

	 <i>Ukraine</i>	
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT		EU/TACIS PROGRAM

**ROUNDTABLE ON ENTERPRISE DEVELOPMENT AND INVESTMENT
 CLIMATE IN UKRAINE
 (Kiev, 13 June 2006)**

SESSION 2: ROLE OF THE FINANCIAL SECTOR IN ATTRACTING FDI

Summary of recommendations and issues for discussion¹

In general, the missions of the state authorities concerning the financial sector are:

- creating the right conditions for development of the effective and secure conversion of the savings of the population into the investment and local business financing;
- supporting the development of the financial markets by setting up regulations and institutions;
- making the country attractive to foreign investors who may bring additional financing and help accelerate the investment process and the economic growth of the country;
- safeguarding the financial system stability.

Trade developments and technological changes have had a significant impact on economic policy leading towards liberalization of goods and capital flows. As a result the financial sector underwent major changes during the nineties, both in terms of regulations and institutions building, internationalization as well as capital movement liberalization. Nowadays the financial markets have a key role in the globalization process and the foreign investors play globally.

In seeking to integrate into the global economy, become an equal player and attract more foreign direct investment, Ukraine faces many challenges, including the adjustment of its financial sector to international standards. Ukraine is in the midst of continuing long-term efforts to improve its investment climate and revise its legislative and institutional environment to make the country more attractive to domestic and foreign investors alike. The

¹ The paper was prepared by Mrs. Ewa Sadowska-Cieslak, Advisor to the President, National Bank of Poland who was also the moderator of the Session 2 of the OECD Roundtable in Kiev on 13 June 2006.

country has recorded good results in macroeconomic stabilization and, according to Ukraine's government, the forecasts are encouraging as regards economic growth, inflation, current account position and budget balance. However, given a low level of domestic savings and limited capacities to mobilize them in the nearest future, the future growth of the Ukraine's economy will to a great extent depend on foreign direct investment inflows.

Despite its potential, especially its large population (50 million inhabitants), significant industrial and technical-scientific capacities, natural resources and experienced and relatively low-cost labor force and large domestic market, Ukraine's position at the international investment market has remained weak and FDI inflows relatively low, in particular when compared with other transition economies. The FDI stock level amounted to USD 9.2 billion in 2004, as against for example USD 61.4 billion in the case of Poland and USD 60 billion in Hungary.

Financial sector liberalization and safety net issues

In addition to the Civil and Commercial Codes, corporate and antimonopoly legislation, discussed in session 1 of the roundtable, countries need a well-regulated, well-functioning, and well-supervised financial sector, which is a key element of the business-friendly environment and indispensable for the market economy. In the market economy, investors act on various financial markets, issue and buy the shares and other securities on the stock exchange and/or other financial markets, need securities depository, use banking system for various operations (not only for keeping money on the accounts), need effective payment services. They are also clients of the insurance and asset management companies, use factoring and forfeiting, leasing, financial brokers, investment advisors, brokerage houses, invest through institutional investors and finance their economic activities from bank credits or through the stock exchange. To conduct all those activities in the globalized economy, free cross-border movement of capital is indispensable.

The experience of the countries, which completed the liberalization process, shows that the liberalization of capital movements has to be accompanied by macroeconomic policies and domestic reforms, which would safeguard financial stability in practice. Liberalization needs to be coordinated with the implementation of the new monetary policy instruments and accompanied by the financial sector modernization. In this process the central banks play the major role, but the cooperation with the Ministry of Finance concerning the exchange rate mechanism and the pace of the liberalization steps is necessary.

Investors expect on one side, freedom for cross-border capital movements (though it may entail risk for financial stability of the country) and, on the other side, they are time interested in placing their investment where it can offer long-term stability and avoid foreign exchange risks and financial crises. Safeguarding financial stability under such conditions became the core challenge for the authorities. Financial stability depends on the economic growth, strong macro-economic fundamentals, efficient regulation and supervision and a favorable business environment. It is a broad ranging task, which requires actions at various levels and goes beyond the scope of a single institution. The responsibilities must be shared among – at minimum - the central banks, institutions responsible for prudential supervision and deposits guarantee funds.

Due to the character of the financial institutions activities and systemic risk on the financial market, the market mechanisms cannot always guarantee the stability of the financial system.

The set of policies and institutions designed to prevent or reverse widespread disintermediation from banks, losses in bank capital, and bank failures constitute the *Safety Net System*. Clearly, Safety Nets can limit the risks and costs of the banking sectors resulting from crises and, more importantly, make crises less likely by insulating banks from reductions or withdrawing of funds by depositors. Safety Net works on two levels: (i) crisis prevention and (ii) crisis resolution. Policy makers often argue that the safety net is essential for a healthy banking system and the economy. Why do policy makers feel the need for a bank safety net?

- First, banks provide credit to other firms and manage the flow of payments throughout the economy. Thus, disruptions in bank credit supply and a breakdown of the payments system may have large spill over effects for the rest of the economy. When a bank fails, valuable firm-bank relationships are destroyed, negatively impacting the firms that depended on that bank for credit. Bank failures or losses in capital lead to contractions in aggregate bank credit, with large social costs to bank borrowers outside the banking system.
- Second, banks are especially prone to failures because the value of their assets is difficult to observe and their debt is often very short-term. Since bank loans are not marked to market and bank debt is demandable, small shocks to bank solvency may lead to widespread disintermediation from banks, contraction in credit, and a decline in economic activity. The difficulties in observing the true value of banks, or asymmetric information problems, may lead to costly systemic runs, where depositors overreact to information, and possibly may lead to closure of solvent institutions.
- Finally, it is sometimes argued that one of the traditional objectives of a safety net is to protect small, unsophisticated depositors: (a) by guaranteeing small deposits, the insurance agency relieves account holders of any need to worry about whether a deposit institution will meet its obligation to depositors; (b) providing regulation and supervision avoids the waste of duplicate monitoring efforts and reduces opportunities for institutions to exploit depositors' information disadvantage. However, critics point out that this function can be performed at lower cost to the economy by assets other than insured bank deposits—such as postal savings or money market funds backed by government debt. More often, policymakers use the “protection of small savers” justification to make the safety net politically more desirable.

A bank Safety Net is difficult to design and operate because it strives to achieve conflicting objectives of (a) protecting against financial crises that can magnify economic shocks while also (b) avoiding moral hazard problems that give rise to imprudent banking practices. Finding the right balance between crisis prevention and market discipline is the most important challenge facing the policy makers. The Safety Net is still developing and changing in accordance with the evolving financial market. There are different models of organizing Safety Net in countries around the world. Even the similar economies adopt different structures of Safety Net, for example in Germany, Netherlands, Sweden and Poland, but they work efficiently.²

Ukraine, which is still in process of developing its financial safety net, has opted for the Netherlands's model. Discussions at the roundtable should allow seeing progress in Ukraine's safety net building and its impact on foreign investment.

Liberalization steps in Ukraine

² O.Szczepańska – Financial stability issues – National Bank of Poland' papers

After introducing a new national currency in September 1996, Ukraine has declared the current account convertibility of its national currency, hryvnia, and maintained the exchange rate in the band vis-à-vis the US dollar. In August 1997, the first sovereign Ukrainian Eurobond was issued. Due mainly to the Russian crisis in September 1998, the band was widened twice and the devaluation of hryvnia took place.

In the first years after gaining independence, Ukraine adopted a relatively liberal approach towards liberalization of capital movements. The non-residents were allowed to open hryvnia accounts with the authorized banks and to buy foreign currency in the Ukrainian foreign exchange market provided that it was confirmed that these funds were obtained by non-resident legal entities through export-import transactions. Also, individual non-residents have been allowed to open accounts with banking institutions in both national and foreign currencies on the same terms as residents.

After the Asian and Russian crises foreign investors withdrew from the T-bills and the NBU had to reintroduce a number of essential capital controls. Ukrainian commercial banks were prohibited from granting credits to residents of Ukraine in foreign currency for subsequent sale in the interbank currency market. In addition, commercial banks were only permitted to grant credits to residents in foreign currency and hryvnias against so-called critical imports, i.e. for purchasing goods from the list defined by the decisions of the government of Ukraine. The NBU recalled a system of limits in other sectors of money and credit market. This measure held back the development of the national banking system. Ukrainian entrepreneurs were restricted in their international operations and their access to global capital markets. This slowed down the modernization of the economy. In March 1999 the NBU was able to gradually withdraw almost all the limits and bans set during the crises. Debt restructuring (both domestically and by the Paris club) has also helped stabilize the situation following the earlier crisis.³

Restrictions concerning foreign bank ownership were abolished in May 1998. From 1 January 1998, the Ukrainian banking system adopted international accounting standards (based on the accrual concept). Finally, after adjustments of the exchange rate mechanism to the current developments, in February 2000, the exchange rate of hryvnia was floated. One of the pre-requisite for doing business in Ukraine was achieved.

Banking sector

The Ukrainian financial sector remains largely bank-based. The laws on “Banks and Banking system” and “On the National Bank of Ukraine” were adopted in 1999 and 2000 and were amended in 2004. They have brought about many improvements with respect to banking legislation. The transparency concerning regulations with respect to both the establishment of new banks and the liquidation of insolvent banks has increased significantly. In addition, the mandate of the NBU to act in these cases was substantially enlarged. Former existing differences between residents and non-residents with respect to the amount of authorized capital required for establishing banks have been abolished. In 2004 a program on the Development of the Banking System was initiated with the objective to raise the credibility of

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A. Shapovalov – Capital Account Liberalization in Ukraine – in: Capital Liberalization in Transition Countries, Lessons from the Past and for the Future, edited by Age F.P. Bakker and Bryan Chapple, Edward Elgar, Cheltenham, UK, Northampton, MA, USA, 2003.

the Ukrainian banking system. In the framework of the judicial reforms, the legal framework has been strengthened by amendments to anti-money laundering legislation.

Structural reforms in the banking sector and in the enterprise sector should have helped reduce interest rates and lengthen loan maturities. The NBU ensured that liquidity support provided to banks will be based primarily on short-term refinancing, and interest rates will reflect market conditions. The question remains, however, to what extent these promises have been effective.

The primary goal in the banking sector has been to enhance prudent lending practices and reduce bad loan portfolios. A reduction in credit risk would have helped lower interest rates and encourage long-term lending. This required steps to strengthen creditor rights, including through the laws on secured interest and mortgages, as well as the approved commercial code. It was reported that it would also require judicial reform and improved financial disclosure of the enterprise sector. In order to strengthen the banking sector, the NBU continued to improve banking supervision and intensify the enforcement of prudential regulations. In this context, Ukraine was moving towards risk-based banking supervision. As a prior action under the program, increase in the required minimum capital adequacy ratio from 8 to initially 10 percent, was effective from March 1, 2004. The NBU intended to strengthen related-party lending legislation and regulations (structural performance criterion) by tightening of related-party lending legislation and rules includes

(a) a clause in the Law on Banks and Banking requiring banks to identify the ultimate owners—physical persons—of the banks, and to communicate their identity to the supervisor;

(b) eliminating the clause in the Law on Banks and Banking allowing an exception for related-party lending linked to the bank's net profit (Article 52, paragraph 4); and, in the interim, amending NBU resolutions by April 30, 2004, so that lending to related parties on favourable terms must be fully matched by set-aside capital, which would be deducted from capital available to meet any other capital requirement, and be granted only on the basis of a decision by the supervisory board, with the explicit consent of the management board;

(c) adopting an NBU resolution requiring banks to introduce procedures preventing any person benefiting from the loan from being part of the credit analysis for the loan or for the credit decision itself. In the interim, the amendment of the NBU resolutions to limit related-party lending at favorable terms by April 30, 2004 (structural performance criterion) was announced.

The process of strengthening the financial position of the *Savings Bank*, in line with agreements with the World Bank should be pursued. A prudent system for development lending should be developed and implemented, with a view that Ukraine will be taken off the list of noncompliant countries.⁴

Although the financial sector reforms have contributed to increase public confidence in the banking sector, as evidenced by the rapid growth in banking deposits, the banking sector in Ukraine remains weak. During the EU/OECD conference held in October 2005, companies reported that raising funds from banks has been difficult. The majority of firms find the level of interest rates very high and collateral requirements prohibitive. The high cost of capital

⁴ The 2004 IMF Country Report

formation and high operational costs, not related to banking activities were blamed for high interest rates on the bank's part. Loans to the non-financial sector were reported typically short term and high cost, with the annualized interest rate margin between commercial bank lending and deposit rates. As such, the banks seem to play only a modest role in intermediating savings to enterprises in search of investment capital. Net annual lending to the economy in terms of the share of the GDP was significantly below the same aggregate in such countries having passed the transition as Poland, Hungary or Estonia.

Attracting foreign direct investment in Ukraine will not be possible without further improvement of legal environment of banking sector. The request to strengthen the legal rules to discourage related party lending was highlighted during the October conference. It was also stressed that the Civil Code requires some modifications to make legal enforcement of collateralized obligations smoother and faster in the view of improving the legal environment of lending activities. Bankruptcy law needs to be strengthened to discourage forced inter-enterprise lending resulting from the delays in paying their obligations. It was suggested that, instead, late payments beyond 90-150 days should be sufficient to initiate bankruptcy and liquidation procedures. Automatic renewal of loans for bad debtors should be discouraged. Accounting rules need further adjustments so that the banks can set required provisions for qualified loans aside before tax earnings.

To strengthen the banking sector, it was recommended to start by clearly revealing all qualified portfolios should in the banks' books through the following measures:

- Establishing limits on large credits and connected lending, as a percentage of the value of the equity of each bank.
- Requiring banks to classify loan portfolio based on European standards and to set aside the required provisions for the different categories of qualified portfolio and for the related/linked/internal loans from before tax earnings.
- Conducting on-site visits by the banking supervision in order to ensure compliance and impose penalties for violations.
- Selling to the government the bad debt portfolio by the banks in exchange for government securities. This scheme must be a one-time exercise only!

Following recommendations include re-capitalization of banks and inviting (also foreign) strategic investors as partial owners pursuing the path as follows:

- After setting the required provisions, banks should be given 2 years to increase their solvency capital to the level where they can meet the 8% minimum capital adequacy ratio.
- Banks should be encouraged to attract foreign strategic investors (banks) to raise their equity capital.
- Those banks, who are unable to meet this requirement in 2 years, should be either forced to merge with others (under the threat of losing their banking license), or if they are too large to merge, their capital base should be increased by the government from budgetary sources.
- In this way the government may acquire a substantial stake in certain banks. However, this should be only a temporary solution; next, the government should sell its stake to strategic investors (including possibly foreign) either directly or through the capital market.

Concerning existing investment climate it was also stated that the FDI in Ukraine is hindered by the lack of efficient network of investment banks, consultancy firms and information sources.

Financial markets

The securities market

The Ukrainian securities market has not succeeded in becoming a source of capital of real importance for the economy. The market consists of several traditional exchanges that primarily function as a market for the initial public offerings of the companies that are being privatized. Except for the Ukrainian Stock Exchange in Kiev, secondary markets are illiquid. In addition to the traditional exchanges there is also an electronic trading platform, the Ukrainian First Trading System. This platform attracts most of the trading, accounting for up to 90 percent of total volume traded. However, the total market capitalization of Ukrainian equity markets is low. Further development of the securities market supposes the following:

- Secure the rights of investors;
- Ensure the transparency of securities transactions;
- Create conditions for easy and reliable transfer of ownership for the securities' holder and establish a user-friendly clearing mechanism for securities transactions;
- Provide the possibility of gaining income from securities investments.

T-bills market

A segment of the capital market that gained significance is the T-bills market. It had become the dominant source of finance for the government with overseas investors and domestic commercial banks being major investors. The positive sign is that the maturity of government securities has been increasing and the market liquidity is increasing. The following recommendations were made:

- An upgrade of the legal environment to a level similar to that in force within the European Union is necessary.
- The market infrastructure regulatory capacities should be strengthened providing regulatory bodies with independence and an adequate level of human and financial resources. This means that a suitable power should be transferred to the Securities Exchange Commission.
- High importance should be attached to the education of professionals, the formation of professional bodies and the education of the public.
- Mobilization of domestic saving through pension and investment funds is necessary in order to avoid destabilizing capital movements.
- The capital market should be kept as "clean" and transparent as possible.

Safety of the market is widely considered as the very important factor for domestic and foreign investors. Steps should be taken towards promoting good corporate governance in both corporate and financial sectors, disclosing information to the stakeholders and the public, protecting minority shareholders and strengthening the responsibility of boards. Protection of the rights of small shareholders is needed. Governments should pursue activities aimed at developing codes of best practices and stock exchanges. It is also necessary to protect the

rights of small shareholders. One of the possibilities is to implement The Code of the Best Practices in companies and at the domestic stock exchanges.

In sum, the following aspects have been identified as the main problems of the Ukrainian financial market:

- Inadequate corporate governance;
- Low level of transparency during privatization process (possible results: corruption and insider trading);
- Inadequate concentration of trades in the securities on the regulated market.

Conclusions

Following a two-day workshop in October 2005⁵, which assessed progress in the financial sector reform in the Ukraine, demonstrated the value of financial liberalization in attracting investment and drew lessons from the experience of the OECD countries, the purpose of the present Roundtable is to discuss main recommendations for allowing the financial markets to play fully their role in enterprise development and contribute to a favorable investment climate for domestic and international investors in Ukraine.

Several factors could be considered as positive, in particular:

- Relatively dynamic economic growth;
- Diversification of financial instruments;
- Strong demand for securities (pension funds and insurance companies).

However, Ukraine's financial sector remained poorly developed by international standards which foreign investors are used to. The financial system in Ukraine is still relatively weak and needs further development to support the expanding economy. There is a strong potential for expanding and deepening capital markets provided adequate regulatory environment and strong institutions. In light of OECD countries' experience, the key conditions for attracting FDI inflows encompass three main areas: (i) internationally acknowledged legal framework; (ii) macroeconomic stabilization and, (iii) business friendly environment comparable with international standards. The financial stability seems to be of a significant value for foreign direct investors. This in turn strongly depends on economic growth and strong macro-economic fundamentals as well as on modern regulations and reliable institutions supporting the system.

The Orange Revolution has provided a window of opportunity for strong reform measures, built upon a coherent strategy involving cooperation between regulators and government bodies and a dialogue with the private sector. Institutional investors can play an increasing role on the capital market and enterprise funding and provide a strong impetus towards better corporate governance in the companies in which they invest. Increased foreign participation in the financial sector would be beneficial for ensuring a better access to capital and know-how. Inward foreign investment would accelerate the financial sector reforms and contribute to a friendly investment climate, thus having a positive impact on the whole economy.

⁵ A CD containing the main contributions and conclusions of the October 2005 workshop were made available to the participants of the Kiev Roundtable in June 2006.