UKRAINE

FINANCIAL SECTOR

REVIEW 2004

Summary Analysis and Conclusions

Part I

June 2004

Ukraine Financial Sector Review
2004

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Acknowledgements

This paper presents a snap-shot review of the state of Ukraine's financial sector in March-April 2004. Its genesis is the FMI/USAID book, Background for Financial Markets Development in Ukraine, January, 2000, a comprehensive review of Ukraine's financial sector which included detailed analyses of separate financial markets segments and extensive recommendations for reform. That volume was valued by Ukrainian policy makers, and cited by the World Bank for its contribution to improved understanding of Ukraine's financial sector.

Since 2000, many changes have taken place in the Ukrainian markets, both positive and negative. In early 2004, USAID decided that given these developments in Ukraine, an updated look at financial sector developments was warranted and began developing this effort.

FMI wishes to thank its partners at USAID/Ukraine for their support and guidance on this initiative, and in particular Gary Linden, Rick Gurley, and Victor Stetsenko in the Office of Economic Growth. We would also like to acknowledge our partners in the Government of Ukraine, local business and finance sector, NGO community, other USAID contractors active in Ukraine, and the international donor community. Thank you.

This analysis is presented in two parts. Part I provides a summary review of the work by the various contributors to this financial sector examination. Part II provides a more detailed analysis of the Ukrainian financial sector, with reports by the individual experts. The principal fact finders and financial sector development experts that contributed to this paper are:

Ann Wallace, Legal and Regulatory Environment
Melville Brown, Commercial Banking
Robert Strahota, U.S. Securities and Exchange Commission, Debt Markets
Demir Yener, Corporate Governance

Not all recommendations of each author were incorporated into the *Summary Analysis and Conclusions Paper*. This reflects the knowledge of limited resources available for future initiatives, and past demonstrations of lack of political will in certain areas.

Robert D. Bond

Charles M. Seeger

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B. Review and Analysis of the Ukrainian Banking Sector, *Melville Brown, M.I.M.*

C. Corporate Governance in Ukraine, *Demir Yener, M.B.A., Ph.D.*

D. Ukrainian Debt Markets: Analysis and Recommendations for Development, *Robert Strahota, M.B.A., J.D., U.S. Securities and Exchange Commission*

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Part I

SUMMARY ANALYSIS AND CONCLUSIONS

Financial Sector Development in Ukraine:

Summary Analysis and Conclusions

By

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June 2004

I. Objectives and Background

This paper examines developments in Ukraine's financial sector from 2000 to early 2004.[1] The objective is to assess the strengths and weaknesses of the financial sector, and suggest priority reforms which might lead to economic growth and poverty alleviation in Ukraine.

> **"A well-functioning financial services sector is essential for sustained economic development and poverty reduction."**
>
> *World Bank/IMF FSAP Review, Feb. 2003*
>
> **"Financial sector development leads to increased investment, economic growth, and welfare. No economy has developed without an efficient financial sector."**
>
> *USAID/EGAT, Financial Sector Strategy Dec. 2003*

Financial sector development remains the critical missing component for facilitating economic growth in Ukraine. The criticality of financial sector development is now well established among international donors and scholars. In their seminal work, *Saving Capitalism from the Capitalists*, two University of Chicago professors, Raghuram G. Rajani and Luigi Zingales, argue persuasively that healthy and competitive financial markets are an extraordinarily effective tool in spreading economic opportunity and fighting poverty. After a comprehensive review of cross-national empirical and historical data, they conclude:

- Financial markets development precedes economic growth. The evidence from a sample of 80 countries over the period 1960 to 1989 indicates that prior financial sector development is associated with subsequent higher rates of growth of GDP, increases in capital stock, and higher productivity.
- Financial markets development reduces barriers to market entry for start-up companies, enhances competition, and creates new opportunities for individuals and firms. In their words, "free financial markets are the elixir that fuels the process of creative destruction, continuously rejuvenating the capitalist system."
- Financial markets development expands opportunities for individuals to become self-employed, and economically mobile, by reducing the importance of having initial wealth (collateral), or connections, in order to obtain working capital.[2]

USAID/EGAT has extended this perspective to argue that in developing countries it is essential to deepen the financial sector, develop financial intermediaries, and broaden access to capital.

A developed financial sector is characterized by several important elements. First, the government has to respect and guarantee property rights. Absent a legal and regulatory system to enforce agreements and contracts, financial markets will remain undeveloped. At its core, financing is a legal contract: the exchange of a sum of money now for the promise of more money later. Second, a developed financial system allocates risk widely (diversification) and efficiently (to those who can best

[1] For the period before 2000, see Charles Seeger and Hugh Patton. *Background for Financial Markets Development in Ukraine,* Financial Markets International Inc./USAID, January 2000. Also known in Ukraine as the "Green Book."

[2] Raghuram G. Rajani & Luigi Zingales, Saving Capitalism from the Capitalists (New York: Crown Business Books, 2003) pp. 108-125.

bear it), thereby reducing the risk premium and the cost of funds. Risk allocation and financial intermediation are provided by a host of private financial institutions, including banks, stock markets, pension funds, insurance companies, etc., who collect savings and allocate them to investors, using a variety of financial institutions and instruments. Third, developed financial systems construct an institutional infrastructure to deal with two additional obstacles to broadened access to capital: limited information and moral hazard (theft, fraud). The required infrastructure includes collateral registries, depositories, clearance and settlement systems, credit rating agencies, regulatory agencies, commercial courts, and self-regulatory organizations.

Ukraine is deficient in most of the above elements of a modern financial system. Property rights and contracts are not routinely respected, judgments in the court system can be arbitrary or biased, and enforcement mechanisms are weak or non-existent. Commercial banking dominates the country's financial sector, while equity markets are illiquid and the development of non-bank financial intermediaries is nascent. Prudential oversight and supervision of banks has improved over the last four years, but the securities commission fails to protect investors. Credit information on potential borrowers is difficult to obtain, and lending policies therefore are based on short maturities, excessive collateral, and cronyism. Financial disclosure and accounting standards are lax, and corporate governance is often more an expression than a reality. Taken together, in Ukraine these financial sector deficiencies result in a risk premium that drives up the price of finance, limits access to capital and credit, and retards economic development.

This paper applies a *functional* analysis in examining the Ukrainian financial sector, and focuses on several *problem indicators,* including:

- Is access to credit from formal financial institutions largely available to SMEs, women-owned businesses, or entrepreneurs?
- Are financial statements of companies and banks reliable indicators of performance?
- Does prudential regulation, especially of banks and securities markets, protect the public and facilitate the economic functions these institutions should perform?
- Does an environment of "confident expectations" exist such that people put savings in banks or invest in businesses?
- Is credit information available, so that lending is neither over-collateralized nor based on cronyism?
- Is capital accumulation growing, reflecting both trust in financial operations and effective asset management regulations that permit diversified holdings rather than a preponderant amount in government securities?

We first examine recent macroeconomic developments in Ukraine and attempt to locate the country in relation to other transition countries. We then analyze Ukraine's financial sector, beginning with the legal environment and moving on to commercial banks and non-bank financial institutions (NBFI). We argue that future priorities should focus more on financial sector deepening, broadening access to

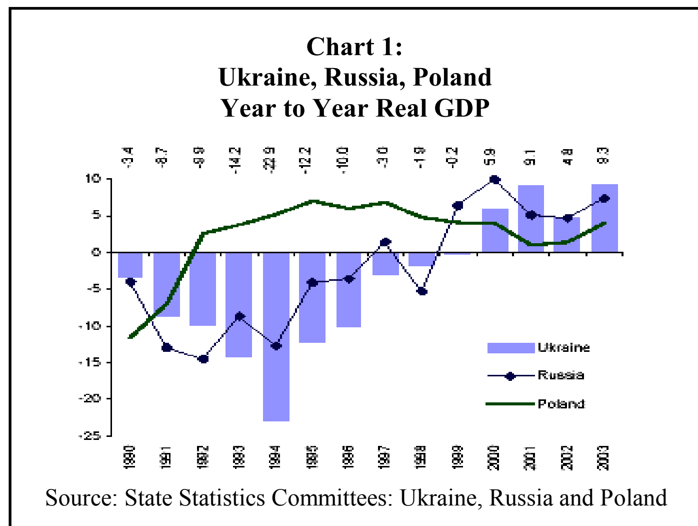
capital, and the development of financial intermediaries, especially in Ukraine's NBFI sector. The emphasis here should be on empowerment, meaning actions designed to *stimulate business activity*, *mobilize capital*, *create jobs, and spur economic growth.*

II. Economic Environment and Financial Sector Development

Economic Environment

Following a decade of severe economic decline, Ukraine's economy has grown strongly over the past four years, with GDP increasing by an estimated 20 percent. As Chart 1 indicates, Ukraine has been one of the strongest performers among the transition countries. Wages and incomes have moved upward, trade and current account deficits have turned to surplus, and the general government budget deficit has narrowed considerably.

Chart 1: Ukraine, Russia, Poland Year to Year Real GDP



Source: State Statistics Committees: Ukraine, Russia and Poland

Net foreign exchange reserves have quadrupled, and now stand at close to US $6.77 billion. Inflation fell to low, even negligible levels in 2001-2002, and this trend continued through 2003. The forecast growth of the real GDP for year 2004 is around 6.2%.

The significant reduction in personal income taxes from 10-40% to 13%, as well as the launch of pension reform, is expected to raise household incomes and stimulate private consumption. The increases in minimum wage, and the reintroduction of a unified wage scaling system in the budget sector, will have positive impact on income levels. Enterprise profit will be taxed at rate of 25%. Currency and interest rates are expected to remain stable.

Ukraine's private sector accounts for about 65% of the economy, which is about the transition country average. However, Ukraine's privatization process was notably different from those of other transition countries in several important respects. First, the process has proceeded slowly and relied heavily on management-employee buyouts, resulting in the creation of "red directors" who captured control of most privatized assets. Given Ukraine's weak legal protection of property rights, minority shareholders were essentially defrauded. In addition, enormous pressure was brought upon the government to continue subsidizing poorly managed and unprofitable enterprises. Second, in 1997 the Ukrainian Rada exempted "strategic" enterprises from privatization, leaving some of the most important enterprises under state control. Consequently, privatization is stalled and a badly needed impetus to the securities market is lacking.

Small and medium enterprises (SMEs) with up to 250 employees have been estimated by USAID/BIZPRO and the Government of Ukraine to provide about 47% of the employment in Ukraine.[3] Large scale enterprises, constituting less than 1% of

[3] This number is based on an analysis of data provided by the Ukrainian State Committee on Statistics. There are, however, difficulties in getting a precise figure as SMEs are not tracked as a separate statistical category and many

all enterprises, provide employment for 53% of the workforce, and generate 56% of the value of production in Ukraine. While small businesses in the private sector have established themselves as the main source of employment in Ukraine, large firms still dominate the economy. The IFC's Business Development Project in Ukraine further reports that there are 3 active SMEs in Ukraine per 1,000 people, compared to 35 in Poland.

Statistics also show that 60% of the Ukraine economy still operates extra-legally in the shadow economy. This lowers tax revenues, increases bad corporate governance, and increases business, sovereign, and financial risk. Lack of risk resolution makes access to finance very difficult, and provides financing at excessively high cost of capital. This is the chronic condition impeding sustained growth of the SME sector.

Ukraine's economic growth over the past four years is due to several factors. First, devaluation of the currency in 1999, coupled with improved economic growth in Russia, resulted in increased demand for products from Ukraine's traditional, metal-based industries. This increase in demand for Ukrainian manufacturing products had a dual impact on the economy: increased asset capacity utilization, and increased productivity for the first time since the early 1990s.

Second, the economy benefited substantially as a result of new economic policies, tax reform, fiscal discipline, and the elimination of arrears and barter and other kinds of non-monetary transactions. In addition, a sharp reduction in barter and netting-out operations, particularly in relation to budget and energy suppliers, benefited the overall economy. Tax simplification increased government revenues, and tended to decrease the shadow economy. In addition, the reduction of price and quantity controls in agriculture, starting in 2000, moved that sector toward a more promising future.

Third, systemic and institutional reforms have begun to make a difference in investor attitudes. For example, new financial sector legislation, changes in budget procedures, improved inter-governmental fiscal relations, and agriculture-land turnover have had a positive impact on Ukraine's economic recovery.

The combination of low inflation, better protection of property rights, better financial regulatory policy, and increased confidence in the banking sector led to substantial deposit inflows to the commercial banks. In addition, flight capital began to return to Ukraine, helping to spark an increase in investment and financial intermediation.

The economic recovery of the past four years will be difficult to sustain. Ukraine's recent growth comes after a decade of severe economic decline. According to the EBRD Transition Report 2003, Ukraine's estimated real level of GDP in 2002 (1989 = 100) was just 47, compared to 71 in Russia, 80 in Bulgaria, and 130 in Poland. For Ukraine to move forward, fundamental economic reforms have to be continued and intensified. In addition, privatization needs to be expeditiously completed in a transparent manner, improvements must be made in the rule of law and

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enterprises manipulate size estimates for tax optimization schemes. The IFC 2003 Business Environment Survey also estimated SMEs at approximately this level.

the creation of an "enforcement culture", and the business climate for private enterprises (especially in terms of deregulation and costs for SMEs) must be improved.

Unfortunately, and despite recent progress, Ukraine continues to lag behind other transition countries on most major economic reform indicators. Table 1 compares Ukraine with selected relevant transition countries (Russia, Poland, and Bulgaria). On the two major indices utilized by the World Economic Forum to measure economic progress, Ukraine trails Russia, Poland, and Bulgaria on Competitiveness and on Macroeconomic Environment. Likewise, Ukraine ranks below these three other transition countries on the EBRD Economic Policy Reform Index. Ukraine is positioned in the lower half of the thirty transition countries in terms of progress toward a market economy.

In terms of foreign direct investment, Ukraine is above only Russia. Since 1991, the cumulative FDI stock of Ukraine is only $6.7 billion, or about $140 in per capita terms. Of total FDI, the major sources are the United States (16.1% of the total), Cyprus (11.7%), and the United Kingdom (10.3%). The relatively large share of investments originating from Cyprus suggests that Ukrainian flight capital is gradually returning.

Table 1:
Economic Indicators

	Ukraine	Russia	Bulgaria	Poland
Competitiveness Index 2003[1]	84th	70th	64th	45th
Macroeconomic Environment Index[1]	70th; 3.27	61st; 3.44	68th (2002)	46 (2002)
Economic Policy Reform Rating/Rank[2]	2.6; 18	2.7; 16	3.3; 10	3.7; 2
FDI/GDP Ratio (2003)[2]	1.88%	.64%	5.77%	2.04%

Sources: 1) World Economic Forum, Global Competitiveness Index, 2003. 2) EBRD, Transition Report 2003; Ratings are on a scale of 1-5, with 5 being the highest. 27 Post Communist countries were rated.

USAID's own 2003 annual review of transition countries places Ukraine in the "Reforming, but Resource-Poor" category.[4] In addition to ranking lower than other transition countries on the scales of economic reform, Ukraine also lags behind in terms of non-bank financial institution development and infrastructure reforms.

Table 2 on the following page provides a comparison of Ukraine with selected countries in terms of international indices designed to capture openness of the political system, commitment to rule of law and property rights, and corruption. Once again, Ukraine ranks toward the bottom of the scale with Russia in terms of democratization and respect for rule of law, and is last among these four countries in terms of corruption.

[4] Sprout, Ronald. "Monitoring Country Progress in CEE and Eurasia". Europe and Eurasia Bureau, USAID. December 2003.

Table 2:
Political Indicators

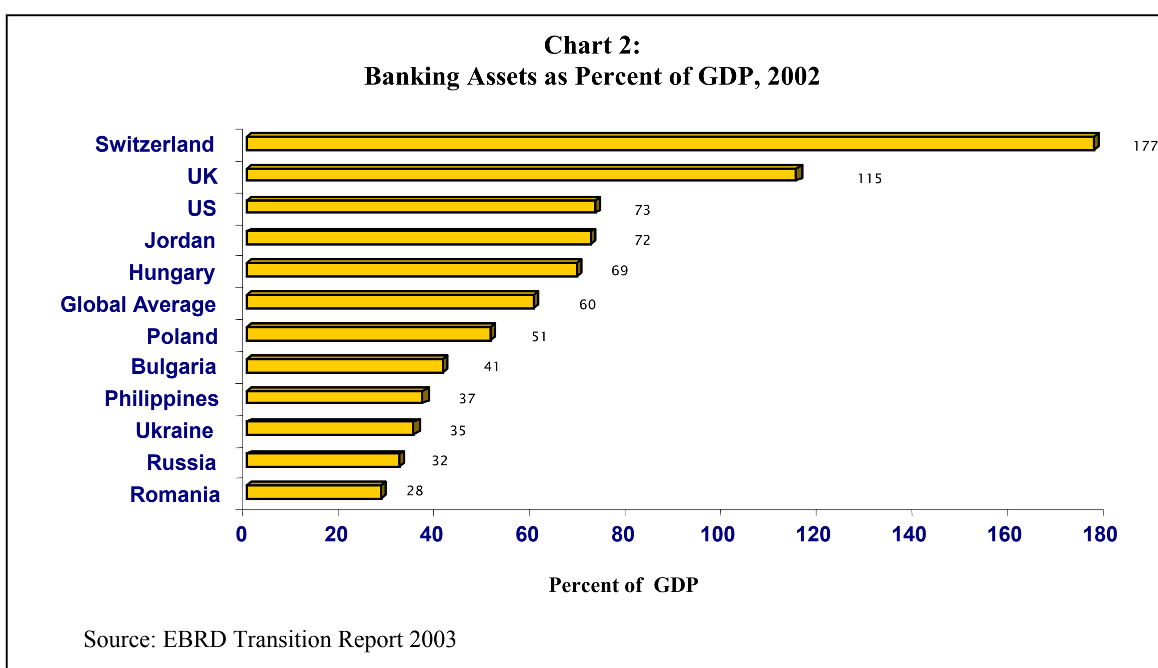
	Ukraine	Russia	Bulgaria	Poland	Kazak.
Democratization Index[1]	4.5	4.88	3.13	1.63	6.13
Rule of Law Ranking Index[1]	5.13	5.13	3.88	2.00	6.25
Corruption Index Rating/Rank [2]	2.3; 106	2.7; 86	3.9; 54	3.6; 64	2.4; 100

Sources: 1) Freedom House, Nations in Transit 2003; Ratings are on a scale of 1-7 with 1 representing the highest and 7 the lowest. 2) Transparency International, Corruption Perceptions Index 2003. Scale of 1-10, with 10 being the *least* corrupt.

Financial Sector Development

Ukraine's financial sector is dominated by the banking sector, which accounts for about 95% of all financial sector assets. Nevertheless, and in spite of significant increases in both bank deposits and bank lending since 2000, the banking sector remains very small, with total assets of less than US $20 billion, equivalent to approximately 35% of GDP. By comparison, net assets of the banking sectors in most transition economies account for an average of 63% of GDP, and in advanced European countries this ratio exceeds 100% of GDP (See Chart 2 below).

Chart 2:
Banking Assets as Percent of GDP, 2002



Source: EBRD Transition Report 2003

Table 3 below provides data on the size and composition of the overall financial sector. Non Bank Financial Institutions (NBFIs) account for less than 5% of the financial structure, reflecting the fact that financial markets development is shallow and that access to capital beyond the commercial banks is limited. The capital markets are small, with market capitalization equal to only 10.5% of GDP. Assets of other financial institutions such as pension funds, credit unions, and leasing companies combined account for less than 1% GDP.

Table 3:
Structure of the Financial Sector in Ukraine: 1999–2003

	1999	2000	2001	2002	2003
Banking					
Number of active banks	162	153	152	157	158
Total assets (UAH mil.)	25,603	36,827	47,204	67,774	100,234
Assets as percent of GDP	19.6	21.7	23.4	31.1	34.6
Insurance					
Number of Insurance Companies	263	283	328	338	358
Total assets (UAH mil.)	N/A	N/A	3,007	5,300	7,716
Premium Revenues (UAH mil.)	1,164	2,136	3,031	4,442	8,684
Other NBFIs					
Number of Investment Funds and Mutual Funds	229	397	362	350	250
Total assets (UAH Mil.)	N/A	373	365	346	340
Number of Active Pension Funds	N/A	21	15	23	21
Total assets (UAH Mil.)	N/A	23	60	55	60
Number of Credit Unions	N/A	>350	>400	>450	133
Total assets (UAH mil.)	N/A	37	50	90	200
Number of Leasing Companies	N/A	22	>40	>50	47
Total Assets (UAH mil.)	N/A	327	280	210	210
Number of Stock Exchanges	10	8	8	9	9
Number of Broker/Dealers	835	839	859	>850	876
Number of Custodians	75	84	86	85	124
Number of Securities Registrars	400	390	375	375	375
Number of Depositories	2	3	3	3	3

Source: NBU; Ukraine, Ministry of Finance; State Commission on Securities and Stock Market, PARD, PFTS.
End of December data. 1/ Estimated number of active leasing companies.

Compared to the other post-communist countries, Ukraine is at the bottom of most indices of financial sector development. For example, on the EBRD Banking Reform Index (scale of 1 to 4+, with 4+ the highest rating) Ukraine rates as a 2+, compared with Russia at 2, and Bulgaria and Poland each at 3+. In terms of the EBRD Index of Securities Markets and NBFI Development, Ukraine is a 2, compared with Russia (3-), Bulgaria (2+), and Poland (4-). Given the criticality of the financial sector to sustainable economic growth and poverty alleviation in Ukraine, much remains to be accomplished.

III. Legal and Regulatory Environment

A basic premise for the effective functioning of the financial sector of any country is the development of core legislation and effective enforcement of the norms of the legislation. A well functioning legal and judicial system is critical to the development of the economy and builds the trust necessary for a vibrant and competitive market economy.

Effective Financial Sector Legislation

2000

Jan	• Bankruptcy Law
Dec	• Law on Banks and Banking

2001

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

2002

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

2003

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

2004

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

While legal traditions vary among countries, there is general recognition that in developing economies there is a wide gap between the formal provisions of the legislation and effective implementation. This is clearly evident in Ukraine. The Ukrainian business environment is characterized by a weak legal system, excessive red tape, and unnecessary Government interference in the process. The lack of effective legal reform has resulted in Ukraine's failure to obtain recognition as a market economy, no accession to WTO despite years of effort, and foreign direct investment below its potential.

One major hindrance to Ukraine's transition to a market economy is a lack of political will at both the executive and parliament level. The Ukrainian legislative process is slow and opaque, with little or no public involvement, which is reinforced by limited regulatory enforcement, and by Government interference in the judicial system. Judicial enforcement is also slow and opaque, with limited public availability of written decisions, and court decisions that lack legal reasoning or explanation. The challenges facing Ukraine in these areas are numerous:

- Laws are too often internally inconsistent, lack clear definitions and standards for a functioning market economy, and conflict with other laws and regulations;
- Gaps in the legislation hamper enforcement;
- Enforcement provisions are often lacking, or based on Soviet era concepts in which the administrative, civil, or criminal punishment do not address or fit the violation, resulting in little or no effective enforcement, and thus no deterrent impact;

- International legal concepts are provided in the legislation, but with little understanding by the legislators, the judiciary, or the regulator as to the meaning of these *market economy* concepts, thus often leading to misinterpretations of the law, or enforcement of merely technical violations rather than substantive ones, and;
- Conflicts between the new Civil Code and the Commercial Code result in lack of a clear, easily understood, and enforceable legal framework.

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

"Business Legislation Roundtable," Kiev, December 15, 2003

Basic Legal Framework. Ukraine's legal system today is in some measure a product of temporary procedures that were put in place to address the rapid changes occurring during the early years of independence. Legal Acts, in the form of Presidential Decrees, were prepared on economic issues not regulated by the law.[5] The transitional provisions governing Presidential Decrees provided that this power would have a three year life, and that simultaneously with the issuance of a Decree there would be a law submitted to the Rada regulating the same issue, but the Decree would remain in force if the Rada failed to act within 30 days. These decrees and legal acts by Ministries still govern in many situations.

The new Civil Code and the Commercial Code, which became effective in January 2004, define the mechanisms for the creation, activities, and liquidation of companies, and establish the legal framework for contracts and other agreements. These two Codes overlap and regulate differently the same relations and issues. Thus, two different legal standards apply to an issue, with neither Code being recognized as "officially" superior to the other Code.

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

Ukrainian experts have stated that the Commercial Code specifically provides that it governs "peculiarities of commercial relations of the subjects of business activities" resulting in the Civil Code regulating only small everyday transactions between natural persons. One of the major legal issues is the lack of clear definition as to the meaning of "commercial relationships." In a specific case an entrepreneur, judge or official will determine whether a particular transaction is deemed "commercial" and which Code governs. This is expected to result in the cancellation of numerous court decisions not because of judicial error but because of poor legislation. For example, in a contract the Commercial Code mandates that the price be provided as a material element of the contract while the Civil Code does not. An even more difficult legal issue is determining what Code applies when a new legal

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

entity is created. Because of the difference in the provisions of the two Codes, an entrepreneur will select one Code over the other, resulting in infringing one of the Codes. It is widely agreed that these confusions will be a serious obstacle to Ukraine's recognition as a market economy and its membership in the WTO.

Draft Joint Stock Company Law. The corporate governance legal framework in Ukraine is not in compliance with international standards. The European Bank for Reconstruction and Development (EBRD) Corporate Governance Sector Assessment Project Report for 2003 ranked Ukraine in the lowest category, "Very Low Compliance," because of the lack of a joint stock company law. In addition, enforcement of existing corporate governance provisions is weak.

The Law of Ukraine on "Business Associations", was enacted October 1, 1991, and is the current legal framework for the establishment of legal entities, including joint stock companies. In the thirteen years since its enactment, the development of the business sector has out paced this legal framework, resulting in many corporate conflicts. In addition, the Law has serious gaps that result in major abuses of about 18 million small shareholders. This outdated legislation fails to include critical international norms, leading to "asset stripping", unregulated transactions with management of the enterprise, share dilution, concealing of profits, and tax avoidance. These flagrant violations of international norms, coupled with the lack of effective enforcement and unequal treatment of shareholders, has debilitated foreign and domestic investment necessary for economic growth.

Despite attempts in July 2001, November 2001, and again in July 2003, the draft Joint Stock Company Law failed to pass a first reading in the Verkhovna Rada. Currently, there is pending in the Rada a draft Joint Stock Company Law submitted by the Cabinet of Ministers on December 18, 2003. This current daft is characterized as "compromise legislation" prepared by the Securities and Stock Market State Commission, at the request of the Cabinet of Ministers, to address the objections of the businessmen who are powerful members in the Rada.

While many of the members of the Rada have not publicly announced their reasons for opposition to the draft Joint Stock Company Law, the anecdotal evidence suggests that the reasons for opposition are not well founded. Reasons suggested include that there is a "careless attitude to ownership rights characteristic of the Soviet time," or, "the current situation is more comfortable for everyone," or, "the executive power is not interested in the draft Law," or, "large owners in the Rada do not want their rights infringed."

The Action Plan of the Cabinet of Ministers of Ukraine for 2004, approved by the Rada, lists among the Government's priorities for financial sector development the further enhancement of corporate governance, and ensuring protection of investor rights, through the adoption of the Joint Stock Companies Law. There have been several public events promoting the passage of the draft Joint Stock Company Law, with particular interest shown by portfolio investors who have significant investments in Ukrainian joint stock companies, but remain minority shareholders with little or no protection of their rights. Further educational work with the Rada members, representatives of the business community, and others is required to inform them on the benefits of a Joint Stock Company Law in compliance with international market

economy provisions. Effective implementation of pension reform will further support adoption of the Joint Stock Company Law, as pension fund portfolio managers seek to find suitable investments in Ukraine with the necessary legal framework to protect their investments.

Failure to provide the fundamental legal framework embodied in the draft Joint Stock Company Law has, and will continue to have, serious negative impact on financial sector development. Foreign direct investment will not improve as Western investors seek a more rational legal scheme, such as that existing today in eastern European countries and Russia. Investments will naturally flow to countries where there is greater legal certainty about shareholder rights. One major Ukrainian portfolio manager has stated that his company is currently selling its minority interest in Ukrainian enterprises and has established a new policy of investing only as a majority shareholder in Ukrainian companies, in order to protect its investment. If Ukraine is to be integrated into the global economy, recognized as a market economy, obtain membership in WTO and the European Union, it will be necessary to pass a modern Joint Stock Company Law. The GOU has stated, that to provide stable competitive growth, Ukraine will require up to $20 billion annually in foreign investments. Government support of the draft law, leading to its passage, will promote a positive image of Ukraine, building on the achievements to date resulted in the removal of Ukraine from the FATF black list in February 2004.

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

Accounting and Auditing Law. Transparency for any economic activity is based on consistent and reliable reporting of financial results. One of the five OECD principles of corporate governance is that, “Information should be prepared, audited, and disclosed in accordance with high quality, internationally recognized, standards of accounting, financial and non-financial disclosure, and audit.” Ukrainian financial statements are prepared primarily for tax purposes, and are based on National Standards of Accounting, which are viewed as “substantially” in compliance with International Standards of Accounting and International Auditing Standards.[6] If Ukraine is to establish a successful capital market based on meaningful transparency, it is essential that the financial statements, the heart of the disclosure system, be prepared and presented in accordance with international norms.

The GOU should adopt new laws that require financial reports to be prepared on the basis of International Accounting Standards and International Standards of

[6] The international donor community, including USAID and the EU, continue to provide extensive training and support for the transition to international standards of accounting and auditing. The training programs cover a wide range of participants. With the support of USAID, the Securities and Stock Market State Commission conducted extensive accounting training for approximately 1,000 publicly traded issuers, to “transform” their financial statements to international standards for the fiscal year ending 2003. While this is a positive first step, mere transformation, without the in depth knowledge on how to apply the international accounting standards represents in most cases form over substance. Publicly traded issuers represent a small percentage of the 12,000 public companies in Ukraine.

Auditing by highly qualified accountants. Immediate transition to international standards, accompanied by reconciliation for tax purposes, will increase tax collection, provide reliable basis for tax collection, reduce off-shore transfer of cash and other assets, promote the development of the economy, and reduce unemployment as the accounting and auditing profession increases to support the growth in the economy.

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

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

Mortgage Law. From 1985 to 2001 residential housing construction declined by more than 70%. The estimated demand for residential housing in Kyiv alone is US $300 million. Ukrainian banks currently advertise 10 year mortgage loans with a 30% down payment, but the reality is that most bank mortgage loans are for only four years with a 50% to 70% down payment.

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

The Law on Mortgages is a positive step forward, but the existence of a second law on mortgages, "Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates," also effective January 2004, results in inconsistent and overlapping legislation.[7]

The noted problems between the two existing laws include the following:

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

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

To effectively regulate the development of mortgages, it is important that Ukraine harmonize the existing Laws with other domestic legislation to ensure its effectiveness and address the legal gaps in the Law.

Public Offering of Mortgage-Backed Securities. The Law on "Mortgage Financing, Transactions with Consolidated Debt and Mortgage Certificates" appears, in many respects, to overlap the Law on Mortgage by establishing another, but conflicting, regime for granting mortgage loans. It also creates a new regime for mortgage asset management to control pooled assets that are pledged to secure the new securities created by the Law, mortgage certificates. In addition it provides for a mortgage on "to be constructed property." The established price for the "construction mortgage" is not clear and conflicts with the Law on Mortgage, which requires the establishment of a contract with a firm price. This "special" Law raises substantive legal issues that must be dealt with in order to make it more effective.

Draft Law on Mortgage Securities. In February 2004, the Cabinet of Ministers submitted to the Rada a draft law on mortgage securities as the key legislation governing the public offering of mortgage backed securities. The draft Law addresses general provisions for the issuance and circulation of two types of mortgage securities—mortgage certificates and mortgage bonds. The draft Law specifically provides that mortgage certificates will be regulated by the "special" Law on Mortgage Financing, Transactions with Consolidated Debt and "Mortgage Certificates" discussed above. Thus, in effect, it appears that the draft Law will regulate only the offering of mortgage bonds issued by banks and other financial institutions, but not the issuance of mortgage bonds by public joint stock companies.

Mortgage financing is an important capital market segment in many developing economies. An accompanying development of mortgage bonds both furthers the mortgage financing industries, and provides attractive debt instruments for pension funds. It is necessary to resolve the major gaps and inconsistencies in the current legal regime in Ukraine if this market is to develop.

Development of Private Enterprise Debt Market Secured by Pledge of Immovable Property. The existing Mortgage Law does not provide a process for public offerings of bonds, or other debt instruments secured by issuers' immovable property. Under the existing legal framework, in order to establish a pledge against immovable property, the creditor and debtor must enter into a notarized pledge agreement. For a public offering of bonds secured by mortgages, the issuer must enter into a separate agreement with *each* bondholder. This is an expensive or impossible process for a public offering. Although registration of the mortgage is not required by law as a condition for validity of the pledge agreement, it will be necessary for establishing the priority position of the mortgage.

Secured Pledge Law. Secured transaction laws reduce the risk associated with extending credit, promote confidence that the creditor can recover the credit in the event of financial difficulties of the debtor, and promotes more favorable credit terms for the debtor. This Law, like the Law on Mortgage, does not provide for the public offering by an issuer of a bond, or debt secured by its movable property such as equipment or other assets. The same issues (as noted above with respect to the Mortgage Law) prevent an orderly process for issuing secured public debt and

effective registration and priority of debt holders. It will be important to monitor the actual effectiveness of the Law as experience is gained following its adoption. This will clarify the practical hurdles to effective implementation of the secured lending law, and help the Rada make necessary changes.

Discouraging Legal Environment

The City of Kyiv Bond Offering Circular of 23 July 2003 included this disclosure to potential investors:

"Risks associated with the Ukrainian legal system include, but are not limited to:

- Provisions in the laws and regulations that are ambiguously worded or lack specificity and thereby raise difficulties when implemented or interpreted;
- Inconsistencies between and among the constitution of Ukraine, laws, presidential decrees, and Ukrainian governmental, ministerial and local orders, decisions, resolutions and other acts;
- The lack of judicial and administrative guidance on the interpretation of Ukrainian legislation, including the complicated mechanism of exercising constitutional jurisdiction by the Constitutional Court of Ukraine;
- The relative inexperience of judges and courts in interpreting Ukrainian legislation and the general inconsistency in their interpretation of Ukrainian legislation in the same or similar cases;
- Corruption within the judiciary; and
- A high degree of discretion on the part of governmental authorities, which could result in arbitrary actions, such as the revocation of our licenses."

Conclusion. The development and growth of the financial sector requires a legal and regulatory framework of confident expectations about financial transactions. Actors in financial markets must have confidence that : contracts will be honored and enforced; loans will be repaid or collateral forfeit; financial information will be reliable; securities and bonds will efficiently clear and settle; the interests of creditors, shareholders, and managers will be protected; and tax policy will be fair and consistent. Without such confidence, domestic capital will not be mobilized and foreign investment will not come. All *sustainable* financial sector reform is achieved through effective legal reform that creates this climate of confident expectations. Ukraine must continue to focus on both legal reform and the creation of an enforcement culture.

IV. Commercial Banks

The major legislative acts governing the Ukrainian banking sector are the Law of Ukraine "On the National Bank of Ukraine" of 20 May 1999 #679-XIV and the Law of Ukraine "On Banks and Banking Activity" of 7 December 2000 #2121-III. These laws provide for the current two-level banking system consisting of the Central Bank (National Bank of Ukraine or NBU) and commercial banks. The National Bank is allowed to issue regulations on all matters falling within its competence, which are mandatory for all covered entities.

At the beginning of 2004, 158 banks were licensed by the NBU to perform general banking transactions. Ukrainian banks are incorporated under various legal structures, with the majority operating as 'open joint-stock' companies which allows for unrestricted sale of shares and periodic increases in authorized capital. The NBU categorizes commercial banks into four tiers, according to their size and performance data.

Table 4 below indicates the high level of concentration and stratification in the Ukrainian banking system. The top 20 banks, or 13% of the total number of commercial banks, account for over 70% of total assets in the banking system, with 55% of the total loans granted by the first ten banks alone. These few banks also hold the highest percentage of customer deposits. Interestingly, the first 10 banks exhibit weaker levels of capitalization than the other groups of banks in relation to their share of risk assets. Additionally, despite their high loan growth in recent years, the percentage of net earnings of these dominant institutions has been flat over the past two years, while the second tier banks have shown some improvement in this area.

Table 4:
Profile of Banking System Structure (% of Total)[8]

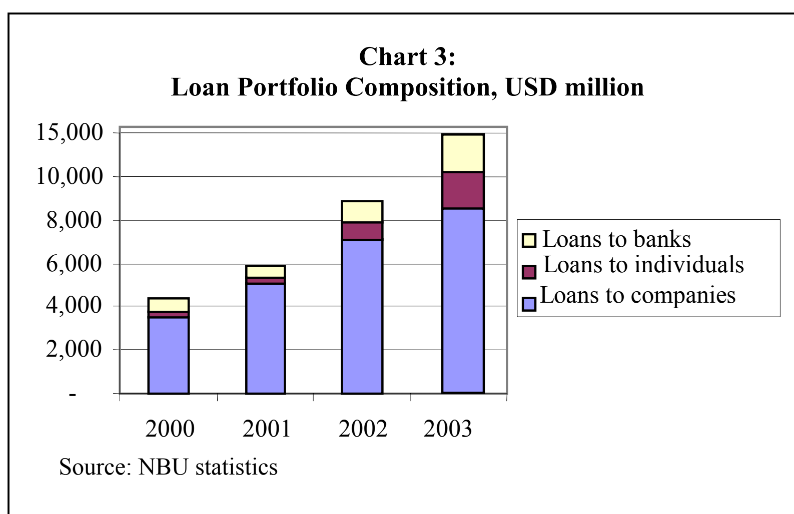
		1st Tier Banks	2nd Tier Banks	Total top 20 Banks	3rd Tier Banks	4th Tier Banks
Total Assets	2000	46.8	16.4	63.2	16.7	20.0
	2003	53.7	17.1	70.8	17.1	12.1
Gross Loans	2000	46.6	18.0	64.6	15.9	19.5
	2003	54.9	17.2	72.1	16.5	11.4
Total Deposits	2000	54.5	14.2	68.7	17.3	14.0
	2003	59.0	15.8	74.8	15.2	10.0
Balance Capital	2000	34.4	13.52	47.9	20.0	32.0
	2003	38.5	14.9	53.4	19.8	26.8
Net Income	2000	----	----	----	----	----
	2003	46.2	17.7	63.9	29.2	6.9

Source: NBU statistics

Twenty banks in Ukraine have foreign investment capital to some degree, and seven such banks are fully foreign-owned. Banks with foreign capital comprise approximately one-fifth of the total capital of banks in Ukraine, whereas their assets

[8] Tier 1 banks are the 7 largest banks in terms of total assets for 2000, 2001 and 10 banks in 2002, 2003.
Tier 2 banks are the next 13 banks in 200, 2001 and 10 banks in 2002, 2003.
Tier 3 banks are remaining banks with total assets > UAH 150 million
Tier 4 banks are all remaining banks (total assets < UAH 150 million). Some of these small banks are "pocket banks" of large enterprise groups. These institutions are used primarily for the internal treasury operations of their parent enterprise groups and as consistent sources of cheap liquidity and equity investment.

make up one-sixth of total assets in the system. Most of the 100% foreign-owned banks specialize in servicing their established corporate clients and marketing their international investment programs.



Net banking assets of the banking system totaled UAH100bn (US $19bn) at the end of 2003, a 57% increase over the 2002 year end level. Although this growth rate is impressive, this is still the equivalent of approximately 35% of the preliminary GDP figures reported for 2003.[9] By comparison, net assets of the banking sectors in most transition economies now account for an average of 63% of GDP. In the United States and most advanced European countries this ratio exceeds 100%. Chart 3 illustrates the phenomenal growth rate experienced in the three major loan account categories of the commercial banks in Ukraine since 2000.

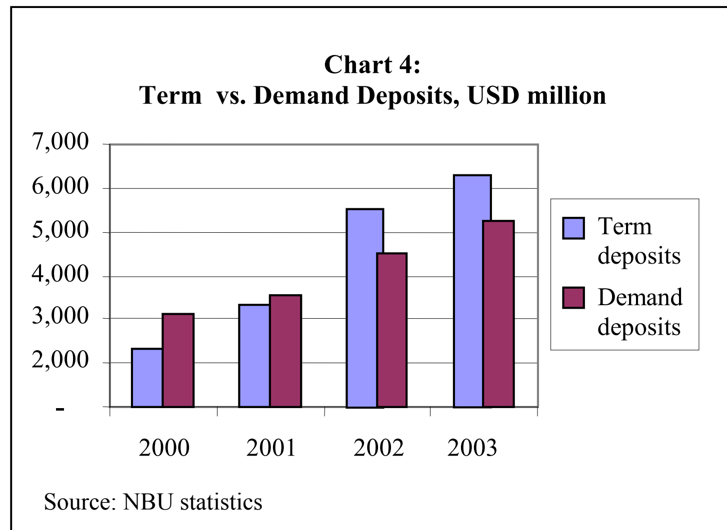
Lending Practices. The financial intermediation effort of Ukraine's commercial banking sector remains very limited. Although rising by 31% in nominal terms during 2003, the total capitalization of the banking sector is still less than US $2.5 billion, or about equal to the capitalization of a single medium-sized European bank. By any measure the banking sector in Ukraine must be considered undercapitalized. Consequently, the ability of individual banks to effectively intermediate in the economy and provide the financing required to stimulate growth is severely limited. Most small and medium enterprises still have only limited access to credit. This is caused by limitations on leverage due to low capitalization, the high interest rate environment, limited credit assessment capacity, and partially due to the interrelationship between banks and industrial groups under common ownership.

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

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

extensions, and the practice of extending past-due loans to avoid additional charges to reserves is still wide-spread.[10]

Deposits. The total amount of deposits in commercial banks has risen sharply, with individuals' deposits rising by more then two-thirds in real terms in 2002 alone. As of July 2003 the total deposits and balances on current accounts attracted by the 15 largest banks exceeded US $6.7 billion, which represents over 70% of total funds attracted by the industry. The increased confidence in the banking sector and no personal income tax on interest income has fuelled the deposits growth.



As shown in Chart 4, total term deposits in 2002 in the banks exceeded demand deposits for the first time since Ukraine's independence. However, the maturity of term deposits is very short, ranging from 6 months to 1 year. This leads to the issue of volatility in the deposit base versus the level of core deposits of the system. Short-term corporate deposits tend to be working capital accounts of businesses and their volume can fluctuate wildly for a variety of reasons beyond the internal control of the banks. Conversely, fund flow statistics strongly indicate that a significant level of 'core' deposits is evolving within the individual deposit base which the banks should be able to depend on for stability. The banks need to develop a wider range of customer products with a range of interest rates and tenor in order to develop a large and stable funding base. A further increase in volumes and maturity of term deposits is vital to provide stable long-term financing to banks, which, in turn, will support long-term lending.

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

This new exposure may pose a significant risk to the banking sector since none of these bonds are regulated or rated by any competent authority. Due to the structural weaknesses of the capital markets, these bonds are extremely illiquid which raises considerable liquidity risks for the banks that own them. Additionally, these

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

investments represent excessive exposure to marginally viable and/or related-party enterprises. There is a fear that even a minor payment default in one or more of these instruments could lead to a systemic liquidity problem for the banks. As a result of recommendations from international advisors, the NBU is in the process of revising its accounting regulations and provisioning procedures for the treatment of these corporate bonds.

Tables 5 and 6 illustrate the rapid growth in new corporate bond issues, the changes in the profile of bank portfolios, and the concentration of risk with these instruments among the few large banks.

Table 5:
Changes in Profile of Securities Portfolio (all banks)
(UAH million)

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

Source: Calculations from NBU statistics

Table 6 on the following page provides a further indication of the highly concentrated nature of the nascent bond market in Ukraine. The top ten banks hold 63.3% of all debt issues in the country. This is a slight decrease in the percentage totals from 2002 levels but all the difference is accounted for in the drop in government securities in their portfolio mix. More importantly, by extrapolation,[11] this table also indicates that these few large banks also hold a disproportionate percentage of the new corporate bond issues. During 2003 the investment portfolio of 7 of the top 12 banks reported a 218% average increase in their risk exposure through investments in new non-government (e.g. corporate bond) securities.

[11] Deducting Oschadbank's government portfolio from the total leaves UAH 2.5 billion or 64% of the total corporate bonds outstanding divided among 9 banks.

Table 6:
Securities Portfolio of Top Ten Ukrainian Banks

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

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

Capital. Despite several years of strong asset growth and steady but mediocre earnings, the level of capitalization for commercial banks operating in Ukraine remains dangerously low. The current minimum statutory capital requirement of the NBU to obtain a general license for nationwide banking activities is set at very low € 5 million.[12] This minimum capital requirement is even lower for the many smaller institutions which operate only on a limited regional basis. For commercial banks the major current source of capitalization remains retained earnings. Over the past two years, earnings of the banking system have increased, but the Return on Assets (ROA) ratio has decreased significantly due to lower interest rates on loans, continued high levels of Non Performing Loans (NPLs), high overheads, and operating inefficiencies.

Capital adequacy remains one of the most problematical issues affecting the Ukrainian banking system today. The quality of a bank's capital is also important. Contrary to existing practices, only certain accounts can be considered as 'real' equity in a bank, with actual paid-in capital from investors being the most critical component of tier 1 capital. The practice of Ukrainian banks to include current earnings, specific loan loss reserves, and fixed asset revaluations into the primary capital account is misleading and goes against Basel standards. The NBU has recently required that local banks increase their minimum Capital Adequacy Ratio (CAR) from 8 percent to 10 percent.[13] However, this will be done without raising the minimum level of equity capital. Given the unstable macroeconomic conditions, market and credit risk factors, and structural and management weaknesses of the Ukrainian banks, many analysts consider that a 10% CAR is still too low.

[12] Although the capital is to be paid-in in Euros, the NBU has recently yielded to pressure from the local Bankers Association to allow capital adequacy to be accounted for in Hryvnia, and recalculated annually, avoiding the negative impact of monthly adjustments that might be necessary due to exchange rate fluctuations.
[13] This new requirement came into effect in March 2004 and the NBU has reported that only a few 'small' banks have failed to meet these criteria to date. Further, the NBU has announced that they will grant a period of forbearance (unspecified) before taking any action against banks which have failed to meet this new minimum CAR.

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

Table 7:
Selected Performance Ratios

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

Source: Calculations from NBU statistics

Table 7 presents a series of ratios commonly used to analyze the operational performance of a commercial bank over time. In general, these ratios measure a bank's operating income and expense figures against total assets and interest and other key expense information. These standard financial performance ratios point out the operational vulnerabilities of the Ukrainian banking system. Although improving statistically (due primarily to the rapid increase in assets in 2003) the annualized intermediation spread for the banking sector is still negative. This negative number is indicative of a fundamental structural inefficiency in the system, since the growth rate of interest expenses exceeds that of interest income, when measured as a percentage of average assets. A negative intermediation figure strongly implies that a number of bank credits are not earning interest income at the rates originally contracted.

This table above also points out certain operating inefficiencies of the commercial banks: a) the high (and increasing) levels of operating expenses to income (74.2%); b) the high ratio of staff expenses against operating income (personnel costs consume over 32.9% of gross operating income), and; c) the strong dependency on non-interest income to support overall earnings all suggest inefficient operations. Fee income accounted for almost 46% of operating income in 2003.

<u>Bank Funding Sources and Liquidity.</u> Many of the Tier 1 and 2 Ukrainian banks have already issued debt securities (bonds) on the local market and several have begun contracting international debt through correspondent banks and syndicated

loans. As of year end 2003 the banking system reports total debt securities issued at 799 billion Hryvnia (US$ 151million).

Table 8 presents a set of liquidity and funding ratios for the last three years:

Table 8:
Selected Liquidity and Funding Ratios

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

Source: Calculations from NBU statistics

While the level of term deposits increased to 58% of total deposits, a detailed breakdown reveals that most of this growth was in short-term individual savings accounts, and that the percentage of deposits with maturities over 90 days declined. Volatile demand deposits remain at almost 50% of the funding base. Additionally, the nominal value as well as percentage composition of bank debt securities issued, subordinated debt and particularly, interbank borrowings, increased as the banks continued to 'over lend' against the internationally accepted limits on the traditional deposit base.

The most active area of alternative bank funding during 2003 was the local interbank market. On a net basis,[14] total liabilities for interbank debt rose 69% during 2003 and represented 18.1% of the total deposit base of the banks during the year.

At year end 2003, subordinated debt issues still represented less than 2% of total deposits but had risen rapidly to almost 12% of Tier 1 capital of the system. Subordinated debt is found in varying percentages of the capital base throughout the banking system and was reportedly the primary instrument used to raise capital (particularly among the smaller institutions) and to meet NBU requirements several years ago. An overdependence on subordinated debt to bolster the capital base is a dangerous practice; it simply does not resolve the fundamental issue of undercapitalization of the institution. The Basel Committee has established a number of guidelines which severely restrict the use and structure of subordinated debt as a source of regulatory capital. Under Basel Guidelines subordinated debt is considered

[14] On a consolidated basis the banks reported a net liability position for transactions on the interbank market. This is the third straight year of remarkable growth in the interbank market with a corresponding increase in dependence on this source of funding by several major banks.

as Tier 2 capital only and is limited to a maximum amount of 50% of the Tier 1 capital base. [15]

International Debt Issues. In late 2003 and early 2004 Privatbank and UkrSibbank each raised US$100 million in 3 year promissory notes through agreements with two large European banks. Several additional Ukrainian banks (Aval, UkrSotsbank, and UkrEximbank) have announced their intentions to issue similar debt instruments during the first half of 2004. Numerous issues arise for the Ukrainian banking system from international borrowing. Experience from a number of countries has shown that international bond borrowings as a primary source of funding for financially vulnerable commercial banks, operating under the constraints of a transition economy such as Ukraine, must be recognized for the double-edged sword that it is.[16] The potential problems include: increased credit and currency risk exposures; the high cost of such borrowings which may force continued high lending rates as the banks seek a positive margin on the use of these funds; minimal oversight and analysis of this foreign currency exposure by the NBU; and the lack of 'absorption capacity' in the economy for large amounts of new loan funds.

In order to issue debt on the Euromarkets, the banks have been required to announce a 'rating' from an international ratings agency such as Moody's or Fitch International. Several banks now have debt and individual financial soundness ratings, and several more have recently contracted with these firms to conduct their due diligence studies on their operations for the same purpose. However, the ratings which have been awarded on each of the two large loan participation debt issues for Privatbank and UkrSibbank are B and B-, which are not considered as investment grade in most countries. Both banks were awarded a Support rating of 5, the lowest classification, and thus investors can expect very little additional financial support to assist these institutions if they run into financial difficulty.

Loan Portfolio Quality and Provisioning. Most banks have reported that the quality of their loan portfolios improved during 2003, with the average share of so-called 'bad loans' for the top 10 banks dropping to an average of 6% in comparison with 13% at the end of 2002. The Association of Ukrainian Banks, citing general numbers from NBU statistics, states that *"Problem loans declined from 4.5% of loan portfolio to 3.4%"* – a statement and ratio which is open to wide interpretation.

The issue of proper asset classifications and the creation of sufficient loan loss provisions have been long standing problems for the Ukrainian banking system. Asset classifications are theoretically performed and updated on a regular basis by bank management. They are further adjusted and verified each year at the time of the annual on-site examination conducted by the NBU and in preparation of audited financial statements. Often these results are not representative of the true level of loans which would normally be adversely classified under prudent bank accounting procedures. While the absolute level of performing loans appears to have improved

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

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

statistically, these percentages are on a rapidly increasingly loan base which by definition include loans that are too new to rate since only minimal time has elapsed in which to monitor performance.[17] Meanwhile the percentage of adversely classified loans has increased over 2002 levels.[18]

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

Table 9:
Changes in Aggregate Asset Classifications
(as a % of total loans)

Classification of loans	**As of 12/31/01**	**As of 12/31/02**	**As of 12/31/03**	**Average % Δ yoy****
Standard (performing)	39.1	37.7	66.6	36.5%
Watch (performing but weak)	36.6	40.5	5.1	-38.4%
Sub-standard (prolonged)	14.8	14.7	21.1	21.5%
Doubtful (past due)	3.6	3.1	4.6	17.3%
Loss	5.9	4.1	2.7	-35.3%
Loan Loss Reserves (LLR)				**Absolute change**
LLR required by NBU*	3,714	4,678	5,452	16.5%
Actual LLR reserved*	3,194	3,878	5,355	38%
Actual as % of required	85.9%	82.8%	98%	9.3%
Charge to LLR for year	1,057	926	1,725	86.3%

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

More specifically, the trend of loans classified as substandard and doubtful continues to deteriorate as a percentage of total loans. NBU statistics indicate that, at a minimum, the level of NPLs was 28.4% of total loans as of year end-2003, which represent an almost 30% increase over the level reported for 2002.[19] The NBU reports that as of year end 2003 the total of adversely classified loan assets was 24.1 billion hryvnia (US$ 4.5 billion) of which 6,2 billion hryvnia (US$ 1.2 billion) was classified as Loss.

Table 10 on the following page illustrates that as risk assets have grown, the overall capital adequacy measurements of the banking sector have remained weak or continued to decrease.

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

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

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

Table 10:
Ratios Characterizing the Capitalization Level of the Banking Sector

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

Source: Calculations from NBU statistics

The continued undercapitalization of the Ukrainian banks and their inability to 'grow out of it' from internally generated earnings is creating an unsustainable situation. This situation is exacerbated by the new cash investments necessary to meet increased NBU regulatory requirements and capital adequacy ratios.

Ownership Structure and Transparency. The historical ownership structure found in most Ukrainian commercial banks has led to a higher than normal incidence of related party lending and insider transactions. Contrary to normal international standards and best practices, there are only minimal restrictions on the ownership structure of a bank. Many banks, including several of the largest, are almost wholly-owned by single individuals, family groups, and/or closely held corporate conglomerates.[20] Partially as a result of work begun during Ukraine's recent anti money-laundering program, the NBU has embarked on a concerted effort to require, under threat of stronger enforcement measures, the banks to provide full and complete disclosure of their ownership and related party structures. The NBU will be requiring more complete ownership disclosure in order to properly calculate compliance with its concentration of credit regulations as well as to better evaluate risk management and corporate governance procedures.

Dollarization of the Banking Sector. Permitting foreign currency deposits has commonly served as a vehicle to foster financial intermediation and financial deepening at a time when the local banking systems were still considered fragile. Dollarization of the financial sector has also made it possible for domestic financial intermediation to be conducted in both domestic and foreign currencies, with residents being able to denominate and settle domestic contracts in either currency, as well as arbitrage freely between onshore and offshore accounts.

The NBU regulates the country's foreign exchange and currency markets and continues to monitor all transactions closely. While the foreign exchange markets are open and the Hryvnia readily convertible (locally), the exchange rate is closely managed through a 'dirty float' which requires the regular intervention of the central bank. Additionally, the NBU has set a general normative limit of 35 % on a bank's total net open position for all currencies and it appears that the banks are in compliance with this operational regulation.

[20] Ukrainian corporate law and NBU regulations require that there be at least 2 separate registered shareholders for an open joint stock corporation. In fact there are several banks that are effectively 100% owned by a single individual through their cross holdings in off-shore corporations and 'third-party' companies in which they also own the majority of shares.

As in other transition economies, domestic and foreign currencies compete in deposit and loan markets of the banking sector. In Ukraine, while the total volume of deposits has increased substantially, the ratio of total foreign currency deposits to total deposits has remained basically flat at 47% over the past three years. As of year-end 2003, foreign currency denominated deposits totaled 19.6 billion hryvnia (US$ 3.7 bn.). The banks appear to have lent a disproportionate level of their funds in foreign currency and are exposed to unhedged foreign currency risks. Bank foreign exchange exposure totaled 28.3 billion hryvnia in 2003, against total foreign currency deposits of only 19.1 billion hryvnia—a long position of 9.2 billion hryvnia or 33% of FX loan exposures. Thus, the banking system is operating its credit portfolios with an increasing currency mismatch.

Conclusion. Several common structural weaknesses and restraints are currently impacting the Ukrainian banking system. The joint IMF/World Bank program for periodic financial sector appraisals (FSAP) of 2002 concluded that the Ukraine banking system is:

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

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

V. Non-Bank Financial Institutions (NBFI)

Structure of the NBFI sector. The Ukrainian NBFI sector includes all financial institutions that are not classified as commercial banks. This includes leasing, factoring, venture capital companies, as well as various types of contractual savings and institutional investors (pension funds, insurance companies, and collective investment institutions), and the capital and securities markets for government and corporate debt, and corporate equities. The common characteristic of these institutions is that they mobilize savings and facilitate the financing of different activities, but do not accept deposits.

Ukraine's NBFI component of the financial sector is limited in every manner: in volume of activity, quality of its products and services, and degree of market penetration. The role of NBFIs in Ukrainian financial intermediation is negligible, with total assets estimated at less than 1% percent of GDP. The EBRD Transition Report (2003) ranks Ukraine NBFI development behind that of Poland, Lithuania, Hungary, Bulgaria, and Russia. The World Bank, IMF and EBRD consider the stage of development reached by the NBFI sector as a good indicator of the degree of development of the financial system as a whole. Vast expansion is necessary for the nascent NBFI sector in Ukraine to have an impact on economic growth.

> **"Multiple alternatives to transform an economy's savings into capital investment act as backup facilities should the primary form of intermediation fail."**
>
> *Alan Greenspan, Chairman of Federal Reserve Bank.*

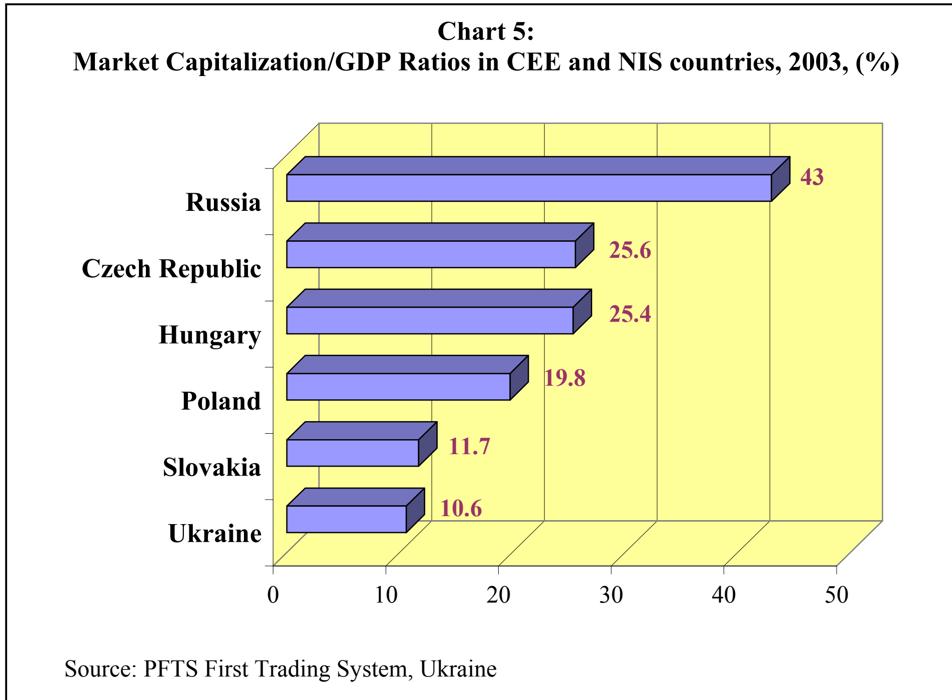
NBFI Legal and Regulatory Framework. The State Commission for the Regulation of Financial Services Market (hereafter referred to as the Financial Services Regulator – FSR) is responsible for the regulation and supervision of NBFIs. The FSR was formed according to the Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets," as of July 12, 2001. The FSR, which came into existence in December 2002, is empowered to carry out the licensing, monitoring, and enforcement functions over the activities of the wide range of NBFIs.

Currently, the FSR is undergoing an important evaluation of its role in all areas of NBFI activities. This is intended as a prelude to start a re-registration and re-licensing program designed to provide a better result from its supervisory responsibilities. The FSR claims to be a collegial organization that wants to enable the further development and capitalization of the NBFI sector. The strategy of the Commission is to create an enabling environment for all NBFI firms so that transparency, accountability, and fairness concepts are applied equitably, and corporate governance practices are improved. The FSR collaborates with the State Stock Market and Securities Commission (SSMSC), the Ministry of Finance and, the NBU on matters pertaining to pensions funds, asset management companies, bonds, equities and other financial markets instruments, as well as in anti-money laundering activities.

The following section briefly surveys certain NBFI industries to offer perspective on the areas of activity that could have economic impact.

Securities Markets. The Ukraine securities markets are under-developed, over-regulated, and provide little intermediation.[21] The securities markets are a legacy of State Property Fund privatization hopes that did not materialize. With inadequate corporate governance, lack of transparency, and weak enforcement by the SSMSC, the securities market environment is not conducive to investors.

Chart 5:
Market Capitalization/GDP Ratios in CEE and NIS countries, 2003, (%)



Source: PFTS First Trading System, Ukraine

Principal participants in the Ukrainian securities markets are institutional investors, such as commercial banks, investment companies, pension funds, and insurance companies. Presently, most of the trading activity is in corporate bonds, followed by government bonds, then equities. The market is illiquid, thin, suitable only for long term, patient, and risk taking investors, and not for portfolio investors.

There are about 9000 open joint stock companies (JSCs) whose shares are publicly owned by 18 million shareholders, but only 300 of these companies are listed companies, and less than a dozen are actively traded. The market is fragmented into 9 stock exchanges, 375 registrars, and three depositories. Most of the trading is done off the exchanges, making price discovery very difficult.

Despite fragmentation and small size, the market has exhibited some opportunities for domestic institutional investors during the last four years. Domestic blue chips have traded at wide discounts relative to their Russian peer companies, the Ukrainian equity market valuation increased by 50% in 2002, and 40% in 2003, reaching its highest level since the 1998 financial crisis in Russia. However, the

[21] The largest one of these exchanges is the First Stock Trading System (PFTS) which carries 92 percent of all organized trading. PFTS is an SRO with a wide variety of market makers and participants in its membership structure. Other exchanges are: Donetsk Stock Exchange (DSE); Kyiv International Stock Exchange (KISE); Prydniprovsk Stock Exchange (PSE); Ukrainian Interbank Currency Exchange (UICE); Ukrainian Stock Exchange (USE); Southern Ukrainian Trade & Information System (SUTIS); Crimean Stock Exchange (CSE); Ukrainian International Stock Exchange (UISE). Organized exchanges represent only 25 percent of all trading. 75 percent of trades in Ukraine are settled off exchange or offshore.

growth is attributed largely to a low comparison base. The market's sustained growth is constrained by the serious problems already described. Even though the PFTS equity market index rose to its highest levels since the August 1998 crisis, the market was still 81% below its all-time high, posted in September 1997. Ukraine's securities market capitalization of US $4.8 billion is comparable to much smaller countries with a fraction of Ukraine's population, like Estonia with US $3.8 billion market capitalization, Lithuania with US $3.5 billion, and Slovenia with US $5.2 billion market capitalization.

However, Ukrainian stock prices likely do not reflect the underlying value of the enterprise sector. The primary reasons for lower valuation of Ukrainian corporate equities are the legal and political uncertainty, lack of transparency and disclosure, and consequent limited investment interest.

Bond Markets. Ukrainian bond markets are growing rapidly. The main *issuers* of bonds are corporations, the GOU, and municipal governments. The main *investors* in these bonds are the commercial banks, international investors, and domestic investment houses. The main *intermediaries* are commercial banks. The listing of corporate bonds permits commercial bank purchasers to avoid discounting the cost of the bonds for regulatory capital purposes. Nevertheless, the secondary market for the corporate bonds is largely illiquid since most purchasers buy and hold the bonds.

The first corporate debt instruments were issued during the 2000-2001 period, and have grown rapidly. As of April 2004, corporate bond trading dominated on the PFTS (63.4%), followed by Government bonds (16.2%). Even though corporate bonds are fast becoming the instruments of choice for trading with a market size of US $1 billion, (with PFTS equities at only 17% of volume) there is no standard benchmark, such as the yield curve, which can serve to benchmark corporate bond performance. While corporate bonds yields vary widely, a yield of about 18% is common.

The corporate bonds are an improvement from the previously favored instrument of tradable debt, the *"veksels"* (a quasi money instrument issued as promissory notes in commercial transactions). Corporate bonds are used mainly to cover the working capital needs of the export oriented larger companies. It is not clear how much of this newly created corporate debt is allocated for fixed investment capital, such as major machinery upgrading.

The growth of corporate bonds may pose a problem in the near future, when the positive environment of declining interest rates and inflation rates of the past three years turns around, and the terms of Ukrainian foreign trade reverses. When that happens, over-leveraged and noncompetitive Ukrainian enterprises may face serious difficulties in repaying the debt load. To date the corporate bond market has not reached dangerous proportions, but the financial sector must be cautious so as not to repeat the same mistakes that lead to the Asian financial crisis caused by excessive enterprise debt and excessive lending on the part of the nascent and undercapitalized financial sector.

Table 11:
Bond Market Comparison: Kazakstan and Ukraine

Factor	Kazakstan	Ukraine
Corporate bond volume as a % of GDP, 2001	2.58%	0.38%
Debt market as a % of total capital market, 2002	59%	22%
Corporate debt as a % of total debt, 2002	21.5%	16%
Outstanding corporate note and bond issues, 2002	$448 million (34 issues)	$109 million (47 issues)
Banking assets, 2002	$5.9 billion	$9.7 billion
Inflation rate, 2002	6.0%	-0.6%
Net spreads on bank rates, 2002	6.7%	15.88%
Estimated pension funds available for investment in corporate bonds, 2002	$1.2 billion	$3.3 billion
Establishment of private pension funds	Yes, since 1998	2004-2007
Estimated insurance funds available for investment in corporate bonds, 2002	$1.7 billion	$2.6 billion
Tax regime	0% for main types of investors (e.g., pension funds) and flexible limits for other institutions	30% for legal entities and 10-40% progressive rates for individuals with a proposal to reduce individual rates to 13%
Modern law on secured transactions	Yes	2004 laws have gaps & inconsistencies
Credit rating agencies	Yes	Not yet

Source: *Ukrainian Debt Markets: Analysis and Recommendations for Development*, Robert D. Strahota, U.S. Securities and Exchange Commission, June 2003.

"Municipal Bond Investors are Political investors"

"In some cases, municipal bond investors are driven by political, rather than economic motives. The placement of Kyiv municipal bonds had a political element, too. Three of the issue's underwriters – Ukrsotsbank, Ukrsibbank and Khreschatyk bank – bought Hr 100 million of the bonds. These bonds weren't actively traded, which would demonstrate that a real market exists. The Kyiv City Administration placed bonds with a 14 percent yield for the first coupon period; with each successive year, yields decrease by one percent. The bonds did not offer bondholders a put option, allowing them to cash in their bonds before maturity. It is not profitable for the investor, and very risky, to buy bonds like that in those conditions."

Vyacheslav Kharchenko, head of the Ukrainian office of Bonds, the Russian information agency, March 25, 2004.

Municipal Bonds. The Ukrainian municipal bond market began to develop when the city of Odessa issued a bond in 1997. The Odessa issue, worth Hr 61 million, had a yield of 50 percent. Battered by the 1998 financial crisis, Odessa defaulted on the loans. The city is still trying to pay off this debt burden, a process that should be complete by 2006. The Odessa fiasco, experts agree, froze the municipal bond market. The City of Kyiv issued a US $150 million Eurobond offering in the summer of 2003, which was subscribed to at an 8.75% yield, against the benchmark 10-year U.S. Treasury Bond then at 3.3%. The success, although limited and requiring a substantial premium of 545 basis points, changed the municipal bond market scene in Ukraine. The cities of Zaporizhya, Donetsk, Kharkiv and Odessa are planning to issue bonds in 2004 and 2005. The

current municipal bond market in UAH however, has yields between 14-15%, and this is inadequate to cover the risk premium. A domestic municipal bond rate, attractive enough to succeed, will likely need to exceed 18-20%. The Ukrainian municipal bond markets suffer from the following weaknesses:

- Ukrainian municipalities are financially weak, leaving investors skeptical about repayment;
- Most cities are dependent on the GOU budget for all their funds because Municipalities do not have taxation capabilities, other than in few areas. Furthermore, municipalities can not generate revenues for services;
- Municipal bonds are not secured by collateral and these bonds are high risk;
- The lack of transparency and good financial information about the municipalities increases risks, and therefore increases the required rates of returns by investors;
- The market for municipal borrowing is much less transparent than the market for corporate bonds;
- Municipal bond yields of 14% to 15% yields are low, compared to higher corporate bonds yields of around 18%;
- Ukrainian municipalities seek to issue bonds in small amounts, inadequate to attract international or domestic bond investors. Municipalities will need to create "municipal pools" to enter the municipal debt markets, and;
- City administrations have little financial management experience.

Depositories. There are three depository institutions in Ukraine, and for the size of the market this is too many. These depositories are the MFS (The Interregional Depository), the National Bank of Ukraine, and the National Depository of Ukraine (NDU). Clearing and settlement is done through MFS for corporate securities, the NBU serves as the depository for government bonds, the NDU has no other function but to codify all of the Ukrainian the securities, issuing each one with an electronic identification number. Most market participants agree that MFS and NDU are duplicative institutions, and suggest that they should be merged.

Pensions. Ukraine has passed important legislation on pension schemes, which is a combination of three pillars, consisting of public provision through the solidarity (pay-as-you-go) system, a publicly mandated private retirement savings of 7% of wages, and voluntary private retirement savings.[22]

The Law on Non-State Pensions came into effect in January 2004, and reflects sound policy in that only defined contribution schemes are permitted and all have to be fully funded. Mandatory accumulated pillar two funds are expected to commence

[22] The financial viability of the new public pension system has been controversial, and it is expected that pillar one pension system will face difficulties in paying the benefits when due. There are several possible reasons for the inability of the public pension system to pay the required retirement benefits when due. One is the rapidly aging workforce as a result of which the burden of the benefits will increase upon retirement. The second is the recalculation of the benefit amounts. Both of these factors are looming questions on the viability of the newly created system. Thirdly, when the mandatory accumulation system begins in 2007, the problem may be that the redirection of 7% of contributions to a funded system may lead to a shortfall in cash available to the Pension Fund of Ukraine to pay benefits.

sometime after January 1, 2007; voluntary third pillar schemes are permitted effective January 1, 2005. Based on experience of pension reform in other countries, it is estimated that third pillar contributions may be as high as 12% of wages commencing in January 1, 2006. It is estimated that this mandatory accumulated scheme will have monthly cashflows between 750 million to 1 billion UAH ($140 million to $190 million). Within eight years, the private pension system could surpass the assets of the current banking system.

These pillar two and three pension schemes will generate significant funds that must be invested. This aspect of the pension regulatory scheme assumes that the workers will take the performance risk of the fund, as well as the solvency risk of the management company. These various pension contributions will form a significant investable pool over time, commencing as early as January 2005.

This means that there should be a priority effort to assure that there is adequate financial asset management capacity, adequate supervisorial capacity by regulators and fund managers, adequate investment instruments in the markets, and educational efforts for contributors about their choices and control over the management of their pension assets. Coordination between the FSR, the MoF, the NBU, and the SSMSC should be improved so that they can play a more effective supervisory role in asset management and custody functions in the pension system, including the licensing, monitoring, and enforcement functions. The supervisorial capacity of the FSR needs to be rapidly developed.

Currently, a small number of privately run pension schemes operate, but there is little reliable data on this sector. It is estimated that 23 schemes are active, with total estimated assets amounting to UAH 55 million (US $10.4 million). The FSR is developing regulations on the formation of Private Pension Funds.

The current voluntary pension law requires minimum capital of Euro 500,000 for Ukrainian asset management companies, which is grossly inadequate by international standards. In EU countries, this capital requirement is Euro 5 million. Capital adequacy requirements should be adjusted in accordance with international norms.

Further, standards on liquidity, portfolio diversification, asset allocation, maturity and currency matching on voluntary pension funds must be improved. Currently the law sets investment limits for pension fund assets to be allocated as follows: bank deposits (cash or cash equivalents) up to 40% of the total; up to 20% in municipal bonds; up to 40% each in domestic corporate equities and bonds; up to 20% in foreign securities; up to 10% in real estate; and up to 10% in other assets. These requirements must be made more flexible, principally because Ukraine lacks investment opportunities sufficient for prudential diversification.

The transition of the existing non-regulated pension fund to pension funds, as required by law, should be vigorously supervised. The provisions for individual asset management choices within the second pillar that is envisaged for the future could be enacted sooner so that individuals would be allowed to have more choices in managing their own assets as in the voluntary third pillar.

The development of the funded pension schemes will also offer a major stimulus for financial engineering. The demand for financial instruments, coupled with the growing need for investment capital by the enterprise sector, should lead to development of new financial instruments such as mortgage backed securities, and new forms of bonds. One possibility may be to introduce new pension-insurance sector products and instruments, such as Guaranteed Investment Contracts or Bank Investment Contracts (GIC/BICs), to hedge risks of retirement benefits for large numbers of retirees at one point in time, without having to rebalance the risk adjusted portfolios. The insurance sector may be in a good position to issue the Guaranteed Investment Contracts or GICs for the pension funds.[23] Other financial products that could be developed as suitable investment vehicles may include, foreign exchange hedge bonds, convertible bonds, preferred equities, mortgage backed securities, and Real Estate Investment Trusts (REITs) to provide more financial instruments for allocating pension fund assets.

The new law on pensions may also provide a good opportunity for pension funds to be more actively involved in the corporate governance of companies in which they invest. Pension funds should actively pursue improvements in the governance of those companies whose stocks compromise an investment portfolios. One way to pursue improvements in this area is to clearly define the rights and responsibilities of pension fund board members. One flaw in the law that needs attention is that it currently has the "Trustee" of the private pension fund appointed by the employer, without the need for any "contributor" representation. This would permit pension fund trustees to become collusive among the big employers (you buy my shares and I'll buy yours) thus losing fiduciary responsibilities.

Insurance. The insurance sector in Ukraine is relatively small, but growing. Aggregate insurance sector revenues were about 1.9% of GDP in 2003. There are 338 licensed companies, which is high for the volume of annual premium revenues. Gross premium income has been growing at an average rate of over 50% for the last six years. According to the FSR and the Ukraine Insurance Association, the aggregate volume of paid-in statutory capital is about 1.6 Billion UAH, (US $302 million) and the equity base of all Ukrainian insurers is 3.2 billion UAH, representing a net growth of 1.5 times the previous year.

However, this increase is in large part the result of regulatory and tax arbitrage attributed to the banking sector: many insurance companies are linked to banks or corporations, which can find it attractive (for tax reasons) to transfer some operations or assets to their insurance subsidiaries. It appears that only one third of the total amount of the insurance premiums collected during 2003 were the result of classic insurance activities. The preponderance of insurance premiums were obtained as a part of a scheme to evade taxes and export capital overseas. This is typically done through foreign-based reinsurance companies, and unlicensed foreign entities, mostly located in the Baltics.

[23] GICs are insurance contracts that guarantee the owner principal repayment and a fixed or floating interest rate for a predetermined period of time. Guaranteed investment contracts are typically issued by insurance companies and marketed to institutions qualified for favorable tax status under federal laws. These products provide institutions with guaranteed returns. Pensions are the most likely institutions to make use of these instruments.

The FSR leadership has announced plans to curb the activities of such "pocket insurance" companies in order to help the growth of serious insurance business activity in Ukraine. Those insurance companies involved in money transfers to foreign locations will be expelled from the League of Insurers of Ukraine, and their licenses will be revoked. The FSR has taken the position that many purported insurance activities may be tax avoidance schemes, that will be examined carefully.

Problems in the Ukrainian insurance sector center around the severe undercapitalization of most firms, low liquidity, low creditworthiness, and issues of solvency and corporate governance. The demographics, family structure, and current political/economic environment also impede the further development of this sector. The FSR is expected to require an industry wide re-licensing and re-capitalization, coupled with license revocation for non-compliance. Instituting a regulatory system that will better enable the development of stronger insurance companies is the intended result.

The growth potential for the Ukrainian insurance sector is quite large. According to the Ukrainian League of Insurance Organizations (ULIO), only 5% of insurable risks are covered in Ukraine, compared with 90% coverage in developed countries. And life insurance accounted for less than 1% of all insurance premiums in 2003, compared to 50% to 60% in developed economies. ULIO estimates annual insurance premium growth for all insurance (life, property, casualty) will exceed 30% per year for the next decade. While this may be optimistic, and discounting for the tax schemes which do not reflect real insurance, nonetheless premium generation in excess of US $1 billion per year is possible. These funds must be prudently managed. This means that there should be a priority effort to assure that there is adequate financial asset management capacity, adequate supervisorial capacity by insurance regulators and insurance managers, and adequate investment instruments in the markets.

Leasing**.** The leasing sector is dominated by public-sector institutions, and in particular the state owned company devoted to leasing agricultural equipment, UKRA. Private-sector leasing activity remains modest, and according to the Ukrainian leasing association, Ukrleasing Association, approximately 50 leasing companies generated about US $13 million in leasing services. Ukrleasing Association is optimistic about growth potential, noting that Western Europe uses leasing at a rate of 25% of volume of investments, while Ukraine is at 1%.

Following the passage of the new tax and depreciation legislation this year, financial leasing activities have become more attractive, causing some foreign lessors to enter the market. The few international companies complain of being penalized for being transparent and following international accounting and reporting standards. Due to the perceived high risk of doing business in Ukraine, the fear that contracts will not be honored, lessors demand high required rates of return on their investment. As a result, lessors require high up front fees and high payments from lessees, which leads to an environment that debilitates an effective leasing sector because of costs.

Financial leasing is preferred over the operational lease. The process is that after qualifying the lessee, the leasing firm would borrow from the bank to purchase the equipment to be leased. A service contract is usually added on the contract to

increase the rate of return. Depending on the creditworthiness of the lessee, interest rates apply 11-20% in UAH currency terms. Industry participants assert there is potential for growth in this area. However, banks have not embraced significant leasing activity as a part of their business portfolio at this time. Another impediment is the tax treatment on operational leasing, which does not allow for more than 50 percent deductibility for interest paid on credit. Financial leasing is more attractive due to full deductibility. Depreciation rules are deemed adequate; allowing the leasing firms to apply accelerated depreciation over the life of the asset.

Credit Unions. The FSR estimates that there are approximately 160 viable credit unions, with total assets of UAH 265 million (US $50 million) as of April 2004 with an estimated 350,000 active members. The National Association of Credit Unions is comprised of 133 institutions with 171,000 members and UAH 200 million (US $37 million) in assets.

Credit unions have been providing most of the housing finance loans to their members for home remodeling, or loans for purchasing household appliances. Some of the remodeling loans may be reported as home mortgage loan transactions.

The FSR has now required all Credit Unions to reregister and submit financial statements and membership information by October 2004. After that, existing credit union licenses will be reissued or revoked. The growth in this sector will depend on well-defined niche market demand where commercial banks are slow to enter, and the effectiveness of the credit union leadership in creating a convincing membership structure. The FSR wants to encourage these developments.

Collective Investment Institutions. The Law "On Collective Investment Institutions (Unit and Corporate Investment Funds)" was passed by the Verkhovna Rada in 2001, and the SSMSC created the necessary normative framework. While presently this area of activity is not significant, it is developing. There existed investment funds and investment companies created during privatization for the purpose of collection of privatization property certificates and their investment in companies being privatized. Pursuant to the Law "On Collective Investment Institutions", these funds are either to be liquidated, or reorganized into the new type of investment fund. The collective investment institutions sector must begin to work actively in the securities market and influence its development.

Implications of Tax regime. The taxation regime on different investment instruments can readily skew individual investor's decisions. For example, interest income on bank deposits is not taxable for individuals; however, interest income from bonds is taxable at ordinary income tax rates. These disparities dictate investor behavior. Similarly preferential tax treatment for one NBFI institution over another (e.g. tax exemption for pension fund gains) will affect NBFI sectors growth. An examination of NBFI tax treatments is appropriate to ensure the economic policy objectives are fostered by tax policies.

Conclusion. Ukraine's NBFI sector is remarkably under-developed. This is a legacy of certain impediments already highlighted in the section on the legal and regulatory environment of Ukraine. Sustainable financial sector reform requires, and is only achieved along with, an effective legal regime.

Two NBFI areas poised for growth in Ukraine are the pension and insurance sectors. In the next few years, the pension industry will likely have approximately US $1.6 to $2.2 billion annually to invest. This means that there should be a priority effort to assure that there is adequate financial asset management capacity, adequate supervisorial capacity by pension and insurance regulators and fund managers, and adequate investment instruments in the markets. Coordination between the FSR, the MoF, the NBU, and the SSMSC should be improved so that they can play a more effective supervisory role in asset management and custody functions in the pension and insurance industries.

VI. Conclusions

In 2004, Ukraine's underdeveloped financial sector continues to retard opportunities for economic growth and poverty alleviation. There are three key dimensions of financial sector development: i) a legal and regulatory system to enforce property rights; ii) a multitude of financial intermediaries to allocate savings and investment, and; iii) an institutional infrastructure to address issues of moral hazard and limited information. Ukraine lags behind even its peer group of post-communist transition countries on all these financial sector dimensions. This lack of financial sector development constitutes the critical missing link to spur economic growth in Ukraine.

Ukraine's entire financial sector (banks, all NBFI intermediaries, securities and debt markets) is extremely small in terms of level of capital mobilized, number of financial intermediaries, market capitalization, and related indicators of financial development. The banking system accounts for 95% of all financial sector assets, but total banking sector capitalization is only about $2.4 billion, and total assets are only about $20 billion. One small/medium European bank has assets comparable to those of Ukraine's entire banking system. In recent years the NBU has received substantial support and technical assistance from international donors, and has made sound advances in its bank supervision capacities. Nevertheless, the Ukrainian banking system continues to exhibit vulnerabilities in terms of capitalization, risk management capacities, related party transactions, and operational inefficiencies. Access to bank credit in Ukraine is also extremely limited.

The Ukrainian NBFI sector, however, is even more seriously underdeveloped. At about 1-2% of GDP, its contribution to mobilizing capital (especially for SMEs) for economic growth is almost negligible. Ukraine's stock market is illiquid, very few equities are actively traded, and very little capital is mobilized for investment. Importantly, as the second pillar of the recent pension reform takes effect, an estimated $2 to $2.5 billion per year will flow into the mandatory contribution plans. In about 8 years, the private pension system could attain the size of the current banking system. It is therefore critically important to provide for sound and prudential regulation of the NBFI sector, and also to develop the institutional capacities of pension funds and asset management companies. Likewise, there is an urgent need to develop and market new financial instruments appropriate for contractual savings institutions (pensions and insurance companies) to meet prudent asset allocation and diversification standards. Developing the NBFI sector so that it can mobilize capital, create jobs, and stimulate economic growth is a high priority.

Ukraine's laws, regulations, and enforcement practices governing financial market activities are inconsistent, permit overlapping jurisdictions, are not harmonized with international standards, and generally fail to create the climate of "confident expectations" critical to investment decisions. A recent example of this problem is the near simultaneous passage of new Civil and Commercial Codes, which frequently conflict with one another on key business provisions. And even if Ukraine's laws were model statues, enforcement would remain problematical because of weaknesses in both the judicial and regulatory systems.

The Ukraine landscape is not entirely barren. Significant new laws have been adopted over the last four years to improve the legal framework for property rights. The NBU has taken positive strides toward improving the soundness of the commercial banking system. A well-developed institutional framework for the securities market (depository and clearance and settlement, trading systems, broker-dealers) exists. In 2002, a new regulator for the NBFI sector became operational, and is exhibiting strong indications that it will address serious problem areas while also establishing the foundation for prudential growth. Finally, the development of a new private pension system has the potential to spur NBFI development and also introduce reform to Ukraine's corporate government practices.

Given the criticality of financial sector development to economic growth in Ukraine, FMI recommends that USAID/Ukraine continue its efforts in support of financial intermediation and broadening access to capital. Based on its foregoing financial sector assessment, FMI suggests that USAID/Ukraine, in collaboration with other international donors, consider an initiative consisting of a series of interconnected activities to develop the NBFI sector. The main components of this effort would include:

1) General assistance and support to continue to improve the legal and regulatory framework for the financial sector (especially in terms of financial disclosure);
2) Targeted technical assistance to the NBFI regulator, the FSR, so that it can strengthen the legal and regulatory and enforcement capacities to maximize sound financial intermediary development. Where possible, integration of the SSMSC into this technical assistance will be important due to the regulatory overlaps and need for improved coordination, and;
3) Provision of technical assistance to selected NBFI sector industries (especially pension and insurance, but also incorporating capital markets institutions such as PFTS, MFS and PARD) to enhance their operational capabilities in order to broaden access to credit and deepen financial intermediation for economic growth.

The three components are intrinsically linked, and progress in one will stimulate positive impacts in related financial sector areas. For example, effective and transparent securities markets are essential to develop the investment capacity of insurance companies and pension funds. Likewise, as pension funds become important participants in the capital markets, corporate governance becomes more effective and reinforces the transparency and accountability essential to financial disclosure and financial markets development. Finally, a robust, properly regulated NBFI sector contributes to financial sector deepening and to banking system efficiency and soundness.

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