Ukrainian Financial Forum. Day #2

City of Odesa 30 September 2016

Panel discussion №3: Development of financial instruments: current situation and outlook

Panel participants:

Yuriy Butsa *Deputy Minister of Finance,*
Dmytro Tarabakin *Commissioner of NSSMC,*
Ruslan Demchak*, MP, Deputy chairmen Parliamentary committee on finance and banking policy*
Mykola Selekhman*, Deputy Director of the NBU Department*
Nazar Chernyavsky*, Partner of Sayenko Kharenko*
Oleg Serdyuk*, Head of Fixed Income and Equities at OTP Bank*
Ruslan Kilmukhametov*, Director of Debt Capital Markets at ICU.*

The second day started with the third panel discussion on the bond market, which centered on domestic government bonds and bonds issued by IFIs[1] denominated in local currency.

During the first part of this panel, which was moderated by financial journalist **Daryna Marchak**, the speakers focused on government borrowings, perspectives on the development of the government bond market, its infrastructure, and the MoF's borrowing policy. Speakers noted that the NBU and the MoF declined the monetary financing of the state budget, which resulted in changes in the structure of demand for new bonds. With increased market demand, the MoF significantly changed the maturities of offered bonds to longer terms. This allows the MoF to borrow about UAH35.5bn in local currency and US$2.5bn in US dollars from the domestic bond market. As Yuriy Butsa noted, between now and the end of the year, they need to borrow less than UAH10.0bn and slightly more than US$100m. This change insures that the MoF's borrowings plan will be fully funded.

Predictability in the MoF's actions, offering of a wide range of bonds, and renewing communication with primary dealers has had a very important and positive influence on the bond market. Banks and NSSMC[2] agree with this policy and support the MoF. **Oleg Serdiuk** and **Dmytro Tarabakin** noted that market demand now is slightly reallocated to longer bonds, with a preference for FX-denominated bonds and local-currency bonds with 20-year and 3-year maturities.

At the same time, the main problem for the market remains its infrastructure, participants of the discussion noted. A developed market for insurance and non-government pensions funds could become a source for long-term liquidity for long-term bonds. To accomplish this, market liquidity of bonds must be improved. An important step toward this goal would be introducing market-makers, which the MoF along with the NBU and NSSMC, are currently working on. Market-makers will also allow the MoF to see indicative levels of yields for new issues, and the spread between bid and ask YTMs[3] will tighten, providing investors with more attractive conditions of a secondary bond market.

During the panel discussion two multi-option questions were fielded. The first one was in the form of a question: when will the Ukraine government make a return to the Eurobond market with a sovereign issue? The audience responded this way: 46% voted for 2019, 37% voted for 2018, and only 17% thought that it could happen next year.

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[1] IFI – International financial institution.

[2] NSSMC – National Stock and Securities Market Commission, Ukraine's securities market regulator.

[3] YTM – yield to maturity.

The second one was regarding Ukraine's warrants or VRI[4], and participants had to choose the scenario of future economic development with an estimate of re-payments size. Only 16% of the voters anticipate that Ukraine will pay much on this instrument, while 34% of voters anticipate no significant payments. Fifty percent of the voters thought that Ukraine would not pay at all, hence, it will seek restructuring of this debt. Twenty-two percent thought that this would be caused by slow economic growth, and 28% thought it would be due to new debt restructuring by 2021.

Commenting on these results, **Yuriy Butsa** noted that the main problem is in liquidity management. His main point was that if effective budget liquidity management is built, it will create a mechanism for buying back any instrument in the market. This process of liquidity management development is difficult and takes a long time. **Mykola Selekhman** also noted that although the level of economy growth will be slow, repayments may be necessary due to possible growth volatility, and this could be the reason for a VRI buy-back.

The second part of this panel was about new corporate bond issuance, including bonds issued by IFIs. Panel moderator **Sergiy Lyalin** noted that the EBRD had significant experience in local-currency bond issuance in different countries, e.g. Rusia, Georgia and Armenia, but the Russian experience was not very successful.

In **Ruslan Kilmukhametov's** opinion, the main problem is segmentation in banking-sector liquidity. About 48% of total reserves is on the books of the state-owned banks, 25% in banks with foreign capital and only 11% in local banks. In each country where EBRD bonds were introduced, new standards were required by the EBRD, which followed Best World Practice, infrastructure, and also availability of a market indicator for a flexible interest rate benchmark. However, Ukraine does not have this benchmark. This is required for the money market and bond market too. So, issuance of these bonds won't be actively discussed until market reforms are in place that build a bridge between the investor and borrower.

Nazar Cherniavsky noted that the EBRD has been pushing Ukraine toward changes in the bond market and developing new market infrastructure. The EBRD wanted to issue its bonds in local currency 10 years ago, but Ukraine was not ready for it then. Now Ukraine is; however, EBRD currently has less interest.

At the same time, **Ruslan Demchak**'s opinion is that the main step now has to be adopting a law for special types of bonds, which will improve investor protection, and bring Ukraine in alignment with Best World Practices, which will widen the investors base for EBRD bonds. He also noted that the main steps would be to improve the markets' transparency and, as the result, we will see new bonds at the market.

[4] VRI – value recovery instruments, which provide investors with revenue stream if real GDP growth qualifies a certain criteria.

Panel participants:

Jerome Vacher, *Resident Representative, IMF in Ukraine*

Timur Khromayev, *Chairman of the National Securities and Stock Market Comission*

Oleg Churiy, *Deputy Governor of the NBU*

Olexiy Kyi, *PARD President*

Oleksii Petrashko, *Head of the Board, AUST*

Panel discussion №4: Institutional capacity of capital markets regulators

This panel discussed the proposed legislation that will strengthen powers of the National Securities and Stock Market Commission (NSSMC). Consensus among market participants is that the commission has all the power it needs. There is concern that the Commission may abuse additional authority.

NSSMC insists that it lacks institutional capability to regulate the market, eliminate securities fraud and punish violators. The moratorium on inspection does not allow for proper oversight over market participants. There are procedural issues with NSSMC being subject to approval from the Ministry of Justice that significantly slows the process. Therefore, the securities market has not seen a cleanup comparable with that of the banking sector.

The Commission aims for joining the IOSCO's Multilateral Memorandum of Understanding. NSSMC believes joining will encourage foreign institutional investors to access the Ukrainian market. It also implies Information exchange between the regulators of the member states that will facilitate investigations of fraud in the future. Currently, all European countries except Ukraine and Belarus have signed the Memorandum.

The IMF considers these legislative changes to be largely overdue and the Commission should be able to perform audits and inspection. Funds were provided for technical assistance earlier this year.

Market participants believe that the Commission already has enough powers. Any further strengthening of its authority should come with increased accountability from both the institution and its individual members. Currently, NSSMC gets reports on every security transaction. There is a concern over confidential data to which the Commission will acquire access. Market participants advocate for ability to access such sensitive information upon special permission granted.

Panel participants:

***Olexandr Panchenko**, Commissioner, National Securities and Stock Market Commission*

***Olexandr Zaletov**, Comissioner, National Commission for State Regulation of Financial Services Markets*

***Andriy Bakhmach**, Advisor to the Vice Prime Minister of Ukraine*

***Konstantin Stetsenko**, Managing Director, ICU*

Moderated by

***Dmitri Lazarev**, member of the board ACI Ukraine*

Panel discussion №5: Institutional investors as a basis of revival of the Ukrainian capital market

The fifth discussion panel continued the discussion started in the third, which was about market infrastructure and institutional investors, who could become very important long-term participants.

First, there was a discussion about a split of NCSRFSM[5] between NBU and NSSMC[6], securities markets regulator. **Olexandr Zaletov** noted that the split is a public call, and this move represents a beginning stage in the development of one mega regulator under the NBU umbrella, which will include all functions of NSSMC and the NBU. **Olexandr Zaletov** and **Olexandr Panchenko** think that this split of functions and their transfer to NSSMC and the NBU will improve market regulation, as the standards of these two regulators are better than NCSRFSM. At the same time, **Andriy Bakhmach** noted that we should not forget about the interaction between the two regulators.

The moderator asked all participants of UFF[7] to vote for what they think would have to be done to attract foreign investment. The most important step was to reform the judicial and law enforcement system (44.9% of votes), 30.6% voted for stable and sustainable economic development, while 22.5% did not see anything attractive about investing in Ukraine any time soon.

But the speakers noted that the main problem for all investors is the lack of attractive instruments in the market, which referred back to the discussions of the third panel. As an example, Zaletov noted that insurance companies have improved their assets, but the list of trusted and safe instruments is very short.

Panchenko described perspective regulation changes scheduled through 2020, including implementation of European rules. Also, he described the current situation in the non-banking sector. According to recent statistics, with the quantity of licenses of AMCs[8] and NPFs[9] falling, investment funds hold just a very small part of the public-issues market. At the same time, Panchenko noted that out of all non-banking investors a large part of their portfolios include securities that are fraudulent, and the market should be cleared of these securities and companies.

Konstantin Stetsenko spoke about positive aspects of the market, as the real market is maturing. Investment structure is becoming more secure, some government bonds were up, although some stocks are falling significantly. He was in agreement with other speakers that markets need more instruments: a wider range of secure investments and securities. He also noted that large companies have started to use REPOs as alternatives for deposits.

Referring to the third panel, Konstantin Stetsenko noted that the market needs new hedging instruments. It also needs derivatives laws adapted to developing market infrastructure.

[5] NCSRFSM – National Commission for the State Regulation of Financial Services Markets, Ukraine's regulator of (non-banking) financial markets regulator.

[6] NSSMC – National Stock and Securities Market Commission, Ukraine's securities market regulator.

[7] UFF – Ukrainian Financial Forum.

[8] AMC – asset management company.

[9] NPF – Non-pension fund.

After this is put into effect, it could be adapted to the OTC market, and two or three years later, at the stock exchanges.

A potential source for the market development, as described by Andriy Bakhmach, is pension reform. He feels the current pension system needs to be strengthened, and after this takes place, a second level pension system could be launched. Currently, the pension fund deficit is too large, but in the future, launching a second level pension system would generate a very significant source for long-term investments.

Panel participants:

Hannes Takacs, *Associate Director, Local Currency and Capital Markets Development, EBRD*

Dmytro Tarabakin, *Commissioner, NSSMC*

Mykola Selekhman, *Deputy Director of the NBU Open Market Operations Department*

Yuriy Shapoval, *CEO, Settlement Centre*

Andrii Porada, *Member of Executive Board, National Depository of Ukraine*

Stanislav Shishkov, *CEO, Stock Exchange Perspektiva*

Oleg Tkachenko, *CEO, Ukrainian Exchange*

Bohdan Lupiy, *CEO, PFTS*

Panel discussion №6: Ukraine’s capital market infrastructure

The problems with Ukraine’s capital market infrastructure is one of long duration and a solution is far from being near.

Ukraine has far too many exchanges, which results in liquidity being modest at all of them. Considering the decreased Ukrainian market volume, local exchanges have little opportunity to grow and develop. Developing a strategy to consolidate these markets seems an obvious solution for the regulator. According to Strategy-2020, it should be agreed upon by June 2017. Market fragmentation is a major concern for the advisors from the EBRD, as they advocate for economies of scale.

Stock exchanges can earn income from clearing by acquiring stakes in the Settlement Centre (SC) or Central Clearing Party (CCP). The SC is likely to give up its general banking license.

The largest exchanges are very cautious in regard to the proposed changes. They view lack of decent issuers as the biggest problem of Ukrainian stock market rather than poor infrastructure or fragmentation. Increasing regulatory requirements give issuers initiative to scale down to private companies or LLCs.

Disclosures

ANALYST CERTIFICATION

This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

EQUITY RATING DEFINITIONS

Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

Hold: Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

Sell: Forecasted 12-month total return significantly less than that of relevant benchmark

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