
Structuring infrastructure transactions in Ukraine will undoubtedly be challenging, and suggesting a particular structure is beyond the scope of this paper. Ukraine has a Law on Concessions originally passed in 1999 and amended several times, but so far it has been little used. Given that this is such an important need for Ukraine, and the pension funds have a need for long-term investments, USAID should explore coordinating efforts with other donors looking at infrastructure finance, with the specific goal of generating quality investments for the pension funds.

d. Implement Asset Securitization Law

Recommendation:
In addition to mortgage bonds, other asset backed transactions should be facilitated by passage of a general asset securitization law. Securitization refers to selling a pool of assets (e.g., car loans) from an entity that originated the credit (e.g., a bank) to a special purpose company that finances the acquisition of the assets by issuing bonds secured by the payment stream of the underlying pool of assets. This represents off-balance sheet financing for the originating institution. In Ukraine the underlying assets could include assets such as a) car loans, b) credit card receivables, and c) pools

of loans to small and medium sized businesses (although the latter would necessitate strong due diligence regarding bank underwriting standards, documentation, corporate governance, and ownership disclosure).

Rationale:
An asset securitization law would result in bond issues that would provide financing to banks, and other credit providers, who need financing to keep expanding credit, and provide an additional investment outlet for investors. Asset backed bonds are potentially very attractive assets for pension funds for several reasons: another at least partially diversifying asset, likely longer term tenors, security underlying the obligation, local currency denomination. As with mortgage bonds, there will obviously be uncertainties initially regarding the underlying pool of assets, and the structure will be new and untested. One important advantage is that the bonds issued by the special purpose company can be done in “tranches,” or hierarchies of claims to the underlying pool of assets. This allows for risk allocation among investors according to risk preference, thereby permitting pension funds to take the less risky senior tranche, leaving the riskiest portion to the transaction originator or a less risk-averse investor.

Strategy:
Passage of an asset securitization law is a potential initiative of the USAID ATCI and CLC, completion of which would greatly foster development of new financial instruments.

ANNEX A:

PROPOSED CHANGES TO PILLAR I LAW AND PILAR II LAW INVESTMENT PARAMETERS

Outlined below are recommendations for key changes to the Investment Parameters of the Pilar II Law and Pillar III Law. In each case this annex details the proposed modifications and explains the rationale for the specific change recommended; however, the recommendations all reflect the overall theme that additional investment alternatives should be permitted so that asset managers will be able to achieve a properly diversified portfolio. In addition, given the dynamic nature of financial markets and the many variations of financial products and investment vehicles, in some instances it is recommended that the SSMSC be able to approve new investment types (or issue regulatory guidelines regarding approved investment types) and to clarify what is allowed under existing investment categories.

The recommendations are grouped according to domestic investments, foreign investments, commodity investments, and other assets. Unless otherwise indicated, the recommendations apply to both the Pillar II Law and Pillar III Law. The relevant terms of the Pillar II Draft Law are not mentioned here given its uncertain status due to pending parliamentary elections.

RECOMMENDATIONS REGARDING PERMITTED DOMESTIC INVESTMENTS

- ***Allow investment in Institutions of Collective Investment***

Recommendation:

Allow investments in Institutions of Collective Investment (ICIs), which are Ukrainian financial vehicles similar to mutual funds.

Rationale:

These funds may represent an efficient way for inexperienced asset managers or asset managers of small Pillar III funds to invest in the domestic equity market. This is less critical for Pillar II funds which have the size to justify direct equity purchases. Obviously, asset managers should carefully consider the professionalism and experience of the ICI asset managers before entrusting funds.

- ***Allow investment in Ukraine-targeted private equity funds***

Recommendation:

Private equity is a broadly used term which refers to an investment vehicle (a fund or investment company) which invests capital in private business ventures. There are different type of private equity investment strategies but most relevant here is venture capital financing of start-up companies or companies needing funds to expand. The private equity fund can target investments in certain sectors of the economy and/or in certain regions or countries.

Investment in private equity funds should be allowed up to 5% of assets with specific investments approved by the SSMSC or made pursuant to regulations adopted by the SSMSC. Initially, private equity funds should be approved only for those managed by experienced, international investors, to remove the risk of political interference in investment decisions, and to ensure that best international practices are applied. Even if the fund vehicle is domiciled outside Ukraine, the investment should be considered a Ukraine domestic equity investment if the sole purpose of the fund is to hold cash and invest in Ukraine investments, or, if the fund is multi-country focused, then it should be considered a Ukraine domestic equity investment to the extent that fund assets are invested in Ukraine

Rationale:

Private equity represents an attractive investment alternative for pension funds for several reasons: diversification away from the limited number of publicly traded stocks, investment exposure to a wider range of sectors of the economy, long-term strategic investment horizon, investments in local currency generating businesses, and potentially higher long term returns. Private equity is a major investment component for pension funds in developed markets. Private equity investments are often not rated and are by nature less liquid than investments in publicly traded shares (after all, the underlying investments in the fund are illiquid investments), and for valuation mark-to-market purposes not subject to a trading market price. However, this valuation question can be addressed by methodologies for periodic audits and valuation. Risk factors specific to Ukraine such as weak minority shareholder rights, can be taken into account by fund managers in making investments and deciding what size share position to acquire.

Finally, private equity investment can provide substantial spin-off benefits for the economy and capital markets: generate economic growth by fostering entrepreneurial activity of SMEs; promote good corporate governance practices since that is a key investment criteria for investment managers; promote knowledge transfer through management; promote development of local capital markets since the investment exit route is often an IPO.

- ***Allow investment in commercial real estate for Pillar II funds directly or through a fund***

Recommendation:

Commercial real estate (offices, warehouses, retail space) should be a permitted investment for Pillar II funds up to 10% of assets (as it is for Pillar III, up to 10% for any type of real estate) with specific investments approved by the SSMSC or made pursuant to regulations adopted by the SSMSC. The form for investing in real estate needs to be examined carefully to ensure that risks are mitigated to the extent possible. Direct real estate holdings, with property construction or management responsibilities, should be avoided. Investment through a fund, using certain types of ICIs which are allowed to invest in real estate, might be an appropriate vehicle. Another possibility would be participation in some type of joint venture with an experienced firm. For any real estate investment, it will be critical to have credible, experienced management, perhaps a firm affiliated with international investors, and well selected projects with some diversification. At least initially, the preference should be for completed, occupied projects, as opposed to more risky and complex construction projects. Real estate investment should not include residential real estate projects.

Rationale:

Real estate constitutes a diversifying asset for pension funds. The recommendation refers only to commercial real estate because the pension funds are likely to have substantial exposure to residential real estate indirectly through mortgage bonds backed by residential property mortgages. There are cautionary factors regarding the real estate market in Ukraine, such as the tremendous price increases in recent years (especially in Kiev); undeveloped state of the appraisal industry; heavy government role in land availability, and others. These factors mean that pension funds should proceed cautiously but do not warrant altogether excluding this asset. There are sophisticated, experienced international investors involved in the Ukraine commercial real estate market, and it certainly is not the role of regulators to second-guess market prices. Real estate risk should not be evaluated in isolation but as a diversifying asset – in a financial crisis or capital markets downturn, holding real estate assets might be better than pure financial assets such as an unsecured bank deposit.

- ***Allow investment in mortgage bonds for Pillar II funds***

Recommendation:

Mortgage bonds should be allowed for Pillar II funds (as they are Pillar III funds, which are allowed to invest up to 40%).

Rationale:

Mortgage bonds represent an appropriate asset class of securities for pension funds due to the enhanced credit quality provided by security and the potentially longer tenors that should be expected to occur as the market develops, although there are cautionary factors related to the underlying assets and untested security structure (as further explained above in the review of domestic market alternatives).

- ***Abandon or Modify Domestic Market Credit Rating Requirement***

Recommendation:
The Pillar II Law limits pension funds to investment in bank deposits, shares, and bonds of entities that have been rated better than speculative on a national rating scale by "Credit Rating Agency", a domestic rating agency founded in Ukraine. This requirement should be dropped, or suspended until in both legal and practical terms the rating requirement can be satisfied by ratings from major international ratings agencies.

Rationale:
Credit Rating Agency has no meaningful track record or market credibility and its procedures are opaque and fail to follow the relevant EU directives or the principles established by IOSCO. [viktor – is this true?]

- ***Consider foreign traded investments (Eurobonds, Depository Receipts, Asset Backed Eurobonds, Private Equity Funds) as "domestic" investments in cases where the underlying investment is in Ukraine***

Recommendation:

For any investments in foreign traded instruments where the underlying investments are in Ukraine (i.e., the underlying investment would be considered domestic if made directly in Ukraine), such investment should be considered "domestic" and not count against foreign limits. This recommendation refers to several types of investments: Eurobonds raising funds for Ukrainian issuers, depository receipts relating to shares in Ukrainian companies, asset-backed Eurobonds related to an underlying pool of assets where the obligors are Ukrainian (for example, residential mortgages), and private equity funds targeted to investments in Ukrainian companies.

The Pillar II and Pillar III laws should be amended to remove requirements that domestic issuer assets be traded in Ukraine. Given that off-shore transactions are done in various, sometimes complex, forms there should be a procedure to allow the regulator (SSMSC) to clarify that an asset should be considered domestic. For example, domestic issuer corporate bonds should be defined to include those where the Eurobond issuer is a special purpose company that issues a eurobond and then loans money to a Ukrainian corporate (a structure used for some Ukrainian Eurobond issues). Also, there may be tax efficiency questions to be resolved to avoid having the pension funds incur unnecessary taxes.

Rationale:

Classifying the investments discussed here as domestic makes sense because the pension funds are ultimately being invested in Ukraine, not abroad. This also has the benefit of providing competition to the Ukraine capital market on a product by product basis, allowing the pension fund to purchase the underlying risk directly in the domestic market or off-shore in another vehicle, depending on which investment form offers the best mix of return, liquidity, transaction structure and documentation, and security (if applicable). Although one could argue that these investments should only be considered domestic when they relate to initial offerings, raising new money for Ukraine, it is in the best interest of pension funds to allow asset managers to trade in and out of these assets as they seek the best overall return.

RECOMMENDATION REGARDING PERMITTED FOREIGN INVESTMENTS

- ***Increase Foreign Investment Parameters for Pillar III funds to 40%***

Recommendation:
The foreign Investment Parameters for Pillar III funds should be increased to 40% by adding a category of "foreign issuers" allowed to be invested in up to 20%.

Rationale:

As further discussed above under "Facilitate Foreign Investment Per Existing Limits," foreign assets provide an important diversifying effect and should be a substantial portion of pension fund assets.

- ***Allow mutual funds and ETFs, including those related to indexes, as foreign investments***

Recommendation:

Investments in mutual funds (pools of investor funds managed by an investment manager and invested in a specified type of stocks or other securities) and ETFs (Exchange Traded Funds, which are pools of stocks or other securities and which are similar to mutual funds but trade on stock exchanges) should be allowed. . It should be noted that this will require some clarification regarding the permissible investment parameters of the mutual funds and ETFs themselves, because these may not meet all the direct Investment Parameters, such as the requirement that a stock company be in business for ten years.

Rationale:

Mutual funds and ETFs offer flexibility, efficiency, and diversification advantages, and asset managers should not be prohibited from using these common investment tools. They offer the easiest way to achieve asset diversification. Also, they can be used as an efficient way to achieve exposure to a category of foreign stocks, such as a wide-based index which tracks a group of stocks (for example, S&P 500, a U.S. stock index) or a sector of the market (for example, small capitalization stocks). Using mutual funds would also allow managers to benefit from the expertise of experienced international fund managers, an important consideration.

- ***Allow derivatives for hedging purposes***

Recommendation:

A derivative is a financial instrument whereby parties contract to make future payments derived from or referenced to some underlying asset or other financial instrument. Most relevant here are derivatives such as forwards, futures, options, and swaps related to interest rates and currencies. Derivatives are not currently allowed for pension funds for any purpose. It is recommended that derivatives be allowed for contracts with international counterparties for hedging purposes related to changing the payout profile of foreign investments (as opposed to purely speculative purposes unrelated to investments).

Rationale:

Prohibiting use of derivatives unnecessarily hampers the flexibility of asset managers who may wish to use derivatives for legitimate hedging purposes that change the risk/return profile of a foreign investment. An example would be using foreign exchange forwards to switch the payout profile of an investment from one currency to another (such as euro to dollar), or using an interest rate swap to change the interest rate basis on an investment from floating to fixed. It should be noted that it is unlikely for the medium term at least that currency swaps would be available for any significant size or tenor for UAH foreign currency swaps or UAH interest rate swaps. Derivatives are permitted for hedging purposes under various pension schemes. For example, the OECD "Survey of Investment Regulations of Pension Funds" (June 2006), shows that the Slovak Republic allows derivatives for purposes of hedging against currency risk up to certain limits. It should be noted that derivatives could also be imbedded in principal protected note structures, which are discussed below.

- ***Allow investments in Principal Protected Structured Notes***

Recommendation:
It is recommended that investments be allowed in "principal protected structured notes." A structured note is a tailor-made instrument created for sale to a pension fund that passes through the return of an underlying "reference" fixed income investment. The structured note issuer could be a financial institution such as a bank or a Special Purpose Vehicle (in which case the obligations under the note are effectively secured by the underlying reference instrument). The underlying reference instrument should be a fixed income instrument which could be held directly by pension funds, such as foreign government bonds. Principal protection refers to the fact that the structured note terms promise to repay the full original purchase price of the note so long as there is no default on the underlying reference instrument. However, rather than a certain yield, the profit return on the note would be linked to a variety of possible investments. For example, the return could be linked to performance of an equity index. In economic terms, in essence these notes work by using the coupons on the underlying reference investment to purchase options on something else, such as an equity index.

Rationale:

The advantage of these notes to pension funds is that they satisfy the conservative investment concerns of protecting principal investment and limiting downside, while offering potential upside linked to a variety of higher risk investments. They may be particularly appropriate under current market conditions alluded to above (stable UAH currency with 10% inflation, well in excess of foreign government bond yields). These investment structures can be expensive in terms of imbedded fees to the structuring investment bank,but that can be controlled through vigilance by the asset manager. These investments, even when listed on an exhange or technically negotiable, are in practice illiquid, and difficult to sell other than back to the investment firm that structured the note issue. However, in practice this should not be a problem because the note structurer can usually be expected to offer a price for the structured note that reflects the liquidity and current market price of the underlying financial instrument and derivative. Finally, it is noted that principal protected structures have been used by pension funds in a number of developing markets. For example, the OECD "Survey of Investment Regulations of Pension Funds" (June 2006), shows that Mexico allows "Financial Protected Notes linked to equity indexes".

RECOMMENDATION REGARDING PERMITTED COMMODITY INVESTMENTS

- **Explicitly Permit Bank Metals Investments for Pillar II Funds; For Pillar II and Pillar III Funds Allow Bank Metals Investments in Various Forms and Broaden to Include Other Commodities**

Recommendation:

Bank metals investments are allowed for Pillar III funds (up to 10%). They are not explicitly allowed for Pillar II funds, and so therefore are subject to the multi-use “other assets” limit of 5%. It is recommended that Pillar II funds be explicitly allowed to invest in bank metals up to 10%. In addition, for Pillar II and Pillar III funds a) bank metals investments should be allowed in forms other than outright positions, including, for example, bank metals-linked funds (in which case the investment should not count against the foreign investment limit) and b) the list of permitted commodities should be broadened (oil, certain agricultural commodities) to provide a wider range of diversification options for the asset managers.

Rationale:

Bank metals and other commodities represent another diversifying asset that will give the asset managers further flexibility to manage risk and achieve asset diversification.

RECOMMENDATION REGARDING “OTHER ASSET” INVESTMENTS

- **Clarify Uses of “Other Assets**

Recommendation:

Pillar II funds and Pillar III funds are permitted to invest up to 5% in “other assets” which are not specifically forbidden and not otherwise subject to another limit under the applicable law. Forbidden assets include unlisted securities, mutual funds, derivatives, and callable bonds, among others (as well as real estate in the case of Pillar II funds). The regulation therefore potentially leaves open various assets. However, the Pillar II Law (80.3) also contains some language that seems to provide a number of criteria regarding investment in national priority sectors and investment projects, and envisions the possibility of a state guarantee. These criteria suggest that “other assets” may be used to pursue projects possibly more for political reasons than pure investment merit.

The SSMSC should publish regulations to provide further guidance on what types of assets qualify as “other assets” so as to provide clarity and efficiency to utilizing this investment category. In addition, the SSMSC should establish a procedure for expeditious approval (clarification) of investment proposals that might be submitted for review to see if they qualify as “other assets”. Suggested assets to approve might include some of the new investments mentioned here, such as principal protected notes and private equity funds, although ideally these investments would be explicitly allowed under the law rather than be subject to the aggregate 5% limit that would apply using “other assets”.

Rationale:

Using the “other assets” category to provide a flexible approval regime to allow the SSMSC to approve new investment types fits with dynamic nature of financial markets, which are always generating new products. Moreover, it will provide certainty to funds and intermediaries selling investment products to the funds regarding what constitutes “other assets”.