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UkrFinForum-2021

30 years of financial independence

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ICU's seventh annual Ukrainian Financial Forum was held on 3 September in Kyiv. This year's Forum assessed the condition of Ukraine's economy, how its financial markets have evolved over 30 years of financial independence, and discussed key issues and outlined what needs to be done to further develop Ukraine's capital markets.

Forum participants took a close look at challenges brought by COVID-19 to the global economy. Authorities of the world's leading economies were quick and decisive in responding to the pandemic crisis by relaxing monetary and fiscal policies. However, the amount of liquidity created by such policies has boosted inflation to multi-year highs, and there are numerous factors that may cause high inflation to last much longer than regulators expect. Governments and central banks need to be decisive and quickly taper stimulus in order to prevent spiralling inflation.

Ukraine was much better prepared when COVID-19 hit than it was for previous crises not least because of a sound banking system and macroeconomic stability that had been achieved pre-crisis. However, the country is still lagging way behind its neighbours in Central and Eastern Europe. The speakers were unanimous in advising that there are no unique or innovative strategies for Ukraine to catch up other than adhering to those already addressed in previous year's forums: an emphasis on the rule of law, improving the business climate, prudent monetary and fiscal policy, and anticorruption reforms.

According to the vast majority of Forum participants, the most important reforms for the financial sector are judicial reform, pension reform, and the restart of the commodity and stock markets. The Ministry of Finance plans to launch the second level of the pension system in 2023–2024. This, together with the new law on capital markets becoming enforceable, should considerably boost development of financial markets.

Not least in importance for the market is the participation of retail investors. As was brought out during the Forum's discussion, the main obstacles to retail participation are low financial literacy and lack of a wide range of instruments offered in the market. One of the solutions is development of an online investment space, even more important in these times of the COVID-19 pandemic. To facilitate retail investors' access to the market, it was widely agreed that regulators should reduce the level of bureaucracy in procedures.

Liberalization and deregulation are also critical for the domestic bond market, which lacks variety of available instruments and remains dominated by government paper. Corporate bonds are very limited due to lengthy and complex procedures for issuance, while taking a bank loan is less risky and more understandable for the borrower. The central bank and the Securities Commission reassured the audience that they are working on facilitating procedures for corporate bond issuers. As for the Ministry of Finance, it confirmed intentions to boost market liquidity by issuing inflation-linked and other index-linked bonds once it sees enough demand. And on the demand side, insurance companies said they are ready to invest not only in government bonds, but also in corporate bonds of state-owned companies, municipal bonds, and even foreign securities.

Keynote Speech: Global economic challenges in a post-pandemic world

Recovery was fast due to massive monetary and fiscal stimulus…

Monetary and fiscal stimulus helped countries navigate through the economic slowdown, but they must be very careful as the risks of high and persistent inflation are very real. **Poul Thomsen**, IMF European Director (2014–2020), argues that the authorities should be quick rather than slow in getting their economies off the stimulus.

Recovery from the pandemic was much faster than expected due to relaxed monetary and fiscal policies, especially when compared with the 2008 crisis. That response managed to prevent spill-over from the real sector into the financial sector, which would have been much harder to deal with. Moreover, equity, debt, and real estate valuations have surged to historic highs. Society has managed not only to overcome a once-in-a-lifetime challenge, but to emerge from it wealthier than before. Although, obviously, that would not be true for everyone.

… but the amount of liquidity created will result in lasting inflation

Enormous assistance was provided throughout world economies. For example, stimulus in the United States was three times the amount of the GDP slack in its economy. The Biden administration is preparing an infrastructure bill that will considerably add to the stimulus the economy already received. However, as a result of so much liquidity being pumped into the economy worldwide, high inflation will persist longer than expected. At some point, central banks will have to stop buying assets and wean markets off excessive liquidity.

Mr. Thomsen believes that Ukraine benefited from the macroeconomic stability it achieved prior to the crisis, which mitigated the impact of the pandemic. Maintaining the flexibility of the exchange rate was crucial, and something that must be preserved. He believes that maintaining the current exchange rate regime, inflation targeting, and modest fiscal policy would benefit the country going forward as well. However, he does not see current financial reforms as irreversible since countries can and do deviate from them.

Ukrainian Keynote Speech: Local economics in a post-Covid era

Ukraine has yet to catch up with European peers who managed to accomplish much more in the past 30 years

Sergiy Nikolaychuk, Deputy Governor of the National Bank of Ukraine, focused on a goal that has yet to be achieved after 30 years of development—catching up economically with the rest of Europe. While both Ukraine and its neighbour Poland began the post-Soviet era at around 40% of the EU's GDP per capita (PPP), Poland is now nearly at 80% while Ukraine is stuck at 30%.

Lack of investment is the key to why the catch-up stumbled. In the pandemic year of 2020, the investment-to-GDP ratio fell to 7%, the lowest in more than two decades. Moreover, while the country has low FDI per capita, its fixed assets have a high degree of depreciation.

Inflation targeting yielded good results, as the CPI is less volatile than before the regime's implementation, even though it rose over 10% in 3Q21. The floating exchange rate helped to absorb some shocks, including those during the pandemic. At the same time, constant accumulation of FX by the NBU led to the increase of international reserves from $5bn at its lowest point in 2015, to the current $30bn+.

Mr Nikolaychuk is certain that catching up is possible and the path has been laid out long ago. The legal system is the weakest link and an area where Ukraine still differs staggeringly from Poland.

Panel I: Dialogue with reformers

Ministry of Finance is looking for ways to launch the second level of the pension system in 2023–24

Serhii Marchenko, Minister of Finance of Ukraine, highlighted the importance of launching medium-term budget planning, and said that the Ministry of Finance is looking for ways to launch the second level of the pension system in 2023–24. According to him, pension reform will give a boost not only to Ukraine's stock market, but also help society understand that it is necessary to save for retirement, because currently, for 10.9 million pensioners there are only 9.7 million unified social tax payers, and the demographics will not change soon.

The main problem of Ukraine's stock market is the lack of investment instruments other than local government bonds

Ruslan Magomedov, head of the NSSMC, believes the main problem of Ukraine's financial markets is the lack of investment instruments other than local government bonds, which currently make up 90% of the market. The entry into force of the new law on capital markets opens up prospects for increasing the number of instruments thanks to commodity markets, but it is necessary that a transparent infrastructure and equal rules for all participants is created. Mr. Magomedov stressed the importance of having high-quality instruments and issuers at the start of the second level of the pension system, which will create a synergy between the development of the pension system and the stock market.

Securitization of various assets is an alternative to printing money by the central bank

Oleksandr Olshanskyi, Deputy Chairman of the Executive Committee of Reforms, President of Internet Invest Group, considers accelerating securitization of various assets as an alternative to increasing liquidity through central bank operations, as securitization plays the same role in the economy as money, but does not accelerate inflation. The potential for securitization is very large given its low level in Ukraine compared with other countries.

Judicial and pension reforms as well as the restart of commodity exchanges and the stock market topped the list of most anticipated reforms

According to the results of the Forum's voting, the launch of the land market was recognized as the main reform last year. Among the expected reforms, the undisputed favourite was judicial reform, followed by pension reform along with restarting commodity exchanges and the stock market. Discussing the prospects of pension reform, Oleksandr Olshanskyi pointed out that most pension savings will be eaten by the capital gains tax, which, combined with historically high inflation rates in Ukraine, may be an obstacle to the success of the reform. Mr. Magomedov added that another problem could be the slow introduction of new financial instruments. In general, with the planned launch of pension reform, in 2023 the amount of savings will be UAH53–56bn given the 1.1% deduction rate, summed up Mr. Marchenko.

Panel II: Retail investing: the road to digitalization of the capital markets

The main obstacles to the participation of private retail investors in the stock market are low financial literacy and lack of a wide range of instruments to invest in, which was highlighted in the Forum's audience survey.

The COVID-19 pandemic has shown the need to develop an online investment space

Yevhenia Hryshchenko, Deputy Director of the ICU, Chairman of the Board of the Professional Association of Capital Markets and Derivatives, stressed the need to develop an online investment space, a need that was clearly demonstrated by the COVID-19 pandemic. The adoption of a new law on capital markets is a key factor for the long-term development of the stock market, as it significantly improves investment conditions and assures investors of the reliability of their savings.

Regulators should reduce the level of bureaucracy to a minimum in order to facilitate access of retail investors to the financial market

Irakli Baramia, a member of the NSSMC, stressed that the low financial literacy of the population contributes to the development of low-quality brokers who offer investment simply by downloading their application to the phone without client verification, financial monitoring or other procedures, in fact, engaging in fraud. At the same time, qualified brokers compete with these companies for clients. In his opinion, the NSSMC and other regulators should reduce the level of bureaucracy to a minimum in order to facilitate the access of retail investors to financial markets. Among the latest steps, he singled out the possibility of remote customers' set-up, servicing accounts using EDS, and direct access to exchange trading.

Ukrainians rank first in the world in the use of crypto-assets by the population

Maksym Demyanyuk, Adviser to the Vice Prime Minister of Ukraine — Minister of Digital Transformation of Ukraine, stressed the great interest of retail investors in virtual assets, as the trading volume in these assets exceeds UAH1bn per day, equal to the stock market including local government bonds. Ukrainians rank first in the world in the use of crypto-assets by the population — about a million Ukrainians have experience using virtual assets. Therefore, the Ministry of Digital Transformation of Ukraine is actively developing regulations for this market. According to Mr. Demyanyuk, the market for virtual assets is more transparent than the banking system, but regulators needed time to learn to work with it, while the main problem is the lack of a legal framework.

NDU desires to convert 100% of the document flow into paperless format

Oleksii Yudin, Chairman of the Board of the National Depository of Ukraine (NDU), stressed the desire of the NDU to convert 100% of the document flow into paperless format. Among its latest achievements is the launch of the E-voting service in 2020, which allows joint-stock companies to hold remote meetings, and bondholders will soon have the same opportunity. The NDU is working to launch a service system for shareholders, which will work in a hybrid mode combining online and offline formats.

Buying local government bonds should be as quick as making a deposit at a bank

Oleg Tkachenko, Chairman of the Board of the Settlement Center, believes that stock market participants should be able to buy local government bonds as quickly as they can deposit funds at banks. The settlement center is currently finalizing processes that will allow brokers to register their clients electronically and buy financial instruments in one day.

Government bonds are the only financial instrument with a high level of investor protection

Peter Chernyshov, private investor in local government bonds, founder of Kontora Pi, member of Farmak Supervisory Board, and member of KSE Board of Directors, stressed that there are no financial instruments with a high level of investor protection other than government bonds in Ukraine. The only alternatives are real estate and cryptocurrencies, which have much higher risk. In his opinion, increasing the level of investor protection is key to the further development of the financial markets, as well as increasing the number of instruments in it.

Panel III: Overview of Ukrainian capital markets and the case for further development: Government bonds, corporate bonds, IPOs, and other instruments

Corporate bonds are more complex for borrowers procedurally, but the Commission is currently working to simplify procedures

Yaroslav Shlyakhov, Commissioner, National Securities and Stock Market Commission, identified several key issues within the corporate bond market, and the NSSMC is working on some of them within its mandate. First of all, he noted that obtaining a loan is less risky and easier to understand for the borrower than issuing bonds. This is especially true in terms of procedures, which clearly need significant improvement. Also, some borrowers do not have a clear understanding of financing priorities. The third important key point is the availability of liquidity in the market. The NSSMC is currently working on simplification of procedures and improved practices.

The NBU is ready to liberalize regulations to increase the liquidity of the corporate bond market

Yuriy Heletiy, Deputy Governor, National Bank of Ukraine, further elaborated on the liquidity problem in the corporate bond market and said that the NBU is ready to discuss liberalization measures with market participants. The liberalization process should be gradual to avoid imbalances and reduce risk. The NBU is ready to consider the inclusion of corporate bonds in the global list, using internal procedures and interaction with other regulators. In addition, the issue of opening banks' access to the sovereign Eurobond market is being considered.

Corporates are more willing now to take loans than go through the lengthy and complex issuance of bonds

Oleg Kyrychenko, Head of Investment and Share Capital Department, Ukrgasbank, praised the NBU for its support of municipal bonds and their inclusion in the list of the assets accepted for refinancing. With regard to corporate bonds, he noted that commercial banks are ready to go through lengthy procedures of bond issuance and listing at an exchange for their clients. However, it is much harder to persuade companies to do this, as they find it much easier to take out a loan.

The MoF reduced the number of bond issues and changed the regulations of primary dealers, thus improving liquidity

Yuriy Butsa, Government Commissioner for Public Debt Management, noted that the Ministry of Finance is the most liquid issuer in the country and does not need to register an issuer prospectus. And yet, the MoF considerably reduced the number of bond issues to 50 from 500 in 2016. This allows banks to focus on certain outstanding issues so as to actively trade them, which is especially important for small banks that remain primary dealers due to their high activity in the secondary market. At present, both residents and foreigners make their quotes in securities with maturities of one to four years in a single liquidity pool. What the market is still missing, though, is a single platform where all quotes will be concentrated to see secondary market bids. The government may further boost the market by issuing inflation-linked, IONIA-linked, or any other index-linked bonds. Butsa noted that the MoF is ready to issue such instruments once it sees demand for them is sufficient and risks of manipulations with the indexes are low.

Insurance companies are ready to invest in corporate, municipal, and foreign securities

Konstantin Lykhytsky, Head of Treasury, ARX, noted that the demand for instruments with linked yields will not only be from non-government pension funds, but also from insurance companies engaged in life insurance. Insurance companies' portfolios have undergone transformation and investment terms have increased. Due to the scarcity of other instruments, the share of government bonds in portfolios increased dramatically. Hence, insurance companies are ready to consider investing in corporate bonds of state-owned companies, municipal bonds, and even foreign securities.

The budget is currently deficit free, so MoF borrows just to refinance redemptions

As soon as October, Ukrainian 2025 notes may be included in the JPMorgan index

Answering questions from the audience, **Y.Butsa** noted that at the moment, the state budget was overperforming in terms of revenues, but underperforming in terms of expenditures by about UAH100bn, and is, therefore, deficit-free. The government continues to refinance debt repayments, but it currently does not make sense to borrow larger amounts, as the Ministry of Finance does not know how much deficit will be created by year-end or how much in loans will be needed. With regard to the inclusion of local-currency bonds in the JPMorgan index, Butsa expects 2025 notes to be in the index soon, as they have been in the watchlist since April. It usually takes six months to get into the index from there. The MoF also plans to accumulate bonds maturing in 2024, 2026, and 2027 up to US$1bn equivalent for further inclusion in the JPMorgan index as well.

Panel IV: How to access foreign securities from Ukraine

Oleksandr Kulikov, Deputy Head of Professional Association of Participants in the Capital Markets and Derivatives, noted that in the four years since the NBU allowed investment in foreign securities, the problems have not decreased. His poll showed that only a third of the Forum's voting participants invested abroad.

In 10 years, Ukraine has passed the first stage on the way to investing in foreign securities

Gregory Ovcharenko, Head of Asset Management, ICU, noted that in a market with a limited number of available instruments, foreign securities have strong potential to boost market development. In Ukraine, the process of introducing foreign securities to the market has been going on for 10 years, yet with each stage of simplification, new problems and difficulties appear. But now that this most critical stage is finally over, investors are able to bring securities into Ukraine, as well as withdraw them from the country.

Transfers within e-limits have tripled in two years, but it is worth attracting domestic brokers to invest abroad

Oleksii Lupin, Director of the Open Market Operations Department, National Bank of Ukraine, mentioned the system of e-limits that allows the transfer of funds abroad for investment. The system is developing dynamically, and in two years the volume of transfers through e-limits has almost tripled to US$565mn YTD from US$200mn in 2019. Only a quarter of the funds are transferred by legal entities, and the rest comes from individuals. The NBU wants the mechanism for transferring funds abroad to switch from foreign infrastructures to a domestic one.

Foreign securities should add diversity to the Ukrainian market

Yaroslav Shlyakhov, Commissioner, National Securities and Stock Market Commission, drew attention to the fact that if earlier investment in foreign securities was a question of opportunities and filling a market vacuum, now the commission would like foreign securities to become a supplement to Ukrainian securities. And the commission will defend its view that foreign securities should diversify the market, not create a separate one.

Vitaliy Milentiyev, Head of Supervisory Board, National Depository of Ukraine, shared his own experience as a portfolio manager in Canada and the United States. The US market is now a second home for Canadian investors, but Canada's financial system spent decades to achieve this. Now it is not necessary for a Canadian to open a US account, as a Canadian investor can buy US shares in his domestic account. As for US investors, they can buy foreign securities through ADRs and, therefore, they are not exposed to FX risks and do not have to open accounts abroad and become subject to foreign legislation.

Tax administration's focus on maximizing state revenues and overregulated procedures may create obstacles to further development of financial markets

Artem Afian, Managing Partner, Juscutum, stressed that the key issue is the attitude of the state tax administration to investments in foreign securities. It is worth remembering that the tax administration is one of the key regulators of Ukraine's financial markets, but its focus remains heavily skewed to maximizing state budget revenues from taxes. Another problem is providing tax authorities with supporting documentation from foreign brokers who do not practice rubber stamps and official signatures as it is required in Ukraine. Taxation of FX gain as a result of hryvnia depreciation remains a serious obstacle to investments in foreign securities, and, in fact, is taxation of investors' inflation hedge. After all, Afian said, the rapid development and current domination of the domestic government bond market was the result of the introduction of tax benefits.

Panel V: Raising corporate governance standards for market participants—who needs it and why?

Olyana Gordienko, ICU Corporate Governance Adviser, noted the importance of the draft of corporate governance standards developed by the NSSMC as a roadmap, but stressed the ambiguity of the wording of certain provisions.

Companies with good corporate governance have 20% better financial performance

According to **Olena Voloshyna**, the Head of the International Finance Corporation (IFC) in Ukraine, IFC has started implementing corporate governance programmes on a coercive basis. But practice has shown the need for educational activities, because until customers see the benefits, their attitude will be frivolous. A 2016 study found that companies with good corporate governance had 20% better financial performance and raised their Corporate Responsibility and Reputation (CRR) score by 1.5 points. IFC is currently developing recommendations for ESG data disclosure.

Victoria Strakhova, a member of the Supervisory Board of Ukreximbank, emphasizes that corporate governance primarily benefits the end consumer and notes the importance of self-assessment of the level of corporate governance by companies. Ms. Strakhova is convinced that it is necessary to start with minimum standards and methodological recommendations, as it will be difficult and expensive to implement the entire draft standards in the current Ukrainian reality.

It is necessary to build an effective corporate governance system that meets minimum requirements

Kateryna Rozhkova, Deputy Chairman of the NBU, stressed that corporate governance in certain companies may be ideal on paper, but not always implemented in practice, so progress in this matter will only be after the shareholders see its value for them. In her opinion, it is necessary to build an effective corporate governance system that meets minimum requirements. Among the obstacles, Kateryna Rozhkova singles out the lack of a sufficient number of professionals in the field of corporate governance and warns against the devaluation of principles in the regulator itself when inspections are carried out only formally.

New requirements for corporate governance should be applied gradually, and regulation should be predictable

Maxim Libanov, a member of the NSSMC, stressed that currently, the vast majority of market participants do not have supervisory boards. He is convinced that the new requirements for corporate governance should be applied gradually, and regulation should be predictable. According to him, the project will not be fully implemented from the moment of its approval, and the regulator will fully explain the prescribed requirements.

Natalia Shevchenko, NDU's corporate secretary, sees the problem in that the existing legislation shifts some administrative functions to the supervisory board, which should deal more with strategic issues.

Iryna Hnatyuk, a member of the Board of the Settlement Center, believes that although corporate governance does not create products and cash flow, businesses must find its value for themselves, and then the implementation of the rules will be much better.

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