The future of finance in post-war Ukraine

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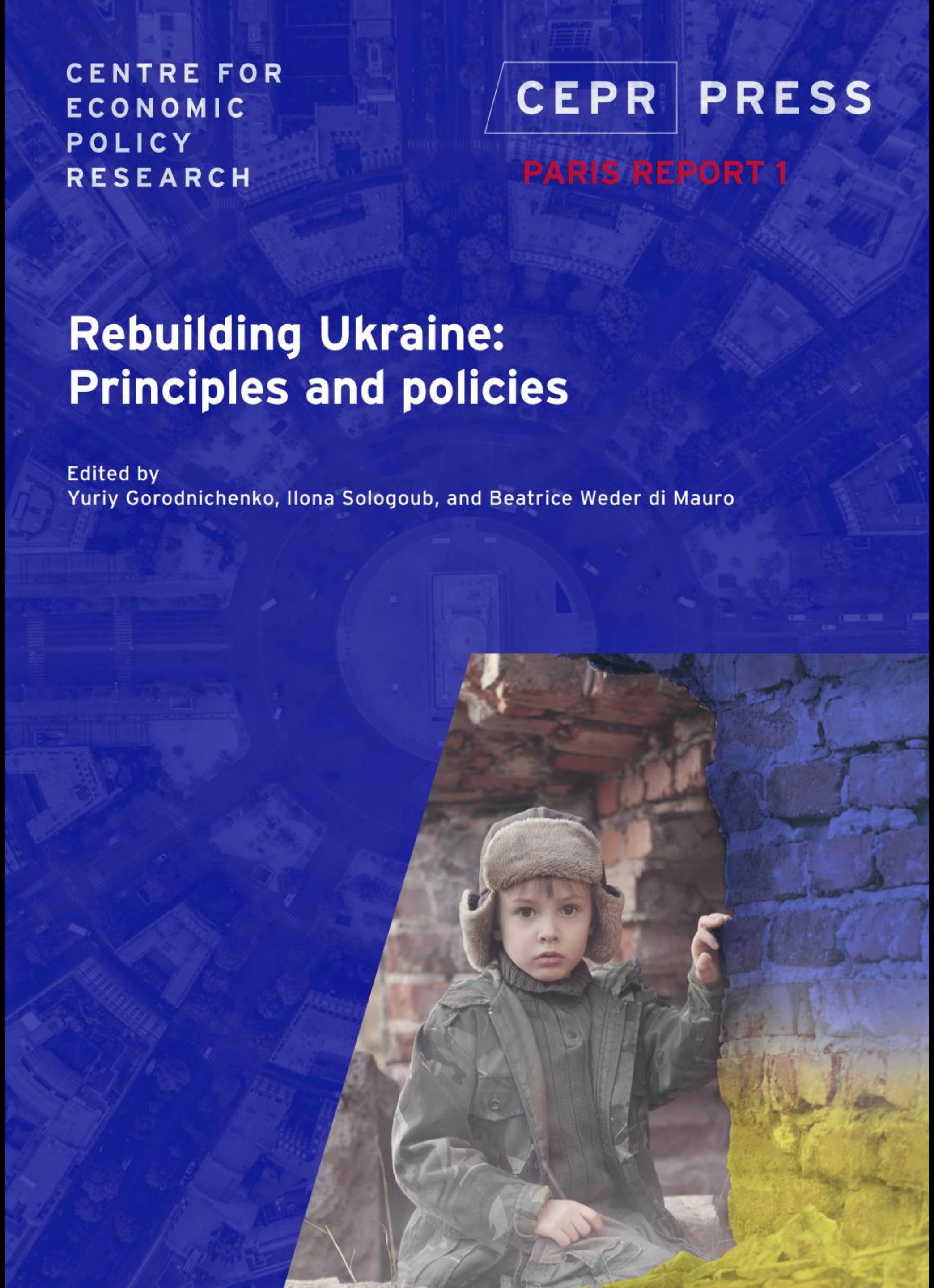
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Rebuilding Ukraine:
Principles and policies
Edited by
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Big picture

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for Reconstruction and Development

- Rebuilding Ukraine's financial sector will be key to post-war reconstruction and development:
  - To mobilize local and foreign savings and channel them efficiently to worthwhile investment projects…
  - …but also to help channel significant official reconstruction and development assistance expected to be provided by Ukraine's allies
- <u>Key challenge</u>: Combining <u>speed</u>, <u>scale</u>, and <u>stability</u>
  - Risk: Ukrainians' exposure to earlier bouts of financial instability eroded popular support for a market-based economic system

Status quo ante

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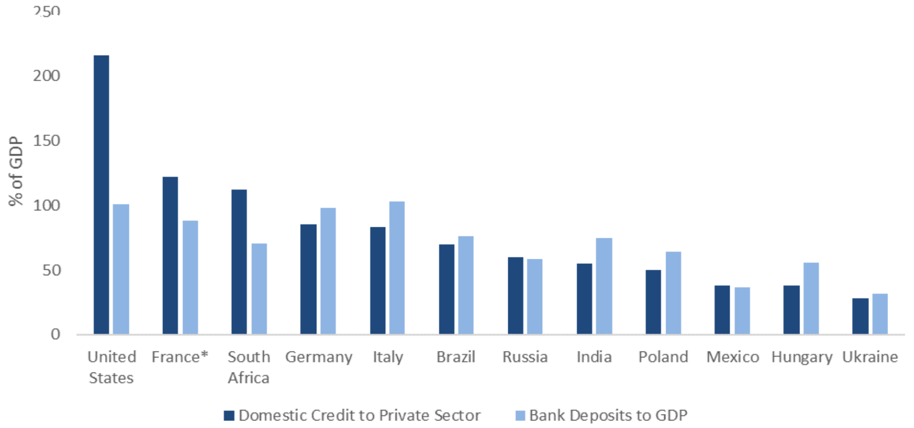
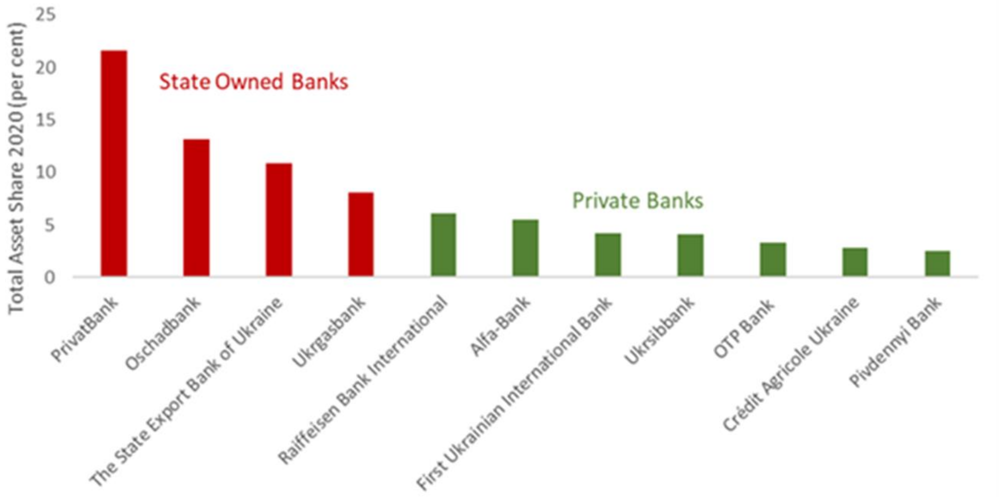
- Stock of private-sector loans small at 28 percent of GDP. Half of sector assets on-lent to the state
- Sector successfully overhauled after 2014. Half of banks closed and largest bank (Privatbank) nationalized. State banks now dominate even more
- Non-bank financial sector even smaller: limited insurance market; thin and fragmented equity market

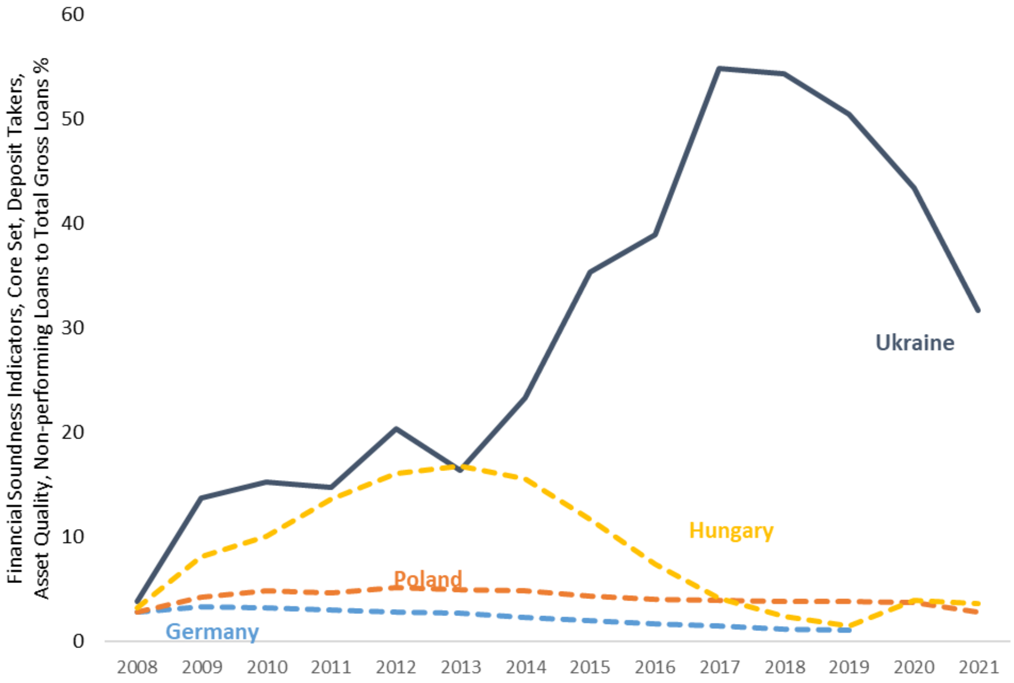




Connected lending endemic up to 2014

- After the war started in 2014, NPLs peaked at >50 percent of all credit. Declined after ‘cleanup’

- In 2016, authorities introduced a simplified approach for out-of-court financial restructuring via arbitration (aka ‘Kyiv Approach’)



Capital markets underdeveloped, too

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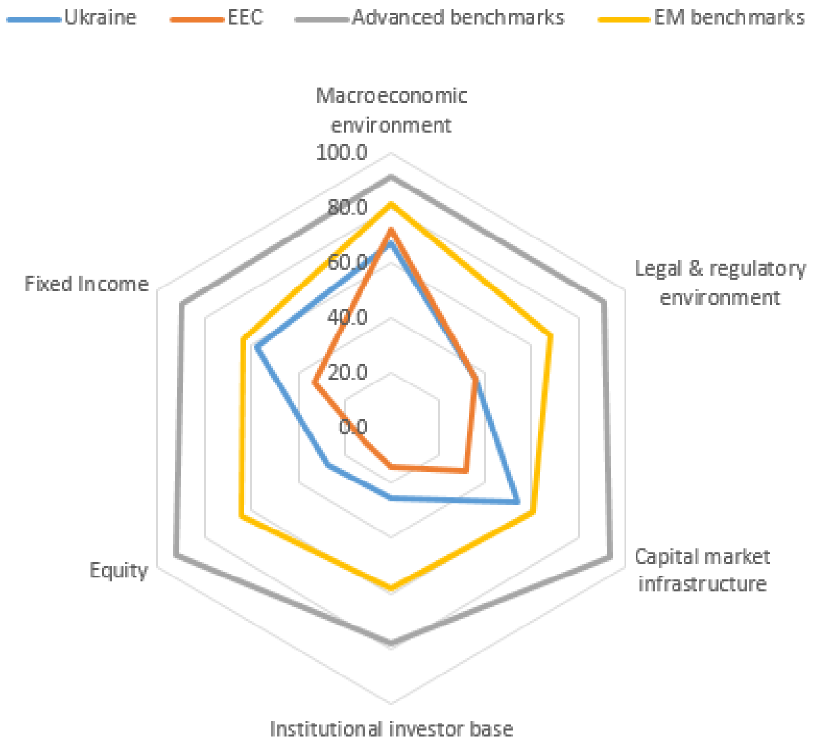
- Macroeconomic pre-conditions for capital markets were emerging before the war

- However, legal and regulatory environment not conducive, capital market infrastructure fragmented (e.g., four separate exchanges), little liquidity in fixed income and virtually no liquidity in equity markets

- Local investor base absent although discussions of ISAs, some penetration of foreign investment (including via Clearstream)



Financial resilience (so far)

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- Banking system 'clean up' since 2014 paid off during the war – only one small bank failed (while two small Russian state banks were liquidated)
- Liquidity injections and supervisory forbearance by the NBU helped stabilize banks
- Unlimited deposit guarantee announced early in the war reduced the risk of a bank run
- Yet, private sector lending virtually seized while non-performing loans increased (including due to the destruction of physical assets)
- Capital markets disrupted; repo market suspended; cross-border forex payments prohibited; recently launched UONIA benchmark index unable to reflect interbank operations, which seized

Reform priorities after the war – key principles

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1. Getting banks back on track: AQR, NPL resolution, recapitalization
2. Fewer state banks/remaining SOBs more commercially run
3. More market-based finance and public/private equity
4. Prompt but stable integration into the European financial sector
5. Fostering financial inclusion

Banking-sector resolution

- War-related asset destruction will translate into a high stock of NPLs
- Already during the war, the NBU will need to prepare for an asset quality review (AQR); as peace returns, launch the AQR to determine bank-specific recapitalization needs (*note: 2023 stress tests just released, 5 banks to strengthen capital base*)
- Next, an NPL-resolution process will need take place which should be quick, efficient and even-handed. In parallel, launch a bank-specific recapitalization process
- Past approaches to NPL resolution include decentralized (e.g., Ukraine after 2014/15), semi-centralized (e.g., Sweden) and centralized (e.g., Korea after 1998) options

Other priorities

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Bank commercialization and privatization

1. NPLs resolved? Privatize state banks, incl. to reputable foreign strategic investors
2. No credible investors in the short run? Consider intermediate options, such as partial listing or inclusion into a national investment fund to be commercially run
3. Reduce progressively political lending, including by remaining state banks
4. Strengthen incentives for state banks to resolve NPLs: currently reluctant to write off or restructure debt in a way that reduces the value of any (collateralised) state assets

Regulatory alignment with the EU

1. Complete alignment work to obtain a positive EBA conclusion: Will facilitate entry and expansion of EU banks
2. Pursue further alignment effort in securities sector but also in other key areas (such as professional secrecy and confidentiality)

Priorities (cont'd)

Developing the hryvnia money market

1. Revert back to a flexible exchange rate once the situation permits
2. Encourage the development of new financial products linked to EUONIA
3. Deepen the repo markets with settlement or other risk augmentations if needed

Developing capital markets

1. Legal framework for capital markets requires much work – e.g., financial collateral law, legislation on derivatives (to obtain a clean ISDA legal opinion), covered bonds and other securitization legislation
2. Establish regulatory frameworks for sustainable, social and infrastructure bonds (including to benefit from international impact and responsible investors)
3. Ensure products common in the European markets (e.g., convertible debt, warrants, mezzanine, preferred equity) are regulated in line with best practices
4. Consider establishing a blended pool of capital that could be deployed for funding equity investments (perhaps to be managed by a development finance institution)
5. Prioritize creation of a local investor base (e.g, second pension pillar, ISAs, etc)

Priorities (cont’d)

Foster financial inclusion

1. Focus on SME access to credit
2. Establish risk mitigation programs for small entrepreneurs, incl. women/youth
3. Assist small businesses to re-orient to EU after closing of markets in Russia and Belarus
4. Resources permitting: SME IPO fund (like in EU and Baltics)

Maintain financial stability

1. Strengthen cross-border coordination with EU bank supervisors
2. Remain vigilant on forex risks
3. Keep macro-financial framework under review to avoid booms and busts
4. Strengthen supervisory authorities (e.g. align securities regulator with IOSCO practices)

More details:

Chapter 6 in *Rebuilding Ukraine: Principles and Policies*
(edited by Gorodnichenko, Sologoub and Weder di Mauro, 2022)