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Programmatic Technical Assistance Partnership (PTAP)
Capital Market Development and Pension Reform

"A Year in Review & Priorities for the Year Ahead"
Report on the PTAP Implementation

World Bank/USAID

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Kyiv, Ukraine

ACRONYMS AND ABBREVIATIONS

AA	Association Agreement
AFSP	World Bank Access to Financial Services Project
AKK	The Hungarian Debt Management Agency
ATCI	USAID Access To Credit Initiative
AUSD	All-Ukrainian Securities Depository
CLC	Commercial Law Center
CMP	USAID Capital Markets Project
CPI	Consumer Price Index
DPL	Development Policy Loan
DVP	Delivery vs Payment
ECSHD	World Bank Europe and Central Asia Human Development Sector Unit
ECSPE	World Bank Europe and Central Asia Poverty Reduction and Economic Management Sector Unit
ECSPF	World Bank Europe and Central Asia Finance and Private Sector Development Sector Unit
EU	European Union
FIRST	World Bank Financial Sector Reform and Strengthening Program
FOP	Free of Payment
FSAP	Financial Sector Assessment Program (FSAP)
FTA	Free Trade Agreement
FX	Foreign Exchange
G-30	The Group of Thirty
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOPS	The International Organization of Pension Supervisors
IORP	Institutions for Occupational Retirement Provision
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
JII	Joint Investment Institutions (similar to mutual funds)
JSC	Joint Stock Company
LTV	Loan-to-value
MFS	The Interregional Depository and Clearing/Settlement Organization, Mizhregionalny Fondovy Sojuz
MiFID	Markets in Financial Instruments Directives
MLSP	Ministry of Labor and Social Policy
MOF	Ministry of Finance
MOU	Memorandum of Understanding

NBFI	Non-Bank Financial Institutions
NBU	The National Bank of Ukraine
NDU	National Depository of Ukraine
NSPF	Non-state pension funds
OTC	Over-the-Counter
PAYGO	pay-as-you-go pension system
PFTS	PFTS Stock Exchange, Persha Fondova Torgova Systema (First Securities Trading System)
PFU	Pension Fund of Ukraine
PTAP	Programmatic Technical Assistance Partnership
Repo	Repurchase Agreement
SCRFSM	State Commission for Regulation of Financial Services Market
SCSSM	State Commission for Securities and Stock Market
SDMD	the Financial Policy and Debt Management Department of the Ministry of Finance
SMI	State Mortgage Institution
SNG	Sub-National Government
SSC	Single Social Contribution
STA	Single Treasury Account
TRS	Trade Reporting System
UAH	Ukrainian Currency – Hryvnia
UC	Ultimate Controllers
UCITS III	Undertakings of Collective Investment in Transferable Securities Directives
UICE	Ukraine Inter-Currency Exchange
UIT	Unit Investment Trusts
USAID	U.S. Agency for International Development

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Any remaining errors and omissions are the sole responsibility of the authors. The authors' views expressed in this publication do not necessarily reflect the views of the USAID or the United States Government.

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EXECUTIVE SUMMARY

1. This Report reviews the results of the Joint USAID/World Bank Programmatic Technical Assistance Partnership (PTAP) from its beginning in June 2007 up to date, and presents the priorities of the Partnership for the year ahead. The objective of the Partnership is to help the Government, the NBU, market regulatory agencies and market participants to develop Ukrainian capital markets in the perspective of their future integration in the EU single market in financial services, and in particular to create conditions for the successful introduction and development of second pillar pensions.

2. Part I presents the rationale and background for the Partnership. Part II provides an overview of key findings and challenges in each of the four Partnership components. Part III presents an action plan for the year ahead.

3. A separate Report entitled "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" (PTAP FTA Report, September 2008) has been prepared by the PTAP team and circulated separately.

4. In June 2007, the World Bank and USAID agreed to join forces in a Programmatic Technical Assistance Partnership (PTAP) to support the Government in implementing this reform agenda. On the Bank side, the Partnership brings together experts from the Human Development Sector Unit (ECSHD), the Poverty Reduction and Economic Management Sector Unit (ECSPE) and the Finance and Private Sector Development Sector Unit (ECSPF) of the Europe and Central Asia Region. On the USAID side, the Partnership brings together experts from the USAID/Ukraine Office, the USAID Capital Market Project (CMP), and the USAID Access to Credit Initiative (ATCI).

5. Over the past year, the PTAP has delivered advice and support to the Government and regulatory agencies to develop security markets and NBFIs, in particular in preparation for introduction of second pillar pensions. The work of the Partnership has focused on four main components: (i) Pension reform; (ii) Strengthening of the legal, regulatory and supervisory framework for securities markets and NBFIs; (iii) Strengthening securities market infrastructure; and (iv) Developing the supply of domestic securities, focusing on the government bond market.

6. Going forward, the capital market policy reform agenda will be shaped by the Free Trade Agreement (FTA) currently being negotiated between the Ukrainian Government and the European Commission. Specifically, Ukraine will face three fundamental challenges in integrating its securities market and NBFIs in the EU single market in financial services: (i) Approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2); (ii) Mutual recognition between Ukrainian securities market and NBFI regulatory agencies and their counterparts in EU Member States; and (iii) Adaptation of Ukrainian securities market professional participants, NBFIs, and securities issuers to the EU single market in financial services.

7. The USAID and the World Bank stand ready to support the Government to design and implement the proposed policy reform agenda and action plan through a broad range of instruments, including Development Policy Loans, the PTAP, the AFSP (including TA component to SCRFSM and SCSSM), and ongoing USAID projects (CMP, ATCI and CLC Projects), working in close collaboration with the European Commission and the European Commission Delegation in Kyiv.

MAIN TEXT

I. RATIONALE AND BACKGROUND

I.1 Rationale for the Partnership

1. Due to adverse demographic trends and budgetary constraints, Ukraine's current Solidarity Pension System (Pillar I) is becoming increasingly unsustainable. To address this urgent problem, in February 2007, the Cabinet of Ministers adopted a draft law "On implementation of the Mandatory State Pension Insurance Accumulation System." In April 2007, the Ukrainian Parliament (Verkhovna Rada) passed the draft law in its first reading. Further review of the draft law has been delayed following recent political developments. The successful implementation of the Pillar II system is critical to the social protection of Ukraine's work force. Equally critical is the adequacy of Ukraine's capital markets to accommodate productive investment of the substantial assets Pillar II will generate. However, the capital markets are unprepared and will require far-reaching legal, regulatory, supervisory and infrastructure reforms to ensure the successful launch of the mandatory accumulation system.

2. More broadly, the development of a well-regulated, broad, deep and transparent securities market and sound NBFI sector is critical for Ukraine to sustain rapid growth and to ensure its successful integration into the EU single market in financial services, as envisaged under the Free Trade Agreement (FTA) currently being negotiated between the European Commission and the Government. In this perspective, Ukraine faces three fundamental challenges: (i) Approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2); (ii) Mutual recognition between Ukrainian securities market and NBFI regulatory agencies and their counterparts in EU Member States; and (iii) Adaptation of Ukrainian securities market professional participants, NBFIs and securities issuers to the EU single market in financial services. These challenges are examined in detail in a separate Report prepared by the PTAP Team entitled: "Opportunities and Challenges of the EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" (PTAP FTA Report, September 2008).

3. The rationale for the Partnership was formulated in a June 2007 World Bank Concept Note on the financial conditions that are required to ensure the successful introduction and development of second pillar pensions, in a Technical Note on Capital Market Development prepared as part of the joint IMF/World Bank FSAP Update in June-July 2007, and in the CMP/USAID's Strategy on Capital Markets Development. The objectives and findings of these Reports were further articulated in a joint USAID/World Bank Position Paper entitled "Developing Securities Markets and Non-Bank Financial Institutions in Ukraine: Key Impediments and Policy Reform Priorities Ahead", presented in September 2007 at the 10th International Forum of Capital Market Participants.

4. The original World Bank *Concept Note* identified the conditions that are critical to successful introduction and development of second pillar reforms. These conditions pertain to four main areas:

- (i) Macro-financial stability and a balanced strategy for financing the transition cost to the second pillar system;

- (ii) A strong legal, regulatory and supervisory framework for securities markets, non-state pension funds (NSPFs) and insurance companies offering retirement products;

- (iii) An efficient financial market infrastructure including payment and securities settlement system, securities trading platform, custodian and depository institutions, and proper accounting, auditing and valuation systems; and

- (iv) A diversified supply of domestic securities in which pension funds will be able to invest, including government securities, municipal bonds and corporate bonds, asset-backed securities and equities.

5. The *joint USAID/World Bank Position Paper* presented a ten-point action plan to remove impediments to securities market and NBFI development, in particular to create the conditions for the introduction of second pillar pensions:

- *(i) First*, the authorities should strengthen the market regulatory and supervisory framework by (i) empowering the regulators to trace the ultimate controllers of financial market entities and carry out economic, fiscal and criminal background checks; (ii) transforming the current regulatory agencies into specialized agencies with the same status as the National Bank of Ukraine (NBU), or integrating them into NBU; and (iii) establishing multi-year twinning programs with counterpart regulatory agencies in European Union (EU) countries using donor support.

- *(ii) Second,* the authorities should implement a well-crafted action plan to strengthen government debt management and develop a government debt market. Donors could support implementation.

- *(iii) Third,* the authorities should undertake a comprehensive reform of the legal and regulatory framework for the sub-national debt market, focusing on (i) increasing sub-national government (SNG) fiscal autonomy, (ii) improving the framework for SNG borrowing, (iii) removing distortions in market incentives, (iv) improving market transparency, (v) establishing a bankruptcy framework for SNGs, and (vi) strictly monitoring connected party lending between banks and SNGs.

- *(iv) Fourth,* the authorities should support development of the equities market through the adoption of the Joint Stock Company (JSC) Law and associated regulations that ensure effective business and financial disclosure of listed companies and their controllers, protection of minority shareholders, and accountability of supervisory and management boards.

- *(v) Fifth,* the authorities should support the development of the market for asset-backed securities through reviewing NBU regulations for risk management of foreign currency and high loan-to-value (LTV) mortgages by banks, adopting a revised legal and regulatory framework for mortgage bonds, privatizing the State Mortgage Institution (SMI), pricing State guarantees of SMI bonds at market, and adopting a Law on Securitization.

- *(vi) Sixth,* the authorities should strengthen securities market infrastructure by (i) tightening information disclosure requirements for first-tier securities; (ii) requiring stock exchanges to establish independent compliance departments reporting to their supervisory boards, (iii) re-licensing all stock exchanges that do not meet minimum activity requirements and (iv) requiring that all off-exchange trades be reported electronically to stock exchanges. Further, the authorities should strengthen clearing and settlement by (i) adopting legislation on multilateral netting, central securities depository, and stock lending and borrowing procedures, (ii) adopting regulations to prohibit acquiring (directly or indirectly) more than 5% of shares in any securities depository and clearing and settlement company, and to allow MFS Depository to open correspondent accounts with depositories abroad. The authorities should streamline the registrar and custodian system, strengthen the accounting and auditing framework, issue regulations for the valuation of infrequently traded stocks, and simplify NBU and Government controls on foreign currency transactions for securities market participants.

- *(vii) Seventh,* the authorities should support development of investment funds through (i) revising the Law on Joint Investment Institutions (JIIs) to allow the establishment of investment funds with compartments and funds-of-funds and the participation of retail investors in Unit Investment Trusts (UITs), (ii) ensuring the political independence and financial autonomy of SSMSC (iii) re-licensing investment funds focusing on tracing and checking their ultimate controllers; (iv) developing risk-based supervision of JIIs, and (vi) exercising oversight over the corporate governance of JIIs.

- *(viii) Eight,* the authorities should support development of voluntary non-state pension funds (NSPFs) by (i) ensuring the political independence of the regulators; (ii) re-licensing NSPFs focusing on tracing and checking ultimate controllers; (iii) developing risk-based supervision of NSPFs, and (iv) exercising oversight over the corporate governance of NSPFs.

- *(ix) Ninth,* the authorities should create the essential capital market conditions for the successful introduction of second pillar pensions, including (i) conducting a detailed assessment of the benefits, costs and risks of alternative financing strategies of the cost of transition to the second pillar; (ii) strengthening the governance framework for the second pillar to ensure that technical criteria prevail in the selection of asset managers and the definition of investment policies, under the supervision of the regulator; (iii) implementing the reforms required to ensure the political independence of the regulators; (iv) implementing the reforms required to strengthen market infrastructure; (v) establishing clear limitations on use of pension fund assets and establishing incentives to attract international asset managers; and (vi) implementing a comprehensive strategy and action plan to develop the government debt market.

- *(x) Tenth,* the authorities should support development of the insurance sector through laws and regulation meeting international standards, re-licensing insurance companies focusing on ultimate controllers; reforming applicable tax laws, and implementing a re-insurance policy based on prudential rules, corporate governance requirements and supervision.

I.2 Joining Forces and Creating Synergies

6. In June 2007, the World Bank and USAID agreed to join forces in a Programmatic Technical Assistance Partnership (PTAP) to support the Government in implementing this policy reform agenda. On the Bank side, the Partnership brings together experts from the Human Development Sector Unit (ECSHD), the Poverty Reduction and Economic Management Sector Unit (ECSPE) and the Finance and Private Sector Development Unit (ECSPF) of the Europe and Central Asia Region. On the USAID side, the Partnership brings together experts from the USAID/Ukraine Office and its projects: (i) Capital Markets Project (CMP), (ii) Access to Credit Initiative (ATCI); and (iii) some involvement from the Commercial Law Center (CLC) supported by USAID.

7. The PTAP launch visit that took place in September 2007 agreed with the Government to implement an action plan structured around four components, i.e.:

- (i) Supporting pension policy reform, in particular strengthening the fiscal framework for implementation of second pillar and designing a balanced financing strategy for the cost of transition to second pillar;
- (ii) Strengthening the legal, regulatory and supervisory framework for securities markets and NBFIs;
- (iii) Strengthening securities market infrastructure, in particular improvement in transparency and efficiency of stock exchanges and strengthening of the depository system; and
- (iv) Developing the supply of domestic securities, focusing on government bonds.

I.3 Follow-Up Visits and Objectives

8. Over the past year, PTAP follow-up visits were organized every three months with two fundamental objectives. *First*, to carry out in-depth discussions with the Government, NBU, market regulators and market participants on the progress achieved in each area of the PTAP action plan. *Second*, to agree with the Government and market regulators on a detailed action plan in the area of capital markets and pension reforms going forward, and on support to be provided by the Partnership for the implementation of this action plan, in close coordination with the European Commission Delegation in Kyiv.

9. The implementation of PTAP is anchored by specific policy reforms in the legal and regulatory environment of capital markets and pension reform, that are included in the Development Policy Loan (DPL II) as future benchmarks. Specifically, DPL-II contains four future benchmarks that are of critical importance for the implementation of PTAP:

- (i) Amendments to the Law on Financial Services and the Law on Banking submitted to the Verkhovna Rada to enable consolidated supervision in the financial sector;

- (ii) Amendments to the Law on Financial Services submitted to the Verkhovna Rada empowering SCSSM and SCRFSM to trace the ultimate controllers of securities market participants and NBFIs and to carry out economic, fiscal and criminal background checks of these ultimate controllers;

- (iii) Government strategy adopted to strengthen the political and financial independence of the SCSSM and SCRFSM, in accordance with international standards; and

- (iv) SCSSM to issue regulation prohibiting any entity (legal or physical) from acquiring (directly or indirectly) more than 5% of shares of any clearing and settlement company.

II. OBSERVATIONS OF THE TEAM: KEY HIGHLIGHTS

10. The PTAP operates in a dynamic political and economic environment. National elections in late 2007 changed the political landscape. In particular,, major progress was achieved in drafting key provisions for the Amendments to the Law on Financial Services, the Depository Law and the Joint Stock Company Law. However, the legislative process in Verkhovna Rada has remained slow. Several laws and amendments expected to be considered before the summer break have not moved forward and while they remain on the Agenda, may face further delays.

11. During the first year, USAID and the World Bank held four joint follow-up visits. This Section presents key findings, achievements and challenges in each of the four PTAP components: (i) Pension reform; (ii) Strengthening the legal, regulatory and supervisory framework for securities markets and NBFIs; (iii) Strengthening securities market infrastructure; and (iv) Developing the supply of domestic securities, focusing on the government bond market.

II.1 Pension reform

12. The Team organized a series of Roundtables with Government, NBU, market regulatory agencies and market participants to discuss key findings and policy recommendations on pension reform.

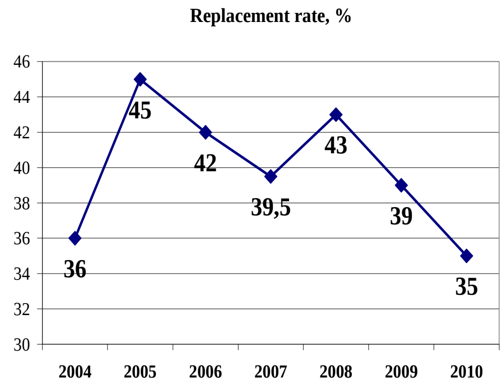
13. Key Analysis and Findings Presented at Roundtables: Under current law, the 2008 parametric changes in the PAYGO system will cause an imbalance in system through mid-2009. Although balance will be restored in the short-term, instability in PAYGO costs will persist. Introducing clear, transparent, and stable indexation rules is a priority to stop the continued swings in replacement rates experienced in the PAYGO system since 2004. At the same time, parametric changes to create savings and restore fiscal soundness to this system are urgently needed.

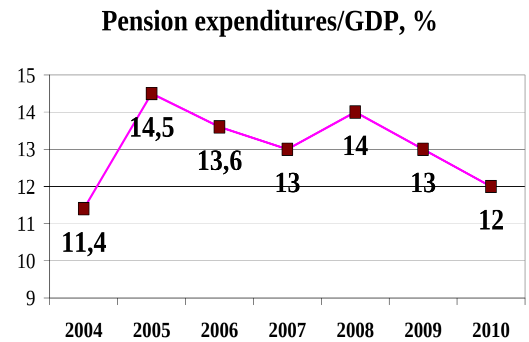
14. The implementation of the second pillar should be conditional upon achieving long-run fiscal sustainability of the first pillar, establishing the operational systems required for the administration of the second pillar, and establishing a transparent capital market regulated broadly in accordance with international standards. Sustainable Pillar I (PAYGO) finance is one of the most important factors determining the timing, size and tempo of mandatory funded pension pillar development. Furthermore, a balanced PAYGO budget is one of the legal requirements for its introduction. Simulations of PAYGO financial flows should provide answers to policymakers as to whether the setting is right or more has to be done to sustain the multi-pillar pension reform. Based on the results of the fiscal analysis carried out by the Team and on the extent of the capital market reforms required, the implementation of the second pillar will not be feasible by 2009 as planned in the Draft Second Pillar Law, and will need to be postponed to 2010 at the earliest.

15. The PTAP team presented the results based on the pension model, developed and maintained by the local consultants. Results indicate that implementation of the suggested

changes would result in a PAYGO deficit of 2% in 2008, replacement rates raising to 45%, and pensions as a share of GDP increasing above 15%.

16. Since 2004, the parameters of the pension system in Ukraine have been changed constantly, resulting in strong swings in the ratio of pensions to GDP and in replacement rates. Following the hikes in pension benefits, balance has been restored or improved mainly by indexing benefits at a rate below inflation so that the real value of pensions fall.





17. The 2008 parametric changes make the pensioners better-off in comparison to 2007. However, pensioners will be worse-off in 2010 as well as and in the longer run. A sharp decline in replacement rates after 2008 may provoke another round of changes to pension parameters, perpetuating the destabilizing cycle of increasing and decreasing real pensions.

18. Introducing clear and transparent indexation rules would stop perpetual swings in PAYGO system parameters. The introduction of full price indexation of pensions in 2009 would preserve the purchasing power of benefits and provide a slower decline in replacement rates. Indexing would yield less fiscal savings than the status-quo option, but could in theory allow for second pillar introduction assuming that the necessary administrative systems are in place and that a transparent capital market regulated broadly in accordance with international standards is firmly established. Fixing the indexation pattern would ensure stability for a second pillar contribution rate that would increase from 2% in the first year to 7% in the fifth year after introduction, as envisaged by the draft legislation awaiting adoption in Verkhovna Rada.

19. Nevertheless, the Government should strengthen the fiscal framework for introduction of the second pillar by implementing parametric changes to the PAYGO system that not only to ensure a manageable transition but also to assure long run sustainability of the first pillar. Moreover, additional savings measures would be needed if the Government decides to launch a stronger second pillar with contribution rate above 2% in the first year. A list of suggested measures is presented below.

20. The Team discussed with the authorities the status and next steps of policy dialogue and analytical work on macro-fiscal-financial scenarios for pension reform. The Team will also continue analyzing pension system developments in the context of the draft second

pillar legislation in Verkhovna Rada and provide comments to the counterparts. The Team will help the Government design a new system of early and privileged pensions in the context of the new multi-pillar pension system.

21. The pension system policy implemented in 2008 temporarily closed the door for second pillar introduction. Recommended policy actions to restore the fiscal space required for the second pillar include:

(i) In 2009 introduce full price indexation of pension benefits;

(ii) In 2009 implement additional parametric changes that generate savings in the PAYGO system. The list of measures include: (i) Gradual increase of retirement age for women to 60 years, starting in 2009; (ii) delaying pension benefit for working pensioners until the pensioner quits working; (iii) elimination of 1% increase of pension benefit for service above 20/25 years for women/men; (iv) revision of pension benefits under special regimes (early retirement, privileged and military).

22. Applying additional policy measures that generate savings in the PAYGO would allow introduction of the second pillar with an initial contribution rate above the currently envisaged 2%. If all proposed measures were implemented, the Pillar II contribution rate could be set at 7% immediately in the first year of implementation. Immediate launch of a stronger second pillar, instead of gradual increase of its contribution rate, would eliminate the political risk underlying raising the second pillar contribution rate and the potential issue of insufficient multi-pillar replacement rates for the oldest second pillar participants.

23. A pension policy should not yield strong swings in replacement rates and pension system parameters should not be revised every two years. Introduction of second pillar absolutely requires as a first step that the indexation rules be fixed to prevent ad hoc politically motivated pension hikes. The team presented an alternative policy based on setting a firm indexation pattern which gives less in the short run but more in the medium run, while preserving the fiscal opportunity for second pillar introduction in 2009. The new indexation rule allows keeping the replacement rate in 2008 at the level of 2007 and results in a slower decline in replacement rates in the long run. While providing more meaningful replacement rates in the future, it allows for second pillar introduction in 2009, depending on technical and administrative readiness.

24. As with Pillar I, Pillar III reforms are also needed. There are indications of problems in all segments of NSPF's operations, including individual accounting and disclosure, asset valuation and unit accounting, custody, portfolio structure, eligible investment, and reporting and supervision practice. There is a general lack of data on the industry performance and practices. For the purpose of PTAP, the team will hire external consultants to screen the current state of the voluntary pension funds industry, identify and analyze the problems, and propose recommendations for improvement.

25. The system seems to be particularly weak along the whole value chain of transparency. There are difficulties in valuation of assets. The role of custodians is very

passive. Accounting practices are uneven and there are still doubts as to whether profits and losses should be distributed to the accounts of members and at what frequency (which translates into the problem of how often should pension unit value be calculated and by what measures). Public disclosure is also very weak.

26. A major weakness is related to prevention of conflicts of interest. Ukrainian pension funds are legal hybrids between common law and civil law models where founders play an important role in initiating a fund and in appointing its Board. Pension funds can invest in securities issued by persons affiliated to founders. Information about relationships between persons surrounding the fund (founders, board members, asset managers, administrators, custodians, their affiliated entities and their ultimate controllers) are not transparent. Regulators' abilities to prevent conflicts of interest are limited and should be substantially extended immediately.

27. Another major weakness is the ability of a large pool of persons (spouse, siblings, parents, etc…) in addition to the participant and the employer to contribute to the participant's account and the lack of a limit on the amount that may be contributed, which caneven exceed the amount of age compensation

28. Even if the whole array of aforementioned problems could be resolved immediately, the limited development of the Ukrainian capital market would still represent a serious obstacle to future growth of pillar III pensions. The lack of transparency of issuers in general; the small number of share issues listed in the 1^{st} and the 2^{nd} tiers, the absence of a government bond market, the large number of illiquid corporate bonds which constitute almost half of pillar III funds' portfolios, and a de facto ban on investment in high quality foreign securities represent major problems.

29. Without rapid improvement of Ukrainian capital markets, it will not be possible to grow the value of assets under management and reach standards of valuation and transparency required under international standards of regulation and supervision for pension funds. In particular, the development of a market for government debt is required not only to develop a meaningful yield curve that can be used as a benchmark for pricing of non-government debt instruments, but also to provide a safe haven investment to be used by pension funds. This is particularly worrisome in an environment where investment abroad is practically non-existent. The absence of foreign investment and government bond investment forces pension funds towards exposures that they would not otherwise prefer.

30. The development of equity markets through promoting IPOs and SPOs is required as well. In addition, regulators should focus on decreasing operational risks by promoting the establishment of a Central Depositary for securities' clearing and settlement of securities.

31. Highlights of Key Meetings: The following are pension reform highlights by pillar:

(i) First pillar. The team discussed with the Ministry of Labor and Social Policy (MLSP) introduction of a fixed CPI indexation rule and further parametric PAYGO

reforms in 2009 to stabilize pension finance, prevent random pension hikes, and support the introduction of the second pillar in the future. The team was informed that the options for the PAYGO parametric changes that will accompany the indexation rule are still being considered and evaluated by the modeling team in the Institute for Demography and Social Studies. The PTAP team will continue to work with the modeling team on simulating alternative scenarios.

(ii) Second pillar. The team also discussed with MLSP the introduction of a second pension pillar and a single social contribution as a vehicle for the establishment of the needed administrative framework for second pillar operations. The Law on Single Social Contribution (SSC) has been submitted to the second reading in September 2007, and has not been discussed since. Among other aspects that the SSC Law regulates, it sets the PFU's responsibility for collection of contribution reports, individual record keeping and establishment of centralized databases, all being the prerequisites for establishment of centralized clearing and individual accounts system in the PFU, as stipulated in the legislation. The Law on Second Pension Pillar has been pending second reading in Verkhovna Rada. The key three parameters the Law should set, i.e. the implementation date, the cutoff age and the contribution rate, have been discussed at the Rada's working group established for this purpose. The team was informed that a postponement of the second pillar implementation date to January 2010 has been considered for fiscal and administrative preparedness reasons. The team agrees that postponement of the second pillar implementation by one calendar year is needed. Indeed, even if the SSC law was passed expediently, we estimate it would need at least one calendar year to be implemented.[1] Regarding second pillar key parameters, the current draft envisages a cutoff age of 40 and a contribution rate of 2% steadily growing to 7% in five years. The team believes there is a public choice to be made between a larger contribution rate for a smaller number of participants and a smaller initial contribution rate for a larger number of participants in the second pillar. There are pro and cons with both and a rich international experience and the team will continue discussing them with the working group and MLSP, with the objective to inform Ukrainian decision makers.

(iii) Third pillar. The team participated in a round table on voluntary pension system, organized by the SCRFSM, with participation of the financial industry, the Government, and donors, to discuss open issues in voluntary pension system, proposed changes in the Non-State Pension Funds law and the supervision practice to improve its implementation. The key document referenced at the round table was the Report on Voluntary Pension Funds, produced by the team and presented to the counterparts in December 2007. During the workshop, the team reiterated the key conclusions from the report, including the need to clearly define unit valuation procedures, improve system transparency and strengthen supplementary regulations and supervision procedures. The team also stated that USAID and the Bank will continue to provide support to the SCRFSM and the Government in that respect.

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[1] Anticipating the passage of the SSC Law, the PFU has taken steps to shorten the time for its implementation, such as starting the work to create a system of electronic signatures infrastructure, needed for electronic submission of reports. PFU's view is that the administrative system in the PFU to support second pension pillar could be within 6 months of enactment of the SSC Law.

II.2 Reform of legal, regulatory and supervisory framework for securities markets and NBFIs

32. Over the past year, several factors significantly improved the overall policy and institutional environment for capital market reforms. *First*, the proposed inclusion of financial services under a deep Free Trade Agreement (FTA+) between Ukraine and the European Union would create major opportunities and challenges for the development of the Ukrainian capital market over the medium to long-term: (i) approximation with EU capital market Directives, (ii) mutual recognition of Ukrainian financial sector regulators with their EU counterparts; and (iii) adaptation of market participants to the new competitive environment.

33. *Second*, the inter-agency Task Force organized by the Office of the President to develop a Presidential Decree on Emergency Measures for Securities Market Development produced a comprehensive set of policy and institutional reform proposals implementation of which would have a major impact on developing modern transparent securities markets and setting the course for integration with the EU single market over the medium-term.

34. At the request of the Office of the President, the Team reviewed the Draft Decree and provided detailed comments. This paper has attempted to identify and focus attention on the most critical impediments to development of a transparent and fair capital market in Ukraine. It is hoped this will lead to further discussion, and eventually to agreement on priorities for removal of these impediments. However, it is not clear at this point whether such a Decree will be issued.

35. The authorities are pursuing the reform of the legal, regulatory and supervisory framework for securities markets and NBFIs under the overall umbrella of the Association Agreement (AA) and of the deep Free Trade Agreement (FTA+) currently being negotiated between the Government and the European Commission. Specifically, the FTA+ will require approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2) (See PTAP FTA Report, September 2008)).

36. The European Delegation in Kyiv is supporting a legal gap analysis of Ukrainian legislation vs. EU Capital Market Directives under the EUROPEAID/119860/C/SV/multi Grant. This analysis is structured around two studies. The first study consists of a legal gap analysis vs. all EU securities market Directives with the exception of MiFID. The study has just started and will be completed by early 2009. The second study will consist of a legal gap analysis vs. the MiFID Directive. It will start in the second half of 2008 and is scheduled to be completed in mid-2009.

37. As for the progress achieved in specific policy reforms, the PTAP team extensively commented on the following:

(i) *Amendments to the Law on Financial Services* to empower financial sector regulators to trace the ultimate controllers (UCs) of regulated entities and to carry out economic, fiscal and criminal background checks of UCs. SCRFSM explained that a revised Draft Law has been prepared integrating comments received from NBU as well as several comments received from the Bank. However, the revised Draft Law maintains the threshold for sufficient participation at 10%. The team's solid position is that the threshold for sufficient participation should be set at 5% in accordance with the best international practice.

(ii) *Preparation of strategies to increase political independence and financial autonomy of SCRFSM and SCSSM*. SCRFSM is currently preparing a strategy paper to increase political independence and financial autonomy of SCRFSM and that the strategy paper was planned to be produced by July 2008. SCSSM explained that the recent decision of the Constitutional Court nullifying the Presidential Decree on SCSSM places it in a position of legal uncertainty, and therefore that it does not plan to prepare a similar strategy paper at this stage. Both SCRFSM and SCSSM recognized that the requirement for political independence of regulators, including financial sector regulators in the Association Agreement between Ukraine and the European Commission will require the authorities to bring Ukrainian legislation in conformity with the requirements of the AA and specifically to prepare new Laws for SCRFSM and SCSSM that establish the political independence of the two regulators. Both SCRFSM and SCSSM management requested that the Bank support the preparation of these two Laws in accordance with international standards under the TA component of the IBRD Access to Financial Services Project (AFSP). The team indicated that such request would need to be submitted to MOF for review and approval.

(iii) *Preparation of a new Law on Depositories, including limitation of maximum direct or indirect ownership share by a physical or legal entity in any depository to a maximum of 5%*. SCSSM indicated that the Draft Law has been circulated among relevant Government ministries and agencies for comments and that it will prepare a revised draft Law integrating comments received by mid-July 2008. The Economic Policy Committee of the Cabinet of Ministers approved a draft Depository Law. . A depository law that establishes a Central Depository will allow the AUSD with assistance from NASDAQ/OMX, to assume the role of the sole central clearing and settlement depository. This will be a groundbreaking event for Ukraine's Capital Markets.

38. SCSSM Senior Management indicated that the Commission issued a regulation requiring that all on-exchange trades be settled by the depository using DVP settlement starting November 24, 2007 (See SCSSM Decision #1001 of 10/17/2006 registered with Ministry of Justice on 11/13/06 and effective as of 11/23/07). SCSSM further indicated that they intend to conduct inspections of stock exchanges, trading systems and depositories to verify their compliance with the regulation, and intend to impose sanctions, including revocation of licenses in case of non-compliance with the regulation. The Team took good note of this positive development and encouraged SCSSM to enforce the new regulation vigorously.

39. The team further recommended that SCSSM adopt three additional regulations to improve market efficiency and transparency: the trade concentration rule, OTC trade processing and reporting regulation, and mandatory trade reporting regulation.

(i) Trade concentration rule. This regulation would require all trades in securities of listed corporations to be executed through the exchange where they are listed. CMP Senior Staff have drafted this amendment for the proposed Joint Stock Company Law currently in the Verkhovna Rada. The SCSSM requested the CMP prepare recommendations for amendments to Regulation #1449 on Rules for Traders. The proposed amendments were drafted to require traders to report trades of listed companies to the exchange on which they are traded (concentration rule) and off-exchange (Over-The-Counter or OTC) trades to a licensed exchange furthering the objectives of PTAP. Given the slowness with which the Rada is passing legislation, the team believes that additional efforts should be focused on the implementing regulations which can be modernized more efficiently to accomplish the necessary change in the legal/regulatory framework. The concentration rule does appear in proposed amendments to the Joint Stock Company law draft which was sent by the SCSSM to the Economic Policy Committee of the Verkhovna Rada and considered on Wednesday, June 4, 2008. The Committee unanimously approved the draft and sent it to the Rada for the second reading. Unfortunately, political events in the Rada prevented the law from being considered by the full Rada in the summer prior to Rada's vacation. Passage of this law would bring Ukraine closer to international standards on such issues as transparency, disclosure, corporate governance, shareholder rights and improving liquidity of Ukraine stock exchanges. It remains a priority issue for the PTAP team, but the team will also work to achieve important goals embodied in the legislation via regulations, decrees and other methods as possible.

(ii) OTC trade processing and reporting regulation. This regulation would require that (i) all brokers adopt the Transaction Reporting System (TRS) in operation in the EU within one year of regulation issuance. Failure to meet this deadline would lead to sanctions, including suspension of license; (ii) all OTC securities trades be executed through a TRS-enabled broker; and (iii) brokers report all OTC trades to a TRS-enabled exchange at T+3 minutes (see (iii) below). CMP Senior Staff have drafted amendments to the Law on Securities and the Stock Market to accomplish these goals and submitted them to the SCSSM for consideration and recommendation to the Cabinet of Ministers.

(iii) Mandatory trade reporting regulation. This regulation would require that (i) all exchanges adopt TRS within one year of regulation issuance. Failure to meet this deadline would lead to sanctions including suspension of license; and (ii) all exchanges report on-exchange and OTC trades to SCSSM through TRS on-line. SCSSM Senior Management indicated that they would welcome the support of the PTAP Team to prepare regulations to require trade reporting through TRS and to implement TRS at SCSSM in the framework of the planned twinning program. The Team indicated the full readiness of the PTAP Team to do so. In this context, SCSSM management indicated to the team that a proposed Law requiring that trades of shares of large "strategic" corporations take place on exchanges was submitted by SCSSM to the Cabinet of Ministers (COM), adopted by COM and sent to the

Verkhovna Rada in 2007. However, the proposed Law did not pass the first reading before the elections and will be resubmitted to the Verkhovna Rada.

40. Opening of correspondent accounts with foreign depositories. SCSSM has established a working group on the opening of correspondent accounts with foreign depositories. The working group consists of SCSSM, NBU, NDU, MFS and CMP. The working group was preparing a model contract and a list of amendments to the laws and regulations that impede the establishment and operations of correspondent accounts. The working group was also preparing new regulations that may be necessary. In parallel, at the request of its members, MFS is in discussions with several foreign depositories that have expressed interest in establishing correspondent relationship with MFS.

41. Development and implementation of guarantee fund. MFS has explored options for the development of a guarantee fund with the support of the USAID CMP. The objective of the guarantee fund is to provide for the payment of an indemnity against default with respect to payment for, or delivery of securities by participants and of obligations of participants towards the depository. A CMP Consultant worked in Kyiv to analyze design options and make recommendations on guarantee fund development and implementation in early 2008.

42. DVP capability. MFS indicated that it has achieved full DVP capability, and is ready to serve the move to DVP by all exchanges. PFTS Senior Management indicated that the order-driven system is ready to process trades on a DVP basis, but that all trades are still processed through the quote-driven system and settled FOP.

43. The following remains key priorities for regulatory and supervisory reform of securities markets and NBFIs:

(i) Approximation of Ukrainian securities market and NBFI legislation and regulations with EU Directives. In light of the requirements of the planned deep Free Trade Agreement (FTA+) with the European Union, SCSSM and SCRFSM will need to approximate Ukrainian securities market and NBFI legislation with EU Directives. This includes approximation of Ukrainian securities markets and NBFI Laws with EU Level 1 Directives, as well as approximation of Ukrainian securities markets and NBFI regulations with EU Level 2 Directives. (See PTAP FTA Report September 2008);

(ii) Strengthening of licensing procedures. Following the adoption of the revised Law on Financial Services, SCSSM and SCRFSM will need to strengthen their licensing procedures, specifically to trace the ultimate controllers of securities market professional participants and NBFIs and to carry out economic, fiscal and criminal background checks on these controllers. As stipulated in the revised Law on Financial Services, all existing professional market participants and NBFIs will be required to disclose their ultimate controllers to SCSSM and SCRFSM within a specific deadline following the adoption of the Law. As a result, the regulatory agencies will need to build their capacity to investigate the ultimate controllers of licensed entities in anticipation of the coming into force of the new legislation, both domestically and abroad, and be equipped to enforce sanctions, including fines, suspension of licenses, and/or revocation of licenses to entities that do not fully and accurately disclose their ultimate controllers, or whose ultimate controllers do not pass the economic, fiscal and/or criminal background checks.

a. SCSSM and SCRFSM will need to prepare enhanced licensing procedures for professional market participants and NBFIs compatible with EU Level 2 Directives. These should cover enhanced governance and conduct of business procedures for financial brokerages, exchanges, depositories, custodians, registrars, investment fund and pension fund asset managers and administrators, and insurance companies. These should include in-depth regulations for the segregation of client accounts at custodians and the protection of customers accounts in case of bankruptcy of custodians, in-depth regulations for the calculation of net asset value by investment funds and pension funds and for the calculation of pension units by pension funds, methodologies for the valuation of infrequently traded assets by investment funds and pension funds, and increasing the responsibility of custodians for checking the valuation of pension fund and investment fund assets. This should be supported by a roundtable with EU regulators to share best practice in licensing procedures for professional securities market participants and NBFIs. This roundtable would cover best-practices in licensing and regulation of custodians.

b. SCSSM and SCRFSM will need to establish systems for tracing ultimate controllers of professional securities market participants and NBFIs. These systems will need to enable tracing the affiliation of founders of investment funds and pension funds, other entities related to investment funds and pension funds and affiliated persons.

c. Finally, SCSSM and SCRFSM will also need to strengthen their cooperation with domestic law enforcement and tax authorities, and to develop detailed MOUs with regulators in major OECD countries, in particular with regulators in EU and EEA Member States to share economic, fiscal and criminal information about ultimate controllers of professional securities market participants and NBFIs residing abroad.

(iii) Strengthening supervision procedures. SCSSM and SCRFSM will need to strengthen on-site and off-site supervision procedures of professional securities market participants and NBFIs by the regulators. This will require building their capacity to exercise effective risk-based supervision of professional securities market participants and NBFIs based on the EU Capital Requirement Directive.

a. Regulations will need to be developed to enhance the intervention powers of the regulators in case of liquidation and/or mergers of pension funds. Specific regulations will need to define the extreme conditions under which the regulators can step in place of the Board of the pension fund and/or administrator in order to protect members' interests, based on best international practice.

b. SCSSM and SCRFSM will also need to enhance their tax due diligence capacity for securities market professional participants and NBFIs, in particular for pension funds and insurance companies that are suspected of being used as vehicles for tax evasion. They will need to review existing regulations to ensure that the regulators have enhanced powers to detect and prosecute cases of tax evasion by these entities, in collaboration with tax authorities and law enforcement agencies. This applies to pension funds during the accumulation and pay-out phase.

c. The regulators will need to revise NSPF regulations on segregation of funds reserved for finance-defined term withdrawals and funds held on individual account during the accumulation phase.

d. Finally, the regulators will need to revise NSPF regulations on the distribution of gains and losses on invested assets to provide for daily distribution of the full value of pension fund assets.

(iv) Strengthening market surveillance. SCSSM will need to strengthen its market surveillance capacity. As a matter of priority, SCSSM will need to acquire a Trade Reporting System (TRS) compatible with TRS systems used by EU market regulators and analytical software to detect suspicious transactions. Commission staff will need to be trained in the detection and investigation of suspicious transactions using this analytical software.

(v) Strengthening enforcement. The regulators will need to strengthen their capacity for enforcement, including investigation, prosecution of cases with law enforcement agencies and in the courts, and application of sanctions.

a. SCSSM and SCRFSM will require significant support to strengthen their institutional capacity in order to implement these priority reforms. Twinning programs between the two regulators and an EU regulator would contribute significantly to achieving this objective; as such programs would help raise the capacity of the two regulators closer to their EU counterparts over time.

b. The World Bank stands ready to finance twinning programs between SCSSM and SCRFSM and EU regulators in the framework of the technical assistance component of the IBRD Access to Financial Services Project (AFSP). The objective of the twinning programs will be to support the two Commissions' convergence with IOSCO, IAIS and IOPS international standards of regulation and supervision and thereby making progress toward eventual mutual recognition with EU regulatory agencies. The twinning programs will include support to SCSSM and SCRFSM to approximate Ukrainian securities market and NBFI legislation with EU Capital Market Directives, based on the results of the legal gap analysis being supported by the EC Delegation. The twinning programs will also support the strengthening of SCSSM and SCRFSM across all their functions, including licensing, risk-based supervision, market surveillance, and enforcement . The PTAP team together with SCSSM and SCRFSM has finalized the TORs for potential twinning partners and submitted the draft ToR for review to MOF. It is anticipated that this program will run three-four years and include: training programs consisting of seminars, workshops, roundtables and other events in both countries; secondment of senior SCSSM and SCRFSM staff to the staff of the twinning partner in its central regulatory office; secondment of a senior staff member from the twinning partner to work with his/her counterpart and provide day-to-day guidance and coaching; assistance by the twinning partner in evaluating, recommending and commenting on existing regulations and in preparing new regulations; and educational and study tours for the Ukrainian regulators to selected countries to participate in relevant training activities.

c. USAID has been supporting a training program for SCSSM staff by US SEC, consisting of (i) participation of SCSSM staff to US SEC Institute in Washington DC (April 2008), and (ii) delivery of specific training modules on site for SCSSM staff. As part of this program, a first group of 12 SCSSM staff participated in the US SEC Institute training course held in Washington DC in April 2008, and the US SEC provided one week of training to the SCSSM in Kyiv in June 2008. The US SEC team plans to return to Kyiv for a follow-up training at six months intervals. The training on international standards and practices covers virtually every aspect of securities markets regulation and includes speakers from both the SEC and private industry. The recently established training initiative for Ukrainian regulators in cooperation with the U.S. SEC is designed to gain critical understanding on the development, operation, and regulation of securities markets.

II.3 Securities market infrastructure

44. The team discussed with the authorities and with key market participants the latest developments in the transformation of Ukrainian securities market infrastructure and the actions undertaken under PTAP in support of this effort.

45. Technology Transfer in the Stock Exchanges and Depository: During this year, discussions have intensified between several Ukrainian exchanges and EU/US exchanges on modernizing their technology. On June 5, 2008, the PFTS Exchange announced a strategic alliance with the Moscow Inter-Currency Stock Exchange (MICEX) to adopt a version of the NASDAQ/OMX trading platform. On June 9, 2008, the Ukraine Inter-Currency Exchange (UICE) announced a Memorandum of Intent to bring the NASDAQ/OMX trading platform to Ukraine, while the NBU announced an agreement with NASDAQ/OMX to provide guidance on the post-trading platform to create an international trading hub with correspondent relationships globally. The latter represents another step toward the anticipated merger of the MFS and the AUSD into a Central Depository which the National Bank would own 25% and current MFS shareholders approximately 60%. The merger would position the AUSD to become Ukraine's Central Depository, thus meeting key G-30 international criteria for depositories while also enabling AUSD to be recognized by other EU country depositories. The NASDAQ/OMX technology will help create a seamless flow of information to assist in efficient operations of clearing and settlement for the market. Two competing stock exchanges have now acquired technology to improve operations of their trading platforms and it is anticipated this will further increase healthy competition for shares in the Ukrainian market.

46. *Central Depository*: A long standing issue in the local Capital Market was finally settled on February 14, 2008, with the establishment of the All Ukraine Securities Depository (AUSD) by 21 private market participants and the National Bank of Ukraine. The private membership includes 2 stock exchanges (PFTS and UICE) and 19 prominent,

mostly international, banks. This clears the way for an AUSD and MFS merger, forming a modern Central Depository which brings Ukraine into conformity with G-30 international standards. Approximately 60% of the statutory capital will come from current MFS owners. The Senior Management of AUSD and MFS confirmed to the team their plans to proceed with a merger of the two entities. Outstanding progress has been made in the establishment of a Central Securities Depository with the anticipated merger of MFS and the newly established AUSD. However, key to this relationship becoming cemented is the continued support of the NBU, SSMSC and the successful completion of the proposed merger.

47. NASDAQ/OMX's agreements to bring its state of the art trading platforms to Ukraine this year and the joint initiatives to establish a world class central depository, which will facilitate international trading and settlement of securities, is a major accomplishment for Ukraine.

48. PFTS Members to Report Trades Executed Off-Exchange: On May 26, the PFTS Exchange Board approved a decision to make it obligatory for PFTS members to file, on a continuing basis, reports on off-exchange trades (hereinafter referred to as 'reported trades') with securities listed on PFTS. PFTS members will file information on reported trades with PFTS listed securities via a PFTS trade terminal no later than on the next day following the trade execution date. This information will be posted on the official PFTS site, in the "Reporting" section. It is essential to note that these are not settled trades, simply contracts that may or may not be settled at a future date. However, the new requirement includes previously unreported contracts thus giving the regulator and market participants more information than previously available. This is an important step in promoting transparency.

49. These developments constitute potential breakthroughs for Ukrainian securities market infrastructure. For example, the adoption of the cutting edge trading and post-trading technology of NASDAQ/OMX by stock exchanges and AUSD could attract considerable liquidity from financial brokerages seeking best execution, and could contribute handsomely to the integration of the Ukrainian securities market in the EU single market and in the transatlantic securities market, thereby providing access to a massive liquidity pool for Ukrainian issuers.

50. The team supported the SCSSM in drafting of a new regulation that will enable all existing depositories to establish correspondent agreements with other international CSD organization and will help the formation of a Central Depository.

51. At the same time, these developments have direct implications for market surveillance. As the Ukrainian securities market infrastructure adopts cutting edge trading and post-trading technology, the SCSSM will need to implement a modern market surveillance technology at par with the technology implemented by EU regulators. In particular, SCSSM will need to acquire, test, and implement the Trade Reporting System (TRS) used by securities market regulators in EU Member countries, and overlay some modern market surveillance software to detect fraudulent market practices. SCSSM requested support from the IBRD Access to Financial Services Project (AFSP) for the

acquisition, testing, installation and maintenance of the TRS system. The team indicated that this request would need to be submitted to MOF for review and approval.

52. The team is concerned with the status of preparation of the new regulation on trade concentration, and the status of enforcement of the regulation regarding DVP settlement of on-exchange trades. SCSSM indicated that it is proceeding with the issuance of the trade concentration rule shortly, and that it intends to enforce the DVP settlement rule forcefully on all exchanges. SCSSM shared their concern that based on the most recent examinations of all stock exchanges, none implement DVP, and only two stock exchanges have electronic signatures necessary for DVP settlement.

II.4 Government bond market development

53. In March 2007, the USAID's Access to Credit Initiative (ATCI) in cooperation with the World Bank, the OECD, and the IMF, co-sponsored a debt management forum with the Ministry of Finance (MOF). This forum for senior policy makers focused on the need to develop the domestic treasury market and construction of a long - term treasury yield curve for reference pricing. The forum produced a summary note with a plan of action and recommendations for implementation.

54. Since an aspect of PTAP includes development of the domestic treasury market and long-term yield curve, ATCI and WB Treasury (Team) are cooperating to facilitate this development.

55. The Team presented the MOF with a detailed set of reforms that would enable the government to meet its objectives for improving the structure of its government debt portfolio while promoting formation of an active and liquid market in government securities. To address requisite changes in portfolio structure, reforms were directed at building institutional capacity through development of a debt management office that could design and implement a debt management strategy. To increase the appetite of institutional investors for government securities in Hryvnyas and to reduce the cost of funding in local currency, recommendations included formation of primary dealers and moving to market pricing when conducting auctions.

56. The scope of the Draft Plan was limited to the priorities set in the DMO policy note and was to be complemented by upgrading the legal framework and strengthening the internal organization of the DMO. Consolidation of primary and secondary legislation in line with EU best practices was to be done in parallel with implementation of the present Reform Plan in order to enhance the probability of successful outcomes and permanence of reform.

57. This joint effort has resulted in the Ministry preparing a Debt Management Concept Note. ATCI/WB treasury response to the Concept Note has resulted in a Reform Plan of Action that generally divides activities between debt management (WB treasury) and debt market development (ATCI).

58. In this context, the Ministry of Finance of Ukraine has publically announced its intentions to increase domestic borrowing (in UAH) to fund its budgetary needs using benchmark issues 2, 5, 7, and 10 years.

59. To begin, the Ministry is looking for ways to improve primary market conditions that would allow it to increase its access to funding at minimal cost. Although rates on treasuries set at auction have been increasing, the use of market pricing has yet to occur. However, auction volume and an issuance calendar have been announced. Once auctions are conducted at market and, based on market response, MOF plans on inviting participating banks that meet selection criteria to become primary dealers. Additionally, the MOF would like to develop the capacity to conduct repo - reverse repo transactions in order to minimize the costs associated with such issuance. Recently, the MOF has acknowledged the importance of coordinating repo – reverse repo activities with the National Bank of Ukraine.

60. The Team has discussed at length the impediments to MOF issuance at market. One stumbling block to market issuance remains the inability of the MOF to earn interest on its balances in the Single Treasury Account (STA) at the NBU to offset the perceived cost to the Ministry of Finance of issuing debt at market. (Financial flows between two public sector institutions do not have any significant effect on a country's budgetary position.) By engaging in reverse repos, the MOF would be in a position to earn interest on the money borrowed to minimize the cost of going to market pricing. However, this approach provides the Ministry of Finance with the ability to initiate secondary market transactions that directly affect bank liquidity - traditionally an activity within the purview of monetary policy and the NBU. ATCI team members along with the IMF representative, U.S. Treasury advisors and market participants have been working on developing an alternative approach that would encourage issuance of domestic government debt at market interest rates without the MOF using reverse repos. This approach does require some cooperation (fee or interest rebates) from the NBU to be effective.

61. Separately, ATCI is negotiating with AKK, the Hungarian Debt Management Agency to send a senior executive to the MOF in order to advise on building reverse - repo capacity and requirements for primary dealers. These activities are expected to last through June of 2009 after which, WB Treasury would begin technical assistance in cash management with emphasis on risk controls, risk management, and risk optimization.

62. The team learned that mandatory credit ratings and use of the Cabinet of Ministers' national scale continue to have a detrimental effect to issuers of bonds. Frequently, companies use private placements to avoid the mandatory credit rating and its associated cost. On average, it takes the domestic rating agency 60 days to rate a company, while international rating agencies do it within a week. Market participants commented that domestic credit ratings were of little use to assess investment risk. The team recommends that the GOU makes credit ratings voluntary and market driven and eliminate the use of a national scale introduced by the Cabinet of Ministers.

III. PRIORITIES AHEAD: A POLICY REFORM ACTION PLAN

63. Politics remain a key variable as the policy intentions and stability of the government will have an important influence on the achievement of capital markets and pension reform. The willingness of the government to continue support for essential new legislation like the new draft Joint Stock Company Law and the Pillar II (Mandatory Accumulation) Pension Law is critical. Both these laws have been submitted for next readings, but to date a lack of Rada consideration of a vote has posed challenges to economic reform and to the achievement of PTAP objectives.

64. The GOU needs to take action to eliminate present restrictive policies on currency flow and broaden the scope of its privatization program to include listing and initial public offerings (IPOs) of state-owned enterprises on the regulated securities markets. The development of a government bond yield curve is important for both financial markets and pension reform. This appears to be gaining traction but the lack of work by the Rada continues to jeopardize success.

65. Major reform challenges remain ahead on the road to the development of a transparent and well-regulated securities market. First, the political independence, financial autonomy, investigation powers, market surveillance, risk-based supervision and enforcement capacity of SCSSM and SCRFSM need to be strengthened considerably in order to bring them closer to international standards of regulation and supervision. In particular, we recommend that both regulators implement without delay comprehensive, multi-year twinning programs with an EU regulator. Second, stock exchanges should move to full DVP settlement in collaboration with MFS without further delay, and they need to further enhance strategic alliances with major international exchanges. MFS needs to be merged with AUSD to form a reliable single central clearing and settlement depository as soon as practicable. Third, the Sovereign Debt Department at the Ministry of Finance needs to implement its domestic government bond market development plan in close coordination with NBU. And fourth, the GOU should make credit ratings voluntary and market driven and eliminate the use of a national scale introduced by the Cabinet of Ministers.

66. Going forward , the capital market policy reform environment may be shaped by the planned Free Trade Agreement (FTA) between the European Union and Ukraine. The FTA would imply (i) approximation of financial sector laws and regulations with EU Directives adopted under the EU Financial Sector Action Plan (the "Lamfalussy Plan"), both during the negotiation period ahead of FTA ratification for a first set of Directives, and during a transition period following FTA ratification for a second set of Directives; and (ii) mutual recognition between Ukrainian financial sector regulatory agencies and their counterparts in the EU Member States at some stage in the FTA process. With respect to securities markets and NBFIs, the FTA will imply approximation with several EU Directives including the Market Abuse Directive, the Prospectus Directive, the Takeover Bid Directive, the Markets in Financial Instruments Directive (MiFID), the Transparency Directive, the Capital Requirement Directive, the Undertakings of Collective Investment in Transferable Securities Directives (UCITS III), the Solvency II Directive Proposal, the Institutions for Occupational Retirement Provision (IORPs Directive), the Directive on

Acquisition and Increase of Holdings in the Financial Sector, the Directive on Supplementary Supervision of Financial Conglomerates, and the Directive on Combating Money Laundering and Terrorism Financing (See PTAP FTA Paper, September 2008).

67. Addressing this policy reform agenda will require careful prioritization and sequencing of actions over the short, medium and long-term. The below action matrix below outlines PTAP support for the next year to implement the reform agenda.

68. The USAID and the World Bank stand ready to support the Government to design and implement the proposed policy reform agenda and action plan through a broad range of instruments, including Development Policy Loans, the proposed PTAP, the AFSP (incl TA component to SCRFSM), ongoing USAID projects including CMP, ATCI and CLC Projects, and possible additional TA grants through the FIRST Program managed by the World Bank. The PTAP team acknowledges the importance of coordination with the EU programs.

Table I: PTAP Action Matrix for the 2nd Year of PTAP Implementation

Reform Action (Counterparts)	**June 08**	**December 08**	**June 09**	**Partnership Support**
1. Support pension policy reform				
Establish fiscal conditions for introduction of second pillar pensions (MLSP/MOF)	Monitor implementation of follow-up mission policy recommendations	-Update simulations and policy recommendations -Monitor implementation of follow-up mission policy recommendations	-Update simulations and policy recommendations -Monitor implementation of follow-up mission policy recommendations	ECSHD/ECSPE 1/
Finalize necessary amendments to pension reform legislation		-Monitor developments in the Rada	-Monitor developments in the Rada	ECSHD/ECSPE 1/CMP
Design financing strategy for cost of transition to second pillar (MLSP/MOF)			-Prepare simulations and policy recommendations -Organize roundtable with stakeholders	ECSHD/ECSPE 1/
2. Reform legal framework for securities markets and NBFIs				

Reform Action (Counterparts)	June 08	December 08	June 09	Partnership Support
Implement ongoing securities market policy reform package (SCRFSM,SCSSM, NBU)	-Promulgate Presidential Decree on Securities Markets -Submit amendments to Law on Financial Services to Rada -Prepare strategies for increased political independence and financial autonomy of SCSSM and SCRFSM -Draft new Depository Law	Follow-up implementation of policy reform package	Follow-up implementation of policy reform package	ECSPF/CMP 1/
Approximate legislation with EU capital market Directives (ex MiFID) (SCSSM)		-Complete gap analysis, -Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine"	-Carry-out approximation (ongoing)	ECSPF (EU grant) 1/
Approximate legislation with EU insurance Directive (SCRFSM)		-Complete gap analysis -Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine"	Carry out approximation (ongoing)	ECSPF (EU grant) 1/

Reform Action (Counterparts)	June 08	December 08	June 09	Partnership Support
Approximate legislation with EU MiFID Directive (SCSSM)		-Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine"	Launch gap analysis	ECSPF (EU grant) 1/
Implement twinning program between SCSSM and SCRFSM	Prepare Terms of References	Implement twinning program Phase I	Implement twinning program Phase II (ongoing)	ECSPF/CMP 1/
Support US SEC Training Program for SSMSC	-Implement module 1 in Kyiv -Support participation in April 08 US SEC Institute	-Implement module 2 in Kyiv	-Implement module 3 in Kyiv -Support participation in April 09 US SEC Institute	CMP 1/ ECSPF
3. Strengthen market infrastructure				
Identify strategic alliance between Ukrainian exchange and EU/US exchange (SCSSM, Stock Exchanges)	Facilitate market assessment by EU/US exchange	Complete market assessment by EU/US exchange	Facilitate the identification of Ukrainian target for strategic alliance with EU/US exchange	CMP1/ECSPF
Explore modern Trade Reporting System (SCSSM, Stock Exchanges)	Request made to the team	Support identification of appropriate TRS for purchasing	TRS purchased and Installation of TRS at the SSMSC and exchanges started	ECSPF/CMP/
Assist in merger of MFS into AUSD (AUSD, MFS, NBU)	Assist in the merger (valuation and legal analysis)	Merger plan developed and approved	Merger of MFS into AUSD occurred	CMP 1/
4. Support development of domestic bond market				
Implement government bond market development strategy	Design strategy implementation plan	Implement strategy –	Implement strategy (ongoing)	ATCI/BDM 1/

Reform Action (Counterparts)	June 08	December 08	June 09	Partnership Support
(MOF)				
Develop and implement government debt management strategy (MOF)		Develop strategy- AKK advises on reverse repos and primary dealer	Design strategy implementation plan	BDM/ECSPE/ECSPF 1/
Develop SNG debt market (MOF)		Design reform of SNG borrowing framework	Implement reform of SNG borrowing framework (ongoing)	ECSPE/ECSPF/ ATCI 1/

1/ Legend

ATCI: USAID Access to Credit Initiative

BDM: World Bank Banking and Debt Management Unit

CMP: USAID Capital Market Project

ECSHD: World Bank Europe and Central Asia Human Development Sector Unit

ECSPE: World Bank Europe and Central Asia Poverty Reduction and Economic Management Sector Unit

ECSPF: World Bank Europe and Central Asia Finance and Private Sector Development Sector Unit

The PTAP team looks forward to work in close collaboration with the Government in further developing and implementing this Partnership in support of the development of capital markets and pension reform in Ukraine.

Table II: The joint team of World Bank/USAID experts (current composition)

Team Coordinators	Position
Mr. Michel Noel	Lead Financial Specialist, Co-team Chief, TTL, ECSPF
Ms. Natalia Berezhna	Project Management Specialist, Co-team Chief, USAID/Ukraine
Mr. Pablo Saavedra	Senior Country Economist, ECSPE, Senior Advisor to the Team
Mr. Zoran Anusic	Senior Economist, ECSHD
Mr. David Lucterhand	Chief of Party, USAID Access to Credit Initiative (ATCI)
Mr. Barry Pitts	Chief of Party, USAID Capital Market Project (CMP)

Team Members	Position
Mr. Vitaliy Bigdai	Financial Sector Consultant, ECSPF-Kyiv
Mr. Victor Stetsenko	Senior Capital Market Advisor, USAID – CMP
Mr. Gary Hendricks	Senior Pension Expert, USAID – CMP
Ms. Natasha Lozitskaya	Communications Specialist, USAID – CMP
Ms. Katerina Petrina	Senior Social Protection Specialist – ECSHD
Mr. Ruslan Piontkivsky	Economist, ECSPE
Ms. Julia Smolyar	ETC Consultant, ECSHD – Kyiv
Ms. Larisa Piskunova	Activity Manager/Portfolio Analyst, USAID/Ukraine
Ms. Darya Lisyuchenko	Activity Manager, USAID/Ukraine