Financial Stability Council
Report on Activities

(June 2017 – July 2018)

Kyiv 2018

Foreword

Systemic risks remained under control through the reporting period. That gave the Financial Stability Council (the Council) an opportunity to concentrate on potential challenges and future developments. E.g., the Council looked into ways to enhance cooperation between the Government and the National Bank on promotion of price stability and balanced fiscal policy, which is important for ensuring financial stability in the long run. The members reached a consensus on further strategy for state-owned banks. In order to support the strategy, a law on development of efficient corporate governance at state-owned banks was adopted. The Council backed up the on-going evolution of the infrastructure of capital and commodity markets. It paid a special attention to prospects of crypto-currencies in Ukraine in view of their growing popularity and risks they entail.

To keep up with the pace of reforms of 2014-2015, the Council repeatedly called on authorities concerned for support and adoption of necessary pieces of legislation. In particular, the Council mentioned new legislation on foreign currency operations, enhanced protection of creditor rights and recovery of lending, and introduction of medium-term budgeting to increase resilience of public finance. Annex to this report provides, for the first time, information on implementation of Council's recommendations in the past three years.

The Council singled out suspension of cooperation with the IMF as the key current risk for financial stability. Launch of structural reforms, which the IMF program mentioned, are of paramount importance for ensuring macrofinancial stability and access to financing from other international donors. We hope that negotiations with the IMF mission will be successful. We believe that its visit this September is a sign of irreversibility of Ukrainian course for reforms and integration into European communities.

Content

Composition of the Financial Stability Council[1]

		Co-chairpersons of the Council:
Yakiv **Smolii**	–	Governor of the National Bank of Ukraine (NBU)
Oksana **Markarova**	–	acting Minister of Finance of Ukraine
		Members of the Council:
Tymur **Khromaev**	–	Head of the National Securities and Stock Market Commission (NSSMC)
Ihor **Pashko**	–	Head of the National Commission for the State Regulation of Financial Services Markets (NCSRFSM)
Kostyantyn **Vorushylin**	–	Managing Director of the Individuals' Deposits Guarantee Fund (DGF)
Kateryna **Rozhkova**	–	First Deputy Governor of the National Bank of Ukraine
Yuri **Geletiy**	–	Deputy Minister of Finance of Ukraine

[1] As of July 2018

Key issues considered by the Financial Stability Council

The Council held three meetings between June 2017 and July 2018.

1. Overview of systemic risks

The National Bank of Ukraine presented an overview of current risks and their change at each Council meeting (Table 1).

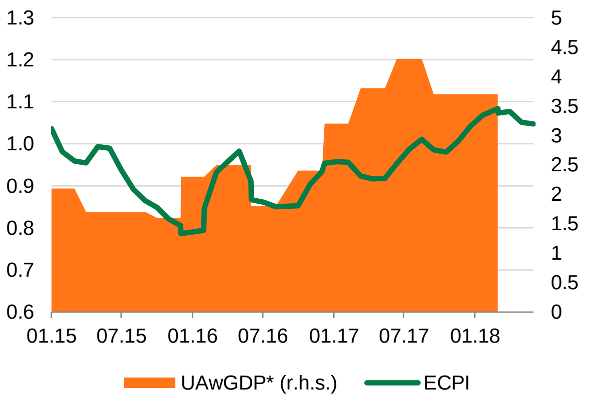
Table 1. Evolution of systemic risks

	2017						2018		
	June	July	Aug.	Sep.-Oct.	Nov.	Dec.	Jan.-March	Apr.-June	July
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.

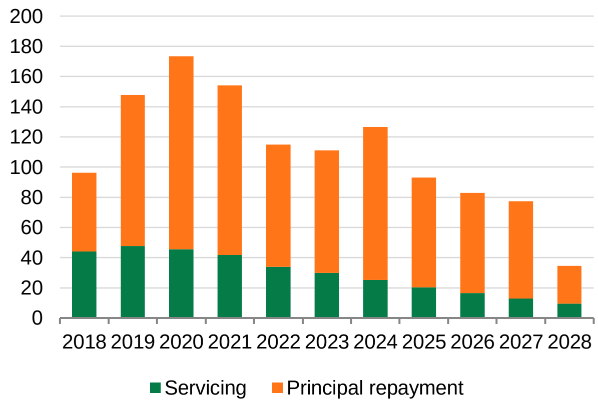
Global economy: Global economy and trade growth accelerated in 2017-2018 in line with forecasts from the previous report. Economies of our major trading partners (MTP) grew dynamically.

Chart 1. Average weighted indicator of annual economy growth of Ukraine's MTPs (UAwGDP), yoy, %, and External Commodity Price Index (ECPI; 12.2004=1)



** Weights for UAwGDP are calculated based on Ukraine's trade turnover with respective countries.*
Source: NBU Inflation Report, July 2018

Chart 2. Scheduled repayments on external public debt, billion UAH*



** At the current exchange rate as of July 2018*

Source: MinFin

However, introduction of new protectionist measures in international trade and hiking of key interest rates by leading central banks can cause a slowdown in global economic growth starting from the next year.

External demand: External environment was mostly favorable for Ukraine. Prices for its exports were high by historic comparisons. The key risk in a medium term are global trade wars between USA, China and other partners.

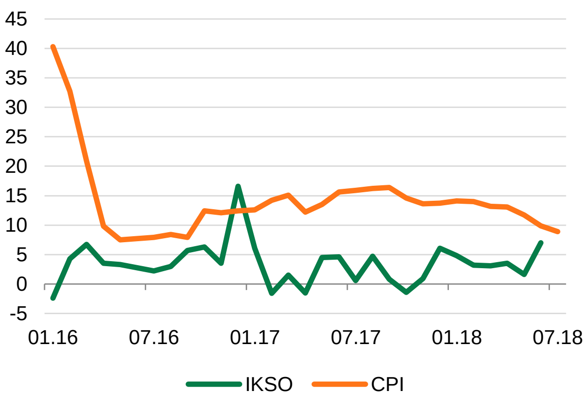
Public finance: Rising social transfers, uneven inflow and outflow of funds from Single Treasury Account, underperformance in terms of external borrowings in first half of 2018 gave rise to liquidity risks for the State Budget. In the absence of resumed cooperation with international financial institutions (IFIs), situation with liquidity is to remain tense against the backdrop of substantial repayments on external debt peaking in 2018 – 2020.

Economic conditions: Economic growth accelerated since early 2018 on the back of increasing private consumption and investment demand. It is likely to slow down in the coming years because of tighter monetary and fiscal policy, limited supply on the labor market, and political risks. Absence of progress in cooperation with the IFIs is yet another risk.

Over the reporting period, inflation stayed above the target range, mostly under pressure from prices for raw products and rising consumer demand. Inflation is set to slow down by the end of 2018. However, its readings in coming quarters is likely to remain in excess of target levels. Thus, the NBU has to follow tight monetary policy in order to tame the inflation.

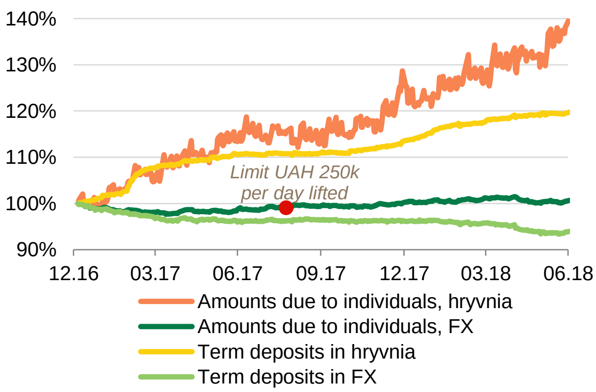
Banking sector has stabilized. Deposits in hryvnia were returning to banks.

Chart 3. IKSO and CPI*, yoy change, %



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

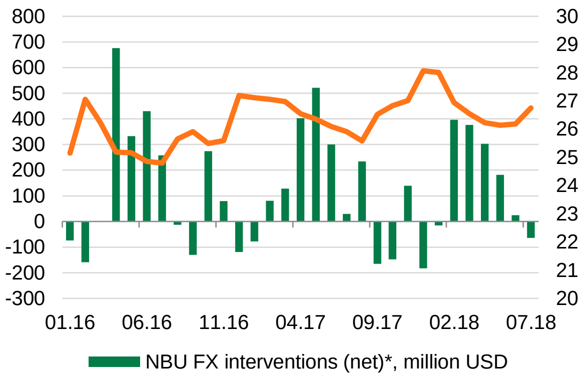
Chart 4. Retail deposits including certificates of deposit, 2015=100%*



** At solvent banks as of 1 July 2018, including accrued interest.*
Source: NBU.

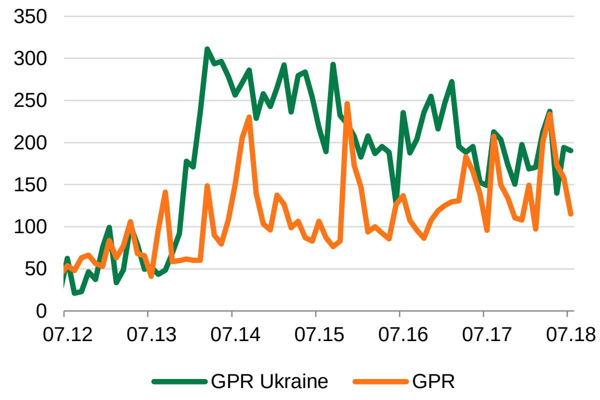
Foreign exchange (FX) market: Over the reporting period, situation on the FX market remained under control. That gave way for further relaxation of administrative restrictions by the NBU. However, the balance is fragile. Resumption of cooperation with IFIs is the key precondition for avoiding sharp volatility on the market.

Chart 5. Hryvnia exchange rate and NBU interventions



** Positive readings indicate that the NBU buys FX*
*** "At the end of a month.*
Source: NBU.

Figure 6. Geopolitical risk index (GPR)[2]



Source: Dario Caldara and Matteo Iacoviello.

Geopolitics: Geopolitical risks remain high because of consequences of Brexit, trade wars between USA and China, tensions between USA and Iran and North Korea, Russian terrorist attacks in third countries. There is no resolution for the prolonged conflict in the east of Ukraine yet.

Council's position. The Council stressed that the key current risk to financial stability is a delay in reforms that Ukraine committed to implement under the IMF program, and thus with the receiving the next loan tranche. The delay also impeded raising funds from other international partners of Ukraine and can raise the cost of borrowing on external markets. The Council called on all authorities concerned to facilitate further cooperation with the IMF and other international lenders.

[2] The geopolitical risk index (GPR) measures the aggregate level of global geopolitical risks, by calculating the instances of words related to geopolitical tension appearing in leading global and regional media publications. Dario Caldara and Matteo Iacoviello constructed the index. Separate indices are calculated for emerging markets like Ukraine. This index is used widely by international experts and by the IMF in particular.

Box 1. Evolving focuses in public communications of the Council

The evolution of the content of the Council's press releases through the three years of its operation was tracked through 'word clouds'[3]. The instrument helps to visualize the key words and topics of the Council's communication for each year of its activity (as described in the respective annual report).

A substantial part of the Council's communications between April 2015 and March 2016 was about explaining its aims and functions. Thus, basic terms were widely used (e.g. 'FSC', 'system', 'financial stability'). The Council focused on mitigating risks ('risks'), including macroeconomic ones ('slow', 'stabilize'). It also discussed transition to inflation targeting regime and its impact on financial stability ('targeting'). The overall assessment of the state of the financial system and risks it was facing at the time made the Council endorse the decision on presence of signs of banking system instability ('signs'). That gave the NBU grounds to impose temporary anti-crisis restrictions ('restrictions'). One of the factors that had an impact on financial stability in terms public finance was a successful public debt restructuring ('restructuring').

Between April 2016 and May 2017, when the State nationalized PrivatBank and re-capitalized state-owned banks, the state-owned banks were one of the key topics of discussions at the Council's (the size of 'SOBs' term). The Council was intensively deliberating on legal amendments necessary to promote financial stability. It was calling on parliamentarians and other authorities to support adoption of these amendments and changes ('law', 'draft', 'amendments', 'registered', and 'submitted'). That also included appeals to expedite the formation of the NBU Council ('NBU_Council') as its absence blocked the transfer of the NBU revenues to the State Budget. The Council stressed the need for improvements in corporate governance at the state-owned banks ('supervisory', 'boards'). It also discussed prospects for life insurance market and its part in financial system ('life', 'insurance'). In general, Council's agenda focused on positive transformations and reforms ('recovery', 'lending', 'development', 'reforming', 'economic', 'growth', and 'improvement').

[3] Size of a word in the cloud reflects the frequency of its use. The cloud shows only those words that were used at least three times. The cloud also omits articles, conjunction, pronouns, etc. For the sake of the analysis, synonyms were brought to a single word in one tense. Acronyms were used there possible (e.g., Financial Stability Council – FSC, state-owned banks – SOBs, etc.).

In June 2017 – July 2018 the Council paid more attention to prospective changes. For instance, it took a closer look at prospects and risks stemming from cryptocurrencies ('status', 'Bitcoin', 'cryptocurrencies'). The Council devoted time to reforms of the financial market infrastructure aimed at raising its resilience and efficiency ('NationalDepository', 'CCP[4]', 'Settlement', 'derivatives'). At the same time, the Council was looking for ways for efficient resolution of legacy problems that still posed risks. That included bringing down NPL ratio at state-owned banks, *inter alia* aided by establishment of a dedicated Committee under the Council ('establish', 'SOBs', 'NPLs'); better coordination of fiscal and monetary policy for the sake of financial stability ('monetary', 'fiscal', 'policies', 'medium-term', 'cooperation'); improving corporate governance at state-owned banks ('corporate'), enhancing financial capacity of the DGF ('debt', 'DGF', 'repayment', 'burden').

Certain words and phrases remained key to the Council's communications through these three years, like its name and names of its members institutions, as well as 'risks', 'financial stability', 'banks'. The Council's communications constantly mentioned cooperation with the IMF as one of the key determinants of stability of the national financial system. Each meeting devoted attention to components of macroeconomic environment, e.g. growth and inflation, situation on the FX market.

Thus, it would be safe to say that the Council's focus has been gradually evolving from stabilization and overcoming immediate threats to longer-term issues and challenges, as well as enhancing of financial system resilience.

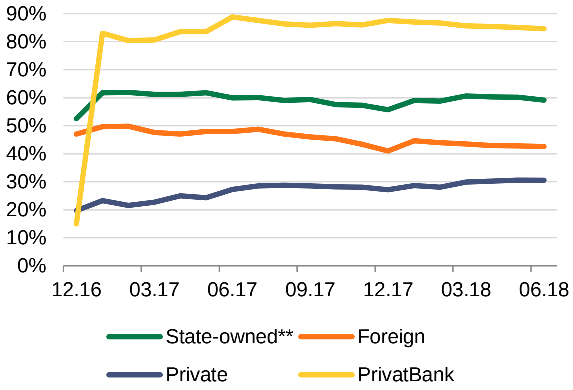
[4] Central counterparty

2. Problems of the state-owned banks

Over the reporting period, the Council extensively debated on work of state-owned banks. The discussions focused primarily on the need to reform their corporate governance framework and to update their development strategy.

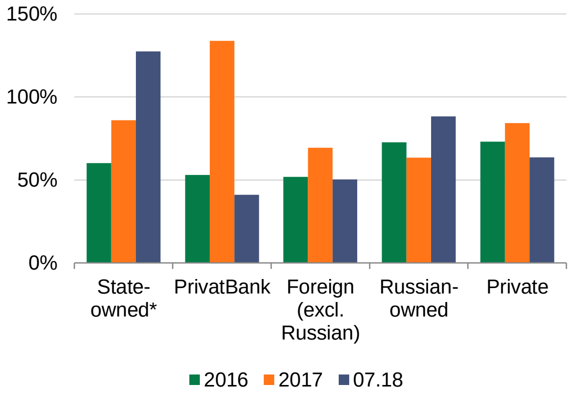
The state-owned banks dominate the market. Their share in net assets and retail deposits as of 1 August 2018 was 54.8% and 63.5% respectively. The largest share of non-performing loans (NPLs) is also found in portfolios of state-owned banks (Chart 7). Their operating efficiency is also low in comparison to other groups of banks (Chart 8).

Chart 7. NPL ratio by groups of banks*



** All banks, including interbank loans and insolvent banks;*
*** Excluding PrivatBank.*
Source: NBU.

Chart 8. Cost-to-Income Ratio (CIR)



** Excluding PrivatBank.*

Source: NBU.

Adoption of necessary legal amendments should promote resolution of the problems of state-owned banks. The Council members repeatedly underlined that.

In February 2018, the Government endorsed the Strategy for the State in banking sector that was submitted by the Ministry of Finance (MinFin). The Strategy aimed at limiting considerably State's presence in the banking sector (Chart 9), encouraging market competition, recovery of lending into economy, raising affordability and access of banking services.

Chart 9. Schedule for limiting State's presence in the banking sector

		2017	2018	2019	2020	2021	2022
Oschadbank	OSCHADBANK MY BANK. MY COUNTRY	100	100	100	80*	80	55**
		17	18	17	16	16	16
PrivatBank	PrivatBank	100	100	100	100	100	0***
		20	19	18	18	18	18
UkrEximBank	UKR EXIM BANK	100	100	100	100	100-80****	100-80****
		13	12	10	8	8	7

		2017	2018	2019	2020	2021	2022
Ukrgazbank		95	75*	75	0*****	0	0
		5	5	5	5	5	5
Share of market controlled by the State		55	53	50	43	42	24

Notes

	Share of the State in ownership, %
	Share of bank on the market (in terms of assets), %
*	Sale of 20% stock to international financial institutions (IFIs)
**	Sale of 25% stock through IPO
***	Sale of 100% stock to an international investor
****	Investment in a minority stock by an IFI
*****	Sale of 75% stock to a strategic investor

Source: Ministry of Finance, *Guidelines of the strategic reform of the state-owned banks.*

The next stage for state-owned banks reform came when the parliament adopted this July the law on improving the functioning of financial sector. The law *inter alia* aimed at fundamental revision of principles and mechanisms of corporate governance at state-owned banks. The key novelties included:

- Each state-owned bank should have an independent supervisory board comprising nine members. Six of those members should be independent, while three should represent the President, the Government and the parliament.
- A list of criteria for supervisory board members was set. Candidates should be selected in a competitive manner.
- Members of supervisory boards should be remunerated. The tenure of the board should be three years.
- Unlawful meddling/intrusion into work of the state-owned bank officials should be criminally prosecuted.
- Shareholders are not allowed to make decisions within the field of competence of a supervisory board.

When the President signs the act into law, the implementation of best international (more efficient) corporate governance practices at state-owned banks shall start.

Council's position. In early 2018, the Council called for expedite resolution of problems of state-owned banks including formation of supervisory boards. The Council supported the updated strategy for development of state-owned banks endorsed by the Government.
In order to promote NPL resolution at state-owned banks, the Council decided in July to set up a special dedicated committee under the FSC.

3. Prospects for crypto-currencies in Ukraine

The Council concentrated on cryptocurrencies given their popularity as underlying asset for financial transactions in Ukraine and around the globe as well as risks that these operations entail. The latter are also related to undefined status of cryptocurrencies in Ukraine[5].

The unclear status of cryptocurrencies is not specific exclusively for Ukraine. The cryptocurrency phenomenon is still studied and remains ambiguous in many developed countries, including the EU (see Box 2 for more). There is still a lack of international consensus on defining cryptocurrencies.

The Council twice included on its agenda the issue of status and prospects of cryptocurrencies, risks for financial stability stemming from transactions involving them. In the course of the discussion, the Council members and invited experts (including members of the parliament of Ukraine) agreed that cryptocurrency mining[6] is legal under Ukrainian legislation. They also debated on regulation of transactions with cryptocurrencies. The Council ruled that the issue required additional investigation. Therefore, it established a working group for producing a joint stance of financial regulators and preparing legal grounds for defining the cryptocurrencies' status.

In November 2017, financial regulators (the NBU, national commissions for securities and stock market and for state regulation of financial services) published a joint statement saying what cryptocurrencies were not under Ukrainian legislation (Chart 10). They also admitted the lack of consensus between leading global regulators on nature of cryptocurrencies and best way to regulate them.

Chart 10: What cryptocurrencies are not under Ukrainian legislation and in the best international practices

money/currency notes
- as it does not exist in the form of bills, coins or bank account entries

foreign currncy/FX assets/foreign legal tender
- as it is not related to monetary unit of any jurisidiction

e-money
- as they are not issued by any bank and are not monetary liability of any person

security
- as it does not comply with specification of a security, e.g. there is no issuer

quasi-money/money substitute
- as it bears no features of a monetary document, has neither issuer, nor purpose of issue

Therefore, cryptocurrency transactions should not fall under provisions of legislation on currency circulation, FX, e-money, securities, or payment instruments.

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[5] The only official attempt to outline the status of virtual/crypto- currencies to that moment was a letter from the NBU of 8 December 2014 that stressed risk related to using Bitcoins in operation of money laundering and 'ponzi schemes'. However, that document did not give a clear answer on the cryptocurrency status.

[6] In cryptocurrency networks, mining is a validation of transactions. For this effort, successful miners obtain new cryptocurrency as a reward. (Wikipedia).

The regulators also warned market participants on numerous risks that cryptocurrency transactions entail (chart 11).

Chart 11: Risks of cryptocurrency transactions

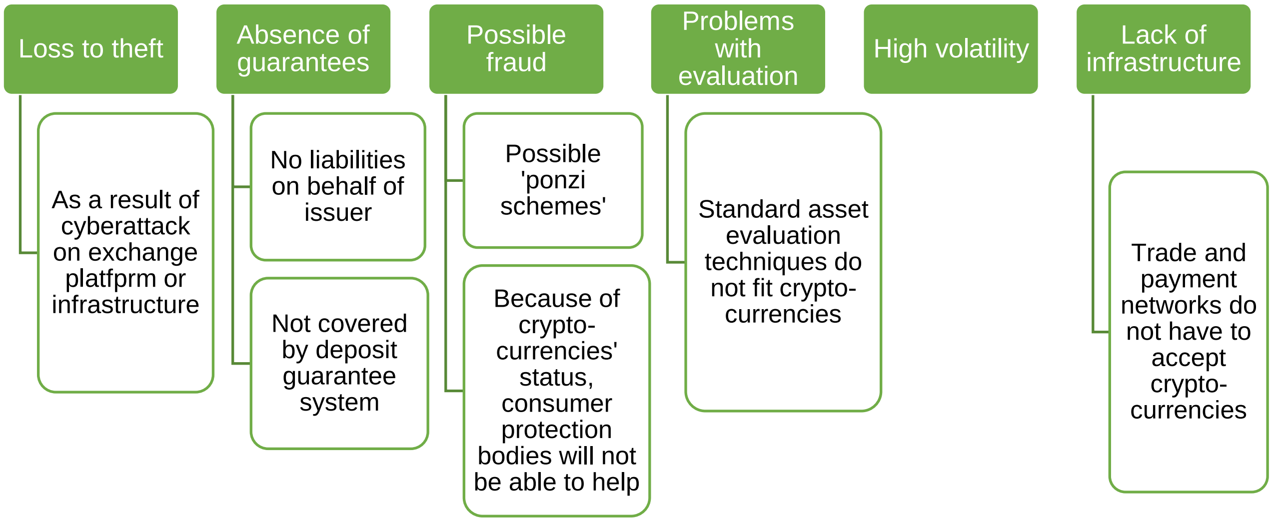
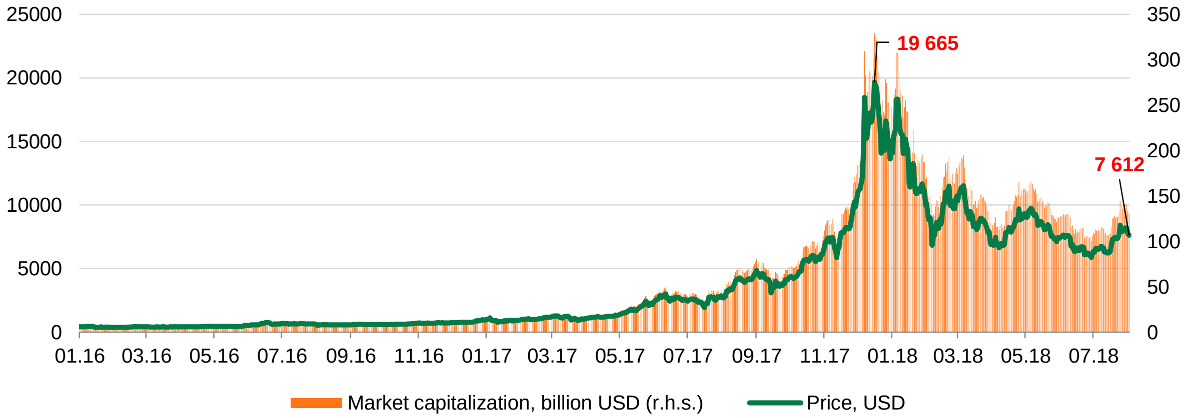


Chart below shows excessive volatility of cryptocurrencies on Bitcoin's example. Bitcoin's exchange rate initially swelled as a bubble but started to deflate since December 2017. The number of cryptocurrency transactions is as volatile as their market value: in the first seven months of 2016, an average daily number of cryptocurrency transactions globally was 211,000, for the same period of 2017 the number hiked to 280,000, while in 2018 fell to 208,000 (based on www.blockchain.info).

Chart 12. Volatility of exchange rate and market capitalization of Bitcoin



Source: CoinGeko

Comprehensive identification of cryptocurrency status in national legislation remains a highly relevant issue. Ukraine ranks amongst Top-25 jurisdictions across the globe where cryptocurrency develops. In 2017 and first half of 2018, 25 initial coin offerings (ICOs) took place attracting USD 100 million for their Ukrainian founders. Infrastructure for this sector is being built. Cryptocurrencies act as means of exchange and store of value and have features of an investment contract. Many regulators globally start to view cryptocurrencies as a sort of financial instruments.

A number of problems hinder cryptocurrency trading in Ukraine now:

- unpredicted legal implications
- unclear taxation and accounting aspects as well as the need for licensing for mining and services of cryptocurrency development
- no opportunity to enter smart-contracts, to export/import certain goods and services in exchange for cryptocurrency
- unclear legal status of ICOs
- no mechanism for consumer rights protection

In order to resolve these issues, the NSSMC prepared a concept for regulation of cryptocurrency operations. It is based on approaches applied to financial instruments. The concept defines mandates of the NSSMC and other authorities on regulation and supervision in the area (Chart 13). The Council endorsed the concept as a basis for a forthcoming law.

Chart 13: Suggested mandates of authorities on regulation and supervision of cryptocurrency transactions

NSSMC	• regulating procedures for cryptocurrency transactions • licensing cryptocurrency exchanges
State financial monitoring service of Ukraine	• regulating procedures for financial monitoring and control over compliance of primary financial monitoring entities (cryptocurrency exchanges)
MinFin (State fiscal service of Ukraine)	• ensuring declaration and discharge of taxes on income from cryptocurrency operations

The work on draft law that would regulate cryptocurrency turnover in Ukraine is ongoing. Financial market regulators take an active part in this process.

Council's position. Council members backed the concept of regulation of cryptocurrency operations as a basis for further work and the suggestion to define cryptocurrency as a sort of financial instrument.
Establishment of a legal framework shall be the next step.

Box 2. Status of cryptocurrencies across the globe

Approaches to defining legal status of cryptocurrencies differ across jurisdictions, ranging from an outright ban to recognition as a mean of payments.

Table 2. Legal status of cryptocurrencies around the globe

Banned	• India – in early 2018, central bank announced a ban on trading in cryptocurrencies. • Bangladesh, Bolivia, Nepal, Kyrgyzstan
Partly banned	• China (prohibited ICOs, mining, ban on Internet access to sites related to cryptocurrency trading, cracked down on cryptocurrency exchanges) • South Korea – trade in cryptocurrencies from anonymous accounts is banned
Not regulated	• Argentina – not a legal tender, but turnover is not restricted • Hong Kong – turnover is not restricted unless cryptocurrencies are used for unlawful purposes • Indonesia, Vietnam – it's illegal to use cryprtocurrencies as a mean of payment, otherwise turnover is not restricted • Brazil, Colombia, Saudi Arabia, Turkey, New Zealand
Regulation under preparation	• EU – currently, "virtual currencies" means a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons, as a means of exchange, and which can be transferred, stored and traded electronically" • UK – cryptocurrencies are treated as foreign currency or 'private money' also for taxation purposes • Mexico, Russia
Turnover as an asset	• Canada – 'intangible asset', regulatory treated as a security • Switzerland – open turnover of cryptocurrencies, ICO regulation is pending. Certain transactions require licences. • SAR – an intangible asset (South African Revenue Service) • Germany – unit of account (BaFIN) • Israel – taxable asset. Miners, traders of bitcoins would be treated as businesses (by tax authorities) • Philippines – virtual currencies - 'digital units used as a medium of exchange or a form to store digital value created by agreement within the community of VC users • Australia – intangible asset, "transacting with bitcoin is akin to a barter arrangement" • USA : classified as a commodity (CFTC), taxed as a property (IRS).
Legal form of payment	• Japan

In most of the countries, cryptocurrencies are not a legal tender and are not used as a mean of payments. Some developing nations banned cryptocurrencies to prevent the outflow of capital and/or financing of unlawful activities. Most of the leading advanced and emerging economies allowed turnover of cryptocurrencies as a financial instrument/asset. Others de-facto opted not to intervene into market development at current stage. Many jurisdictions including the EU draft legal frameworks that would provide for adequate regulation of and supervision over cryptocurrency operations and infrastructures of this market segment (cryptocurrency exchanges and others). Many states tax cryptocurrency operations.

Status of cryptocurrencies tends to change in time. For example, Iceland initially banned cryptocurrency operations related to foreign exchange due to anxiety about possible capital outflows. In 2017, these restrictions were lifted.

The biggest cryptocurrency-related risk that regulation seeks to mitigate is money laundering, fraud and financing of other unlawful activities.

4. Coordination of fiscal and monetary policy

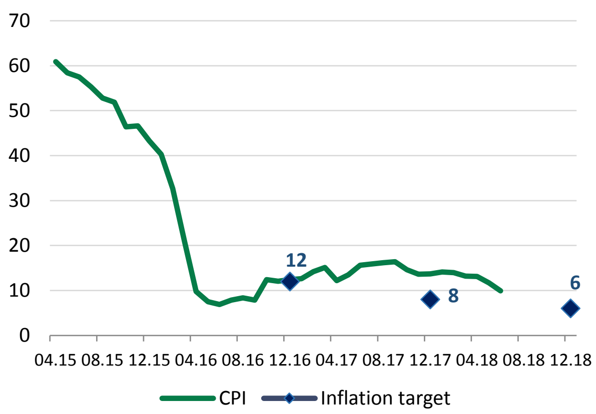
The Council discussed coordination of fiscal and monetary policy at each meeting during the reporting period, given that this is a prerequisite of price and financial stability in the longer run. ‘The lack of coordination between the monetary and fiscal policy’ may lead either to a central bank being ‘incapable of raising inflation expectations’ or to the economy entering ‘a spiral of growing debt, declining output, and raising inflationary pressures’ (Francesco Bianchi and Leonardo Melosi «*The Dire Effects of the Lack of Monetary and Fiscal Coordination*», 2017).

The Ministry of Finance and the National Bank arrived at a consensus that coordination of fiscal and monetary policy is of mutual benefit in terms of achieving their objectives. On one hand, balanced fiscal policy on behalf of the Ministry of Finance promotes the monetary policy objective of price stability. On the other, low and stable inflation facilitates lower public borrowing costs.

The Council focused on the most topical issues of the Ministry of Finance and NBU policies coordination, primarily on better forecasting of balances of Single Treasury Account (STA). The authorities can achieve the latter by expanding the forecast of the STA balance change to the three-month horizon, timely identification of possible sources of expenditure financing in case of lack of funds, establishing an inter-agency working group on public finance liquidity, etc.

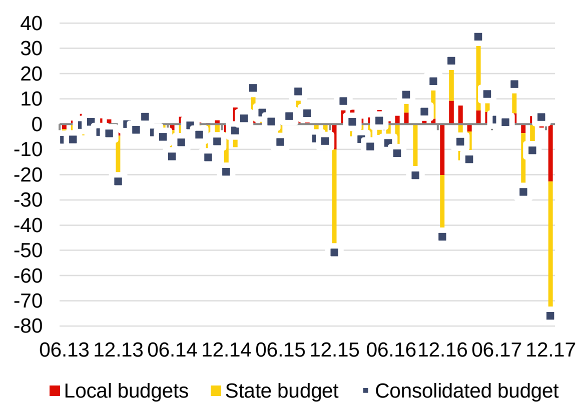
The Council also discussed introduction of full-fledged medium-term budgeting at local level (to supplement central budgeting). That would promote more even and predictable budget expenditures and help to avoid excessive expenditure peaks at the end of a year as they have a negative impact on exchange rate, FX and inflation expectations.

Chart 14. Inflation and inflation targets of the NBU, %



Source: NBU.

Chart 15. Consolidated budget of Ukraine and its components, billion UAH



Source: NBU.

In Q1 2018, the Government endorsed a package of legal amendments that aim to introduce continuous medium-term budgeting at all levels of public finance (bills registered No. 8099, No. 8044, No. 8043). The amendments provide for several changes:

– coordination of key documents of public strategic planning (Budget declaration, strategic plans of main budget administrators and State Budget)

– identification of additional parameters and assessments in the Budget declaration, like the ceiling of total appropriations and lending, ceiling for total expenditure of budget administrators, assessment of fiscal risks, strategic goals and results of activities of main budget administrators

– introduction of a comprehensive assessment of efficiency and expediency of expenditures

– enhanced accountability of main budget administrators (reporting to parliament on goals and results of activities, publication of information on achievement of goals and efficiency indicators, performance on budget programs, reports on progress of investment projects, etc.).

However, as of the end of August, the bills has still been pending consideration at the parliament. This means a delay in one of important steps of budgetary reform aimed at improving transparency, quality and efficiency of spending public funds as well as higher visibility of budget policy.

Council's position. The Council called for enhanced coordination of monetary and fiscal policy through information exchange, both at the top and at the expert level of the respective authorities. The Council also stressed the need for fast adoption of legal framework for full-fledged medium-term public budgeting.

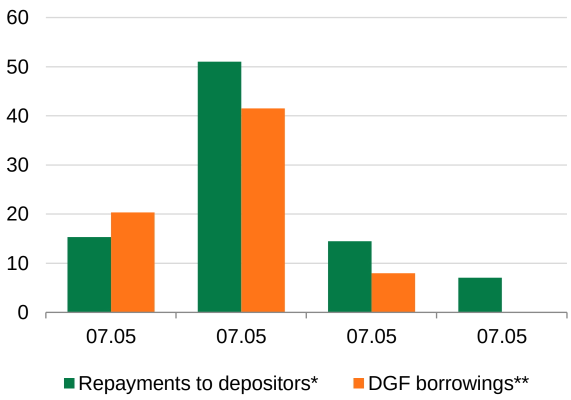
5. Capacity of the Deposit Guarantee Fund (DGF)

Reliable operation of deposit guarantee system and balanced finance of the DGF are important components of fiscal and therefore overall financial system stability.

Over 2014 – 2017, 94 banks were declared insolvent or liquidated for other reasons. The funds that were at the DGF's disposal at the start of the crisis were insufficient for timely repayments to depositors of those banks. Thus, the DGF had to turn to the Ministry of Finance and the NBU for finance. Gradual enhancement of the DGF's institutional capacity as well as higher efficiency of recovery from failed banks helped the DGF to raise necessary funds and to start repayments on those borrowings.

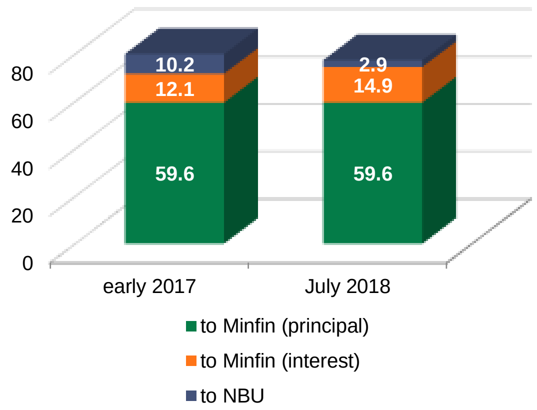
In 2017 and in first four months of 2018, the DGF mostly repaid the NBU loans. The outstanding NBU loans shrank from UAH 10.2 billion to UAH 2.9 billion. However, the possibility of early repayment on MinFin loans (that were issued against promissory notes) stays on agenda. This portion of loans to DGF bears risks of accumulation of interest on promissory notes that will significantly exceed the principal debt amount by maturity date. As of early 2018, the DGF capital was negative (-UAH 80.7 billion).

Chart 16. Repayments and borrowings of DGF, billion UAH



** From failed banks.*
***From NBU and MinFin.*
Source: DGF.

Chart 17. Change in DGF liabilities, billion UAH



Source: DGF.

The Council reviewed this situation in January 2018. It backed the suggestion to look for ways for early repayment of DGF's debt with regard to positions of all authorities concerned.

The Council revisited the issue in July. It considered the scenarios and the roadmap for the problem resolution prepared by the DGF. The key components of the roadmap were:

- approval of the procedure of early repayment on promissory notes, conversion of promissory notes. The principal of the MinFin loan would be repaid in full. Repayments of interest would be linked to recovery of assets of failed banks at the expense of former owners and managers
- investigation of possibility of increase of covered deposit amount
- inclusion of Oschadbank into retail deposit guarantee system.

The Council members supported the roadmap in general. They agreed that more intensive and efficient asset recovery (i.e. through litigations) from failed banks would facilitate the roadmap implementation. That would also help to recover DGF's funds and make repayments to depositors and creditors of failed banks (in excess of covered amounts).

Adoption of the EU Bank Recovery and Resolution Directive (BRRD)[7] can boost the DGF's efficiency in future and mitigate the risks of its potential insolvency. The Directive requires banks to set aside necessary resources and prepare in advance for possible risks of failure, inter alia with the help of capital from its owners. That can mitigate the adverse effects for ordinary depositors. The adoption of the Directive would also give way for earlier intervention in case a bank runs into problem, before its assets are depleted.

Council's position. The Council backed the idea early repayment on DGF's debt to the Ministry of Finance and supported in general the DGF's roadmap for avoiding its potential insolvency. The Council also endorsed phased inclusion of Oschadbank into deposit guarantee system with gradual payment of initial contribution. Representatives of authorities concerned should refine the roadmap. The NBU, the MinFin, and the DGF should set up a working group charged with this task.

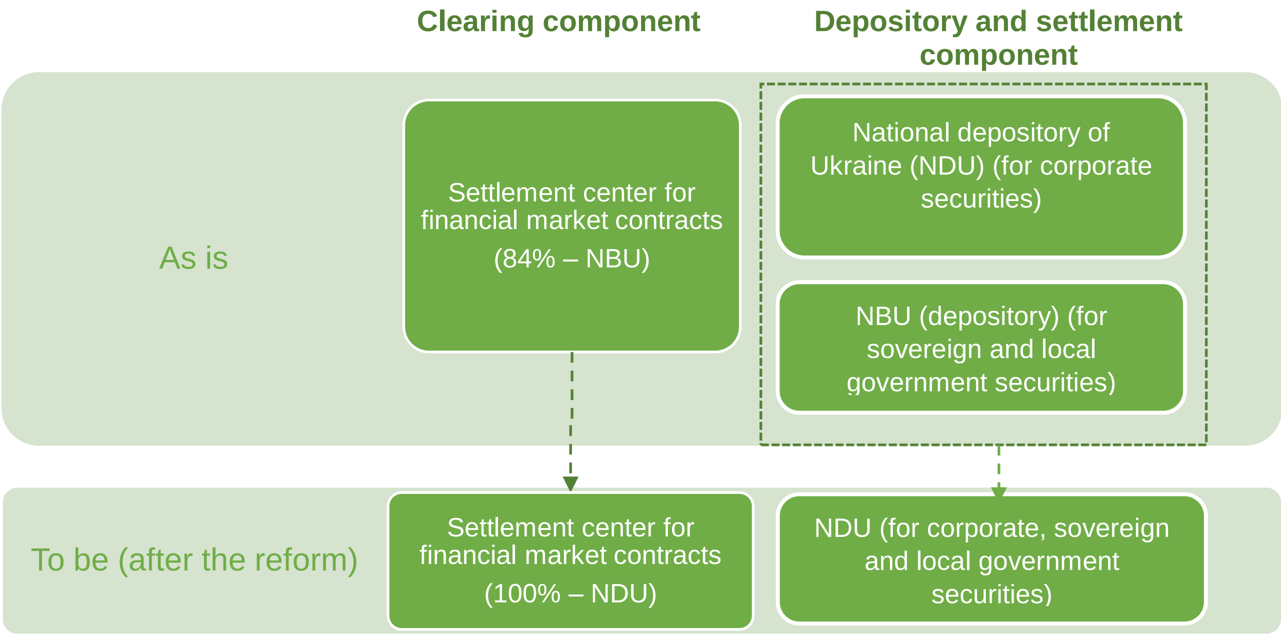
[7] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council

6. Scheduled reforms of capital and commodities markets infrastructure

Financial market infrastructure is one of the key elements of the financial system and matters a lot for its stability. Reforms in the area of capital and commodity markets infrastructure aim to bring them closer to best European practices and to raise their efficiency.

The Council considered future reforms in order to assess their impact on financial stability. In particular, the Council discussed guidelines for consolidation of capital market infrastructure over the next three to five years. A memorandum between the NBU and NSSMC provides for gradual reforms (in line with international) standards of two elements of capital market infrastructure in Ukraine: depository and settlement and clearing (Chart 18).

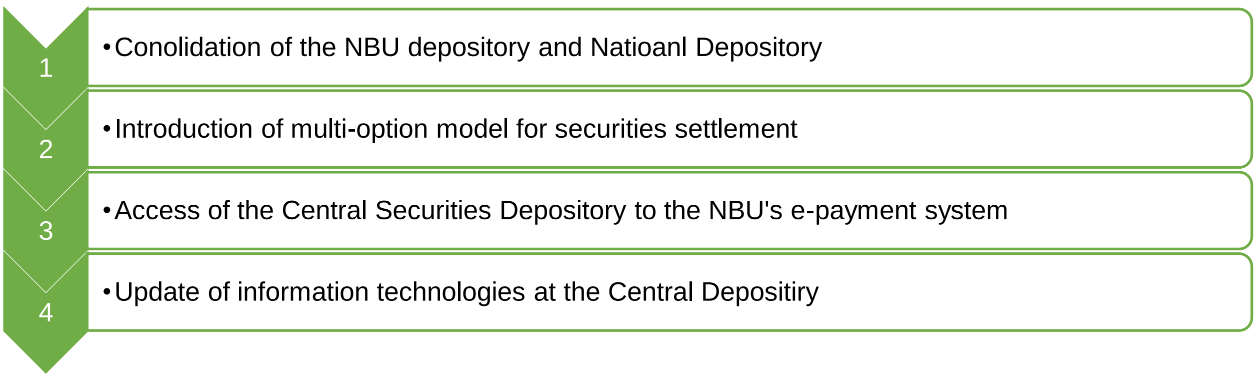
Chart 18. Key changes in the components of the capital market infrastructure



After ensuring compliance with major functional, technological, and regulatory preconditions, the depositories of the NBU and NSSMC will merge into a single depository. It will account for sovereign, local government and corporate securities. The single depository should start generating profits after the consolidation.

The NBU and the NSSMC are currently working on consensus over the list of preconditions and ways for check the compliance.

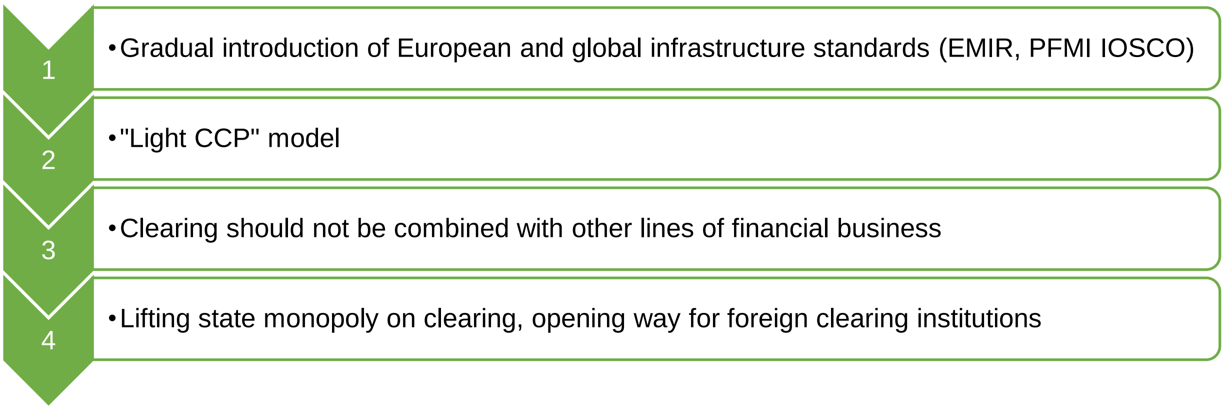
Chart 19. Guidelines for reforming depository and settlement element



For clearing system, the reforms provide for gradual implementation of regulations of the EU (EMIR)[8] and International Organization of Securities Commissions (IOSCO)[9], introduction of the “light central counterparty (CCP)” model, other transformations aimed at enhancing efficiency and transparency of clearing services (Chart 20).

Benefit and costs analysis should underpin the expediency of establishing a CCP. The analysis should be made with the help from independent highly qualified experts. If the analysis shows that the CCP cannot play a key part on the sovereign securities market, the authorities should consider establishment of a CCP based on the Settlement center for financial market contracts.

Chart 20. Guidelines for reforming clearing element



The Council also discussed development of capital markets and regulated commodity markets and their impact on financial stability. The NSSMC drafted a bill in this area, ‘*On capital markets and regulated markets*’ (registered No. 7055). The bill aimed at implementation of provisions of the EU directives on financial instruments and regulated markets in Ukraine.

In order to increase capital markets efficiency, the NSSMC suggested amendments to legislation on development of derivatives markets. Introduction of derivatives with commodities and financial instruments as underlying assets would enhance resilience of producers to price and FX volatility. However, that would require transparent pricing for the underlying assets. The introduction of full-fledged derivative market in Ukraine just for agricultural commodities (grain, sunflower) and energy (gas, electricity) would help to create a market in a volume of around USD 30 billion per year. As of today, Ukraine lacks adequate regulation for several commodities markets as well as fair pricing procedures.

Moreover, bill No. 7055 provides for implementation in Ukraine of provisions of MiFID II[10], MiFIR[11], EMIR, as well as Principles for Financial Market Infrastructures (PFMI) of IOSCO. This approach should facilitate development of derivatives market and its infrastructure (including trade repository, CCP), promote better risk management, allow for introduction of qualified investors and notion of underlying asset of a derivative, and secure additional protection for unqualified investors and bondholders.

[8] European Market Infrastructure Regulation - Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
[9] Principles for Financial Market Infrastructures (PFMI) of IOSCO
[10] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.
[11] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments

Better pricing for underlying commodities markets, lower price volatility, and greater independence of Ukraine from price movements in other countries would bring down aggregate risks to financial stability.

Chart 21. Key provisions of the bill No. 7055

New 'flexible' definition of derivatives

- that includes futures (on regulated market), option and swap (on regulated and OTC market), forward (on OTC market), as well as any other contract that provides for: a)single or regular payments depending on underlying value; or b) obligation to buy or sell (if requested) the underlying asset or enter another derivative contract; or c) obligation to dispose of the underlying asset at a specified point of time in the future, obligation to receive and pay for it

Concept of reglated market

- unficication of approaches to regulation of 'exchange activity' depending on the asset

New infrastructure for derivatives market

- operator - license for making derivatives on regulated
- CCP – clearing
- trade repository - function of Central depository

Mechanism of protection for market participants

- finality of settlement (irrevocable transfer of funds and financial instruments and encumberement documents)
- liquidation netting

'Qualified investors' concept

- automatically recognized (IFIs, foreign countries and their central banks, the State of Ukraine, financial institutions and certain legal entities)
- any legal entity or person meeting the recognition criteria

Novelties on bonds

- bondholder meetings summoned upon request of: the issuer or holder of 10% or more of stock of bonds; quorum - 75% for initial meeting, 25% for following meetings
- introduction of institution of bond issuance administrator; provision for remuneration for services of issuance administrator by the bond issuer

Council's position. The Council endorsed the concept and financial model for development of capital market infrastructure, as outlined in the Memorandum between the NBU and the NSSMC.

The Council also supported suggested guidelines for development of capital and regulated commodity markets. It called to approve bill No. 7055 given its significance for financial stability.

7. Cooperation with international donors and progress in financial sector reforms

The Council members constantly reiterated the need for further progress in reforms that Ukraine committed to implement under the IMF program. These reforms are crucial for macrofinancial stability and access to financing from the IMF and other international partners. This is especially important for securing demand for Ukrainian sovereign debt against the backdrop of global trend for investment from emerging markets assets and in view of scheduled massive repayments on external public debt in 2019-2020.

Coming peak repayments on external public debt (over USD 10 billion in total over the next two years) on the back of rising interest rates on international debt markets made the Council focus on resumption of cooperation with the IMF. One of the key requirements of the IMF was already implemented: the parliament adopted the Law of Ukraine '*On high anti-corruption court*'. Another key requirement remains to bring gas tariffs for households to market levels.

Table 3. Projected volume of financial assistance from principal international lenders

Source (international lender)	for support of State Budget	for replenishment of international reserves
IMF (EFF program, 11.03.2015)		**USD 2.0 billion** (V tranche, 2018)
EU (IV macrofinancial assistance, 06.07.2018)	**1 billion euro** (two tranches, in 2018 and 2019)	
World Bank	**USD 0.80 billion** (2018)	
Others		**USD 0.1 billion**

By the end of the year, total financial assistance from international lenders is projected at USD 3.48 billion. Of these assistance, the IMF is expected to provide USD 2 billion and the EU – USD 0.58 billion under new (fourth) macrofinancial assistance program. The European Parliament and the Council have decided to offer this program to Ukraine in July 2018. The new program should supplement previous three operations of macrofinancial assistance that the EU had provided since the 2014 crisis. Those programs totaled to 2.8 billion euro.

Access to official financing from the IMF and other external partners should allow the Ukrainian Government to borrow from international capital markets on acceptable terms. In September 2017, Ukraine placed USD 3 billion worth of 15-year Eurobonds on external debt markets at 7.375% per annum. At that moment, demand for new Eurobonds was around USD 9.5 billion.

Council's position. The Council stressed the need to resume cooperation with the IMF. Council members underlined the necessity to promote the reforms that Ukraine undertook to implement under the IMF program. They emphasized that delays in program implementation may cause substantial risks to macrofinancial stability in the medium term.

ANNEX

Implementation of the Council's recommendations and agreements
(April 2015 – July 2018)

Recommendations / agreements	Status of implementation
To confirm the presence of signs of financial instability of the banking system as well as conditions that threaten financial stability. In order to promote banking and financial system stability. To let the NBU keep anti-crisis measures until the Council decides that signs of financial instability of the banking sector are no longer observed. *(Council meeting of 2 March 2016)*	At the height of the crisis, the NBU introduced a number of anti-crisis restrictions on money and FX markets. That included mandatory surrender of FX proceeds for legal entities; 120-day limit for settlement on operations of goods export/import; 1-day hryvnia reserve requirement for purchasing FX at the interbank FX market; a ban on early loan repayment to non-residents; a limit on daily cash withdrawal from FX account. As of today, the NBU lifted some of these restrictions, and relaxed some other.
To recognize substantial systemic risks and threats to financial system stability in case that PrivatBank fails to complete capitalization plan / restructuring program, which was based on diagnostic study results. The MinFin, the DGF, and the NBU should take coordinated efforts to mitigate possible adverse effect upon financial stability in case of resolution (including bailout) of a systemically important bank. *(Council meeting of 21 October 2016)* In line with article 7[1] of the Law 'On the National Bank of Ukraine', to confirm the presence of signs of financial instability in banking sector and conditions that threaten financial stability. To suggest that in order to ensure financial system stability the NBU may exercise its right to set temporary peculiarities of regulation and supervision over banks and other entities subject to its supervision - if situation requires so. If needed, the NBU is recommended to define specifics of regulation for a bank. The decision is effective until the Council decides that signs of financial instability in the banking sector are gone. *(Council meeting of 18 December 2016)*	On 16 December 2016, former owners of PrivatBank addressed a letter to the Government of Ukraine requesting the purchase of bank's shares by the State. On 18 December 2016: – the DGF withdrew PrivatBank from the market based on the NBU decision and placed it on receivership – the Cabinet of Ministers of Ukraine resolved (resolution No. 961) that the State will inject capital into Privatbank – Minister of Finance and the NBU Governor held a joint press conference to explain situation and further steps authorities would take to stabilize situation. The Government issued UAH 155.4 billion worth of domestic government bonds in total to re-capitalize PrivatBank.
To endorse the concept of establishment system of public audit oversight according to the EU standards, in order to enhance control over quality of auditors' opinions, to promote financial stability, to boost trust to financial institutions and auditors. (*Council meeting of 31 July 2015)*	In December 2017, the parliament adopted the Law '*On audit of financial reports and auditing*'. It provided for establishment of a brand-new Public Audit Oversight Body (PAOB). It would comprise Audit Oversight Board and PAOB Quality Control Inspection. The PAOB would ensure quality control and may employ sanctions to auditing entities that audited the enterprises of public interest.
To back the appeal of the DGF to the MinFin requesting to facilitate decision granting UAH 21.5 billion of financing to the DGF. (*Council meeting 31 July 2015)*	The Government decided to grant the DGF UAH 21.5 billion for repayments to depositors of liquidated commercial banks (September 2015).

Recommendations / agreements	Status of implementation
To call for initiation of lifting of FX restrictions, primarily on repatriation of dividends. That would improve national investment climate and pave the way for effective privatization. (*Council meeting of 2 March 2016)*	The NBU progressed with gradual liberalization of the FX market. It lifted restrictions that impeded day-to-day business. Gradual revocation of anti-crisis restrictions on the FX market will procced at the pace that does not pose substantial risks to macroeconomic and financial stability. The key move in FX liberalization was the adoption of the Law '*On currency and FX operations*' in June 2018.
To stress the importance of enhanced cooperation between the NBU and the MinFin on ensuring macroeconomic and financial stability. *(Council meeting of 29 January 2016)*	The NBU introduced inflation targeting regime, which was underpinned by coordinated fiscal and monetary policy.
To underline the importance of adoption by the parliament of priority legal acts on financial sector reform. *(Council meeting of 21 October 2016)*	The parliament adopted laws that aimed at lending recovery: • '*On consumer lending*' aimed at protection of financial services consumers by providing them with full information on loan offer. Signed into law by the President on 8 December 2016 • '*On lending recovery*' aimed at mitigation of credit risks for banks. Having their creditor rights protected, banks could provide better terms for potential borrowers. Adopted by the parliament on 3 July 2018. However, adoption of several other crucial bills is still pending: • '*On certain legal amendments on enhanced protection of consumers of financial services*' reg. No. 2456-d. Its implementation should offer legal framework for interaction of individuals with banks and financial companies following European patterns • '*On certain legal amendments on consolidation of state regulation of financial services markets*' reg. No. 2413a, aimed at split of mandate of the NCSRFSM between the NBU and NSSMC. That should ensure parallel effective supervision over banking and non-banking financial services. Thus, this would ensure new quality of financial regulation • '*On insurance*', reg. No. 1797-1 aimed at better protection of rights of insurance services consumers and improved control over activities of insurance companies • '*On certain legal amendments (on regulated markets and derivatives)*' aimed at establishing framework for development of derivatives' market and introduction of state supervision over regulated commodity markets.

Recommendations / agreements	Status of implementation
To promote implementation of NCSRFSM initiatives aimed at boosting potential for development of insurance market and better protection of consumer rights. *(Council meeting of 31 January 2017)*	The NCSRFSM and the MinFin discussed at working level the possibility of exempting insurance premiums on endowment life insurance contracts paid by employers from single contribution to state mandatory social insurance. The Commission drafted certain legal amendments on introduction of possible instruments to guarantee repayments on life insurance policies
To speed up the reform of state-owned banking sector and to update the strategy for state-owned banks development *(Council meeting of 31 January 2017)*	The Government endorsed the updated Guidelines for strategic reforms of state-owned banking sector prepared by the MinFin with support from IFIs (February 2018)
To back the corporate governance reform at state-owned banks. *(Council meeting of 19 January 2018)*	The parliament adopted the Law 'On improved functioning of the financial sector (reg. No. 8331) that introduced independent professional supervisory boards at state-owned banks and fundamentally revised principles and mechanisms of their corporate governance (July 2018). That should boost their competitiveness and efficiency, which would in turn make them attractive for foreign investors in the course of privatization.
To set a task force engaging members of the parliament concerned to prepare for publication over the coming weeks a joint position on status and prospective regulation of cryptocurrencies. *(Council meeting of 31 August 2017)* To endorse the concept for regulation of cryptocurrency operations as a basis for further work. To support the initiative on identification of cryptocurrencies as a sort of financial instrument. *(Council meeting of 20 July 2018)*	Financial regulators published a joint statement on cryptocurrencies' status in Ukraine (November 2017). The Council endorsed a NSSMC-design concept for state regulation of cryptocurrency operations. The concept suggested that the NSSMC should regulated the cryptocurrencies market.

Terms and Acronyms:

CCP	*Central Counterpart*
CPI	*Consumer Price Index*
DGF	*Deposit Guarantee Fund*
EU	*European Union*
FSC	*Financial Stability Council (the Council)*
FX	*Foreign currency/exchange*
GDP	*Gross domestic product*
ICO	*Initial Coin Offering*
IFI	*International Financial Institution*
IMF	*International Monetary Fund*
IOSCO	*International Organization of Securities Commissions*
MinFin	*Ministry of Finance of Ukraine*
NBU	*National Bank of Ukraine*
NSSMC	*National Securities and Stock Market Commission*
NCSRFSM	*National Commission for the State Regulation of Financial Services Markets*
NPL	*Non-performing loan*
OTC	*Over-the-counter (market)*
UAH	*hryvnia*
USD	*US dollar*
Q	*quarter*
H	*half of year*
yoy	*year-on-year*