Focus
Ukraine

Markets
Debt markets

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Local Fixed Income Market

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The sixth annual Ukrainian Financial Forum organized by ICU was held on 27 September in Kyiv. This year's forum was dedicated to the domestic bond market, which has received significant impetus due to unprecedented demand from foreign investors for the government's UAH-denominated bonds. Perspectives and development of the domestic bond market were discussed on the majority of the Forum's panels.

Trade wars between the US and China were in the spotlight of the Forum's discussion on the global macroeconomy for the second year in a row. Substantial monetary easing in these two countries has set the trend of declining interest rates in the world. This results in escalating hunt for yields in emerging and frontier markets.

Ukraine is one of the main beneficiaries of this trend. The country's robust economic fundamentals, prudent fiscal and monetary policies, high yields and simplified access to the market through a Clearstream link have led to a 15x increase in foreign investors' portfolio of the government's domestic bonds to nearly UAH100bn or $4bn this year. However, Ukraine must also accelerate reforms and finally open the long-awaited land market, conduct privatization and liberalize labor relations, and get rid of its curses: weak legal protection, monopolies and corruption.

The Ministry of Finance of Ukraine declared ambitious plans for developing debt markets and decreasing the debt-to-GDP ratio to 43% in the next three years. New technology in the primary market, tight policy for primary auctions should provide more development opportunities for the secondary market of government paper. On the other hand, high real rates will continue to attract foreign investors, add demand in the secondary market, and increase market liquidity.

Further development of infrastructure will help to significantly increase investments in the domestic bond market. Extending the cooperation with Clearstream will allow DVP settlements for non-residents and launch the corporate local bond market. Ukraine's cooperation with Bloomberg will raise the market functionality to a new higher level with the launch of the Bloomberg Auction Systems platform for the primary market on 1 October and the launch of the EBND platform for the secondary market in the near future. For individuals, one of the most important infrastructure features is the development of the Bank ID system, which will significantly expand the geography of investing as it does not require physical verification of customers. Other key focus areas include introduction of online government bonds and tax amnesty.

The coming adoption of the law on derivatives is expected to revolutionize the financial market soon. Together with the future implementation of ISDA and GMRA standards, this will give the market new functionality, a new level of protection, and new services that will boost inflows from long-term portfolio investors.

Keynote Speech: Macroeconomic Challenges and Opportunities for the Global Economy

The Sino-American standoff dominated the Forum's discussions on the world economy for the second year in a row. **Dr Gerard Lyons,** leading international economist and expert on the global economy, Board member of the Bank of China (UK) and Chief Economic Strategist at Netwealth, identified three factors that led to the slowdown of the world economy last year: the trade dispute between the US and China, and monetary policy tightening by both the Federal reserve and the People's Bank of China. We now see a turnaround in both countries' central bank policies making way for lower interest rates. In emerging markets, real interest rates are now 200 bps higher than in developed economies, some of which have plummeted below zero.

Ukraine has benefited from the global run from negative yields

Currently, up to US$15trn of debt have negative yields, which reflect the views of ultraconservative investors. Others, however, are rushing for higher interest rates. Ukraine has clearly benefited from this trend as investors became evermore interested in its government domestic bonds. On the other hand, the search for yield has pushed term premiums into negative territory along with issuers coming out with longer and longer maturities.

Dr Lyons stressed the shift in the balance of power. Most economic growth is expected to come from emerging markets led by China. The EU will generate less than 20% of global growth in the years to come. This year, growth in China will fall to 6–6.5%, but what is considered to be a slowdown in the 30-year growth cycle will be the equivalent of adding a Netherlands or Saudi Arabia to the Chinese economy. The Chinese yuan exchange rate also remains one of the most important indicators in this market.

Brexit has become a very politicized issue, Dr Lyons argues. He expects it will benefit the UK, which will be able to cut better deals with the rest of the world and play a more vital role in world politics, including mediation of the US–China standoff as an independent player rather than as part of a 28-country union. The EU intends to be very protective of its agricultural sector, which is not as vital for the UK economy. This potentially can lead to Ukraine having a better trade deal with the UK than it has currently with the EU.

Keynote Speech: Macroeconomic Challenges for Ukraine

Ukraine has managed to earn investors' confidence through reforms …

Sergiy Nikolaychuk, Deputy Minister, Ministry of Economic Development, Trade and Agriculture of Ukraine pointed out that Ukraine has managed to gain investors' confidence in recent reforms as well as expectations that these reforms will speed up and continue. Favourable external conditions and sound macro management brought Ukraine back on the radar of international investors who have invested around UAH100bn (US$4bn) into Ukrainian domestic government bonds.

Ukraine's GDP per capita remains among the lowest in Europe, but Mr Nikolaychuk believes the country can turn its weaknesses into strengths since it is easy to bounce from a low base. However, the country is still struggling with obstacles it has had for years: corruption, a weak legal system, monopolies, and a state dominated by oligarchs in addition to the military conflict with Russia.

… yet the expected transformation must speed up

Mr Nikolaychuk expressed great hopes for the introduction of a land market. Reform, which has been halted for two decades, could add several percentage points to the country's GDP growth. Investments into the sector would improve crop yields in wheat and other major agricultural products. Privatization has been a failure for the last several years, generating negligible proceeds as no major SOE became private. A more liberal labour market should encourage business to hire more people officially, therefore, decreasing the official unemployment rate.

Keynote speech: Development of the Ukrainian Public Debt Market

The Ministry is going to develop a domestic bond market and investor relations

Yuriy Butsa, Government Commissioner for Public Debt Management, explained the Ministry's plans and debt strategy for the next several years. The key objectives are to increase the share of UAH-denominated debt, smooth the debt repayments profile with maturity extensions, attract long-term concessional financing, and develop investor relations.

Ministry will decrease debt-to-GDP ratio, and also increase UAH-denominated debt share

The Ministry plans to decrease the debt-to-GDP ratio to 43% by 2022 (excluding state-guaranteed debt) down from 52% as of end 2018. To meet this goal, from the debt side, they are going to increase the share of UAH-denominated debt and decrease the share of domestic FX-denominated bills. Eventually, these instruments will only be issued in hryvnia. However, currently, banks do not have alternative instruments for FX-denominated funds.

Foreign investors still invest in domestic debt due high real rates, despite their decline

Very important is to increase the participation of international investors in the domestic market. This category of investors significantly increased their presence in UAH-denominated debt to about US$4bn this year, and expected to keep building up their portfolios. The main reason is the level of interest rates. Real rates in August 2019 were about 6.7%, down from 9.4% seen in March 2019.

The MoF will offer bonds up to three years and cap amounts, giving chance for secondary market development

Mr Butsa said that one of the main complaints from the market is that the Ministry satisfied most of demand at the primary auctions, which does not allow the development of a secondary market. The Ministry will remedy this by capping offerings and decreasing the number of bonds it offers in the primary market. By the end of this year, the MoF will borrow about UAH50bn (US$2bn). They will not issue five-year notes, instead keeping the offerings to three-year maturities. Also, Mr Butsa announced that the Ministry will start to hold primary auctions via the Bloomberg terminal starting 1 October 2019.

Panel 1: Overview of the primary and secondary local bond market

Secondary bond market is the most important at the current stage of development

The key points made by the panel were about developing a domestic-bond secondary market. To do so, it is very important to develop market infrastructure, transparent pricing, and secondary market liquidity. All speakers were unanimous that secondary market trading on Bloomberg will have a positive impact on market development. A very important step will be having quotes and deal amounts listed via the Bloomberg platform.

Market liquidity can be improved by MoF's active operations in the market, but NBU disagrees with this idea

The discussion participants pointed out that the domestic market has low liquidity due to a shortfall in long-term funding, which could have come from NBU certificates of deposits and from active operations of the MoF in the bond market. A Debt Management Agency should be created to actively participate in the secondary market. On this point, the NBU disagrees due to its current monetary policy design, which requires liquidity concentration in NBU.

Panel 2: Trends and opportunities for retail investors in Ukrainian securities and stocks

Investing only 10% of foreign cash held by population will make individuals one of the main owners of govt bonds

The NBU estimates the amount of foreign cash held by the population to be US$86.3bn, which actually exceeds the national debt of Ukraine. Investment of only 10% of this amount would make individuals one of the largest holders of domestic government bonds in Ukraine, so it is difficult to overestimate the importance of developing the infrastructure for retail investors, according to **Yevgeniya Gryshchenko**, Head of Brokerage Services Department, ICU.

Expanding Bank ID is one of the top priorities for retail market development

Kateryna Rozhkova, First Deputy Governor, National Bank of Ukraine, believes that expansion of the Bank ID system is a priority for the development of this market. Given that banks are reluctant to share customer information with other banks or non-banking organizations for free, the NBU is currently developing a system of fees for Bank ID members for using the service, which should increase the number of program members. Ms Rozhkova also emphasized that the existing law on financial monitoring of individuals is not working as it should. To simplify the process of financial monitoring, the NBU is preparing a bill that will divide individuals into three groups: 1) high-risk clients including public officials; 2) people living on salaries and retirees, and 3) small and medium-size businesses. The first group will be tested more thoroughly, while the second two groups will have a simplified procedure.

The NBU is preparing a new law on financial monitoring to simplify the procedure

The introduction of online trading and a tax amnesty will be important drivers of retail-market development

Yevgeniya Gryshchenko believes that apart from the development of Bank ID, which will significantly expand the geography of investing as customers will not need to be physically verified, other drivers of retail market growth will be the introduction of online trading of domestic government bonds (e.g. through mobile applications), and tax amnesty. Obstacles to the development of the retail market are the need to file a tax return when investing in government bonds, and low public awareness of government bonds.

Amnesty tax bill suggests a tax rate of only 2.5% when investing in government bonds

Natalia Rudenko, Senior Manager, Deloitte Private, added that another incentive for individuals investing in government bonds is the absence of a personal income tax, while the tax amnesty can significantly increase the volume of investments in government bonds. The draft bill of the amnesty tax law suggests a tax rate of only 2.5% if legalized money remains abroad, but is invested in Ukraine's domestic government bonds. However, if they are not invested in government bonds, the rate increases to 10%. At the same time, Natalia Rudenko noted that tax amnesty has not had much success in other countries, primarily due to the lack of confidence in local governments and lack of understanding of how legalization of funds will be controlled in the future.

Panel 3: Institutional investors in Ukrainian financial market

Ukraine's strong fundamentals, high yields, and simplified access boosted this year's inflows from foreign investors into Ukraine's domestic government bonds

In the third panel, representatives of various institutional investors shared their vision of the Ukrainian capital markets. The views of foreign investors were summarized by **Martin Bloom**, Head of Desk Strategy, Raiffeisen Bank International. He believes that this year's inflow of foreign investments into Ukraine's local government bonds was caused by a combination of several factors: strong fundamentals, high yields, and simplified access thanks to the opening of a link with Clearstream. These factors, as well as clear fiscal and prudent monetary policies, make Ukraine one of the top destinations for foreign investors, Bloom said, while the inclusion of Ukrainian government bonds in international indices and increased liquidity will further increase investment inflows. **Vadim Samar**, Head of Asset Management, National Bank of Ukraine Pension Fund, added that local investors, especially non-state pension funds (NPFs), are also interested in government bonds. In this connection, he stressed that the current limit of 50% of government bonds in the portfolio of NPFs impedes the development of the market, since for the duration of two to three years, there are practically no alternatives for T-bills in Ukraine.

Deposits will continue to dominate assets of insurance companies

Corporate clients prefer to invest in overnight deposits or place funds in current accounts with banks, which pay interest on these funds

At the same time, insurance companies and corporate clients are less optimistic about T-bills. **Konstantin Lykhytsky**, Head of Treasury, ARX, says that due to the special relationships between insurance companies and banks, deposits will continue to dominate their assets. Insurance companies are now sidestepping government bonds because of large spreads and poor understanding of these instruments, so he expects that insurance companies' investments in government bonds will remain at their current levels in the near future. **Maria Kotlyar**, Head of Treasury, Head of Department of Strategic Planning and Financial Transactions, Farmak, emphasized that corporations invest mainly in short-term instruments because of investor insecurity and high risks in Ukraine. She identifies two groups of financial instruments: 1) fixed-term instruments including deposits, T-bills, and repurchase transactions, and 2) more liquid — placement of funds in current accounts with banks, which pay interest on these funds, and overnight deposits. Given that the returns of the financial instruments in the second group are now higher than those of T-bills, corporations invest more in them.

Long-term instruments have low liquidity, while there is currently no demand for corporate bonds

The panelists noted that short-term instruments in the Ukrainian market have quite high liquidity, but with the increase of the investment term liquidity declines, while spreads widen significantly. Development of derivative instruments, increasing the number of investors, and creating a single platform for transactions in financial instruments can help to solve this problem. The panelists also agreed that corporate bonds will not be in demand in the near future with either local or foreign investors.

Panel 4: Local bond market infrastructure: What's new?

The next stage of cooperation between Ukraine and Clearstream may be the introduction of trade in local corporate bonds

All panel members noted that the growth in the portfolio of foreign investors of almost 15 times this year was possible due to the establishment of a direct link between the NBU depositary and the international depository Clearstream. **Serge Christ,** Vice President of Network Management, Clearstream, is looking forward to the next stage of cooperation with Ukraine, including local corporate bond trading and the delivery-versus-payment (DVP) method. To do this, Ukraine needs to do some homework.

Thanks to the work of the NBU, individuals will soon be able to trade government bonds with mobile applications

Head of the Depository Division of the National Bank **Andrey Suprun** notes that Ukraine keeps moving toward integration into the international financial infrastructure. The central bank focuses on simple but reliable mechanisms so that foreign investors could buy Ukrainian financial instruments without obstacles. The NBU is currently in dialogue with the international depositary to explore new opportunities. The NBU has established API interaction with its depository accounting system for depository institutions. This will make it easier for the market to develop mobile applications, which will very soon allow individuals to buy T-bills with just a finger swipe and a click.

The secondary market urgently needs a system of constant quotations

Daria Dergunova, a specialist in electronic platforms at Bloomberg, in turn, confirmed that starting 1 October, primary government bond auctions will be held via Bloomberg Auction System. As for development of the secondary market, it is impossible without the introduction of a system of constant quotations. This is particularly important for involvement of foreign investors. For that purpose, Bloomberg plans to introduce in Ukraine its EBND system, testing of which has already been started in cooperation with Ukrainian primary dealers.

Panel 5: Future of the derivatives market and the introduction of ISDA and GMRA

The adoption of the derivatives law will soon revolutionize the financial sector

The availability of effective derivative instruments is an important prerequisite for the development of the financial market. **Timur Khromayev**, chairman of the National Securities and Stock Market Commission, stated that unfortunately in the last four years, the financial market has not actually developed because of the inherited archaic financial law. But over the past two weeks, there have been more changes in financial legislation than during the previous five-year parliamentary term. Therefore, market development will accelerate significantly. Mr Khromayev is looking forward to adopting the law on derivatives: it is currently being finalized to be tabled next week, and it may revolutionize the financial sector. Regarding ISDA and GMRA structures, all the key domestic financial institutions need to meet and form an association to write the relevant regulations. It will give new functionality, a new level of protection, and new services that have never been in Ukraine because market participants have always treated infrastructure as a secondary issue. We have now reversed this attitude because the market must be built on a stable foundation in order to increase liquidity and bring long-term portfolio investors to the market.

One of the most important conditions for developing a derivatives market is effective liquidity movement, sound monetary policy, and sufficient institutional capacity.

Andrei Shinkevich, Senior Vice President, Frontclear, believes that movement of liquidity from one bank to another is one of the most important functions of derivatives. Therefore, the Ukrainian financial market needs first such derivative instruments as interest rate swaps and currency swaps. In this respect, the monetary policy currently pursued by the NBU is very important for the market. Adequate institutional capacity is also crucial: all market participants must feel confident in dealing with documentation and interacting with counterparties, accountants and auditors should know the place of derivatives in financial statements, and tax officials and tax advisers should correctly interpret derivative transactions. Overall, improving the marketplace is an ongoing, long-term project that can take years.

Andriy Potapov, Head of the Financial Markets and Treasury Department, ING, noted that after the law on derivatives is passed, interest derivatives and options would not automatically appear in Ukraine. In reality, this will greatly depend on the pace of development of the financial markt and its economic base. For example, use of interest rate swaps will become possible if interest rates decline substantially and the real mortgage market evolves. That said, Mr Potapov is confident that these processes will accelerate as soon as the next year.

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