Financial Stability Council
Report on Activities
(April 2016 – May 2017)

Kyiv 2017

Foreword

The period since publication of the first annual report of the Council was not an easy one for Ukraine and its financial system. In that time, Ukraine ensured macroeconomic stability: tamed inflation (to 13.5% in May 2017), GDP grew for the first in four years (+2.3% in 2016), and budget deficit contained within the target. However, against the backdrop of an ongoing Russian aggression, Ukraine had to face risks arising from global trends for populism and protectionism that threaten financial stability.

Financial sector kept on overcoming legacy problems that had been accumulating for years. Among them are massive related-party lending by local banks, inadequate risk assessment, and opaque ownership structures. They resulted in an increasing volumes of NPLs and a shortage of capital to cover credit risks. This problem became especially acute for Privatbank at the end of 2016. Given its importance for banking system (over 36% of deposits, over 50% of active bank cards), the State had to nationalize it. The Council facilitated coordination between authorities in this process. This necessary and timely step helped to protect interests of the bank's depositors and sector overall.

We managed to curb FX market volatility, although this required maintaining certain administrative restrictions. At the same time, the Council promoted lifting of pension levy on cash FX purchase and supported further liberalization of market in the interest of business.

In order to respond the challenges facing financial sector, the Council also supported:

- *adoption of draft laws necessary for advance in reforms;*
- *initiatives on development of life insurance market.*

The Council also repeatedly called to maintain cooperation with international donors. This cooperation remains one of key cementing elements of financial stability in Ukraine.

Content

Composition of the Financial Stability Council

		Co-chairpersons of the Council:
Valeria **Gontareva**	–	Governor of the National Bank of Ukraine
Oleksandr **Danyliuk**	–	Minister of Finance of Ukraine
		Members of the Council:
Tymur **Khromaev**	–	Head of the National Securities and Stock Market Commission
Ihor **Pashko**	–	Head of the National Commission for the State Regulation of Financial Services Markets
Kostyantyn **Vorushylin**	–	Managing Director of the Individuals' Deposits Guarantee Fund
Yakiv **Smolii**	–	First Deputy Governor of the National Bank of Ukraine
Yuriy **Butsa**	–	Deputy Minister of Finance for European Integration

Key issues considered by the Financial Stability Council

Over roughly a year between April 2016 and May 2017, the Council held seven meetings, including two extraordinary meetings. The latter were required for urgent consideration of issues that posed risks for financial system.

1. Overview of systemic risks. Start of FX control relaxation.

The National Bank of Ukraine presented an overview of current risks at each Council meeting.

Table 1. Evolution of systemic risks

	2016			2017		
	Q2	Q3	Q4	January	March	May
Global economy	↗	→	→	→	→	→
External demand	→	↗	→	↘	→	→
Economic conditions	↘	→	→	→	→	→
Public finance	↗	↘	→	→	→	→
FX market	→	↗	↗	↗	→	↘
Geopolitics	→	→	↗	→	→	→

Note:
Evaluation of change of risks. Arrows up – higher risks; arrows down – lower risks.

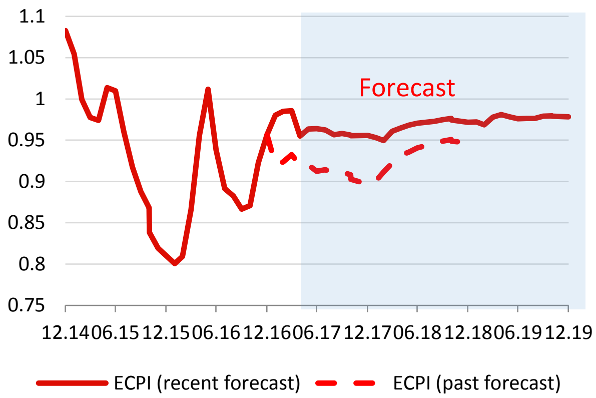
Global economy: since the previous Report, the global economy faced a few shocks, including Britain's vote to leave the EU (Brexit), elections in the US, France and Netherlands, and events in Turkey (attempted coup and constitutional referendum). This gave rise to a few volatility episodes on financial markets. However, global financial system has weathered through them successfully. Growth rate of the global economy remained under its potential. Over 2017-2018, a revival is projected for international economy and trade. The key risks today are geopolitical uncertainty and fast transition to stricter monetary policy in the US.

External demand: prices for Ukrainian exports were moving in both directions during the period. In several episodes, trends on international markets were unfavorable for agricultural commodities, and several times for steel prices as well. Starting from early 2017, price trends for key Ukrainian exports were overall positive and exceeded previous expectations. Projected recovery in global economy and trade supports optimistic outlook for external demand for Ukrainian exports.

Public finance: risks that were highlighted as potential in 2016, e.g. the threat of sudden drop in budget revenues or widening budget deficit, have largely not materialized. Fiscal policy remained balanced; deficit was kept within the target range.

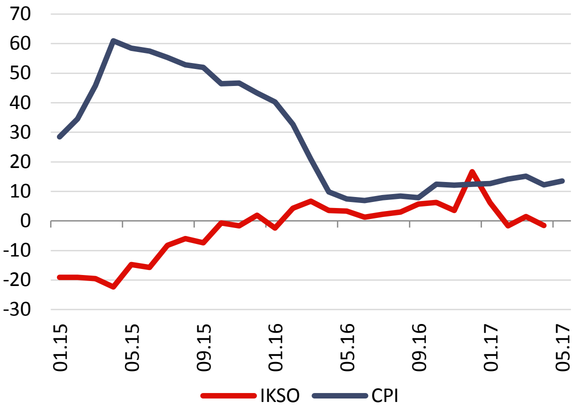
Economic conditions: Inflation stabilized within the target range, economic recovery rate was higher than expected. Economic growth is set to accelerate in 2017. However, the growth rate will be lower than desired primarily because of suspension of freight transportation across the delimitation line to and from the non-government controlled areas of Ukraine.

Chart 1. Ukrainian Export commodities price index (ECPI), 12.2004=1



Source: NBU

Chart 2. CPI and IKSO*, change yoy, %



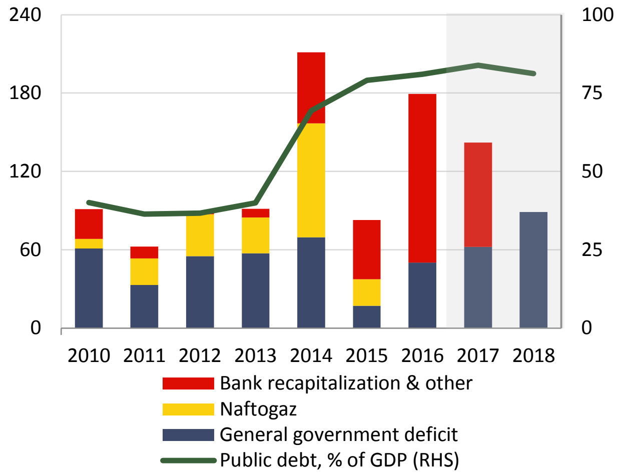
CPI – consumer price index; IKSO – Index of key sectors output
Source: NBU

FX market: twice during the period – in August-September 2016 and in December 2016 - first half of January 2017 – demand for FX spiked and market volatility increased. The Council repeatedly noted in December the signs of unstable situation in banking sector and conditions that threaten financial stability. The National Bank had to keep certain limitations on FX market to counter the crisis. In spring 2017, risks on FX market subsided, hryvnia rate moderately appreciated.

Geopolitics: tensions in the east of Ukraine remain elevated, fire exchange occasionally intensified, threatening lives of people and inflicting losses to national economy. A standoff at Avdiivka was especially remarkable. Temporary uncertainty around prospective support for Ukraine from its key Western partners at the times of ongoing election processes is an additional unfavorable factor.

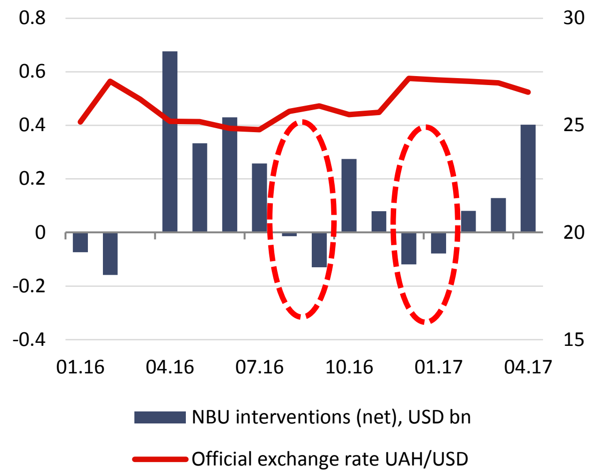
At the same time, macroeconomic stabilization, prudent fiscal policy, and gradual recovery of balance on FX market allowed for certain FX liberalization and relaxation of previously imposed restrictions. The Council articulated first recommendations on relaxation of FX restrictions back in March 2016. In May 2016, the Council supported abolition of pension levy on cash FX purchase. The parliament adopted respective decision in December 2016. This step promotes fight against the “black market”. At the same time, National Bank takes other steps to facilitate transparent FX market. On 1 December, the National Bank of Ukraine (NBU) presented a concept of a new FX Regulation.

Chart 3 Deficit of general government sector and public debt, UAH billion



Sources: Ministry of Finance, IMF, NBU

Chart 4. Hryvnia exchange rate and NBU interventions



Source: NBU

Council's position. At its meetings, the Council repeatedly detected further risks and volatility of Ukrainian financial markets. In view of that, the Council noted signs of unstable situation in banking sector and conditions that threaten stability of national financial system. That provided grounds for retaining certain of administrative restrictions on FX market.
At the same time, the Council called for a gradual relaxation of restrictions on FX market and supported abolition of pension levy on cash FX purchase.

Box 1: Agendas of international/foreign financial stability committees and in April 2016 – March 2017

The Council and its secretariat were following the risks and threats monitored by international and foreign (primarily European) financial stability committees/councils. The risks detected by foreign colleagues may be tentatively classified into one of the three categories: global financial, economic, and political challenges to financial stability; risks specific to advanced countries; sectoral risks.

Uncertain world economic outlook, volatility of international financial markets, Brexit consequences can be seen as global challenges. Risks specific to advanced countries are primarily stemming from persistence of close to zero interest rates andthey are not characteristic for Ukraine. We remain vigilant to discussions on sectoral risks.

Table 2. Risks monitored by international / foreign financial stability committees / councils[1]

Risk category	Essence of risks	When discussed	Committees noting risks
Global financial, economic, and political risks for financial stability	- Uncertain world economic outlook / global developments, inter alia because of voting in key nations	Q2, Q3, Q4 2016	FSB, ESRB, FPC, HCSF, FSC Sweden, FSC Poland
		Q1 2017	FSOC, HCSF
	- Unfavorable geopolitical trends / growing geopolitical tensions	Q2 2016	FSB, FSC Poland
	- Changing development model and vulnerabilities of China, their effect	Q3, Q4 2016	FSB, FSC Netherlands
	- Volatility on international financial markets	Q2, Q3, Q4 2016	FSB, ESRB, FPC, HCSF, FSC Netherlands
	- Brexit and its consequences	Q2, Q3, Q4 2016	FSB, FPC, FSOC, FSC Netherlands, FSC Sweden
Risks specific to advanced countries	- Lower profitability / weakening balance sheets of European banks, low risk premia stemming from close to zero interest rate environment	Q2, Q3, Q4 2016	FSB, ESRB, FSOC, HCSF, FSC Netherlands, FSC Sweden FSC Poland

[1] Based on public reports, minutes, press releases of respective bodies.

	- Threats from uncertain further trajectory of interest rates	Q1 2017	FSB
Sectoral risks	- Increasing mortgage lending and situation in real estate sector	Q2, Q3, Q4 2016	FSB, FPC, HCSF, FSC Netherlands, FSC Poland
		Q1 2017	HCSF
	- FinTech	Q3 2016	ESRB
		Q1 2017	FSB
	- Growing debt burden on households	Q2, Q3, Q4 2016	FSC Sweden, FPC
	- Low asset quality / high NPL rates in certain economies	Q3, Q4 2016, Q1 2017	FSB, ESRB, FSC Netherlands
	- Cyber attacks	Q2, Q4 2016	FPC
	- Restructuring of FX mortgage portfolio	Q4 2016, Q1 2017	FSC Poland

Note:
FSB – Financial Stability Board; ESRB – European Systemic Risk Board; FSOC – Financial Stability Oversight Council (USA); FPC – Financial Policy Committee of Bank of England; HCSF – High Council for Financial Stability (France); FSC Netherlands – Financial Stability Committee (Netherlands); FSC Sweden – Financial Stability Council (Sweden); FSC Poland – Financial Stability Committee (Poland).

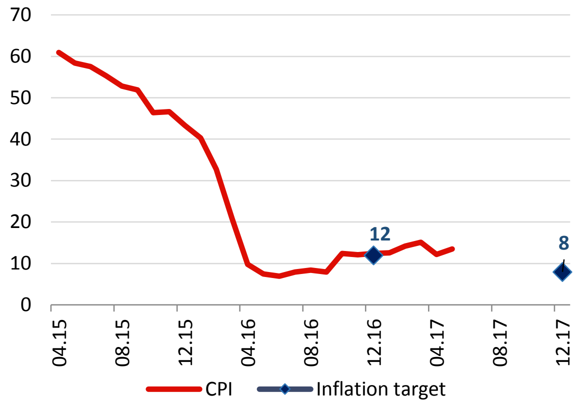
Building crisis preparedness and crisis management functions is the area where interesting international best practices of foreign financial stability committees / councils emerge. For instance, Financial Stability Council of Sweden develops simulation games: interested officials from financial regulators and authorities (sometimes also financial market practitioners) "rehearse" coordinated actions under a given crisis scenario (designed in beforehand).

2. Coordination of monetary and fiscal policy.

Council repeatedly considered coordination of fiscal and monetary policy, which is vital for financial stability.

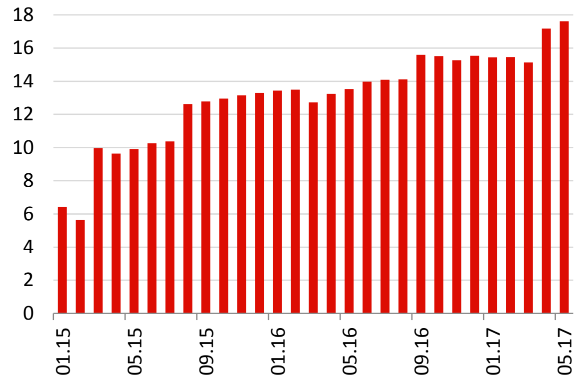
Budget deficit kept within a target range and coordinated Council's position established favorable conditions for National Bank to hit inflation target and to ensure steady increase of international reserves.

Chart 5. CPI and inflation targets of NBU, %



Source: NBU

Chart 6. Official international reserves, USD billion



Source: NBU

Predictable and rational management of public funds accumulated at the Single Treasury Account (STA) is an important precondition for effective monetary policy.

Recently, substantial funds used to be accumulated at the STA and then disbursed at the end of a year. Then National Bank had to intervene to mop up excessive liquidity from the market.

In order to avoid such situations, the Council suggested:

- to introduce medium-term projections of hryvnia liquidity on the STA;
- to expand the STA forecast horizon to three months;
- to timely identify and reflect in the STA projection of financing sources for covering expenditure in case of expected liquidity gap; plans on application of extra funds in case of budget surplus;
- putting to good order and ensuring predictability of depositing local budgets' funds at banks;
- ensuring smooth and even spending of budget funds during a year as well as during a month.

A new procedure for VAT refund effective since 1 April 2017 is expected to produce a positive effect. The refund is automatic based on information provided through databases of State Fiscal Service and Treasury, in chronological order, within the fund limits on STA. From now on, businesses may plan their activities more efficiently, and the government can ensure more even fund outflows from the STA.

In May 2017, the Government approved action plan for the implementation of the Reform Strategy for Public Finance Management of Ukraine for 2017-2020. Currently certain terms and tasks are being agreed, primarily those related to better liquidity management. The material results of implementation should be:

- extended forecast horizon for daily movements of funds on the STA (from one to six months) and gradual improvement of quality of forecasts;
- coordination of terms of major revenues and expenditures of the State budget;
- introduction of a simplified model of tax payments to a single account that was open by a taxpayer at the Treasury, etc.

Ensuring an increased predictability and an even disbursement of budgetary funds throughout a fiscal period should facilitate keeping inflation within the projected range.

Council's position. The Council called for enhanced coordination of monetary and fiscal policies as a precondition for the National Bank reaching declared inflationary targets. The Council also emphasized the need for a more even disbursement of the STA funds throughout a year by all public funds administrators.

3. Nationalization of Privatbank: role of the Council.

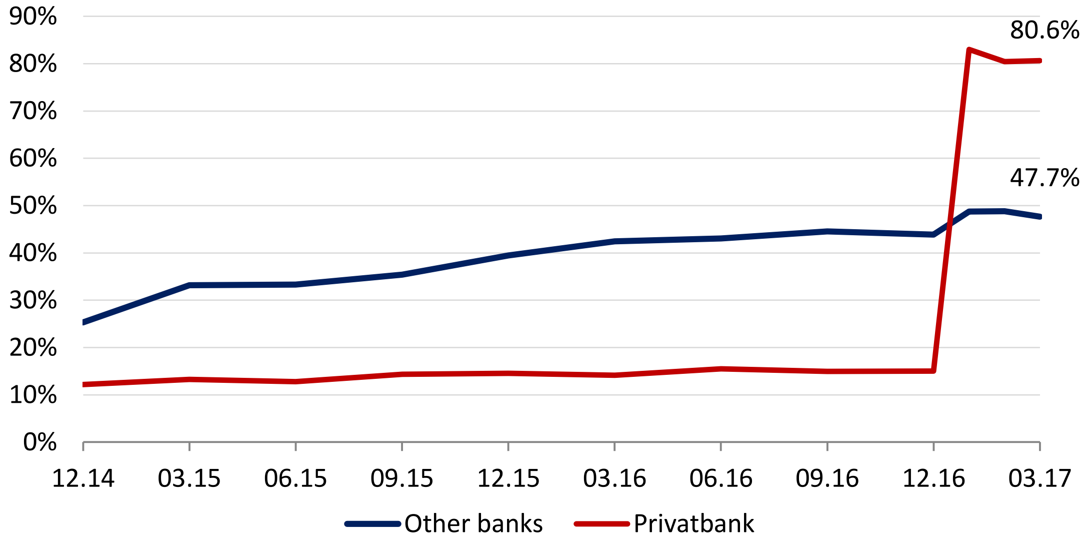
Nationalization of Privatbank in December 2016 was a fine example of decisive and efficient joint actions of the Government, National Bank and Deposit Guarantee Fund supported by the Council and the National Security and Defense Council.

In 2015, the diagnostics revealed material problems that had been accumulating at the bank for years. Imprudent credit policy, especially aggressive related party lending without sufficient collateral led to bank's capital losses. Re-capitalization and restructuring program were aiming at lowering credit risks and attracting additional capital from its shareholders in order to comply with capital adequacy requirements. Privatbank, given its systemic importance, was under constant vigilant regulator's supervision.

Bank's management and owners failed to comply with the program. For impartiality sake, an international reputable auditing company was invited to assess the quality of the bank's assets and capital. The company's assessment was close to the NBU's one. According to NBU, Privatbank needed additional UAH 148 billion in total on the eve of nationalization.

Almost all corporate loans of Privatbank were issued to related parties. Often these were operationally inactive "dummy" companies; loans to those companies should have been classified as NPLs (which was properly done after the bank's nationalization).

Chart 7. NPL rate at Privatbank and at other banks



Source: NBU

When shareholders suspended implementation of the recapitalization plan, National Bank resolved to declare the bank insolvent. Given the systemic importance of the bank, the regulator turned to the Government suggesting its bailout by the state in line with article 41.1 of the Law of Ukraine "On Households Deposits Guarantee System".

Shareholders of Privatbank sent a letter to the Cabinet of Ministers asking the State to bailout the bank. In this letter, they undertook to restructure corporate loans of the bank in accordance with the National Bank's requirements by 1 July 2017.

Having analyzed all resolution options at its meeting on 18 December 2016, the Financial Stability Council supported the motion to nationalize Privatbank in accordance with article 41.1 of the Law of Ukraine "On Households Deposits Guarantee System". This decision allowed protecting the financial sector from a substantial shock and households from losses.

Table 3. Privatbank's part in Ukrainian banking sector

	Privatbank	Share in banking system	% GDP
Balance sheet indicators, UAH billion, as of 01.12.2016			
Total assets, of which	299.2	18.3%	12.6%
cash	8.7	28.6%	0.4%
corporate loans	179.2	20.5%	7.5%
retail loans	33.0	21.0%	1.4%
Liabilities, of which	240.1	21.1%	10.1%
NBU funds	19.2	50.9%	0.8%
corporate deposits	39.0	11.2%	1.6%
retail deposits	148.3	36.3%	6.2%
Infrastructure, thousands, as of 01.10.2016			
Active bank cards,	29 330.4	52.0%	
of which with debit option (for payment of wages, pensions, etc.)	15 618.4	56.3%	
ATMs	20.3	60.6%	
POSs	140.2	60.2%	

As of April 2017, total recapitalization of Privatbank reached UAH 116.8 billion; all capital injections were made in the form of domestic government bonds. Total capital need for recapitalization with public funds was reduced through conversion of certain liabilities into capital (bail in). The due diligence by auditing company will help to define the need for additional recapitalization of Privatbank. At the meeting of the Council in May, the members emphasized that public costs should be compensated by ex-owners of the bank. They also stressed the need to hold productive talks on restructuring of non-performing loan portfolio in line with commitments under the Memorandum with IMF.

Additional issue of domestic government bonds had no direct impact on inflation as proceedings from monetization of these bonds were primarily channeled to replenish cash and to restore required reserves at the National Bank. Bank quickly recovered to business as normal. Market sentiments stabilized. Thanks to that, the deposit outflow observed in December-January has gradually subsided.

Council's position. Given rising risks related to financial conditions of systemically important Privatbank at the end of 2016, the Council supported motion from National Bank and Cabinet of Ministers to resolve the bank by selling it to the State represented by the Ministry of Finance. The bailout of Privatbank helped the bank to meet obligations to all of its clients and to mitigate a major systemic risk for financial stability.

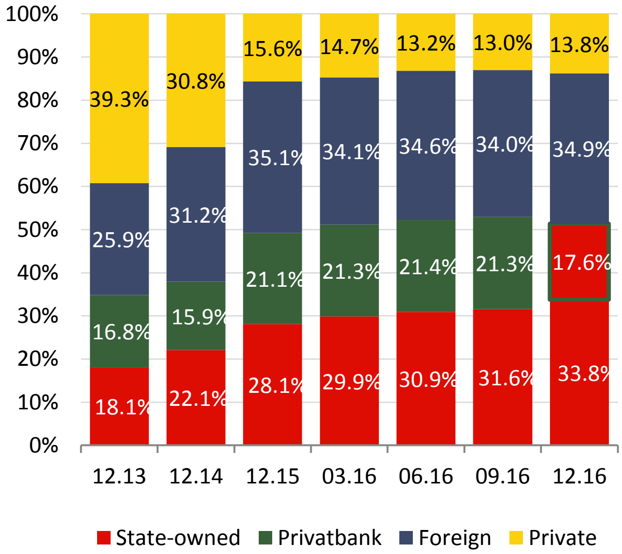
4. Increased role of state-owned banks and the need to revise their strategy.

Reforms of state-owned banks was one of the key issues on the Council's agenda in the period.

Ministry of Finance of Ukraine that represents the owner of state-owned banks ensures implementation of the reforms strategy for state-owned banks[2]. One of the first successes is a Memorandum of Understanding signed between the Government, the EBRD, and Oschadbank. It stipulates EBRD's assistance to Oschadbank in enhancing corporate governance, as well as a 50 million euro of loan guarantees for Ukrainian business development.

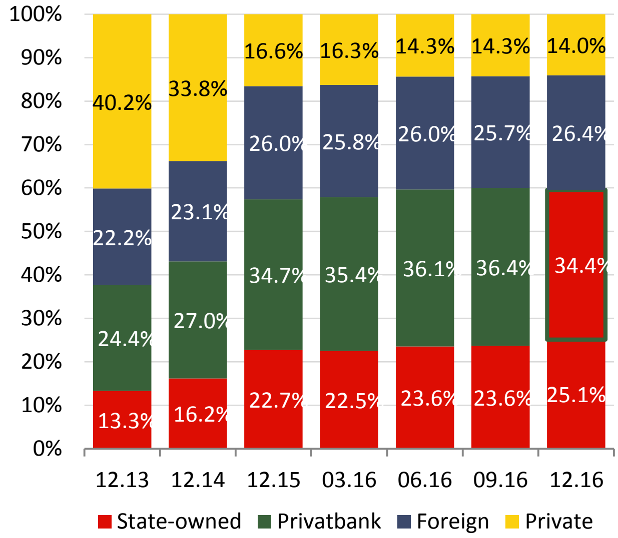
At the end of 2016, a need to revise the strategy arose on the back of a significant increase in the share of state-owned banks in national banking system. After the Privatbank nationalization, their share in net assets exceeded 50% and surged to almost 60% in retail deposits.

Chart 8. Net banking assets by groups of banks



Source: NBU

Chart 9. Bank deposits by groups of banks



Source: NBU

In the course of the strategy revision, the basic principles of state-owned banks reform will stay unchanged, including better corporate governance and ensuring preconditions for a full or partial privatization to reduce government's share in the banking market.

Ministry of Finance is working on revision of the paper together with international financial institutions and the National Bank.

[2] Supported by the Government in February 2016 – see Report on the Council's activities of April 2016

Chart 10. Basic principles of reforms of state-owned banks

Reduction of State's share in the banking sector

- full divestment from Ukrgazbank
- international investors take part in captial of other banks

Specialization of banks

- should be redefined due to nationalization of Privatbank

Ehnanced corporate governance at state-owned banks

- incl. establishment of supervisory boards comprising majority of independant members

Decelopment of operational models (enhanced risk management, NPL workout)

An important next step should be amending the Law of Ukraine "On banks and Banking" to enhance corporate governance at the state-owned banks. Transformation of state-owned banks into efficient, transparent, and profit-making banking institutions depends on successful implementation of these tasks. Ultimately, this would mean higher quality of services for clients and saving money for taxpayers on recapitalization of state-owned banks.

The Council supported recapitalization of Ukreximbank and Oschadbank as the asset quality review by NBU in January 2017 revealed deterioration of loan portfolio quality at these banks since the diagnostics. Payment discipline on large exposures decreased substantially; some companies suspended servicing their loans. That ensued in growing need for additional capital at state-owned banks, which the Government had to cover this year.

Council's position. Council members agreed that the Strategy for development of state-owned banks has to be updated given structural shifts in the sector. At the same time, the basic principles that underpin it should remain unchanged.
The Council backed legal amendments suggested by the Ministry of Finance to system of corporate governance at state-owned banks. The Council expects a new impetus for reforms of the banks.

5. Enhancing capacity of the Deposit Guarantee Fund.

In order to establish an efficient deposit guarantee and bank resolution framework, Ukraine strives to implement international standards and best world experiences developed in this field by different countries. Implementation of provisions from core international documents will help better protection of depositors, facilitate more efficient resolution of insolvent financial institutions, and ultimately enhance financial stability in Ukraine.

Chart 11. Core documents setting international standards on deposit insurance

Ukraine's commitments under Association agreement with the EU is of special importance in this respect. Among other things, they provide for transformation of Ukrainian deposit guarantee system by 2018. Some of provisions of the EU directives had been already implemented successfully into Ukrainian legislation. However, there is a number of amendments that still have to be made:

- gradual increase of covered deposits and further cuts in terms of repayments;
- participation of all banks in deposit guarantee system on equal terms (via the Deposit Guarantee Fund (DGF));
- transition to differentiated regular contributions based on risk assessment;
- expansion of list of entities eligible for deposit guarantee;
- higher efficiency of management and disposal of assets of banks under liquidation.

Work is in progress on amendments to the Law on deposit guarantee system that resolve these issues to some extent. However, increase in covered deposits or transition to a new system of regular contributions to a risk-assessment based DGF would require further joint efforts from the Council members and finding optimal options in terms of financial stability.

Furthermore, the Council emphasized the need for more efficient work of law enforcement agencies and courts. This should facilitate proper protection of creditors' rights.

The Council members also supported adequate financing of the Fund under current circumstances. The work is currently in progress to optimize the system of financial support for DGF that will ensure its continuous functioning in the interests of depositors and creditors.

Council's position. The Council backed up holding of a separate strategic session on priorities of reforms of deposit guarantee system in Ukraine. The council also called to enhance cooperation with law enforcement agencies and executive services for better protection of creditors' rights and efficient repayment of debtors' liabilities.

Box 2: Financial safety net and its part in promotion of financial stability. International trends in development of deposit guarantee schemes.

Financial safety nets exist to assist in effective protection of banks and clients in crisis times, primarily through insuring deposits and giving banks an emergency access to short-term liquidity. A functioning financial safety net reduces risks for financial stability by:

- removing incentives for depositors to withdraw money, as the deposits are protected by a guarantee; therefore, the risk of bank runs is lower;
- allowing to save banks that experience temporary liquidity difficulties but remain solvent, and to resolve insolvent banks as their further existence multiplies problems for depositors, creditors and system overall.

Table 4. Components of financial safety net for Ukrainian banks

	Function	Responsible authority
1	Prudential regulation and banking supervision	NBU
2	Lender of last resort	NBU
3	Bank resolution	DGF after NBU's decision
4	Deposit protection	DGF

Being close in its essence to the system of state insurance in financial sector, financial safety net grounds on the following principles:

- protecting primarily those categories of depositors who are not in the position to assess themselves risk of depositing (investing) their money;
- deposit coverage / guarantee should be sufficient to cover most retail deposits; yet it should not be too high as to allow the transfer of risks from owners of large assets/wealth to government and taxpayers.

These principles largely shaped core international development trends for deposit insurance schemes:

- gradual transition to contributions to deposit insurance funds based on assessment of risks of its participants;
- extension of list of depositors eligible for coverage (e.g. apart of individual depositors coverage is often extended to SMEs[3]), shorter terms of repayments to depositors;
- international convergence (levelling) of covered deposit amounts (lowering excessive coverage; increasing from comparatively low coverage to internationally accepted ones).

[3] However, covered deposit amount remains the same for households and companies, so covered medium and large-size companies still have incentive for prudent management and depositing of their funds.

Table 5. Changes of covered deposits by jurisdictions

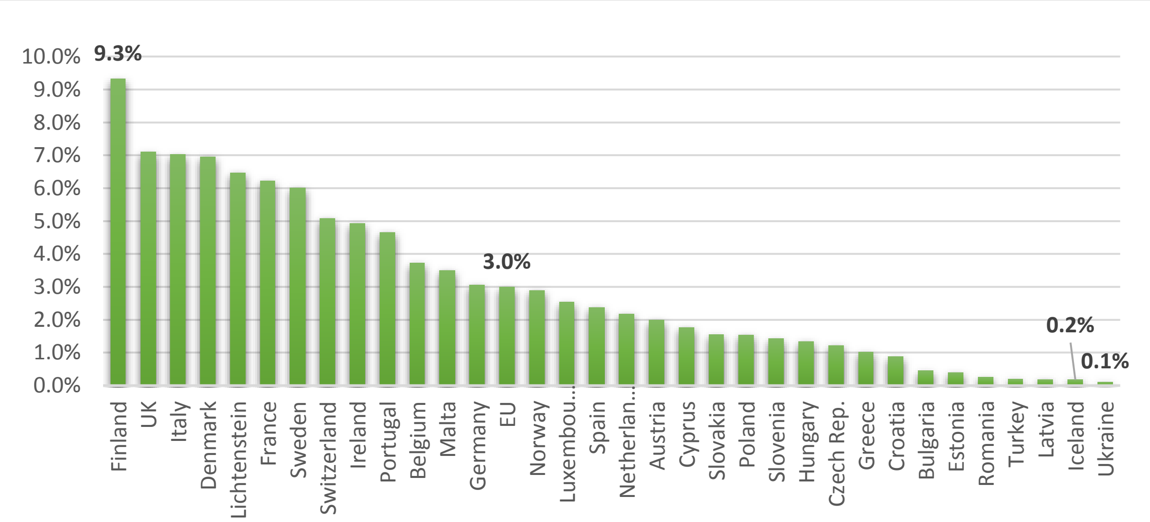
Jurisdiction	Currency (symbol)	Period			
		Sept. 2008	Dec. 2008	Jan. 2011	Aug. 2016
Australia	A$	-	1 000 000	1 000 000	250 000
Austria	€	20 000	unlimited	100 000	100 000
Belgium	€	20 000	10 000 000	100 000	100 000
Brazil	R$	60 000	20 000 000	20 000 000	250 000
Canada	CAD	100 000	100 000	100 000	100 000
Czech Rep.	€	25 000	50 000	100 000	100 000
Denmark	DKR	300 000	unlimited	750 000	750 000
Estonia	€	20 000	50 000	100 000	100 000
France	€	70 000	70 000	100 000	100 000
Germany	€	20 000	unlimited	100 000	100 000
Hong Kong	HK$	100 000	unlimited	500 000	500 000
Hungary	€	25 170	unlimited	100 000	100 000
Ireland	€	20 000	unlimited	unlimited	100 000
Italy	€	103 291	103 291	100 000	100 000
Japan	¥	10 000 000	10 000 000	10 000 000	10 000 000
Latvia	€	20 000	50 000	100 000	100 000
Netherlands	€	20 000	100 000	100 000	100 000
New Zealand	NZ$	-	1 000 000	500 000	-
Norway	NOK	2 000 000	2 000 000	2 000 000	2 000 000
Poland	€	22 500	50 000	100 000	100 000
Portugal	€	25 000	100 000	100 000	100 000
Romania	€	50 000	50 000	100 000	100 000
Singapore	SG$	20 000	unlimited	50 000	50 000
Slovenia	€	22 000	unlimited	100 000	100 000
South Korea	KRW	50 000 000	50 000 000	50 000 000	50 000 000
Spain	€	20 000	100 000	100 000	100 000
Sweden	€	25 000	50 000	100 000	100 000
Switzerland	CHF	100 000	100 000	100 000	100 000
Thailand	BHT	unlimited	unlimited	50 000 000	15 000 000
Turkey	TL	50 000	50 000	50 000	100 000
UK	£	35 000	50 000	85 000	75 000
USA	$	100 000	250 000	250 000	250 000

6. Life insurance: possible risks and threats, existing problems, ways and mechanisms to mitigate them. Life insurance market has an important social part to play; it is an instrument for raising retail savings as well as an element of infrastructure of pension system in Ukraine. This segment of insurance market of Ukraine is narrow so far (as of 31.12.2016, 39 companies with assets of UAH 10.9 billion and UAH 7.8 billion in reserves). At the same time, life insurance market as a market for pension savings is a major source of long-term funding for economy in European countries.

Currently, the insurance market of Ukraine is highly concentrated and dominated by foreign companies. Top-6 companies account for 83% of the market by amount of insurance reserves. Asset quality at these companies is high: 78% of their assets are made up of domestic government bonds and bank deposits (at banks with AA or above grade), in line with new supervisory requirements[4]. The clean up of the market is in progress: in 2015-2016, ten companies were delisted from the State Registry of Financial Institutions; charges are pushed against owners / managers of five of them.

Insurance market of Ukraine is less advanced than in the EU countries, including Eastern European states; however, it has a large growth potential. Ratio of life insurance segment in insurance business in the EU is 60% vs. 8% in Ukraine. Corporate segment of life insurance market has also a large potential. Currently its share is 4.2% vs. 17% prior to imposing of Single Social Contribution on life insurance operations; on the other hand, in the EU, group life insurances make up 23.3%.

Chart 12. Life insurance rates (paid premiums to GDP, %) in European countries



Sources: EIOPA, National Committee for Regulation of Financial Services Markets

To give a fresh impetus for development of the life insurance market, the National Commission for Regulation Financial Services Markets designed an action plan and

[4] For a life insurer the ratio of 'low-risk' assets should be at least 40% of its insurance reserves

presented it to the Council. Its implementation will promote improvement of financial situation of insurance companies and development of the financial market overall.

Chart 13. Actions promoting development of the life insurance market.

Tax incentives	• introduction of tax incentives for long-term contracts
Integral mechanism	• implementation of an instrument for guaranteeing repayments on life insurance policies
Regulatory requirements	• implementation of the second stage of increasing requirements to asset quality of insurers
Checking criminal investigations	• establishment of cooperation with law enforcement agencies in order to implment a system of control over financial services markets, to prevent new and to fight exisiting offences of management and owners of financial institutions

On their part, other Council member institutions will work on expansion of the range of high-quality investment instruments available for insurance companies.

Council's position. The Council backed initiatives of the National Commission for Regulation of Financial Services Markets that promote development of the life insurance market.

On general, the Council members agreed with a need to design procedures for application of tax incentives for long-term agreements. The DGF stood ready to assist in organizational capacity building for life insurance policies guarantee fund, which was to be established.

7. Promoting reforms in financial sector.

Consideration and support to draft laws that are vital for financial sector is another contribution of the Council to the financial sector reform, resolving legacy problems, and transition to a more transparent regulation and supervision. The largest banks reconciled their positions in terms of capital adequacy in line with recapitalization programs. The banks that failed to comply with minimum capital adequacy requirements or to ensure transparent ownership structures were withdrawn from the market. The clean up of the non-banking financial sector advanced. In January 2017, the Council member-institutions updated in a joint effort the Comprehensive Program of Ukrainian Financial Sector Development until 2020. This should help to enhance the system's resilience to shocks and to lay foundations for further growth.

Financial sector reforms often require legal amendments. Therefore, the Council backed at its meeting in October 2016 draft laws aimed at protecting rights of consumers of financial services, restructuring of FX debts of households, consolidating of functions of state regulation of financial services markets. As of today, the parliament has not approved all of these crucial initiatives.

Table 6. Draft laws backed by the Council and their status

	Draft law	Primary goals	Current status
1.	"On amendments to certain laws of Ukraine (on promotion of lending in Ukraine)", reg. # 4529	Lower credit risks for banks and thus promotion of intensified lending.	Defeated and withdrawn. Currently a new draft law aimed at protection of creditors' rights has been registered[5].
2.	" On amendments to certain laws of Ukraine (on regulated markets and derivatives)", reg. # 3498	Establishment of conditions for development of derivatives markets and introduction of public supervision on regulated commodities markets.	Approved for a new second reading
3.	"On consumer lending", reg. # 2455	Ensuring protection of rights and lawful interests of borrowers in the area of consumer lending, including protection of financial services consumers from risks of violation of their right by providing them with full information for making a decision.	Adopted by the parliament on 15.11.2016, took effect on 10.06.2017
4.	"On amendments to certain laws of Ukraine on improved protection of rights of consumers of	Setting authorities' mandate for protection of rights of financial services consumers. Introduction of level playing field for banks and non-banking financial institutions. Introduction of liability of	Passed for a new second reading

[5] Draft Law # 6027 on enhancing trust between banks and their clients. It also aims at establishment of legal grounds for mitigation of risks of banks at all stages of retail and corporate lending through improvement of legislation regulating warranties, collateral, inheritance, etc.

	Draft law	Primary goals	Current status
	financial services ", reg. # 2456-д	financial institutions for violation of rights of financial services consumers.	
5.	" On amendments to certain laws of Ukraine on refining provisions on prevention and fight against money laundering", reg. # 4960	Improvement of internal financial monitoring of financial operations; cutting the list of operations subject to mandatory financial monitoring.	Considered and withdrawn
6.	" On amendments to certain laws of Ukraine on consolidation of functions of state regulation of financial services markets", reg. # 2413a	Distribution of functions of National Commission for Regulation of Financial Services Markets between the NBU and National Commission for Securities and Stock Market. This will ensure effective supervision over both banking sector and non-banking financial services markets; therefore, it will entail higher quality of financial market regulation.	Being prepared for second reading
7.	"On insurance", reg. # 1797-1	Upgrading protection of rights of insurance services consumers, improving monitoring of insurance business.	Being prepared for second reading
8.	" On amendments to certain laws of Ukraine on specifics of licensing of economic activities related to provision of financial services", reg. # 3739	Defining specifics of licensing of economic activities related to provision of financial services.	Defeated and withdrawn

The parliament adopted a number of laws that are crucial for financial markets– on establishment of institute of private enforcement (02.06.2016); on financial restructuring (14.06.2016); on lifting moratorium on inspections from National Commission on Securities and Stock Market; on removing of barriers to export of services (03.11.2016); on upgrading of corporate management (on squeeze-out); on corporate agreements; on simplification of procedure of bank consolidation (23.03.2017). These laws introduced mechanisms for effective restructuring and foreclosure, transformation and consolidation of banks, set modern requirements to corporate governance. Their full implementation will facilitate prevention of shocks as well as more efficient mitigation of their results. Adoption of Budget-2017 with main indicators in line with the Memorandum of Understanding with IMF also promoted greater fiscal sustainability.

In 2016, some members of the parliament attempted to constrain legally the central bank independence and to subordinate the regulator to political interests. That would have made impossible performance of the Bank’s core functions: maintaining price stability, promoting financial stability, and thus underpinning economic growth. The fact that Ukrainian parliament defeated these amendments is a positive signal for further reforms.

Council's position. The Council called members of the parliament to adopt laws that were vital for reforming and development of the financial sector. At the same time, the Council members emphasized that attempts to limit the National Bank independence and to distort its mandate should not be allowed.

Box 3: Cooperation with international donors and promotion of reforms in financial sector.

Assistance from international partners is an important driver of facilitation of financial sector reforms and enhancement of institutional capacity of Ukrainian regulators. This cooperation helps to attract financing, to learn from best international practices, and to approximate Ukrainian standards to international ones.

The four-year IMF program (the Extended Fund Facility, EFF) that provides for financing of up to USD 17.5 billion remains the key element of international assistance in terms of stabilization of financial situation and promotion of reforms. For the first time in its history, Ukraine successfully went through the third revision and received the fourth tranche under EFF program.

Table 7. Volumes of assistance from international donors (in USD billion, 04.2016 – 05.2017).

Inflows (international donor)	for Budget support	for replenishment of international reserves	for development project finance
IMF (EFF, 11.03.2015)		**2.00** (III tranche, 14.09.2016 IV tranche, 03.04.2017)	
EU (III macrofinancial assistance, 22.05.2015)		**0.75** (II tranche, 05.04.2017)	
USA (loan guarantees)	**1.00** (agreement, 03.06.2016)		
World Bank	**0.03**		**0.01**
EBRD			**0.01**
EIB			**0.04**

Total financial assistance for Ukraine from key international donors for the period reached almost USD 4 billion, of which USD 2 billion came from the IMF.

However, at its meeting in May 2017, the Council considered a long-term suspension of cooperation with the IMF under potentially worsening conditions as an alternative (shock) scenario alongside with a base-line scenario. Should this scenario materialize, the NBU may have to employ a wide range of instruments to mitigate risks.

Council position. Cooperation with the IMF and implementation of Memorandum is a necessary precondition for financial stability.
The Council members underscored the need for timely implementation of reforms stipulated by the IMF program. They also emphasized that delays in the program implementation may pose significant risks for macrofinancial stability in the medium term.

The Report was prepared by the Secretariat of the Financial Stability Council. Official data and information from the National Bank, the Ministry of Finance, the National Commission on Securities and Stock Market, the National Commission on Regulation of Financial Services and the Deposit Guarantee Fund was used.