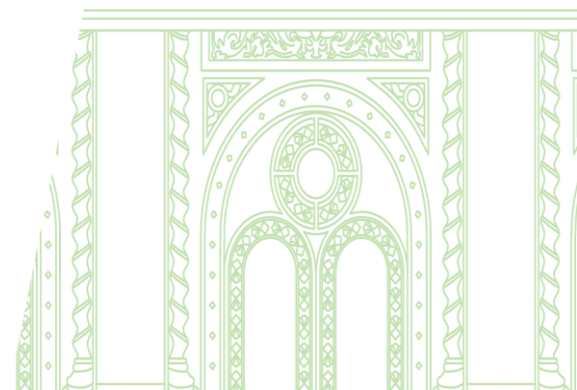


Development of Markets for FX Risk Hedging Instruments

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Context

Paragraph 64, Monetary derivative instruments bullet, of the Memorandum of Economic and Financial Policies concluded following the fifth review of the Extended Fund Facility (EFF) program with the IMF.

“To hedge foreign exchange and interest rate risks and improve monetary transmission, the NBU in consultation with IFIs, including via technical assistance, will prepare a concept note by end-December 2024 that will set out the steps, conditions and timing needed to introduce and develop the derivative financial instruments (including forwards) market.”

- **The note was drafted to fulfill the commitments** outlined in the Memorandum of Economic and Financial Policies concluded as part of the Extended Fund Facility (EFF).
- The objective of this note is **to define the approaches, conditions, and potential timelines for restoring the functionality of the foreign exchange derivatives market** to its pre-war parameters.
- The National Bank **has already begun implementing the approaches outlined in the concept note.**

Background

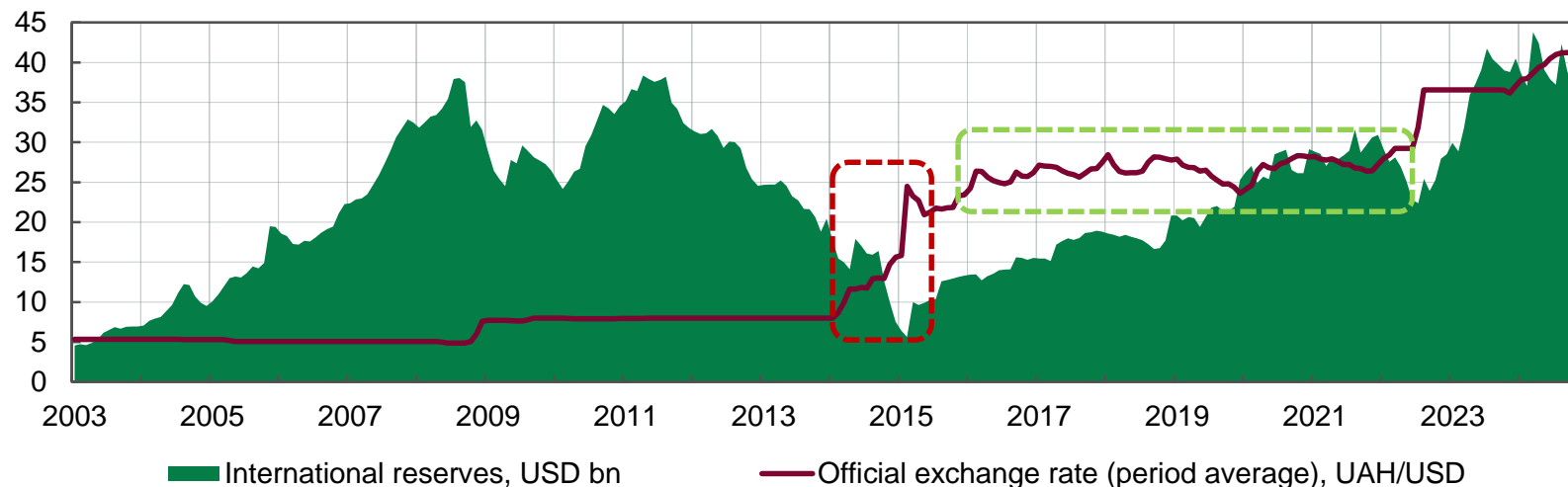
- Before 2014, Ukraine had a de facto fixed exchange rate regime with significant regulatory restrictions on entering into foreign exchange derivative contracts.
- As a result, most business entities lacked proper understanding of currency risks and were largely unfamiliar with currency risk hedging instruments. Consequently, banks, seeing little demand, rarely offered said instruments.
- Regulatory restrictions on entering into FX derivative contracts began to ease with the adoption of the new Law *On Currency and Currency Operations* in 2019, consistent implementation of currency liberalization, and introduction of the floating exchange rate regime.
- However, even after these measures were introduced, there was still a lack of financial awareness of derivative contracts and the procedure of operating derivative contracts
- Before the full-scale invasion, the NBU lacked the time to fully liberalize FX derivatives transactions. And after the full-scale war began, the NBU was forced to return to the fixed exchange rate regime and apply significant FX restrictions (including on FX derivative transactions)
- In 2023, the NBU approved the *Strategy for Easing FX Restrictions, Transitioning to Greater Flexibility of the Exchange Rate, and Returning to Inflation Targeting of the exchange rate, and returning to inflation targeting*, began a gradual easing of FX restrictions, and switched to managed flexibility of the exchange rate.
- The Roadmap for Gradual Easing of FX Restrictions developed as part of the Strategy provides for transactions with FX derivatives to be eased in the third and final stage of its implementation.
- Moreover, the concept note *On Defining Approaches, Conditions, and Timelines for Restoring the Functionality of the Foreign Exchange Derivatives Market prepared under the EFF program* made it possible to begin easing such restrictions already within the second stage of the Roadmap.



The Past: Before the Full-Scale Invasion

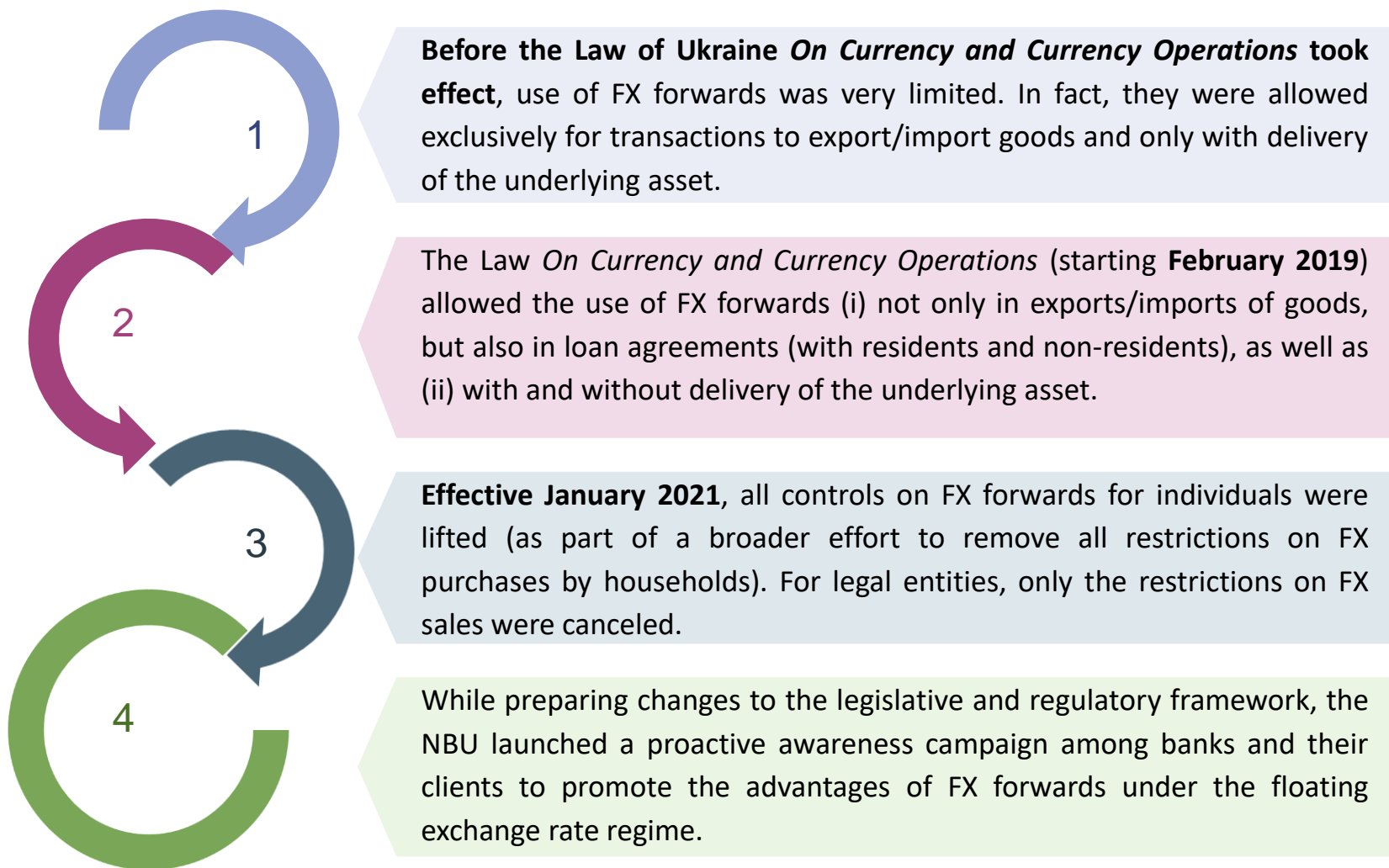
Yearslong exchange rate peg and FX restrictions impeded the development of the FX derivatives market

NBU's international reserves and hryvnia-to-dollar exchange rate

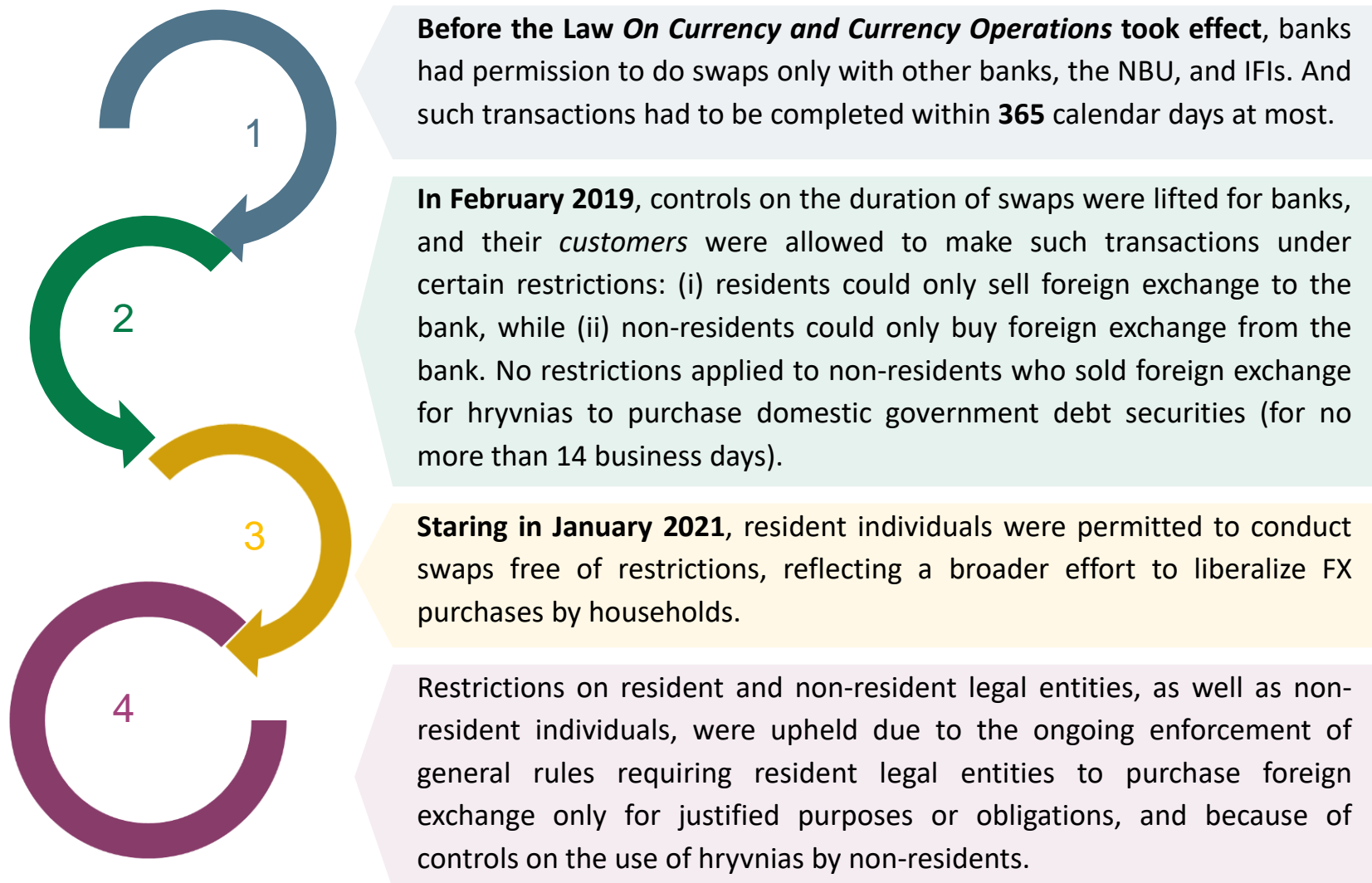


- The yearslong effort to maintain the de-facto fixed exchange rate was usually accompanied by risks of an unexpected major depreciation occurring due to a drawdown of FX reserves
- While the currency peg was in effect, the NBU kept in place harsh restrictions on the conduct of FX derivative transactions in order to prevent additional pressure on the exchange rate
- After the switch to a floating exchange rate in 2014, the controls on FX derivatives began to be gradually relaxed, but the market for such contracts developed sluggishly due to poor awareness and the lack of a generally accepted practice of dealing in such instruments.

How the regulation and conduct of FX **FORWARDS** evolved before full-scale war

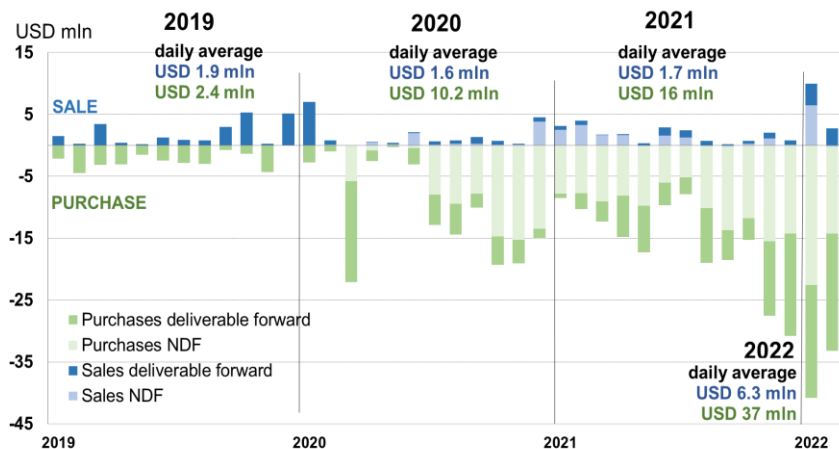


Evolution of FX **SWAPS** regulation and use prior to full-scale war

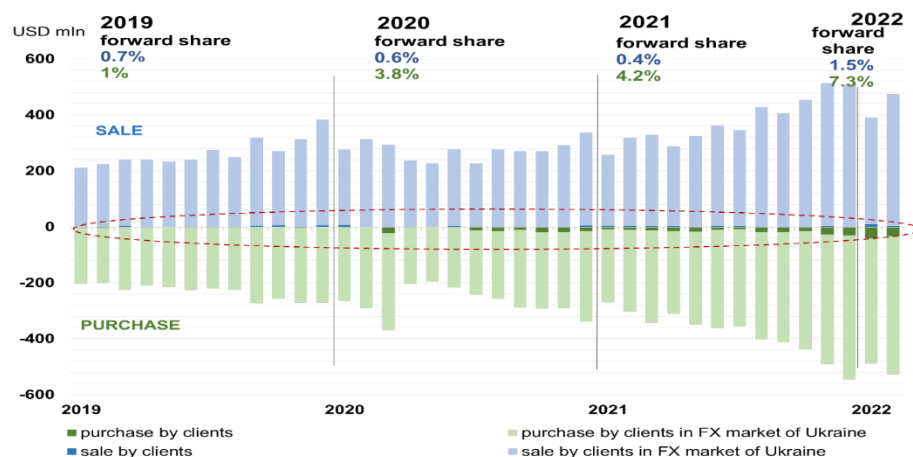


Forward transactions in Ukraine's FX market before large-scale invasion

Average daily volumes of **forward** transactions by banks' customers prior to full-scale invasion



Average daily volumes of **forward** transactions by customers in Ukraine's FX market before full-scale war



Prior to the large-scale invasion, **forward transactions by banks' customers were trending higher:**

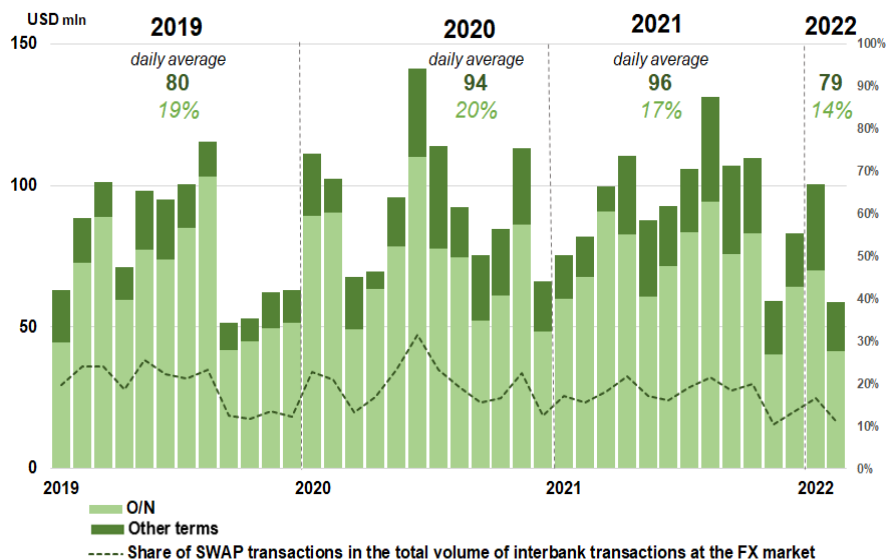
- ✓ **average daily transaction volumes** surged to USD 37 million (buying) and USD 6 million (selling) in January–February 2022, up from just USD 2 million (both buying and selling) in 2019
- ✓ **the shares of FX forwards** in the total volume of cashless transactions by customers in Ukraine's FX market rose to 7% (purchases) and 2% (sales) in January–February 2022, up from 1% (both purchases and sales) in 2019
- ✓ **the shares of transactions with no delivery of the underlying asset** in the total volume of FX forwards by customers were **50%** (both purchases and sales) in 2021 through January–February 2022, down from **62%** (FX purchases) and up from **39%** (sales) in 2020.

Except for a brief break between October 2019 and January 2020, forwards to purchase foreign exchange dominated the breakdown of FX forwards conducted by banks' customers. This reflected market participants' asymmetric choice of depreciation risks over appreciation risks when making efforts to manage risk.

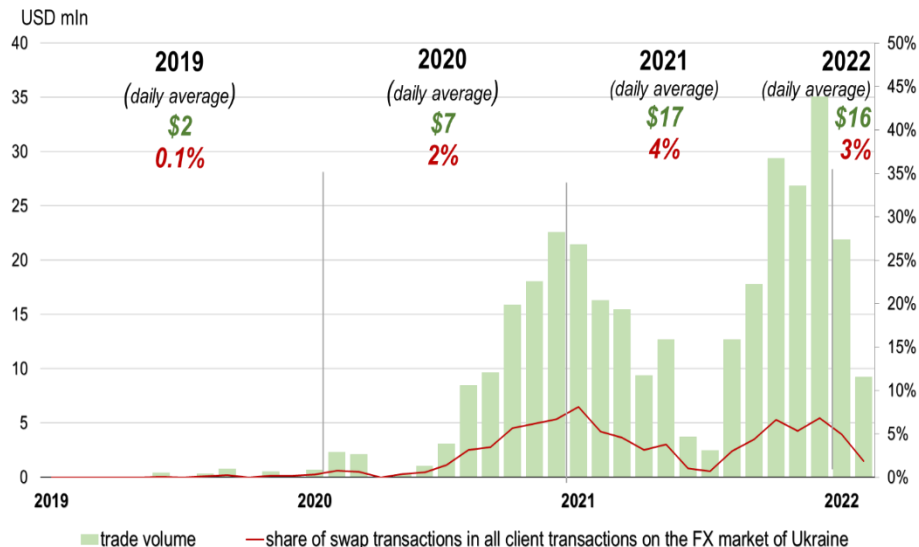
Banks did not feel a significant need to use forwards to hedge their FX risks, as banks were able to spot-purchase foreign exchange without restrictions, within established FX-position limits. Forward transactions therefore made up just **0.03%** of total trading volumes **between banks** in Ukraine's FX market.

SWAP transactions in Ukraine's FX market prior to full-scale invasion

Average daily volumes of **SWAP transactions** between banks prior to full-scale invasion



Average daily volumes of **SWAP transactions** by banks' customers to sell foreign exchange in Ukraine's FX market before full-scale invasion



Prior to the full-scale war, **SWAP transactions** by banks' customers (to sell foreign exchange) were trending up:

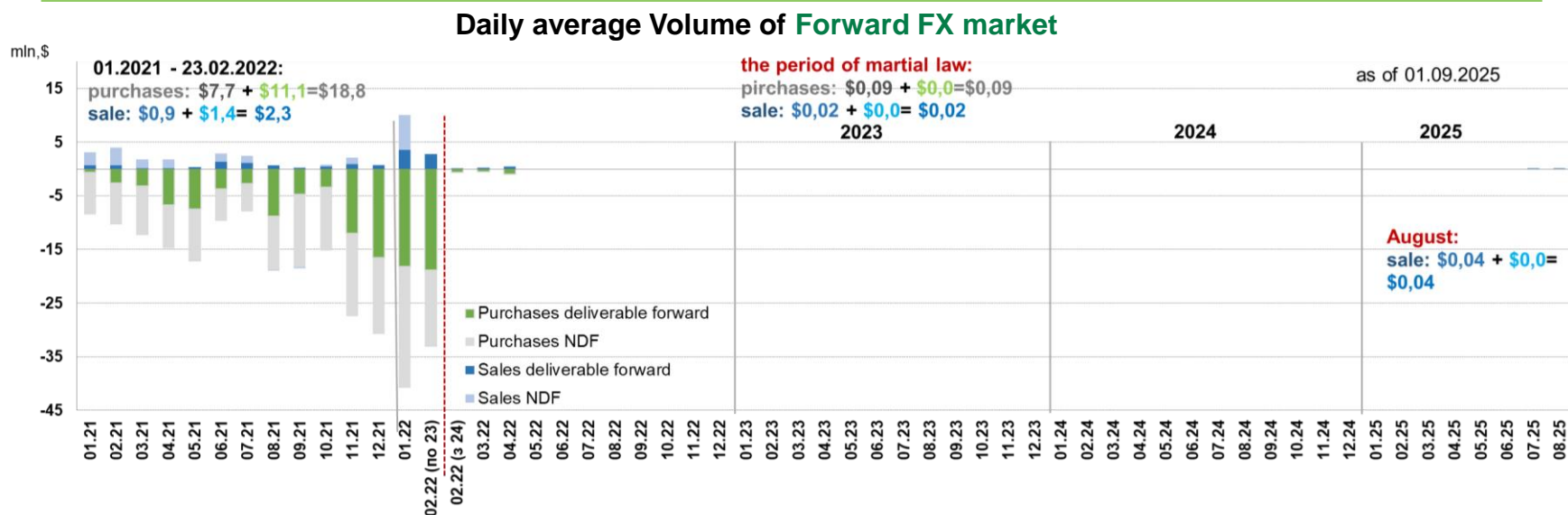
- ✓ **average daily transaction volumes** rose to USD 16 million in January–February 2022 from USD 0.2 million in 2019
- ✓ **the shares of such transactions** in the total volume of cashless transactions by customers in Ukraine's FX market increased to 3% in January–February 2022 from 0.1% in 2019

To **banks**, SWAP transactions were traditionally not so much a tool to hedge currency risk as a money market operation to raise or place liquidity. However, in the face of an ever-growing liquidity surplus, room to make funding operations was narrowing.



Modern: Martial Law Period

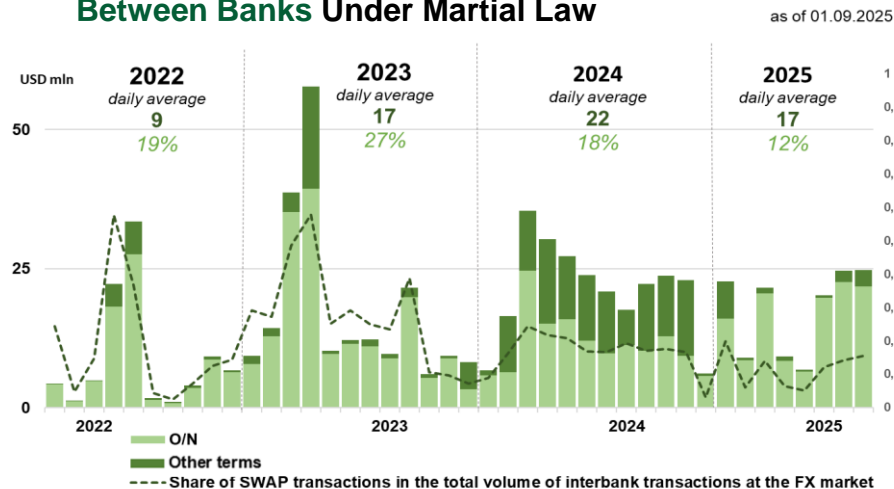
Forward Transactions Under Martial Law



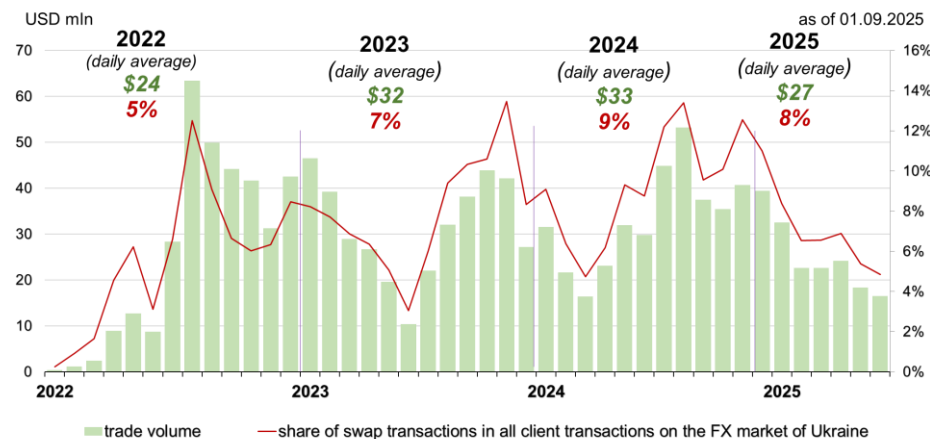
- With the onset of large-scale invasion FX derivative contracts were banned. In March 2022, banks were allowed to close positions under forward contracts concluded before the introduction of martial law.
- The volume of bank clients' transactions on forward terms in the Ukrainian FX market (only the closing of transactions concluded before 23 February 2022) for the purchase of foreign currency was USD 4 million per day and for the sale of foreign currency was USD 1.6 million per day from the beginning of the war until October 2022. Since November 2022, such transactions have not been executed.
- *In May and August 2025, the NBU allowed certain types of FX forward contracts to be concluded (see slide 20 for details). At the same time, market participants have hardly taken advantage of these opportunities to date. Specifically, during the period from 10 May 2025 to 31 August 2025:*
 - ✓ Five forward contracts for clients to sell foreign currency with delivery of the underlying asset were concluded (1 contract worth USD 0.1 million in July, 4 contracts with a total value of USD 0.8 million in August).
 - ✓ No transactions between banks or transactions with clients were executed to purchase foreign currency on forward terms. No transactions were executed by clients to sell foreign currency on forward terms without delivery of the underlying asset.

SWAP Transactions Under Martial Law

Average Daily Volumes of SWAP Transactions Between Banks Under Martial Law



Average Daily Volumes of SWAP Transactions for Currency Sales by Bank Clients* Under Martial Law



* Excluding the central counterparty and foreign depository bank

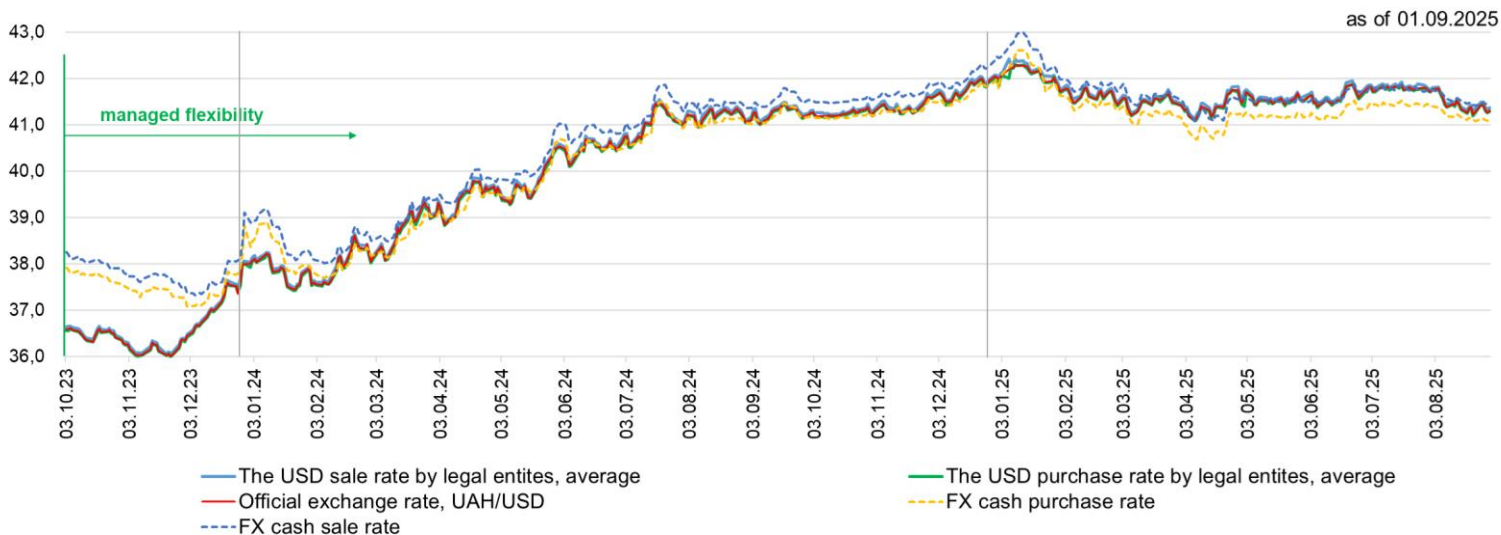
- During the period of martial law, banks were allowed to execute the following swap transactions:
 - ✓ with other banks, international financial institutions, and the central counterparty without restrictions
 - ✓ with other resident clients only for the exchange of foreign currency within Group 1 of the Classifier and/or for the purchase and sale of foreign currency, if the first part of the transaction involves the purchase of foreign currency by the bank from the client
 - ✓ with a depository bank that has a securities account with the NBU (Clearstream), for the purchase and sale of foreign currency, if the first part of the transaction involves the sale of foreign currency by the bank to Clearstream.
- The volume of interbank FX swap transactions increased from USD 9 million per day in 2022 to USD 22 million per day in 2024 and USD 17 million per day for the first 8 months of 2025.
- The volume of swap transactions to sell foreign currency by bank clients (other than the central counterparty and foreign depository bank) increased from USD 24 million per day in 2022 to USD 33 million per day in 2024.



Future: Approaches, Conditions, and Possible Steps for Liberalization of FX Derivative Transactions

Exchange rate fluctuations under the regime of managed exchange rate flexibility pose additional currency risks to economic agents

Official and market UAH/USD exchange rates after the introduction of the regime of managed exchange rate flexibility



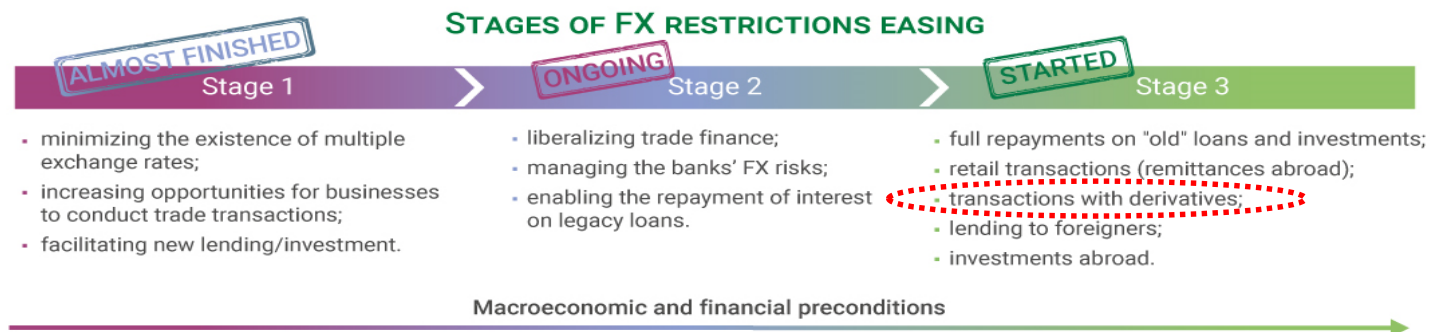
Different categories of market participants currently have different opportunities to hedge their currency risks. Banks and individuals have many more opportunities than non-bank business entities. Specifically:

- ✓ **banks** can freely purchase foreign currency on a spot basis within their established foreign-exchange position limits
- ✓ **individuals** can relatively freely purchase and accumulate foreign currency both in the cash segment and (with limitations) in cashless transactions. Also, the option to have their deposits tied to the exchange rate is available to them
- ✓ **legal persons** have a limited capacity to purchase and accumulate foreign currency in accounts: (i) there is an exhaustive list of transactions for which the purchase of foreign currency is allowed; (ii) the purchased foreign currency should be used for the stated transactions in two days; (iii) the purchase of foreign currency is not allowed if own foreign currency is available in the account.

Therefore, legal persons have a justified need to have access to currency risk hedging instruments.

Easing the restrictions on FX derivatives: pros and cons

Easing of restrictions on transactions with FX derivatives will be carried out within the framework of the Strategy, subject to the macroeconomic and financial prerequisites defined therein.



PROS

- **Businesses get the opportunity to reduce currency risks** → promotes economic activity and reduces pass-through effects of exchange rate fluctuations on prices and the dollarization rate.
- **Large amounts of FX purchases/sales are spaced out in time** → reduces the probability of sharp exchange rate fluctuations in response to ad-hoc shocks.



CONS

- **More pressure on the exchange rate**, towards a point where market participants have uniform expectations about future exchange rate changes.
- **FX forwards promote the possibility of purchasing foreign currency at the expense of borrowed hryvnias** → may put more pressure on international reserves as the need for NBU interventions rises to smooth out exchange rate fluctuations.

Economic agents' exchange rate expectations in the medium and long term are significantly shifted towards depreciation. Therefore, the probability of the adverse impact materializing is high, and the higher it is, the lower is the probability of the positive effects being realized.

Mechanisms to minimize the risks of easing the restrictions on FX derivatives transactions

- As the easing of any FX restrictions carries both opportunities and risks, efforts to restore the FX derivatives market's operation in Ukraine will be accompanied by **risk-mitigating mechanisms**.

The primary ones are:

- ✓ *step-by-step lifting of bans on transactions in money market derivative contracts*
- ✓ *placing precautionary limitations on the direction (sale or purchase), volume (limits), grounds, and method (with or without delivery) of transactions*
- ✓ *continuous monitoring of the volume and price parameters of transactions with hedging instruments, and supervision of compliance with established restrictions by banks and their clients*
- ✓ *assessing the impact of derivative transactions on the spot segment, bank balance sheets, and international reserves*
- ✓ *where necessary, calibrating the established restrictions and postponing the next steps to lift the bans on transactions in derivative contracts.*

Key principles of FX liberalization to preserve the controllability of FX market processes

- **The first to be relaxed are restrictions that do not affect the balance of supply and demand** in the FX market, or that help generate additional FX supply. Such restrictions may be lifted **during the implementation of Stage II of the Roadmap**.
- All restrictions that have **the potential to generate additional demand for foreign currency** are relaxed **at Stage III of the Roadmap's implementation**.
- Regarding uniform transactions, restrictions are first relaxed on transactions **with delivery of the underlying asset**, and then **on transactions without delivery of the underlying asset**.
- First, restrictions are eased on transactions that **hedge the currency risk of operations to import goods**, and then on transactions **to raise funds from non-residents or from a bank**.
- Restrictions on transactions **that create more demand in the FX market** are initially loosened **within a certain limit**, and only later can banks be allowed to make such transactions **without limits on volume**.
- Restrictions that require **additional reporting to monitor the effects** of their easing are relaxed only **after statistical reporting systems are ready** (in particular, easing the conduct of transactions by setting limits for conduct).

Easing of restrictions on **FX forwards**

Within Stage II of the Roadmap *without setting limits*

- ✓ Any forward transactions between banks
- ✓ Transactions by clients (individuals and legal persons) to sell foreign currency to banks on forward terms with delivery of the underlying asset
- ✓ Transactions by clients (individuals and legal persons) to sell foreign currency to banks on forward terms without delivery of the underlying asset.

Within Stage III of the Roadmap *within limits, with their gradual increase and cancelling**

- ✓ The purchase by resident clients of foreign currency from banks on forward terms (with delivery of the underlying asset) to hedge the risk of exchange rate fluctuations affecting transactions to import goods
- ✓ The purchase by resident clients of foreign currency from banks on forward terms (without delivery of the underlying asset) to hedge the risk of exchange rate fluctuations affecting transactions to import goods
- ✓ The purchase by resident clients of foreign currency for hryvnias from banks on forward terms (with delivery of the underlying asset) to hedge the risk of exchange rate fluctuations affecting loan agreement transactions
- ✓ The purchase by resident clients of foreign currency for hryvnias from banks on forward terms (without delivery of the underlying asset) to hedge the risk of exchange rate fluctuations affecting loan agreement transactions.

**limits on the amount of foreign currency that banks will be able to sell to clients through the relevant transactions. The limits will be set as a ratio to banks' regulatory capital. During FX liberalization, these limits will be gradually expanded until completely abolished by the end of Stage III of the Roadmap.*

Easing of restrictions on **SWAP** transactions

It is proposed to ease the current restrictions on **swap transactions** within the framework of Stage III of the Roadmap.

Individuals

Stage III of the Roadmap removes the restrictions on FX transactions by resident individuals. This lifting of restrictions will also apply to transactions to purchase foreign currency on swap terms.

Such liberalization of swap transactions should be carried out after individuals are given back their ability to purchase cashless foreign currency without any restrictions on the amount and without providing any grounds or undertaking any obligations.

Legal persons

The ultimate goal of implementing the Roadmap is to return to the currency regulation regime that existed before martial law.

For operations by resident legal persons, the same regime is already in effect for making transactions on swap terms that was in place before martial law was imposed.

Non-residents

Before the war, non-residents were able to sell foreign currency on swap terms for up to 14 days if hryvnia funds were used to buy domestic government debt securities.

Currently, there is no urgent need to resume such operations due to non-residents' lack of interest in purchasing domestic government debt securities. Reinstating the option to make such transactions is therefore possible once demand from non-residents for domestic government debt securities becomes significant again.

Market participants are not actively using the opportunities already provided by the liberalization of FX derivatives transactions

As of 10 May 2025, the NBU authorized:

- 1) transactions by clients to **sell** foreign currency to banks on forward terms **with delivery of the underlying asset**.

As of 6 August 2025, the NBU authorized:

- 1) transactions by clients to **sell** foreign currency to banks on forward terms **without delivery of the underlying asset**
- 2) transactions by resident clients (legal persons and sole proprietors) to **purchase** foreign currency on forward terms **with delivery of the underlying asset for hedging** the risk of exchange rate fluctuations affecting transactions to import goods, **subject to the following condition:**

*At the end of **each** business day, the total volume of foreign currency sold by the bank to clients on forward terms under **active** contracts **does not exceed** the total volume of foreign currency purchased by the bank from clients **under active** forward contracts (both with and without delivery of the underlying asset).*

FOR REFERENCE: From 10 May 2025 to 31 August 2025,:

- ✓ Five forward contracts for clients to sell foreign currency with delivery of the underlying asset were concluded (1 contract worth USD **0.1** million in July, 4 contracts with a total value of USD **0.8** million in August).
- ✓ No transactions between banks or transactions with clients were executed to purchase foreign currency on forward terms. No transactions were executed by clients to sell foreign currency on forward terms without delivery of the underlying asset.

Development of markets for FX risk hedging instruments: *questions for discussion*

Please share your opinion on the following:

- ✓ *To what extent are the principles and sequence of easing FX restrictions on transactions with FX derivatives perceived as clear and optimal?*
- ✓ *What factors are hindering more active utilization of the available opportunities for conducting transactions with FX derivatives by market participants?*