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# Ukraine's Reconstruction Policy Options for Building an Effective Financial Architecture

Elena Carletti, Yuriy Gorodnichenko, Harold James, Jan-Pieter Krahenen,  
Vladyslav Rashkovan, Alexander Rodnyansky and Ilona Sologoub



# UKRAINE'S RECONSTRUCTION: POLICY OPTIONS FOR BUILDING AN EFFECTIVE FINANCIAL ARCHITECTURE

Frankfurt Report

CEPR

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## Frankfurt Report

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# Acknowledgements

Ukraine is a country at war. The devastation from the Russian invasion is enormous, with millions of people losing their homes and being displaced, factories destroyed and infrastructure in ruins. At some point, the fighting will cease, and the Ukrainian people and the world will face the question how to rebuild the country and, in the process, restructure and reform the economy. In fact, work on the reconstruction has already begun as Ukraine reconfigures its infrastructure to make it more efficient and resilient. In this report, we ask a simple question: How can the Ukrainian financial system be reformed to raise the necessary resources domestically and from international – public and private – capital?

The question was first raised during a discussion round at CEPR’s “European Financial Architecture” Research Policy Network in the summer of 2022, only months after the Russian invasion in Ukraine had started. We owe a lot to the participants in these discussions. Above all, our thanks go to Erik Berglöf, whose lifelong work on political crises and economic development has influenced our thinking about the role of finance and its institutions for growth and governance in Central Europe enormously.

Indeed, his influence in our group goes so far that some, upon reading the report, may be led to believe Erik was a co-author of this study. While not being a co-author in the formal sense, we nevertheless thank him for his inspiration and orientation that has shaped our thinking throughout this project.

The report outlines an ambitious reform programme for Ukraine’s financial sector, aiming for a significant move towards a widely trusted financial system. We firmly believe that trust in financial institutions and their governance is key in attracting large amounts of investment capital – needed to rebuild the Ukrainian economy. No trust, no investment.

Building trust in the financial system requires knowledge of Ukraine as a country, its history, its institutions, its policies and its people, but also an understanding of the international experience from reconstruction and reform of war-torn economies. The author team, half of whom are of Ukrainian nationality, hope that we have a critical mass of both familiarity with local conditions and international experience that allows us to derive relevant conclusions and to develop useful proposals.

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# Foreword

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It is now over two years since Russia launched its brutal full-scale invasion of Ukraine. Ever since those early days, a broad network of CEPR economists has been working intensively with colleagues in Ukraine and across the international research and policy communities to explore how to tackle the big economic challenges of the war and how to plan for the country's post-war reconstruction. The many outputs include a series of 'Rapid Response Economics' reports, as well as in-person and online meetings with researchers and policy officials, and a string of columns on VoxEU, CEPR's core platform for disseminating research evidence and ideas to the wider community of decision-makers who can make use of them.

This new report is our latest contribution to the pressing debates surrounding Ukraine's future, and it addresses a major precondition for the country's reconstruction and development: a healthy and widely trusted financial system. The team of authors – which combines leading Ukrainian economists with experts from CEPR's Research Policy Network (RPN) on European Financial Architecture – starts from the status quo of Ukraine's banking and capital markets, and suggests policy options for improving effectiveness and increasing international trust in the system.

Key messages relate to institution-building: a National Reconstruction and Reform Council should develop and communicate a broadly shared vision for reconstruction, strive for agreement on the reform agenda and monitor its implementation; a Ukraine Development Bank could leverage the capacity of existing banks in the country's reconstruction and ambition to build back better; and a Ukraine Development Platform would be a multilateral venture, with strong Ukrainian ownership, that is dedicated to strategic planning and donor coordination relating to the reconstruction effort during and after the war.

Further reforms would focus on the recapitalisation and subsequent privatisation of banks, the liberation of bank assets for lending purposes, and the future role of capital and housing markets. The policy options described in the report draw on historical experiences in other countries, aiming for a sea change in Ukraine's attractiveness for international investors, both public and private.

Our thanks go to Nadine Clarke for organising several CEPR-RPN workshops at which the ideas in this report were discussed, Romesh Vaitilingam for working with the authors in writing the report, Anil Shamdasani for his skilled handling of its production, and Sophie Roughton for managing its dissemination. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for this important contribution to plans for Ukraine's reconstruction.

Tessa Ogden  
Chief Executive Officer, CEPR  
April 2024

# Executive summary

Discussions about the post-war reconstruction of Ukraine inevitably start with observing the huge physical damage inflicted in the course of the Russian invasion, and the consequent need for the rebuilding of hospitals, housing, schools and other essential infrastructure. But this tragedy also gives Ukraine an opportunity to build back better, to modernise the country along many dimensions, and to be ready to withstand possible further Russian aggression and become an important element of the NATO security system.

To this end, ravaged by war as it is, Ukraine will need massive support from its allies. The key policy question is how to ensure first, that resources become available in sufficient volume, and second, that they go to the best uses and foster sustainable development of the country. As we argue in this report, both aspects are deeply dependent on the existence of a widely trusted and visibly effective financial system. The emerging financial system in Ukraine is supposed to function well at two levels: channelling investible funds; and establishing good governance by screening and monitoring projects across the country.

In thinking about Ukraine's future, there is a clear precedent in the provision of large-scale aid from the US to Europe after World War II. The European Recovery Program or Marshall Plan of 1947 is often held up as the 'gold standard' for the economic reconstruction of areas in the wake of political, military or economic devastation because it stood at the beginning of an era of unprecedented growth coupled with political stability. To be clear, the Marshall Plan was not just about the transfer of money, but rather about institutional reforms such as establishing deep connections linking national economies to their neighbours and to the world, and helping to create an effective financial system domestically.

In the three-quarters of a century since the launch of the Marshall Plan, the world has accumulated a rich experience of reconstruction and development efforts. History is littered with failed attempts to impose designs and manage domestic processes, but also impressive examples of collaborations that have fuelled rapid recovery. The successes point to the need for strong recipient country ownership of donor coordination and application of core governance standards along with environmental, social and procurement standards. Ukraine's reconstruction and modernisation offer rich opportunities to put these lessons to use and ensure that the country's transition to an advanced European economy goes as quickly and smoothly as possible.

Consistent with this view, German Chancellor Olaf Scholz declared at the June 2022 G7 summit at Schloss Elmau, Germany, that there was a consensus that a new Marshall Plan was needed. In a similar spirit, the G7's first major international conference on the "Recovery, Reconstruction and Modernisation of Ukraine" in October 2022 underscored

the role that institutions play in governing and coordinating recovery and reconstruction, as well as the need to establish a recovery framework that emphasises cross-border linkages and a deepening relationship of Ukraine with the European Union (EU), with membership as one stage in that process (G7 Germany 2022).

These aspirations will require large investment. Funds will partly be drawn in from public sources, national and international. Some foreign public capital will come from international institutions and sources such as the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the World Bank. But a large part of the required funds will have to be mobilised from private sources abroad. Furthermore, such a mobilisation will not be possible without mobilising domestic savings.

This report makes a series of proposals on reforms and policies necessary to achieve these goals. We stress that a well-designed financial sector – the whole of banks, capital markets, insurance, mortgages, financial regulation and supervision – can play a catalytic role in Ukraine's reconstruction and development. We also show how preparing for EU accession can help to steer that process and build confidence among investors and the public.

What financial system can facilitate recovery and development? The answer is clear to us: an effective, competitive, widely trusted financial system, living up to recognised standards of integrity, compliant with the EU accession process, and assuming a recognised role in Europe's banking and capital market unions.

What strategic steps are necessary to deliver this longer-term vision?

*Principle #1: Ukraine's institutional framework for banking and financial markets should be aligned with that of the euro area and the EU's Banking Union, in particular with regard to financial legislation and supervisory practice.*

To access global capital and to converge with the rest of Europe, Ukraine has to integrate its financial system into European markets and institutions. This does not mean that Ukraine should copy everything from the euro area's regulatory framework right away. But to integrate fully into the euro area's banking and capital markets and thus tap into vast resources and experiences, Ukraine will need to adopt the euro area playbook.

For example, on its transition to EU accession, Ukraine could and should sign a formal agreement with the EU's Single Supervisory Mechanism (SSM) to help align supervisory standards and practices with those commonly applied inside the EU.

In a similar spirit, aligning enforcement for transparency and reporting (e.g. the International Financial Reporting Standards, the International Sustainability Standards Board and the European Securities and Markets Authority) should facilitate more the access, at least for large Ukrainian firms, to capital markets outside the country (e.g. Frankfurt, London, Paris and Warsaw), thereby unlocking potentially significant investments and strengthening their governance.

The same logic suggests that the resilience and international recognition of the mortgage lending market in Ukraine can be supported by introducing collateral rules in line with international practice, for example limiting the ratio of loan-to-value and debt-to-income service, and strengthening the role of covered bonds and specialised lending institutions, such as savings and loans associations.

Finally, by making the institutional framework compatible with the EU, Ukraine should facilitate the entry of foreign banks and other financial firms, thus deepening domestic capital markets further and boosting competition.

*Principle #2: Financial sector effectiveness can be significantly improved by creating recognised and catalytic institutions that are capable of coordinating international donors and investors, as well as integrating foreign capital markets and domestic financial institutions.*

We suggest establishing three institutions, partly based on existing institutions, in order to strengthen and widen Ukrainian ownership of the reconstruction and reform process.

First, a National Reconstruction and Reform Council (NRRC) should be established that develops and communicates a broadly shared vision for reconstruction, strives for agreement on the reform agenda and monitors its implementation.

Second, a Ukraine Development Bank (UDB) could leverage the capacity of existing banks in the country's reconstruction and ambition to build back better. The UDB would raise capital in the markets to finance programmes (e.g. machinery, energy, housing) by entering into co-financing deals with existing banks, thereby leveraging their ability to invest. Moreover, the UDB would lend to sub-sovereign entities carrying out infrastructure projects (roads, rails, reconstruction). The UDB is envisioned as an institution co-owned by national and multilateral development banks, to ensure world-class practices as well as access to cheaper capital in international markets.

Third, a Ukraine Development Platform (UDP) would be a multilateral venture, with strong Ukraine ownership, that is dedicated to strategic planning and donor coordination relating to the reconstruction effort during and after the war. The government would put projects on the platform for multilateral and bilateral development banks to explore how they could collaborate. The UDP would also promote core standards to be applied to projects and encourage development institutions to come together in financing individual projects.

Together, the UDB and the UDP should be capable of facilitating Ukrainian banks' access to international capital flows, while the NRRC would help to ensure a broad consensus within Ukrainian society for the reform agenda.

*Principle #3: Reforms of the financial sector should seek to resolve post-war legacies and deliver a market-based allocation of capital.*

There is a clear need to recapitalise banks and compensate for losses caused by war-related non-performing loans (NPLs). To the same end, war insurance and various public-private partnerships are needed to de-risk investment and credit in a country that is likely to continue to live in the shadow of potential Russian aggression.

To support the achievement of a market-based allocation of capital, the government should privatise state-owned banks by selling stakes to investors and other banks, aiming for a diverse and competitive, (largely) privately owned domestic banking landscape, with somewhat limited roles for institutions remaining under state ownership.

*Principle #4: Financial development should be supported by broader reforms of corporate governance, the rule of law, pension systems, etc. – and by a favourable macroeconomic environment.*

Over the last decade, Ukraine has made great strides in strengthening its macroeconomic framework and banking sector, but these achievements must now be supplemented by wider governance reforms. In a nutshell, reforms of the financial sector are unlikely to yield sustainable benefits if the rest of the country suffers from corruption, if households have few incentives to save, if investors cannot protect their projects from expropriation, if markets are closed to competition and if oligarchs control much of the economy.

Because broader reforms are essential for EU accession, we can hope that the determination of Ukraine to join should provide a sufficiently strong institutional anchor that motivates them.

What happens in Ukraine may be a model for the rest of the world, and in particular for the issues faced in post-conflict reconstruction. Ukraine's experience highlights the many difficulties that emerging economies face on their path to creating effective capital markets: tough initial conditions, political constraints, state capture, high sensitivity to external shocks, corruption and fragile institutions.

Overcoming these obstacles clearly becomes even harder when a country is invaded by a neighbour. An effective Ukrainian transformation may thus have something to teach Europe and the rest of the world about how institutions can be made better, more transparent and more resilient.

*Principle #5: Faith in the long-term success of Ukraine.*

Before we develop these principles in the report, we would like to flag the final key ingredient: faith. Alexander Gerschenkron, the great Odesa-born economist, concluded his famous 1951 essay on technological leapfrogging with:

*"To break through the barriers of stagnation [...], to ignite the imaginations of men, and to place their energies in the service of economic development, a stronger medicine is needed than the promise of better allocation of resources or even of the lower price of bread. Under such conditions even the businessman, even the classical daring and innovating entrepreneur, needs a more powerful stimulus than the prospect of high profits. What is needed to remove the mountains of routine and prejudice is faith – faith, in the words of Saint-Simon, that the golden age lies not behind but ahead of mankind" (Gerschenkron 1962).*

We see the prospect of Ukraine as a free, democratic and prosperous country and a full EU member as a faith-breeding promise in the sense of Gerschenkron. We hope that others share our faith in the long-term success of Ukraine, not only for the sake of the brave Ukrainians who defend their homes and freedoms but also for anybody who believes in the free world.

## PROPOSED ARCHITECTURE: NEW INSTITUTIONS FOR FINANCING RECOVERY



**Ukraine Development Platform (UDP):** A repurposed and expanded G7 donor coordination platform.

**National Reconstruction and Reform Council (NRRC):** A repurposed and expanded National Reform Council.

**Ukraine Development Bank (UDB):** A state-owned development bank, with multilateral banks as key shareholders, mobilising funds domestically and abroad.



# Introduction and overview

Ukraine faces an enormous challenge irrespective of when the war ends. There is a natural desire to rebuild the country, indeed to rebuild it better, coupled with a desire to strengthen the economy in preparation for the EU accession process. Both of these aspirations will require huge investments, and thus huge amounts of capital. Given these amounts, only part of the investments can be financed out of Ukraine's public budget. Some foreign capital will come from international institutions and sources, like the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the International Monetary Fund (IMF) and the World Bank.

Much of the remaining funding gap, probably the much larger part, will have to be covered by private capital. Part of the latter may flow from abroad, the other part will have to come from domestic savings. Realising investments, therefore, requires a strong and effective domestic financial system, capable of mobilising and allocating large amounts of capital.

The current political situation, with a threat of diminished financial and military support from the US and similarly from some countries in Europe, adds to the demand for strengthening the financial system in Ukraine: the country must prepare for a further drying up of government support, be it from the US or Europe. The only way forward is to render Ukraine's financial institutions viable enough and the system as a whole effective enough to attract sufficient international capital, from public and private sources, to master its sizable reconstruction challenges.

The main conclusions and recommendations developed in this report can be grouped under four headings: a longer-term vision; a suitable rule book; institutional innovations; and regulatory changes.

## **LONGER-TERM VISION**

Consider the bearing point for Ukraine's financial development: an effective, competitive, widely trusted financial system, living up to recognised standards of integrity, compliant with the EU accession process, and assuming a recognised role in Europe's banking and capital market unions.

## **RULE BOOK**

In conformity with the vision, Ukraine's institutional framework for banking and financial markets should be aligned with that of the euro area, in particular regarding financial legislation and supervisory practice.

## INSTITUTIONAL INNOVATION

We see significant potential for improvement of financial sector effectiveness, in line with the longer-term vision, by creating recognised public institutions that assume a catalytic role, coordinating among international donors and investors, as well as integrating foreign capital markets and domestic financial institutions in large-scale government-sponsored/led programmes. We thus suggest establishing three institutions, partly building on existing institutions:

- First, a National Reconstruction and Reform Council (NRRC) should be established that develops and communicates a shared Ukrainian vision for reconstruction, and that strives for agreement on the reform agenda.
- Second, the Ukraine Development Bank (UDB) would be a publicly owned Tier-2 bank, i.e. a bank that provides financing to other banks, potentially with co-ownership by multilateral development banks. The UDB would engage in co-financing and syndicated lending, thereby enabling projects that otherwise would not happen at all, or would not happen to the same extent. This would leverage the capacity of existing banks to build back better in alignment with NRRC and government policies (see Chapter 5 for the details).
- Third, the Ukraine Development Platform (UDP) would be a multilateral venture with strong Ukrainian ownership, dedicated to strategic planning and donor coordination relating to the reconstruction effort during and after the war.

Together, the UDB and the UDP would be capable of facilitating banks' access to international capital flows, while the NRRC would be critical for achieving a broad consensus within Ukraine society for an ambitious reform agenda, including extraordinarily difficult choices the country faces in reconstruction

## SIGNIFICANT DECISIONS

Based on the above institutional innovations, a quasi-surgical financial sector reform building on the previous achievements is feasible that attempts to remedy remaining major weaknesses of today's financial system in Ukraine. This should ideally involve the following seven initiatives, which are described and discussed in greater detail in Chapters 4, 5, 6, 7 and 8 of this report:

First, banks with losses that are due to war-related non-performing loans should be compensated by adequately recapitalising them with public money, be it domestic or foreign. See Chapter 4 for details on this topic, and the next two points.

Second, subsequent to bank recapitalisations, state-owned institutions should be privatised by selling stakes to investors, including other banks, aiming for a diverse and competitive, privately owned domestic banking landscape, with somewhat limited roles for institutions remaining under state ownership.

Third, competent bank supervision is key for developing the financial sector and maintaining financial stability. We recommend aligning supervisory standards and the supervisory code of practice with those applicable inside the EU, as soon as possible. This EU touch is relevant both in banking and capital markets. A formal memorandum of understanding (MOU) agreement with the Single Supervisory Mechanism (SSM) ahead of formal accession talks may be an effective way forward.

Fourth, we recommend securing reliable access to international capital markets (e.g. Frankfurt, London, Paris and Warsaw) rather than immediately launching a stand-alone domestic capital market. Required infrastructure investment relates to standard-setting for transparency and reporting (e.g. the International Financial Reporting Standards, or IFRS, and the International Sustainability Standards Board, or ISSB), as well as a domestic partner institution for European market oversight (e.g. the European Securities and Markets Authority, or ESMA). Details are in Chapter 6.

Fifth, we recommend strengthening the resilience and international recognition of the mortgage lending market in Ukraine by introducing collateral rules in line with international practice, for example limiting the ratio of loan-to-value and debt-to-income, and by facilitating the development of a market for covered bonds. See Chapter 7 for details.

Sixth, we make the case for some sort of war insurance. Developing a public protection scheme covering war-related losses of invested real capital will – if done properly – lower the cost of capital incurred by firms, thereby increasing investment incentives. See Chapter 8 for details.

Seventh, the task of financial modernisation may be seen as part of the EU accession process. Extending European standards for financial supervision and regulation will be a key to developing more transparency, a deeper capital market and more financial inclusion. Easier entry into the Ukrainian market by foreign banks may bring substantial enhancements of managerial and technical capacity, and of lending expertise (see Chapter 9).

Lastly, what happens in Ukraine may also be a model for the rest of the world, and in particular for the issues faced in post-conflict reconstruction. Ukraine's experiences highlight the many difficulties that emerging economies face on their path to creating effective capital markets: tough initial conditions, political constraints, state capture, high sensitivity to external shocks, corruption and fragile institutions. For Europe to better support countries dealing with these challenges, reforms of the EU's own development finance architecture may be necessary. It might also be desirable to review the restrictions on institutional capital, and financial institutions in particular, to facilitate for them to help build the financial system necessary to absorb capital and technology from the outside.

Our list of recommendations gives priority to institution building in Ukraine – three institutions (the NRRC, the UDB and the UDP) that will help to achieve maximum benefit for the country from the various financial flows expected now and after the war. Making good use of these funds, and even attracting more such funds, requires the build-up of a financial system trusted by the rest of the free world, far-away governments and global capital market investors alike.

All the recommendations in the report share a close alignment with the requisites of the EU accession process – whether already in the books or coming later at some point. Implementing these proposals, therefore, is no waste of energy and time; indeed, it is a key way to accelerate the integration process.

# A brief history of Ukraine's financial development

To appreciate the scale of the challenge of building an effective financial system in Ukraine, as well as the degree of progress in the country's financial sector since independence in 1991, it is instructive to provide a comparative perspective. Given the difficult initial conditions of the immediate post-communist period, it would be unfair to compare Ukraine to countries with deep and established capital markets. The analysis that follows therefore focuses mainly on comparators that have also been in transition from a command economy to a market economy over the past three decades.

Some peers – for example, Poland and other East European countries in the EU – are chosen because Ukraine aspires to emulate their success. Some – for example, Bulgaria and Romania – are selected to get a better understanding of the costs of unfinished reform agendas (e.g. persistent corruption issues), while others – for example, Slovakia – demonstrate how to catch up after a slow start. Some peers – Croatia, Georgia and Moldova – shed light on the challenges faced by countries scarred by war, as well as issues related to living in the shadow of Russian aggression. Finally, Germany, the country with the largest economy in Europe, is an indicator of the frontier of what can be achieved in terms of development within the EU.

The following provides a comparative outline of what has happened in Ukraine's financial sector and related business and economic developments over the past three decades, including the stock market, banks, mortgages, institutional investors, corporate governance, privatisation, financial market liberalisation and macroeconomic stability.

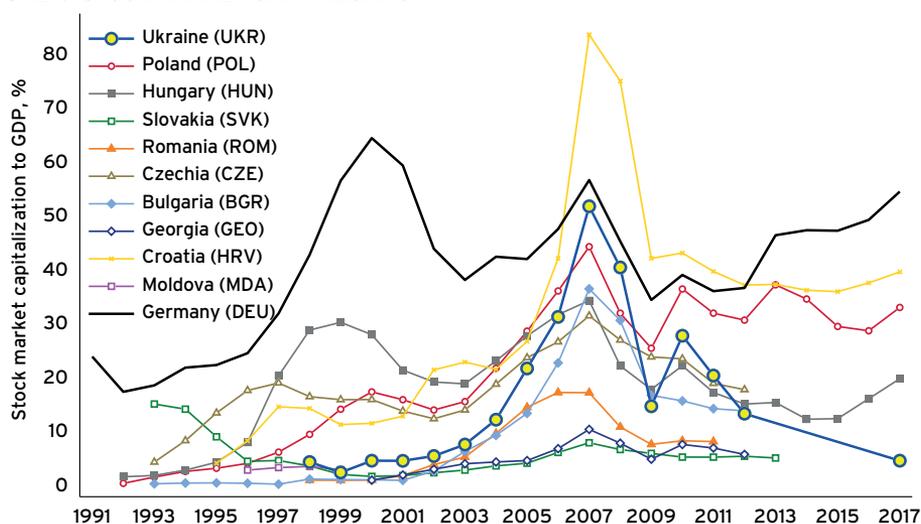
## THE STOCK MARKET

Similarly to other transition economies, Ukraine had little to no market infrastructure when the command economy collapsed in the Soviet bloc. Although Ukraine was more developed than some East European countries, it experienced a particularly difficult repression under Soviet rule in the 1930s (including the *Holodomor*, the man-made famine), which continues to weigh heavily on economic and political life even in the post-Soviet era (Yaremko 2023).

Much policy work in the early 1990s focused on providing a legislative basis for creating financial markets. Laws were passed, regulators were created, government property was privatised and stock exchanges mushroomed. Formal indicators suggested that Ukraine was making good progress towards establishing a well-functioning financial sector, but this turned out to be only an appearance.

Indeed, even relative to its peers, Ukraine's performance was lacklustre. Data collected by Beck et al. (2020) convey this message clearly. Market capitalisation as a percentage of GDP remained low up until the early 2000s (see Figure 1.1). For example, Poland, a popular (although not well justified) benchmark for Ukraine, had capitalisation that was four times higher. The Czech Republic and Hungary had also performed well, but these countries had earlier exposure to the market economy. More generally, the 1990s demonstrated that achieving a developed stock market is not guaranteed, and there is large variation in outcomes, ranging from laggards like Bulgaria to successes like Poland.

FIGURE 1.1 STOCK MARKET CAPITALISATION



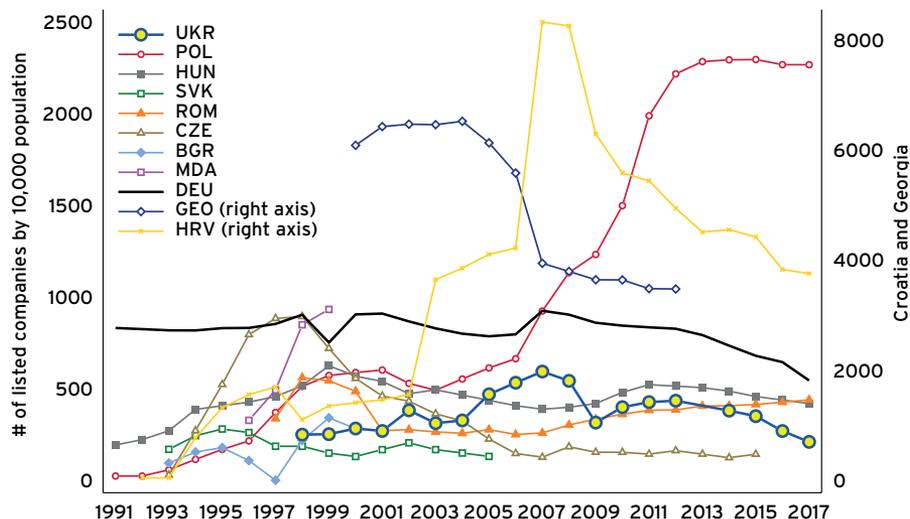
Source: Beck et al. (2019).

The Orange Revolution in 2004 gave hope that Ukraine would re-energise its reform efforts and thus spur more development of capital markets. Consistent with that view, market capitalisation soared as more investors showed interest. But this was a broad trend for Eastern Europe rather than a Ukraine-specific development. Nearly all countries in the region experienced a boom until the global financial crisis of the late 2000s and early 2010s.

The collapse of market capitalisation in East European countries was nearly universal, but Ukraine was hurt more. This was not only because the country had more exposure to fluctuations in commodity prices, but also because it had weaker institutions and weaker policymaking. Some markets (e.g. Poland) recovered, but many stayed depressed for years. These dynamics suggest that while some forces are common for East European countries (e.g. the appetite of investors for taking risks in this part of the world), policies are also important.

The dynamics of the number of listed companies per capita (see Figure 1.2) tell a similar story. Ukraine was firmly in the middle of the cross-country distribution with some elevation after the Orange Revolution in 2004, but the number of listed companies has been trending down since the global financial crisis.

FIGURE 1.2 NUMBER OF LISTED COMPANIES PER CAPITA



Source: Beck et al. (2019).

Russia's annexation of Crimea and occupation of the Donbas in 2014 gave another shock to Ukraine's financial system and broader economy. With a tsunami of non-performing loans (NPLs), a spike in inflation and massive economic contraction, the stock market became a ghost: market capitalisation was at 4% of GDP.

The Revolution of Dignity in 2013-14 accelerated reforms and the course of Ukraine towards greater integration with the EU. Yet despite significant progress in cleaning up the financial sector, fighting corruption, decentralising economic and political life, and many other areas, the stock market showed few signs of life, even with much of the necessary infrastructure already in place.

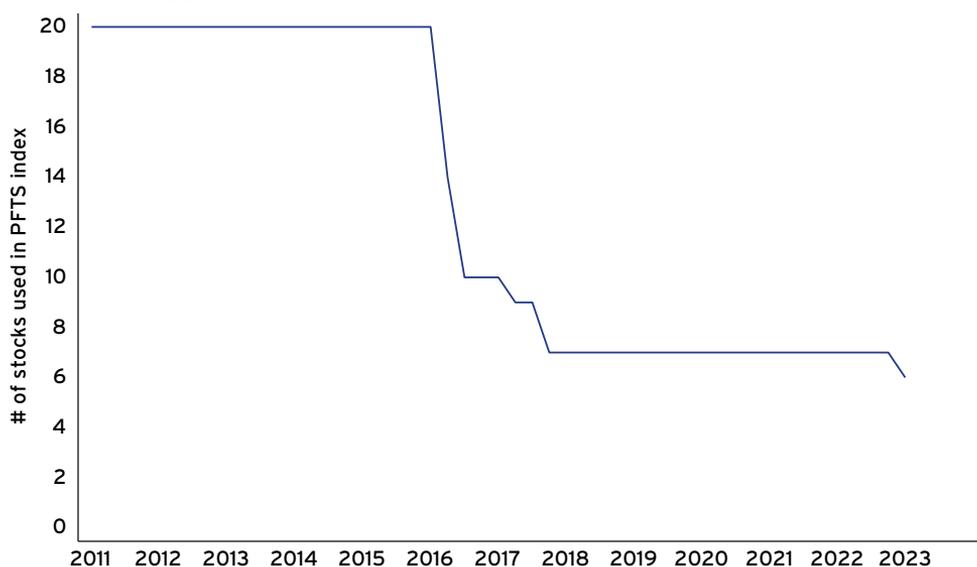
A few statistics reveal the state of affairs. At the end of 2021, Ukraine had four organised exchanges: Perspektiva Stock Exchange, Stock Exchange PFTS, Ukrainian Interbank Currency Exchange and Ukraine Exchange. But nearly all trade was done on Perspektiva and PFTS; the other exchanges were largely dormant. In 2021, three new firms were listed, bringing the total to 88 listed domestic firms, which is low by international standards.

The volume of trade on these exchanges was modest (approximately, UAH451 billion in 2021), but 98% of the trade was in Ukraine's government debt. Trade in shares accounted for UAH0.5 billion. This is tiny not only relative to GDP (UAH5.4 trillion) but also relative to the trading activity outside these exchanges (the volume of trade in shares outside the exchanges was UAH21.3 billion in 2021). Trade in derivatives and shares issued by foreign firms was equally dismal.

In other words, although the organised exchanges had some trading activity, these exchanges were effectively dead as stock markets or a capital market for privately issued bonds. The National Securities and Stock Market Commission of Ukraine, the regulator of the stock markets, appears to be unable to revamp regulations and revive the markets.

The history of listed shares is informative too. Figure 1.3 shows that the number of shares used for calculating the stock market index for the PFTS exchange has been shrinking. The Russian invasion in 2014 created highly adverse economic conditions for many Ukrainian companies, but some were affected directly by the aggression. For example, Donbasenergo (DOEN), a utility in the Donbas, and Yenakieve Iron and Steel Works (ENMZ), a steel mill in the Donbas owned by Metinvest, were under Russian occupation since 2014. While DOEN was partially under Ukrainian control and thus was partially operational, ENMZ was fully under Russian control and was shut down in 2022 as the factory did not have workers to operate (they were mobilised into the Russian army). Thus, Russia's occupation of the Donbas in 2014 was a huge blow to the market.

FIGURE 1.3 NUMBER OF STOCKS IN PFTS INDEX



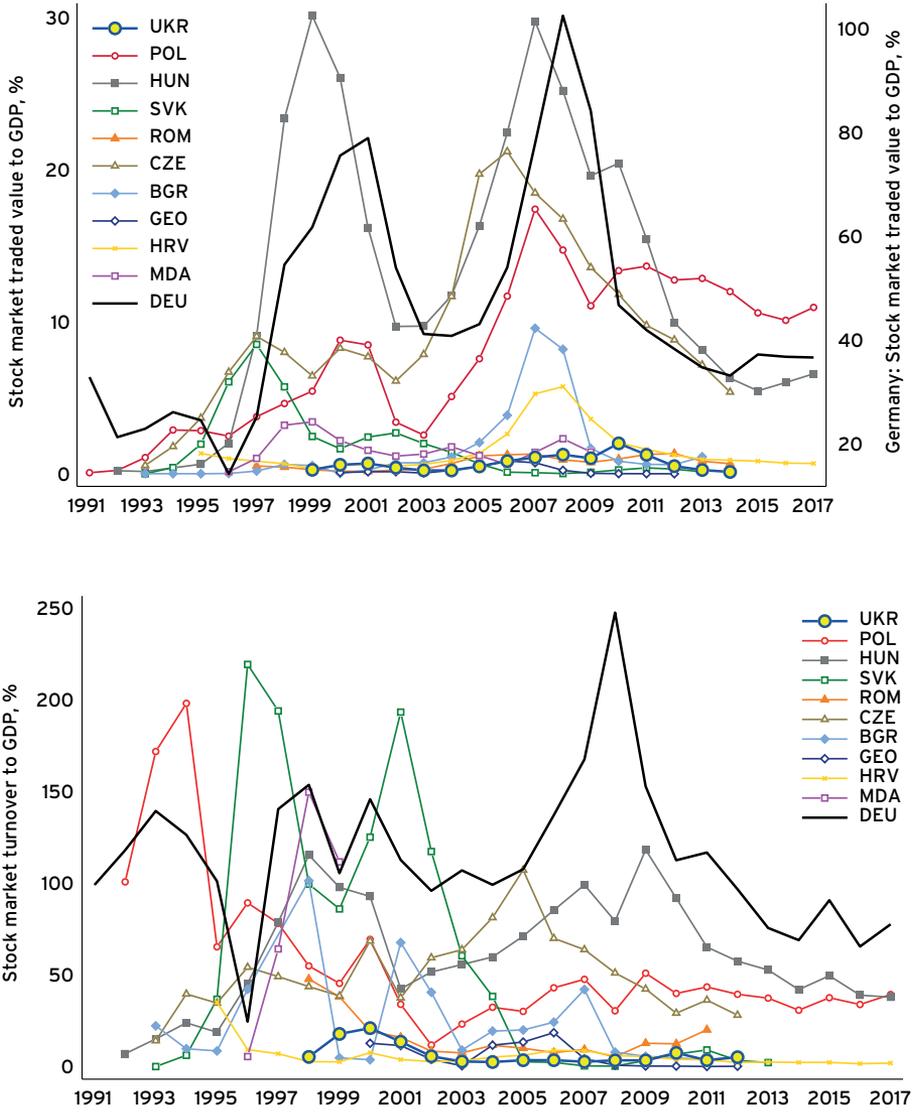
As of the end of 2023, only six companies were in the PFTS index: two utilities, one foreign-owned bank, one telecoms firm and two manufacturing firms. Apart from the bank – which was founded by the country’s central bank, the National Bank of Ukraine (NBU), in 1992 – all firms are Soviet legacy. As far as is known, there are no plans to expand the list to the target of 20 firms. For comparison, the ‘waitlist’ to join the index included 13 firms in 2008.

This brief overview may give the impression that Ukraine’s stock market was a victim of the global financial crisis and Russian aggression. Indeed, stock markets in other countries declined in 2008-09, and after another Russian invasion, Georgia’s stock market capitalisation fell significantly in 2008-09.

But other indicators paint a more troubling picture. Figure 1.4 shows that liquidity (the volume of trade and market turnover) was miniscule in Ukraine even during the golden years of 2004-07. In other words, there has never been a deep stock market in Ukraine. This is important because markets that do not achieve a certain level of liquidity often fail (as discussed in Albuquerque de Sousa et al. 2023). To be fair, other East European exchanges also have modest liquidity. This pattern points to the broader need for Ukraine to team up with other countries to ensure that trade volumes and liquidity for Ukrainian shares are adequate (see Chapter 6).

The experience of Ukrnafta (UNAF), which was removed from the index in early 2023, is indicative too. The firm was owned by Ukrainian oligarchs Ihor Kolomoyskyy and Gennadiy Bogolyubov (42% of the shares) and the government (50%+1 shares). Although the government had the majority, the management of the firm was installed by Kolomoyskyy and Bogolyubov. Scandals in the firm were perennial but, more importantly, unlike other state-owned enterprises (SOEs) after 2014, Ukrnafta remained unreformed as the government could not establish control. In the end, the government nationalised Ukrnafta on grounds of national security in November 2022 and the firm was subsequently delisted.

FIGURE 1.4 STOCK MARKET LIQUIDITY

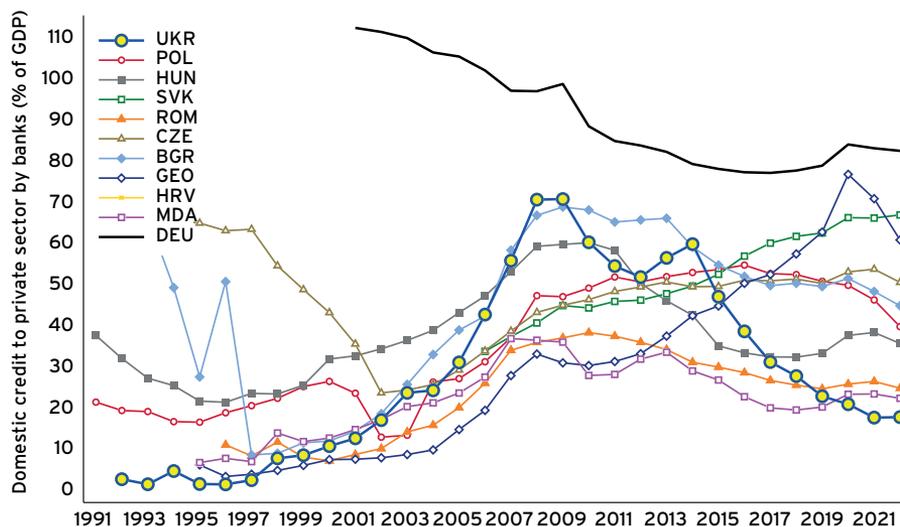


Source: Beck et al. (2019).

## BANKS

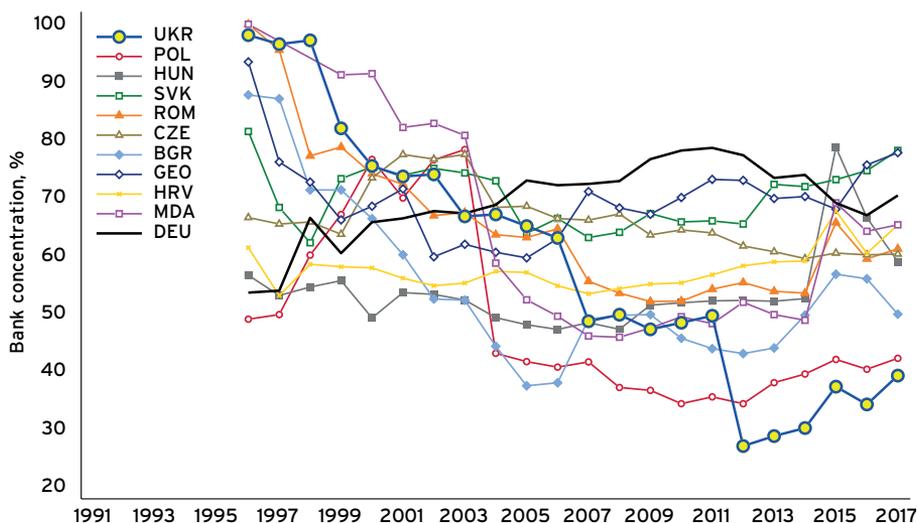
Figure 1.5 summarises the development of the banking sector in Ukraine and comparator countries. In short, after the initial economic stagnation in the early 1990s, many transition economies saw rapid growth of banks. Bank credit to the private economy as a share of GDP increased dramatically in the mid-1990s, and by the start of the global financial crisis it was approaching the levels of Germany. Entry into the sector rapidly reduced bank concentration (see Figure 1.6).

FIGURE 1.5 DOMESTIC CREDIT TO PRIVATE SECTOR BY BANKS



Source: World Bank (series code: FD.AST.PRVT.GD.ZS).

FIGURE 1.6 BANK CONCENTRATION

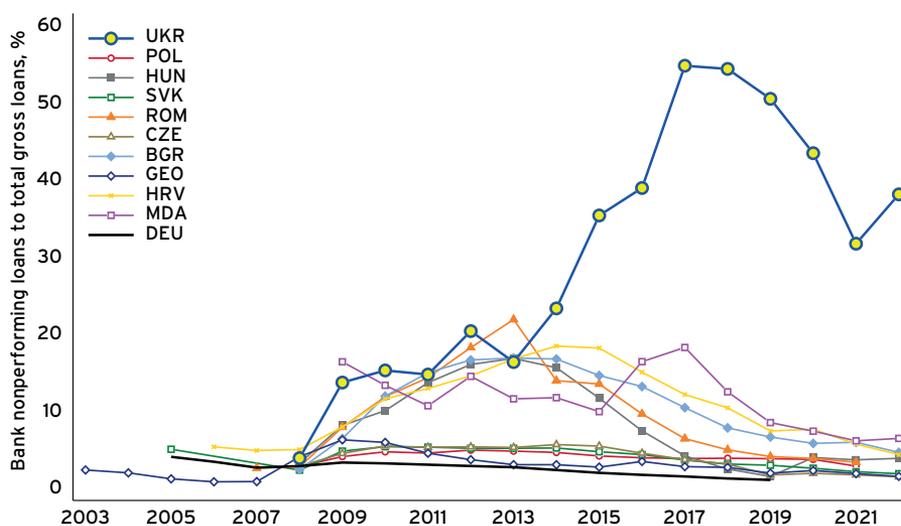


Source: Beck et al. (2019).

Note: Assets of three largest banks as a share of assets of all commercial banks.

The global financial crisis inhibited growth of the banking sector in all East European countries, but Ukrainian banks were hit harder than those elsewhere. Lending and deposits declined significantly in 2009-12. These dynamics reflected not only the high exposure of Ukrainian banks to highly cyclical industries and commodities such as metals, but also poor risk management and supervision. The share of NPLs mushroomed in Ukraine, which is similar to the experience of other countries – Bulgaria, Croatia and Hungary – that faced similar financial and macroeconomic imbalances and were hit hard by the global financial crisis (see Figure 1.7).

FIGURE 1.7 NON-PERFORMING LOANS



Source: World Bank (series code: FB.AST.NPER.ZS).

While Bulgaria, Croatia and Hungary gradually resolved their NPLs, Ukraine was hit by the Russian aggression in 2014 and went through another banking crisis. Because the banking sector in Ukraine was not reformed and had not really recovered from the global financial crisis, this blow was particularly hard. The share of NPLs skyrocketed to more than 55% in 2016. (To be clear, many of these NPLs were on banks' books before 2014, but banks were reluctant to recognise the losses.)

In the process of cleaning up and recapitalising the banking sector, the NBU forced the banks to recognise their losses and thus the share of NPLs shot up. Following the stipulations of a 2008 IMF programme, a system-wide asset quality review (AQR) involving all banks in Ukraine was undertaken in 2014/15.

The AQR resulted in the closure of around 80 banks, which, at the time, accounted for one-third of total assets. These assets were partly sold – at first via auctions through the Ministry of Justice, and later via the Prozorro system. Some of the assets remained with the deposit guarantee fund (DGF), created in 1998; some were bought by former owners because no one else wanted to buy them. Foreign financial institutions were invited to acquire shares in the remaining banks, but without sweeping success. Several banks

including PrivatBank, then owned by an oligarch, were nationalised. Furthermore, there were changes made in the insolvency code and the deposit insurance framework and later (in 2020) a new resolution framework integrated into the DGF was introduced to facilitate out-of-court restructurings. Overall, the clean-up cost Ukraine about 15% of GDP (VoxUkraine 2019).

Although the NBU was able to engineer a gradual improvement in bank balance sheets and the financial system proved to be much more prepared for another round of Russian aggression, the role of the banking sector in the broader economy has been shrinking since the global financial crisis. In terms of bank loans and deposits as shares of GDP, Ukraine was close to Moldova in 2021, which is a dramatic fall from the heights it had reached in 2007.

As far as cooperative banks in Ukraine are concerned, they are small and modelled after, and initially supported by, US credit unions. There are two associations today – the National Credit Union Association (NACSO) and the All-Ukrainian Credit Union Association (VACS) – representing competing networks. While the traditional focus of cooperative banking was almost exclusively on consumer finance, a recent change in legislation (in August 2023) has opened the door to financing agricultural and industrial firms. The legislative move has also changed the governance model: while supervision of cooperative banks has been taken away from the supervisory agency and moved to the NBU.

To complete the picture, we note that while there are over 1,000 non-bank financial institutions, they are almost all relatively small, including the subsidiaries of foreign banks (e.g. Polish PKO Bank Polski, Austrian Raiffeisen Bank, French BNP Paribas and Crédit Agricole, US Citibank and German ProCredit Bank).

The outlook for the banking sector remains difficult. The share of NPLs has increased, nationalisation of banks has raised concentration (state-owned banks control 60% of deposits) and bank credit to the private sector continues to decline. The scars from previous banking crises weigh heavily on trust in the financial system (see Chapter 4).

## **MORTGAGES**

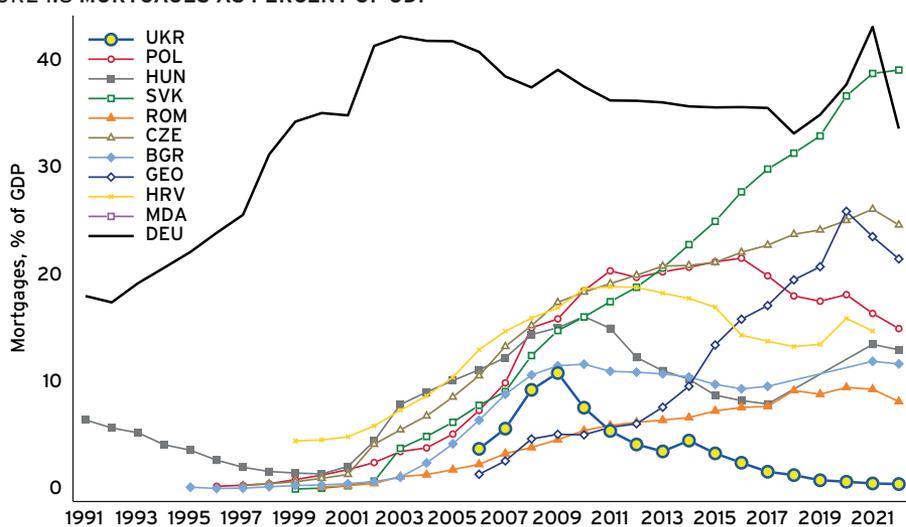
Similar to other segments of the financial markets, mortgages are relatively underdeveloped in Ukraine and have a long history of piecemeal reforms, contradictions, populist urges and crises.

For example, the law 'On Collateral' that allowed the use of property or land as collateral was adopted in early 1992, but the law on mortgages was adopted 11 years later. Only in 2022 was property under construction included in the list of eligible mortgages. A law on covered bonds was adopted in 2005, but only a few of these bonds (about \$110 million in value) were issued by the Agency for Refinancing of Mortgages, which is owned by three state banks and two persons, and is currently under liquidation.

Strikingly, a single credit registry was established only in 2018. Another important development that year was a law strengthening creditor rights protection: specifically, the law clarified how a mortgage issuer can obtain property rights over a mortgaged property or the money from the sale of the property.

The challenges in the banking sector – the main issuer of mortgages in Ukraine – have amplified the difficulties of developing mortgages. As a result, mortgages are negligible in Ukraine's economic landscape and stand at less than 1% of GDP (see Figure 1.8). This is small relative to almost any other country in the region (though they may be even smaller in Moldova, for which data are not available). Chapter 7 explores the mortgage market in more detail.

FIGURE 1.8 MORTGAGES AS PERCENT OF GDP

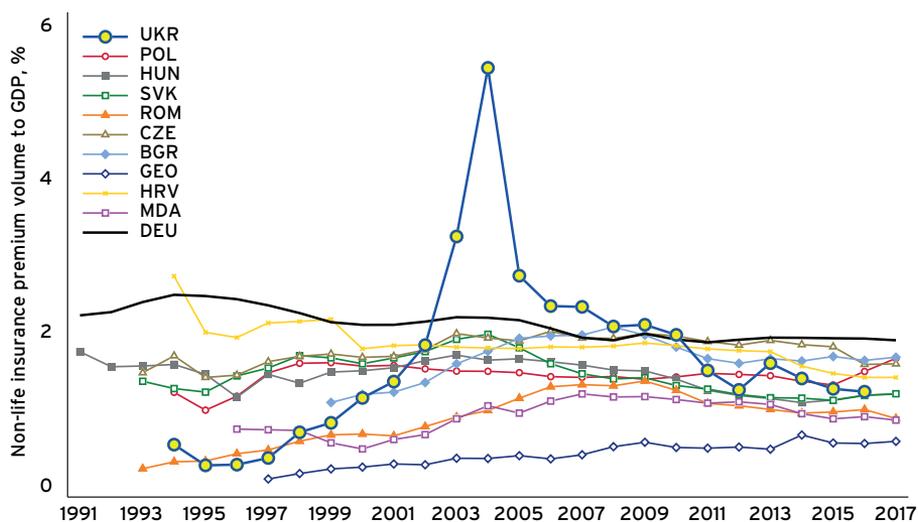


Source: Helgi Library ([www.helgilibrary.com](http://www.helgilibrary.com)).

## INSTITUTIONAL INVESTORS

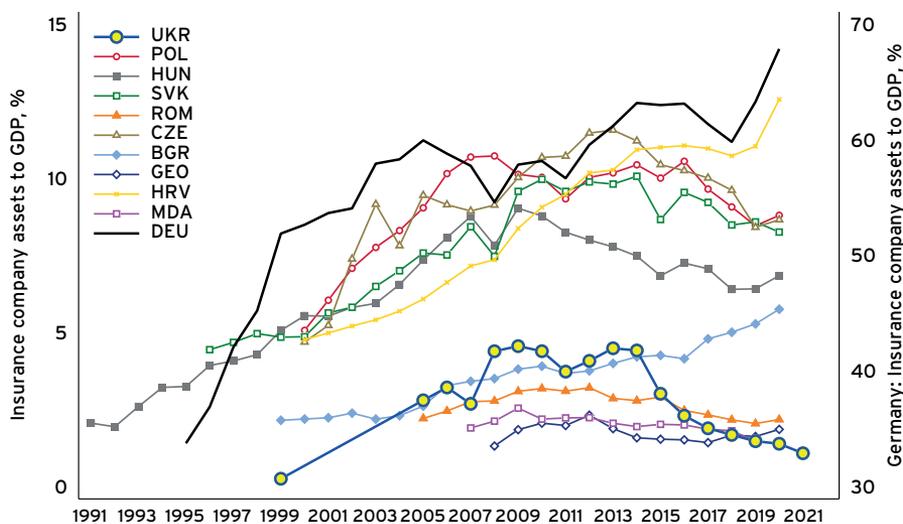
Although insurance markets in East European countries lag behind their counterparts in advanced European countries, the difference is not as large as for the stock market. For example, Germany collects approximately 2% of GDP in non-life insurance premiums, while East European countries collect about 1.5% (see Figure 1.9). But these relatively small differences in flows can accumulate to relatively large differences in asset holdings (see Figure 1.10). For example, German insurance companies had assets valued at close to 70% of GDP in 2021. East European economies have experienced some growth over the years, but the levels of their assets as a percentage of GDP remain low: from approximately 12% for Croatia to 6% for Bulgaria in 2021.

FIGURE 1.9 NON-LIFE INSURANCE PREMIUM VOLUME



Source: Beck et al. (2019).

FIGURE 1.10 INSURANCE COMPANY ASSETS



Source: World Bank (series code: GFDD.DI.I1).

Ukraine generally followed the growth trend of other East European countries (although its base was lower), but the Russian annexation of Crimea and occupation of the Donbas sent the industry into decline: assets fell from 4.5% of GDP in 2013 to 1% in 2021. How quickly insurance companies recover depends on several factors:

- First, insurance companies have had to compensate for the loss of property and life due to the Russian aggression from 2014. The full-scale invasion in 2022 led to another dent in the balance sheets of insurance companies.
- Second, high premiums charged by insurance companies after 2014 have reduced demand for insurance. Post-war security risks may continue to dampen

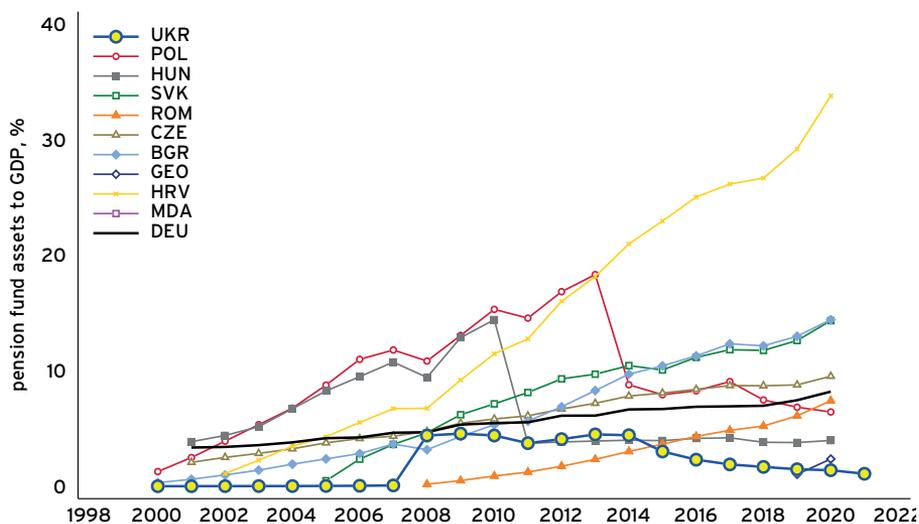
the ability of insurance companies to accumulate significant resources. On the other hand, providers like the Multilateral Investment Guarantee Agency (MIGA) can stimulate the insurance market (Repko 2023). The MIGA, which is part of the World Bank Group, offers political risk insurance to protect foreign direct investment (FDI) from various non-commercial risks, including wars (see Chapter 8).

- Third, domestic insurance companies accounted for 8% of the life insurance market and 46.5% of the non-life insurance market in 2021. Thus, the dynamics will depend on how companies headquartered outside Ukraine respond.
- Finally, the market for life insurance is very concentrated (the top three insurers account for 75% of reserves) and competition may need to be improved in this segment to stimulate growth.

In short, insurance companies are unlikely to play a major role as institutional investors in Ukraine for the foreseeable future. Pension funds appear to be a long shot too. Although Chile and other countries that introduced fully funded pension systems are prime examples of how pension funds can invigorate the development of stock markets, pension funds in East European countries are still too small to become key institutional investors.

To highlight the difference, it is worth noting that the Chilean pension system holds assets valued at close to 70% of GDP in 2023; the corresponding figures for most East European countries are close to 10% (see Figure 1.11). While East European countries introduced a funded pillar to their pension systems much later and it takes a long time to accumulate assets, the main reasons for low asset holdings of pension funds lie elsewhere. The capitalised parts of East European pension systems are voluntary and relatively small. Pay-as-you-go (PAYGO) systems dominate in the region.

FIGURE 1.11 PENSION FUND ASSETS



Source: World Bank (series code: GFDD.DI.I3).

Furthermore, the ageing populations of East European countries put a strain on pension systems and slow down the accumulation of assets. Consistent with the view that voluntary pension savings are unlikely to create large holdings, the experience of advanced European economies varies from ~6% of GDP in Germany (mainly PAYGO) to ~190% in Denmark. Note that Croatia (which, with more than 30% holdings by pension funds, is an outlier among East European countries) has a mixed pension system and roughly a quarter of mandatory pension contributions go to pension funds as capitalised savings.

Since 2004 in Ukraine, PAYGO pensions financed out of current taxes were meant to be supplemented by a state accumulative pension insurance (second-tier) and private accumulative pension funds (third-tier). Yet, instead of developing second-tier pension insurance schemes, the government only facilitated the creation of the third pillar, paving the way for private pension funds to be established. Many of those funds did not survive the global financial crisis: the number of registered private pension funds declined from 95 in 2009 to 63 in 2012.

As of today, according to NBU data, only about 7% of the working population contribute to a private pension fund, and the total accumulated private pension fund assets are less than 1% of the state pension fund, with very few funds earning positive real returns (Ovcharenko 2019). Furthermore, the ageing of the population in Ukraine is much faster than in other East European countries, and negative scenarios suggest that the population of Ukraine could shrink from around 41 million pre-war to around 30 million. This means that contributions to pension funds may be dwarfed by payouts. To appreciate the scale of the problem, the deficit of the pension fund stood at 4.5% of GDP in 2020.

## **CORPORATE GOVERNANCE**

The transition from the command economy to a market economy in the early 1990s highlighted the importance of corporate governance for economic outcomes and ownership. Specifically in the context of Ukraine, so-called 'red directors' effectively controlled SOEs even after their privatisation and used this control for personal benefit. The schemes varied from outright looting to legal transfer of property to red directors and their associates.

The wave of privatisation had mixed results in terms of delineating property rights and the risk of renationalisation or other legal challenges persisted for some time (for example, the largest steel mill in Ukraine was renationalised and privatised again). With weak and unclear property rights, ownership structures drifted towards more concentration. Indeed, the rise of oligarchs in Ukraine was partially driven by the need to consolidate and protect property rights in an uncertain legal environment (Gorodnichenko and Grygorenko 2008). As a result, the emergence of vertically integrated conglomerates

was a response to pervasive hold-up problems and weak property rights. While this was perhaps helpful for economic recovery in the 1990s, the concentration of economic power led to state capture by a handful of oligarchs who extended their influence to the media and political processes.

#### BOX 1.1 ANTI-CORRUPTION AND JUDICIAL REFORM

Reform of the judiciary, as well as other parts of the law enforcement mechanism (police and prosecution) has been high on Ukraine's agenda for a long time. Part of this struggle has been the creation of a system of anti-corruption agencies because a great deal of corruption was present within the police, prosecutors, the judicial system and the political system.

In 2016, amendments to the constitution related to judicial reform were introduced. In line with EU tradition, these changes gave judges more independence and more self-governance. But it soon became clear that the corrupt system was unable to reform itself.

Since the judiciary can only be reformed top-down, much depends on the people who constitute the Higher Council of Justice (HCJ), the highest self-governing body that can investigate disciplinary cases against judges and dismiss them, and the Higher Qualification Commission of Judges (HQCJ), the commission that evaluates the integrity of judges and recommends to the HCJ whether to hire a candidate or to dismiss an operating judge.

In 2021, new procedures for election of HCJ and HQCJ officers were adopted, and selection of candidates for these bodies was completed in June 2023. Now, the HQCJ needs to evaluate about 2,000 acting judges and about 2,500 candidates for judges (together, these will constitute about a half of Ukraine's judges).

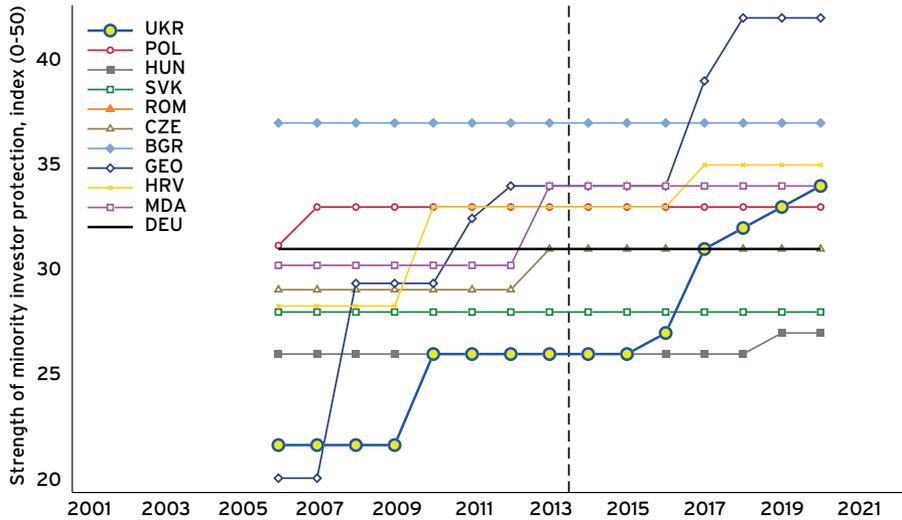
Another important step in the judicial reforms is proper selection of the Constitutional Court (so that it is politically independent and does not roll back reforms). Adoption of the relevant legislation was among the seven conditions for starting Ukraine's EU accession negotiations.

Of the police reforms, only the first step has been implemented: the creation of patrol police instead of highly corrupt road police. The prosecution reform and the state security service reform (depriving the latter of the right to investigate economic crimes and corruption) remain stuck.

The anti-corruption pairing of new courts and investigating bodies works rather well, despite constant attempts by various vested interests to undermine it. To prevent backsliding, Ukraine's civil society and international partners need to keep a close eye on this area.

In a similar spirit, the limited protection of creditors encouraged the creation of financial-industrial groups so that the cost of capital could be reduced by having a bank within the group. This business model did not encourage transparency and high-quality corporate governance. Not surprisingly, Ukraine scored poorly on various metrics of corporate governance quality, such as protection of minority investors' rights (see Figure 1.12).

FIGURE 1.12 STRENGTH OF MINORITY INVESTOR PROTECTION



Source: World Bank's Ease of Doing Business.

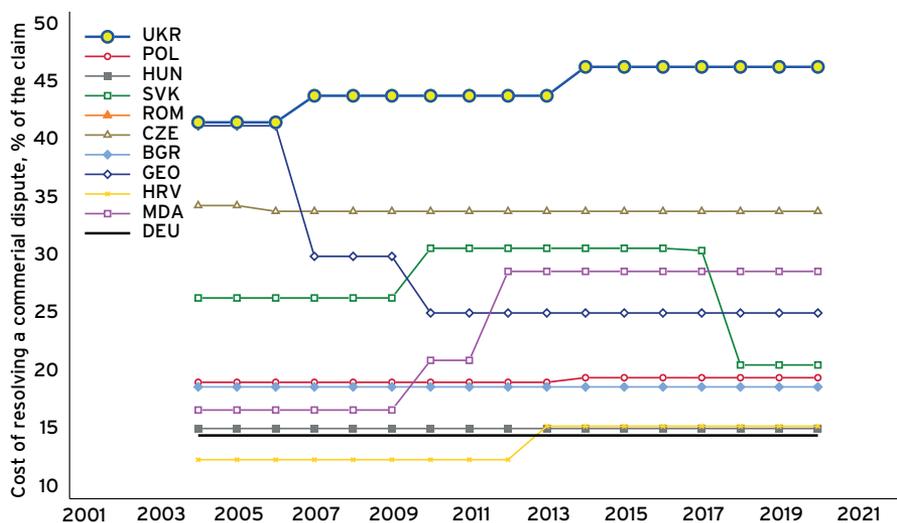
The nationalisation of the largest Ukrainian bank, PrivatBank, in 2016 revealed the exuberant excesses and glaring gaps, but it also suggested ways forward. Founded in 1992, Privatbank was a leader in developing the financial sector: it was the first to participate in the Visa payment system, introduce online services and develop a network of ATMs. But it also had a dark side.

In 2015, just two people (Ihor Kolomoyskyy and Gennadiy Bogolyubov) controlled 90% of the largest private bank in the country, which is extreme concentration. Pervasive conflicts of interest, an opaque network of ownership and related parties, a weak corporate board, the lack of personal responsibility of directors and poor oversight by the government are some of the hallmarks of this case. A forensic audit by Kroll documented that the owners siphoned off the bank's funds (\$5.5 billion) via related-party lending, fraud and other means (NBU 2018). As of January 2024, the legal battles continue in Ukrainian and foreign courts. But an independent, competent corporate board and qualified management appointed by the government turned the bank around and generated approximately \$1.3 billion in profits in 2021.

The global financial crisis was an impetus to reform the financial system and corporate governance, but tangible reforms started only after the Revolution of Dignity in 2013-14. Specifically, Ukraine made strong progress in requiring directors and other stakeholders to reveal their conflicts of interest and in increasing transparency for ownership stakes and compensation, but other elements remain problematic. For example, shareholders have a difficult time suing directors for self-dealing since the cost of legal protection is high.

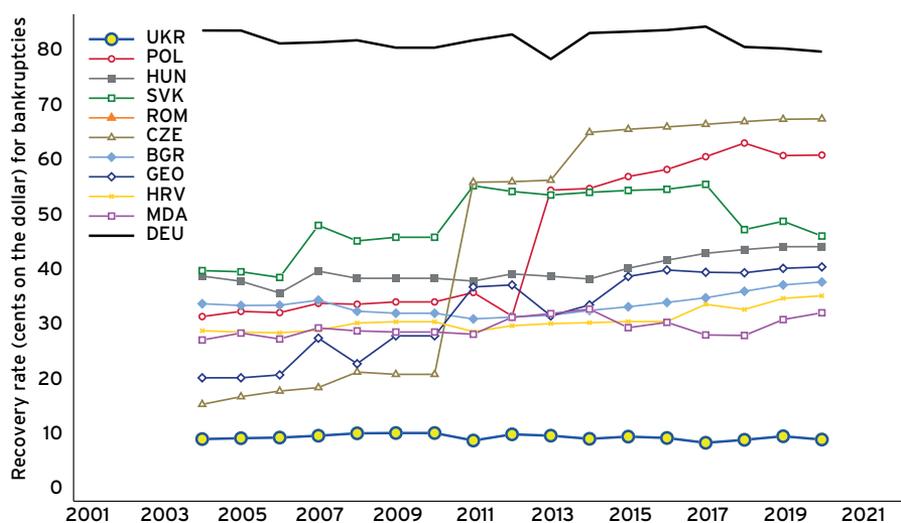
Issues with corporate governance are compounded by problems with enforcing commercial contracts and mixed progress in this area. For example, despite improvements in the quality of judicial processes for enforcing contracts since 2015, the World Bank's Ease of Doing Business data suggest that Ukraine has the highest costs of contract enforcement among East European countries and that there has been an increase in these costs over time (see Figure 1.13). Similarly, creditors can recover only a small fraction (~10%) in bankruptcy cases, and there is no sign of improvement since the early 2000s (see Figure 1.14).

FIGURE 1.13 COST OF RESOLVING A COMMERCIAL CLAIM



Source: World Bank's Ease of Doing Business.

FIGURE 1.14 RECOVERY RATE FOR BANKRUPTCIES



Source: World Bank's Ease of Doing Business.

## PRIVATISATION

Privatisation of state-owned enterprises (SOEs) can provide a boost to the development of the financial sector. For example, Megginson and Netter (2001) document that in many countries, some of the largest market capitalisations in national stock markets are privatised companies (typically in telecoms and utilities, but occasionally firms in manufacturing and banking). As discussed in Perotti and van Oijen (2001), privatisation may also provide indirect benefits such as signalling commitment to private property.

In the early 1990s, many governments in transition economies hoped that massive privatisation would spur local capital markets and exchanges. The outcome was modest even in the best cases: in a fleeting moment, various exchanges and traders mushroomed, but then this burst of activity largely disappeared. For example, privatisation via voucher schemes, as happened in Ukraine, created a secondary market for 'shares' in government property given to the population, but many investment funds turned out to be frauds and Ponzi schemes. Indeed, no major investment fund in Ukraine today traces its origin to trades with vouchers, but some of those trades gave capital to future oligarchs. If anything, the giveaway privatisation generated popular resentment rather than a class of owners.

Subsequent rounds of privatisation focused on selling large SOEs to strategic investors (for example, KryvorizhStal, the largest steel mill in Ukraine, was sold to Arcelor Mittal) but often these companies ended up being owned by oligarchs and others connected to the government (KryvorizhStal was first sold to Victor Pinchuk, an oligarch and son-in-law of President Leonid Kuchma, and Rinat Akhmetov, another oligarch). This focus was justified on the grounds that the stock market was too underdeveloped in Ukraine to generate a good price. While likely to be true, this approach also denied the nascent market the opportunity to establish itself. Even for countries where stock markets were more developed than in Ukraine, the experience was mixed at best. Poor corporate governance and many insider owners led to thin trade volumes (Brada 1996).

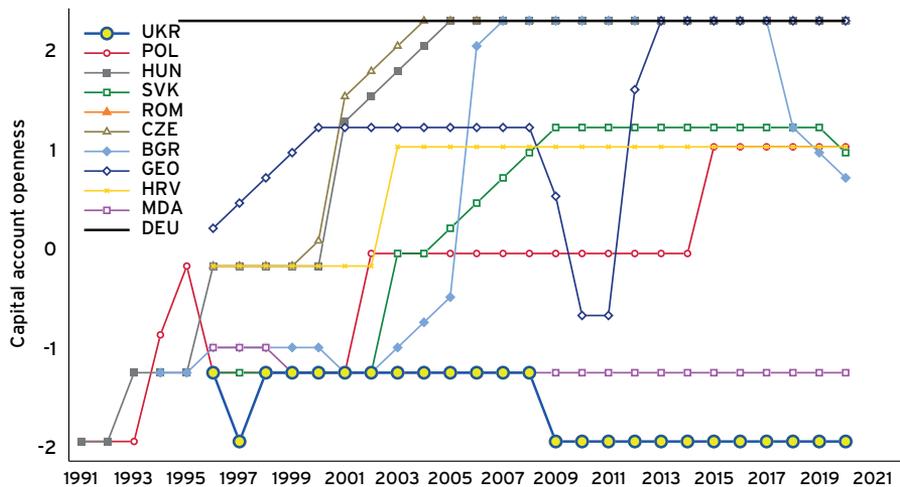
In short, there is little indication that privatisation in Ukraine facilitated the development of the financial sector. To be clear, this negative experience does not mean that privatisation cannot help to develop a local capital market. But the experience provides much material to learn from mistakes.

## FINANCIAL MARKET LIBERALISATION

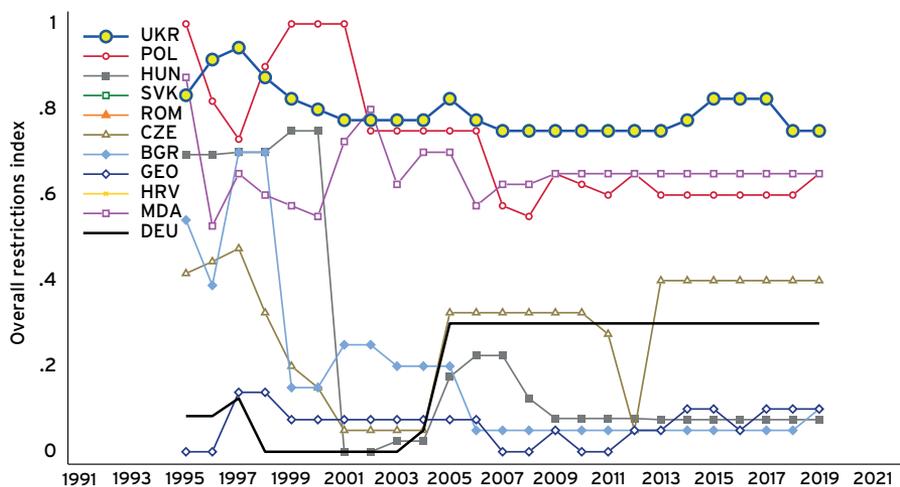
Countries of the former Soviet bloc all started with very tight restrictions on capital account transactions in the early 1990s. Over time, most East European countries opened up significantly to global markets (see Figure 1.15). In contrast to this trend, Ukraine remained relatively closed (especially in terms of capital outflows): popular indices of capital account openness score Ukraine as one of the most closed countries in the region (Chinn and Ito 2006, Fernandez et al. 2016).

FIGURE 1.15 CAPITAL ACCOUNT RESTRICTION

a) Chinn-Ito index



b) Fernandez-Klein-Rebucci-Schindler-Urbe index



Note: The top panel uses Chinn and Ito's (2006) index of capital account openness. The bottom panel uses Fernandez et al.'s (2016) index of restrictions on capital account.

Furthermore, some of the liberalisation was rolled back after the global financial crisis and the Russian invasion in 2014. Some of these policy moves may be justified by the need to impose capital controls to tame financial panic, but the high level of restrictions even before the crises suggests that the roots of these restrictions go deeper. For example, even now, foreign investors cannot own agricultural land because the public is concerned about this 'sacred' asset being taken over by foreigners.

At the same time, these indices may overstate the degree of restrictions. For example, acquisition by a foreign investor of equity securities does not require state registration. Once registered with the Ukrainian securities commission, foreign assets can be traded on the Ukrainian exchanges if they are traded on the exchange in their country of origin. The former is counted as 'no restriction', while the latter is counted as a 'restriction'. The degree to which this restriction is binding may be debated but one may expect that few foreign issuers have a materially important interest in being traded on Ukrainian exchanges. In other words, some formal restrictions may be non-binding, but these restrictions capture the spirit of outdated regulations and they probably contributed to the absence of Ukraine in major indices covering emerging economies (e.g. MSCI).

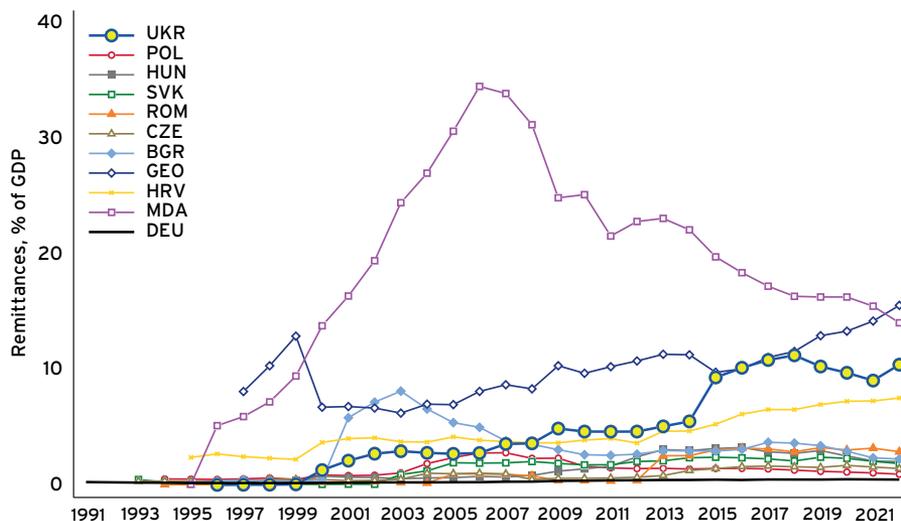
Once Ukraine stabilised its financial sector after the shock in 2014, there was a thaw in restrictions. Historically, Ukrainian residents required a licence (from the NBU) to purchase foreign shares, but this requirement (up to a limit) was abolished in 2019. In a similar vein, FDI no longer requires state registration and foreign exchange may be purchased and transferred to repatriate dividends abroad to a foreign investor. At the same time, many restrictions are still in place. Some, such as those on cross-border credit flows, may be justified on macroprudential grounds (for example, Ukrainian households cannot borrow in foreign currency to avoid a repeat of the 2008-09 meltdown when many households borrowed in dollars), but others can be rather archaic (for example, foreign banks need approval from the government to issue bonds in domestic currency). Some restrictions on cross-border capital flows were introduced in February 2022 to help Ukraine's financial system to cope with the full-scale Russian invasion.

Despite these restrictions on capital flows, remittances in Ukraine are high (~10% of GDP in 2021) and have been growing steadily over the last 20 years (see Figure 1.16). There was significant FDI into the banking sector before the global financial crisis (the share of foreign bank assets among total bank assets peaked at 60% in 2008), but the prevalence of foreign-owned banks declined after the crisis. Although some big banks in Ukraine are foreign-owned (e.g. Austrian Raiffeisen Bank and Hungarian OTP), their role is modest relative to the role of foreign banks before the crisis. Ukraine has one of the lowest levels of FDI per capita among East European countries (see Figure 1.17). For example, in 2021, FDI as a percentage of GDP was 4% in Ukraine, whereas it was 19.8% in Estonia. This lacklustre performance shares its roots with other economic problems, such as poor corporate governance, weak rule of law and an unstable macroeconomic environment.

This dynamic suggests that although restrictions on cross-border capital flows could be an obstacle, the entry and exit decisions of investors were also a function of the global financial conditions. Consistent with this view, foreign investors purchased significant amounts of Ukraine's public debt in the era of ultra-low interest rates in advanced economies in late 2010s, as this debt could accommodate the 'reaching for yield' imperative at the time.

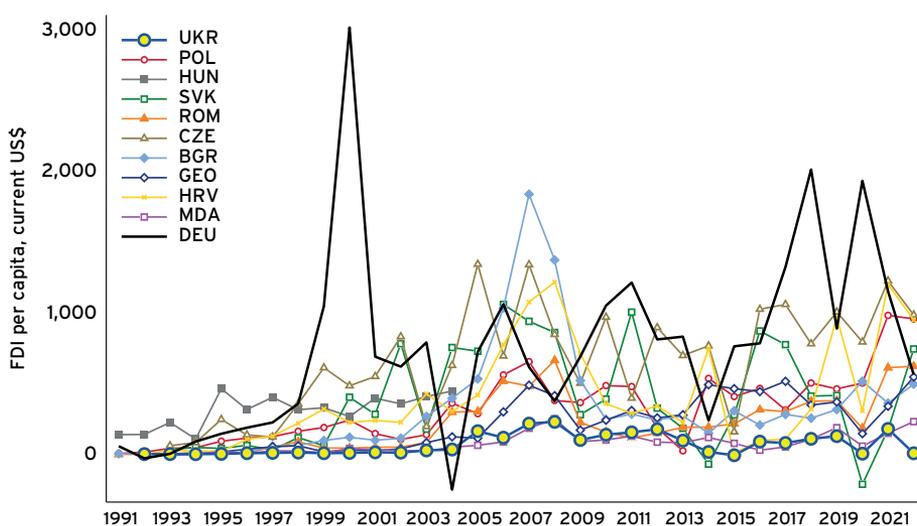
Financial liberalisation appears to be unlikely in the near future. During the war or even immediately after the war, the government will be focused on macroeconomic stability (for example, to avoid a boom-bust cycle at the reconstruction stage) and thus lifting capital controls or rapid financial liberalisation seem improbable. But the logic of post-war reconstruction and developing capital markets suggests that a more liberal environment is needed to attract capital to Ukraine. There is also a need to restructure public debt as soon as the war is over to have a clean slate for the public finances and to avoid the pressure of potential sovereign defaults on financial development (Kim and Wu 2008).

FIGURE 1.16 REMITTANCES



Source: World Bank (series code: BX.TRF.PWKR.DT.GD.ZS).

FIGURE 1.17 FOREIGN DIRECT INVESTMENT

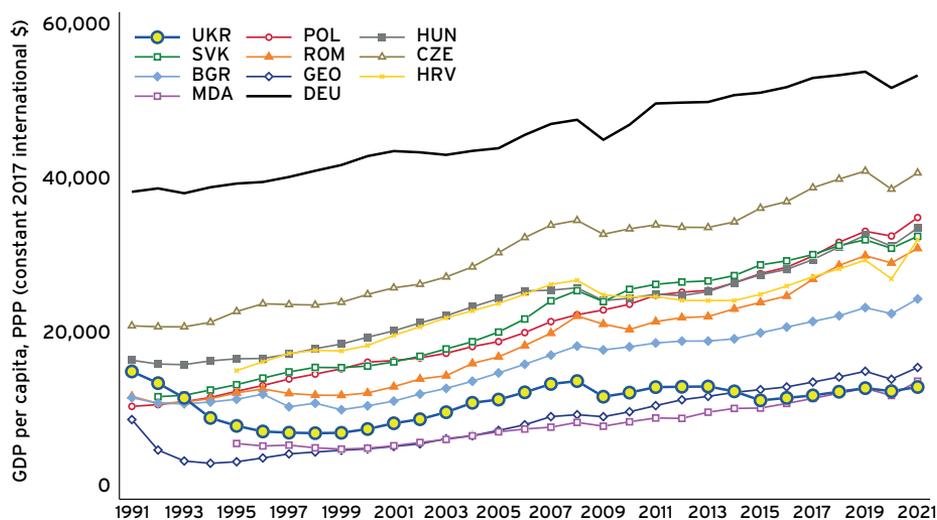


Source: World Bank (series code: BX.KLT.DINV.CD.WD).

## MACROECONOMIC STABILITY

Macroeconomic factors have generally been unfavourable for developing Ukraine's capital markets (see Table 1.1). Ukraine is one of the poorest countries in Eastern Europe, it has experienced much volatility and little economic growth, and inflation has been chronically high and volatile. Strikingly, Ukraine had a lower GDP per capita (fixed PPP \$) in 2021 than in 1991 (see Figure 1.18).

FIGURE 1.18 GDP PER CAPITA



Source: World Bank (series code: NY.GDP.PCAP.PP.KD).

TABLE 1.1 MACROECONOMIC INDICATORS

	Growth rate of real GDP (%)				Inflation (%)				Income per capita (US\$2017 PPP)
	Mean	Median	Std.	2019	Mean	Median	Std.	2019	2019
BGR	3.3	3.4	3.2	4.0	4.3	3.0	4.1	3.1	23,266
CZE	2.5	2.9	3.1	3.0	2.9	2.3	3.1	2.9	40,990
GEO	5.5	5.2	4.5	5.0	5.4	5.4	3.6	4.9	14,989
HRV	2.3	3.3	4.6	3.4	2.3	2.1	2.5	0.8	29,348
HUN	2.6	4.0	3.3	4.9	4.5	4.1	3.3	3.3	32,646
MDA	4.0	4.9	5.3	3.6	8.5	7.0	5.8	4.8	12,777
POL	3.7	4.0	2.1	4.5	2.9	2.3	3.1	2.2	33,160
SVK	3.6	3.6	3.6	2.5	3.5	2.7	3.2	2.7	32,056
UKR	0.6	3.1	9.4	3.2	11.9	10.2	10.3	7.9	12,805

Source: World Bank; period: 2001-22.

Some of this adverse environment is determined by exogenous forces such as Russian aggression, but some has been a result of poor policies. For example, Ukraine had multiple banking and currency crises before it cleaned up its banking sector in 2015-16 and switched credibly to an inflation targeting regime. The dynamics of macroeconomic indicators since the full-scale Russian invasion in 2022 are a source of both despair and optimism: the economic losses are huge, but the economy has proved to be resilient and shows signs of recovery.

### **TAKING STOCK**

This analysis of the life cycle of Ukraine's financial sector since 1991 suggests that many factors have contributed to the boom-bust dynamic and lack of progress more generally. The transition to a market economy created opportunities (private property was introduced) and obstacles (insider ownership, weak property rights and weak rule of law). The latter led to vulnerabilities to economic and military shocks. The recovery from the economic collapse in the early 1990s and reforms helped to set the economy on a trajectory of growth. The upturn in the commodity cycle during the early 2000s helped to buoy the economy and global investors' interest in Ukraine.

But these good times reduced the incentives for reforming the economy further, and so corporate governance and other fundamentals for a successful market economy were not improved. The global financial crisis was a major blow to all emerging markets, but Ukraine was affected particularly severely. Global investors had little appetite for risk and the corrupt regime of President Viktor Yanukovich had little appetite for reform.

Stagnation, if not decline, characterised the period from 2008 to 2013. The economy and the financial sector appeared to be in a self-sustained bad equilibrium. The Russian annexation of Crimea and occupation of the Donbas in 2014 were further blows that made Ukraine an emergency market rather than an emerging market (in 2014-15, Ukraine's GDP fell by 15% compared with a fall of 29% in 2022). Security concerns inhibited economic and financial development. Most recently, the full-scale Russian invasion in early 2022 put Ukraine's capital markets in the deep freeze.

## CHAPTER 2

# The Marshall Plan: Lessons for Ukraine

No one knows how long the war in Ukraine will last, or when reconstruction will receive undivided attention, with an end to continuing violence and destruction. Plans thus need to contain multiple scenarios, including the ‘corner solutions’ of a rapid end of the war and a long, drawn-out or near permanent conflict.

There is a clear precedent in the provision of large-scale aid from the US to Europe in the aftermath of World War II. After the June 2022 G7 summit in Schloss Elmau, Germany, Chancellor Scholz declared that there was a consensus that a new Marshall Plan was needed.

The European Recovery Program (ERP), or ‘Marshall Plan’, is often held up as the gold standard for the economic reconstruction of areas in the wake of political, military or economic devastation because it stood at the beginning of an era of unprecedented growth coupled with political stability. Thus, there was a substantial demand for an equivalent programme for Central and Eastern Europe and the former Soviet Union in the 1990s following the collapse of communism; for Iraq after the 2003 war; for the Middle East after the Arab Spring; for Syria and the surrounding areas after the Syrian conflict; for Western/Saharan Africa in the 2010s; and for Haiti after the earthquake and political unrest. These demands mostly fell on deaf ears.

It is clear to any practitioner that a modern version cannot simply involve a rehash of the 1947 initiative. There needs to be new thinking, but some of it will revolve around the issues that preoccupied the Marshall planners. They identified exactly the right issues: how the amount of aid given relates to the scale of the intended effects; how aid can be used as a catalyst for a general development of productive forces; and how the support can bind the recipient into a deep network of international connections. The Marshall planners wrestled with the problem of how much should be organised by governments, and how much a wealth of knowledge in the private sector of the donor could be used to transform productivity in the recipients.

In all of these areas, there are strong and still relevant lessons: above all, money should not be simply splashed around; rather, the focus should be on how aid can be precisely targeted and its results become catalytic. As George C Marshall, the US Secretary of State after whom the plan is named, eloquently put it: “It would be neither fitting nor efficacious for this Government to undertake to draw up unilaterally a program designed to place Europe on its feet economically. This is the business of the Europeans. The initiative, I think, must come from Europe.”

But there are also clear differences: pre-World War II Germany was an industrial powerhouse, while Ukraine in the post-Soviet period has suffered from much lower growth (and much lower productivity increases) than either neighbouring Poland or Russia. It has also had severe governance and corruption problems, and accumulated a sizable international debt (~50% of GDP in 2021). There is thus a hesitancy to solve the Ukrainian reconstruction issue by simply urging the country to take on more debt (in a global environment where debt is becoming harder to finance).

Ukraine also has one clear advantage that needs to be preserved: unlike Marshall Plan Europe, which was a continent scarred by dictatorship, occupation and collaboration, there is now a powerful and vibrant democracy, and a sense of national commitment built by the experience of the war. This is an asset that must not be dissipated.

This chapter uses the history of the Marshall Plan to draw a number of lessons for rich Western countries in the North Atlantic – of what to do, but also what not to do. It is also important to dispose of a number of myths that surround the Marshall Plan, both positive – a ‘uniquely generous act’ is the phrase often used in commemorative events – and negative – a ‘tool of US imperialism’ was a common response of critics, and one that was inculcated in many East Europeans with whom it still sits deeply.

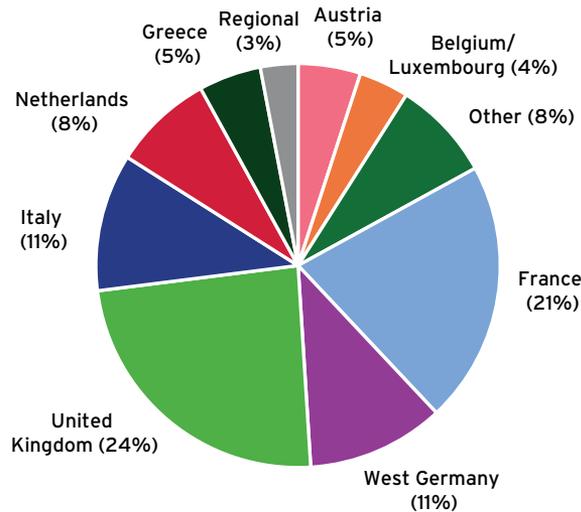
## HISTORY

The original Marshall plan was announced at a moment of great geopolitical tension (Steil 2018): in the middle of an incipient Cold War, in a speech by Marshall at Harvard University on 5 June 1947. The bare bones of the idea had already been sketched out in his first speech as Secretary of State, at the Princeton University Alumni Day on 22 February, when there was less geopolitical tension and the civil wars in Greece and Turkey had not yet erupted.

At Princeton, Marshall explained: “Most of the other countries of the world find themselves exhausted economically, financially, and physically. If the world is to get on its feet, if the productive facilities of the world are to be restored, if the democratic processes in many countries are to resume their functioning, a strong lead and definite assistance from the United States will be necessary.” This vision linked economic prosperity with the flourishing of democracy.

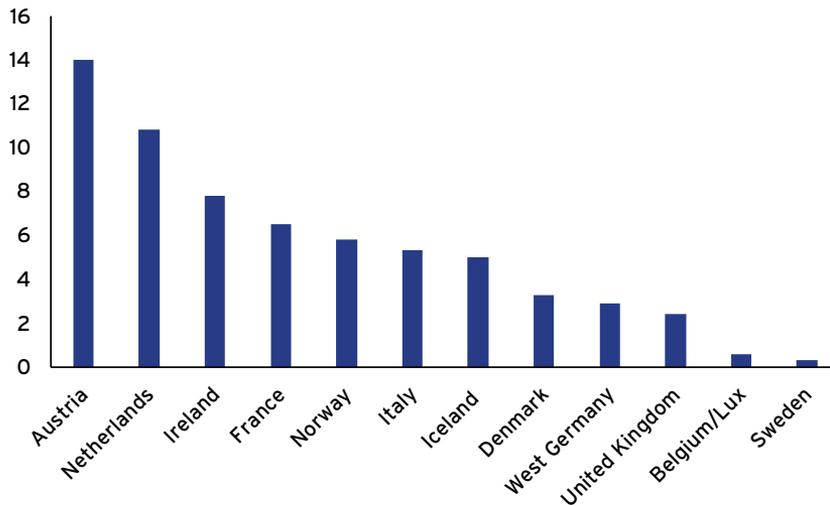
Marshall support was given to 16 countries, and initially offered to more, including countries in the Soviet sphere of influence in Central and Eastern Europe, but Moscow ordered Czechoslovakia and Poland not to attend the crucial conference. There were big differences in the levels of support for recipient countries (see Figures 2.1 and 2.2).

FIGURE 2.1 COUNTRY ALLOCATIONS OF THE EUROPEAN RECOVERY PROGRAM



Source: Statistical Abstract of the United States (1954).

FIGURE 2.2 MARSHALL PLAN AID AS A SHARE OF NATIONAL INCOME



Source: Statistical Abstract of the United States (1954).

The most important element of the real Marshall Plan – as opposed to later fantasies about it – is that it was not simply the unleashing of an enormous amount of purchasing power. Revisionist historians such as Alan Milward (1984, 1989) have frequently made the argument that because the size of ERP support was quite small, it cannot possibly explain the amazing speed of European post-war economic recovery and that maybe there was simply a catch-up effect.

But that argument rather misses the point of the programme. The ERP was carefully targeted to allow the recipient countries in Western Europe to import goods from the US and the Western hemisphere that they could not have otherwise obtained because of the general dollar shortage and because, due to the extent of wartime devastation, they could not produce goods for export that might earn dollars.

These imports constituted bottlenecks for economic development, in particular, foodstuffs and machine tools. Foodstuffs were important because Western Europe was not self-sufficient nutritionally, and without an adequate caloric intake, its workers could not engage in the heavy labour needed in reconstruction. Key sectors, such as coal mining and steelworks, required heavy physical exertion, at a time when there was much less mechanisation, as did the reconstruction of buildings.

What's more, factories that had been dismantled in the course of the war by the Nazi occupation armies, often with the intent to rebuild them in Germany, or production sites that had been destroyed by bombing required machine tools. But the world's pre-eminent producers of machine tools before 1939 had been Germany, Japan and the US, and the first two had clearly been devastated. So the US was in fact the only possible source of the equipment that would be needed to restore European manufacturing capacity.

In the first year of the ERP, half of the assistance went to food imports but this share would be reduced quickly, and in the second year, a much heavier share went to machinery and engineering products.

The ERP was designed to finance imports of the goods (foodstuffs, and machine tools and engineering products) required in reconstruction. The importers would pay their governments, and the US government would pay the exporters. The resources that the recipient governments gained (in domestic currency) could be used for projects that those governments believed to be essential for development. Again, they sought to identify particular bottlenecks, frequently in energy provision, so that substantial sums were spent in constructing new electricity stations, both coal-powered but also hydroelectric in mountainous areas since there was a general coal shortage.

'Counterpart funds' were a considerable resource for fiscally strained governments, and allowed the development of planning initiatives. There is thus in France in particular a close association between the Marshall Plan and the celebrated Monnet Plan for the revitalisation of French industry.

Of the total sum, 90% involved grants with no interest and no repayment. The total amount provided by the US in ERP assistance was \$13.3 billion – the current value of which would be around \$175 billion. To put these sums in context, the total war damages to February 2023 are estimated at \$411 billion; Ukraine's GDP was \$200 billion in 2021; and the US provided an estimated \$75 billion in overall aid commitments, including \$42.4 billion in military assistance, to Ukraine up to mid-January 2024. By contrast, the EU provided around \$93 billion, including \$6 billion in military and 85 billion in financial assistance commitments.

There is an additional element involved in the calculation of what relief was brought by Marshall aid. Some recipients, notably the UK, which was the only ally that had fought all through World War II, had high levels of debt, augmented by the additional credit (which had to be repaid and which carried interest) of a \$3.75 billion loan concluded when wartime Lend-Lease stopped with the end of European hostilities in May 1945.

On the other hand, some belligerents, in particular Germany, had little debt because of the extent of wartime and post-war currency depreciation, which amounted to a de facto cancellation of debt. Of course, the Allies might have insisted on the revaluation of the substantial liabilities that Germany owed, mostly to countries in Eastern and Southern Europe – Greece, Hungary, Romania and Yugoslavia – which had built up big (and now worthless) Reichsmark balances. But many of these countries were in the Soviet sphere of influence and, in any case, there was by 1947 a reluctance to repeat the 1919 mistake of imposing a big burden on the defeated powers. So it is possible to argue that the absence of a debt repayment requirement amounted to a large financial and fiscal relief (Ritschl 2012).

From the beginning of discussion about the character of the ERP, it was suggested that the US contribution should be catalytic. There were thus a range of individual projects specified for Marshall Plan assistance: 139 in total, of which 27 were in energy production and 32 in iron and steel. The cost was \$2.25 billion, but of this, only \$565 million came directly from the Marshall Plan. This was perfectly in line with Marshall's original vision expressed in his speech at Harvard.

Another vital part of the plan consisted of the promotion of interlinkages between the different European economies. A critical element in the vision was that small and medium-sized countries could not supply all their goods themselves, and there was thus a need to break through the patterns of autarky that had been established in the 1930s in the aftermath of the Great Depression.

Thus, there was a great deal of emphasis on facilitating and eventually multilateralising European payments. The process inevitably involved an inter-European tussle. The creditor countries in intra-European payments (chiefly Belgium, where there had been little war damage) wanted to be compensated disproportionately by an increased funding in dollars, whereas the debtor countries, such as the UK, pressed for a greater share of direct dollar access.

The plan was administered through an Economic Cooperation Administration, with an administrator (Paul Hoffmann) and a wide representation of US business, labour and agricultural interests. These private sector actors played a decisive role in making choices as to which projects could be funded. Critics characterised the result as being dominated by Ivy League-educated 'Wall Street wolves' who wanted to carve out business empires in the new Europe (Hogan 1987).

The underlying idea was that the US experts could give specific and targeted advice on how to raise productivity; the mechanism is seen in consequence as part of a radical reassessment of productivity growth as a key to economic advance. The European side of the coordination was managed through the newly created Organisation for European Economic Co-operation (OEEC), the technical committees of which managed particular sectors (food and agriculture, coal, electricity, oil, iron and steel, raw materials, machinery, non-ferrous metals, chemical products, timber, pulp and paper, textiles, etc.).

Hoffmann (and the diplomat and bureaucrat George Kennan) also envisaged the Economic Cooperation Administration as well as the OEEC as a way of detaching continental Europe from the UK, which was mired in debt and obsessed with its imperial legacy. Kennan thought that the UK might appropriately be reduced to an “education and travel centre” (Hogan 1987).

The management of multilateralisation required a mechanism for managing and supervising cross-border payments. It is here that the international governance structures come into play. A clear candidate to manage this process might have been the newly created IMF. But there was considerable US suspicion of the Fund, because of accusations that the wartime assistant to the US Treasury secretary and first US executive director of the IMF, Harry Dexter White, had acted as a Soviet spy, and that he had brought many of his staff into the new IMF.

As a consequence, the US Department of State pushed to involve the Bank for International Settlements (BIS) instead, even though the institution had been severely criticised for wartime collaboration with Germany, and the Bretton Woods agreement had envisaged a winding up of the IMF. This was probably desirable and beneficial, in the sense that the BIS was a more technical and apolitical institution than the IMF, which was intentionally controlled by finance ministries and treasuries, and was designed as an alternative to the technocratic management by semi-autonomous central banks.

The Marshall Plan was inevitably mixed up in the politics of the Cold War. It was sold to Congress and the American people largely as part of a necessary strategy of containing Soviet influence. What after all did leaving the process to Europeans really mean? How far could they be trusted to come up with the right outcomes?

The Truman administration was deeply concerned about what it called Soviet “psychological warfare”. Kennan, who played a key role in designing both containment and the Marshall Plan, wrote in May 1948 about “the inauguration of organised political warfare”, and National Security Council Directive 10/2 (18 June 1948) set up a network of clandestine organisations to challenge Stalin and the Soviet Union.

Kennan had seen covert operations as an element of the overall policy, and the result was that – as a recent history of the CIA rather exaggeratedly claims – a substantial part of the Marshall Plan funds were “syphoned off” to the CIA (Weiner 2007). It is not surprising that there was a political suspicion among some Europeans of the motives of US policy.

On the other hand, many Americans were inherently suspicious of the multilateral engagement and expense of ERP, which was often caricatured as pouring money down a rathole. (The same language was used in discussions of post-Soviet reconstruction assistance in the 1990s.) Treasury secretary John Snyder repeatedly complained that “Americans were always the milch cow”, and Europeans responded by lamenting that he was a “small minded, small town semi-isolationist” (Hogan 1987).

There was thus plenty of mutual distrust, which faded gradually as stunning economic growth set in, and as Americans as well as Europeans saw the fruits of a generalised prosperity.

## LESSONS

Some lessons for Ukraine follow from each of these historical points.

### Sources of funds for reconstruction

A large amount of money is required for reconstruction, but the US was not the source of the major funding or investment required for the entire reconstruction effort after World War II. The same principle should apply to Western governments funding Ukraine’s reconstruction.

### Tackling bottlenecks

The key to effective reconstruction is to identify bottlenecks that hinder the restoration of economic activity, and which limit the country’s immediate ability to earn foreign currency from exports. Examples might include the devastated steel works of Mariupol’s Metallurgical Combine Azovstal, which in addition to its primary output is also essential for producing by-products such as the neon gas used in semiconductor production. But above all, the bottlenecks of today are in high-tech sectors, and may be complementary to the sophisticated software capabilities that many Ukrainians have, and which they have used productively in the course of the conflict.

### Debt relief

Debt relief will play a major part in the reconstruction effort, but it requires careful handling as it raises vital questions about equity and political justice. At the end of 2021, Ukraine’s external public debt was around \$57 billion (or over a quarter of GDP), including \$13.4 billion owed to the IMF. There was also a large private sector debt, so that total external debt was around \$127 billion. But this gross debt position corresponds to substantial, mostly privately held assets abroad, so that the net international investment position at the end of the third quarter of 2023 was calculated by the NBU as \$168.2 billion in assets (including \$123.2 billion in the category currency and deposits) and \$171.0 billion in liabilities.

How much of the privately held debt can be used to pay off public debt? Germany started the Marshall Plan period with virtually no international public debt, but also with an effective expropriation of many assets at the moment of the June 1948 currency reform. Foreign creditors are unlikely to want to see debt relief without some major capital contributions from oligarchs, some but not all of which are associated with Russia or Russian interests. One major oligarch, the media magnate and politician Viktor Medvedchuk, was arrested (and has since been released to Russia in a prisoner swap).

### **Creating ownership and building democracy**

The employment of some part of the funding of reconstruction at the discretion of the recipient government (in the style of the Marshall counterpart funds) is a key part of the process of creating ownership and building democracy, which are vital to the desired process of restoring normality. Western funders should be concerned about the potential for corruption, but too intrusive monitoring by outsiders, as opposed to democratic control in Ukraine, would be counterproductive. The German development bank Kreditanstalt für Wiederaufbau (KfW), created with the use of the counterpart funds, was a model of how a development institution can make key strategic investments (see Chapter 5).

### **Restoring cross-border economic interactions**

The restoration of regional cross-border commercial and financial linkages is an essential element in the reconstruction process. The essence of the Marshall Plan was the vision of a European context, and Hoffmann spoke repeatedly about the need for a European political union. That context is still essential. The issue of closer engagement with the EU was a critical element in the precipitation of the Revolution of Dignity from November 2013 and a civilisational choice for Ukraine.

### **Promoting financial integration**

The process cannot effectively be entrusted to a world-level multilateral institution such as the IMF as long as there are geopolitical tensions. In general, the less politicised the administering organisation, the better the likely outcome (that was why the BIS was used in the implementation of the technical, clearing multilateralisation, aspects of the Marshall Plan). The equivalent to that agenda today is financial integration: including Ukraine in broader European banking and capital markets (see Chapters 4, 5 and 6). A governance structure for the re-engagement of Ukraine needs an element of flexibility.

### **A model for managing post-conflict societies**

Envisaged as the path to a generalised and global prosperity, the Marshall Plan was not directed at one specific country. As it is, Western engagement in and support for Ukraine is often contrasted unfavourably with the absence of effective support for democracy and against Putin's agents in Syria (and elsewhere). There is thus a strong case for building a general programme for the management of post-conflict societies, rather than a special Ukraine-oriented effort.

### **Values - and fears of hidden agendas**

The dark side of the Marshall Plan needs to be avoided. A reconstruction project in Ukraine will not work if the money is seen as a way simply of advancing the agenda of the United States, or of some EU countries or the European Commission. In any case, there is no need to teach Ukrainians lessons about democracy and democratic values. On the contrary, Ukraine has a great deal to teach the West in this respect.



# The governance of reconstruction and reform

Reconstructing and reforming Ukraine will require extraordinary collaboration from within and outside the country. This is not an unusual ambition for any rebuilding programme, but what makes the Ukrainian situation stand out is the scale of the challenge and its geopolitical significance. The project could become an example of how the world can come together to reconstruct a country ravaged by war. Fundamental choices about what and how to rebuild and reform, and in what order, will have to come out of an inclusive domestic political process where all domestic stakeholders are adequately represented and where decisions are owned by the Ukrainian population. The country needs an integrated architecture for both reconstruction and reform, one that is firmly rooted in democratically elected and professionally capable institutions.

To succeed, the reconstruction effort will require external support of an extraordinary magnitude. Contributors need to be reassured that the resources provided will be used in an efficient, effective and transparent way, and, in the case of loans, that they will be repaid. This will have to be achieved under time pressure, as the expectations of citizens will be high after the sacrifices incurred. ‘Donor fatigue’ is also likely to set in as memories of the war fade among external contributors.

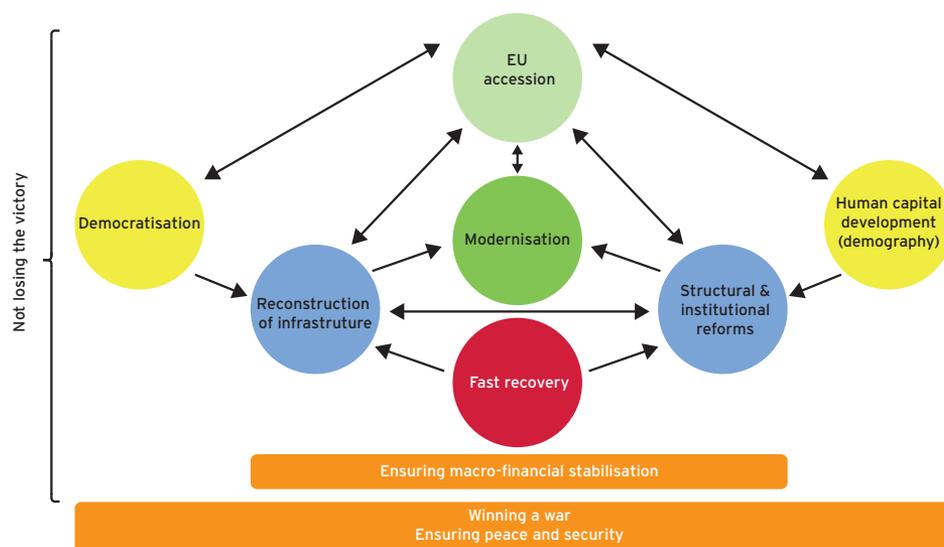
This chapter discusses the governance architecture needed to ensure Ukrainian ownership of reconstruction and reform while providing reassurance to external contributors.

### THE CHALLENGES OF WAR AND ITS AFTERMATH

While still working on winning the war and ensuring sustainable peace and security after the war, Ukraine is going through several complex processes in parallel. First, the Ukrainian authorities, with the help of international financial organisations, are working to ensure macro-financial stabilisation (bringing down inflation, reducing fiscal risks and building up the necessary reserves and buffers for future potential shocks). Since the start of the full-scale Russian invasion, the challenge has been to work on rapid recovery of infrastructure and housing, while also increasing resilience and preparing for a more complex reconstruction. The process has necessarily begun in the middle of war and, once outright hostilities have ceased sufficiently to scale up reconstruction, it may have to accommodate the risk of future Russian aggression and sabotage.

The Ukrainian authorities have also focused on sustaining the momentum of important structural and institutional reforms, to keep the democratisation processes alive despite the war. It is clear that the loss of human capital will be dramatic, and that demographic, migration and labour policies will need to be enhanced to keep up with the post-war recovery. In addition, there is the structural transformation needed to create a globally competitive economy and an economy working with increasingly binding environmental and social constraints. In a broad sense, Ukraine has no choice but to target a full-scale modernisation as part of its accession to the EU (see Figure 3.1).

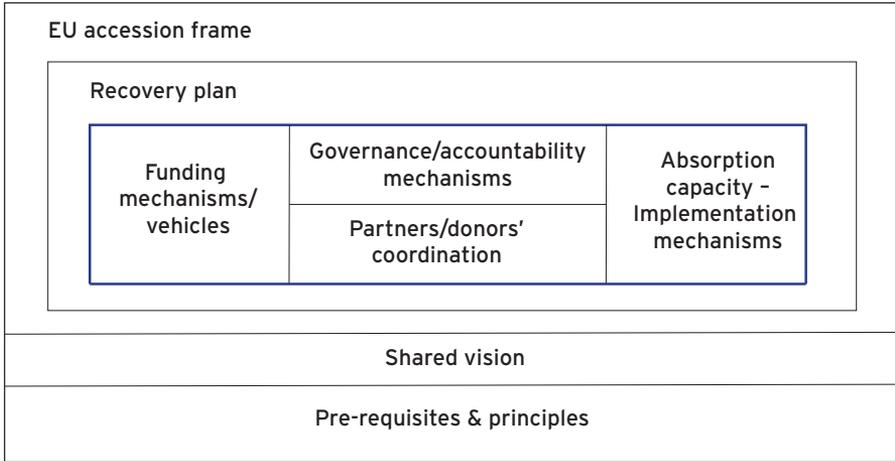
FIGURE 3.1 UKRAINE'S RECONSTRUCTION AND REFORM CHALLENGE



Those efforts may take a decade, if not a generation. That is why a proper reconstruction architecture needs to be built to make this process sustainable. The challenge of creating a sense of local ownership during a war and while millions of citizens are still displaced internally or abroad should not be underestimated.

Over the last two years, many of the elements required for a successful reconstruction have been established or created; some are still missing or work in progress. This chapter describes the key elements of this architecture (Figure 3.2 aims to capture the structure of the chapter). It draws on the experiences of previous reconstruction projects and Ukraine's own reform efforts, but it also briefly looks at how the EU can enhance the effectiveness of its support. Finally, we draw conclusions for Ukraine's governance of reconstruction and reform.

FIGURE 3.2 THE RECONSTRUCTION AND REFORM ARCHITECTURE



**PREREQUISITES AND PRINCIPLES OF RECONSTRUCTION AND REFORM**

The answer to the question of when the reconstruction should be started is clear: it has already commenced. In fact, it already started from the first days of the war and has continued in the liberated territories over the last two years. Having a proper damage/need assessment has been a prerequisite for a proper reconstruction process, and such assessment has been done both by the World Bank and the Kyiv School of Economics. Other prerequisites – increasingly well-functioning state governance; an effective banking system subject to enhanced prudential supervision by the NBU, operating in the middle of a full-scale war; and effective macro-financial surveillance supported by an IMF-financed programme – are in place to run the reconstruction and reforms.

Principles of reconstruction and reform for Ukraine have been discussed in multiple reports (including Gorodnichenko et al. 2022). These analyses highlight the importance of partnership, coordination, transparency, the rule of law, democratic participation, multi-stakeholder engagement, inclusion, sustainability, alignment of goals and accountability. Such principles apply to all cases of reconstruction after wars and natural disasters, and they connect with the *Busan principles of aid effectiveness* from 2011 to which all development actors should subscribe (OECD 2020).

*The overriding principle for any reconstruction and reform is country ownership of the vision’s formulation and implementation*

Only Ukraine can determine its future and define a vision of the post-war country that it wants to build and the priorities in the reconstruction. For investment decisions to be undertaken efficiently and for reforms to be lasting, they must be viewed as legitimate by the citizenry. Aid will be dispensed most effectively when it is seen as consistent with

Ukraine's own interests. Ownership should rest on broad domestic support achieved through inclusive and transparent consultations with local authorities, civil society and business, while the vibrant Ukrainian civil society offers different models for the involvement of citizenry (e.g. Vyshlinsky et al. 2022).

For example, a group of more than 30 local civil society organisations have built a coalition, RISE Ukraine, to promote the principles of integrity and participation for Ukraine's reconstruction and development, building accountability mechanisms for reconstruction, timely disclosure of data, just compensation for the damages inflicted by the aggressor, development of digital solutions for reconstruction, and involving citizens and businesses in the planning, monitoring and oversight. The group works in close cooperation with the government on both sides of the process – increasing the capacity of government institutions and also ensuring/controlling the integrity of the reconstruction projects.

*Reconstruction and reforms must go hand in hand*

Even while addressing the urgent tasks of rebuilding, the government and donors should work to advance Ukraine's structural reform agenda. Reconstruction is an opportunity for the country to leapfrog generations of technologies, and it should facilitate significant economic and institutional modernisation. The goal should be a post-war Ukraine that is structurally transformed to be greener, more inclusive and more dynamic.

*Private capital – for example, through FDI and public-private partnerships – is essential*

Reconstruction cannot rely on the funds of governments and international organisations alone. Private capital will bring not only money but also technologies and managerial expertise. Private flows will be particularly vulnerable to any remaining threats of war actions, and even with functioning war insurance, they are unlikely to come in very large sums until a lasting peace has been achieved, although some foreign investors are continuing to commit capital at present, mainly in the parts of Ukraine less affected by the war.

*Even while the war continues, Ukraine can strengthen market mechanisms, promote competitive market structures and foster market development*

Like reconstruction, critical structural reforms should not wait for the end of the war. The major players can start now to put in place the prerequisites for comprehensive reconstruction. Some *structural* measures – for example, investing in a more decentralised energy infrastructure based on renewables – can also help to reduce the country's short-term vulnerability to military threats.

## Funding mechanisms

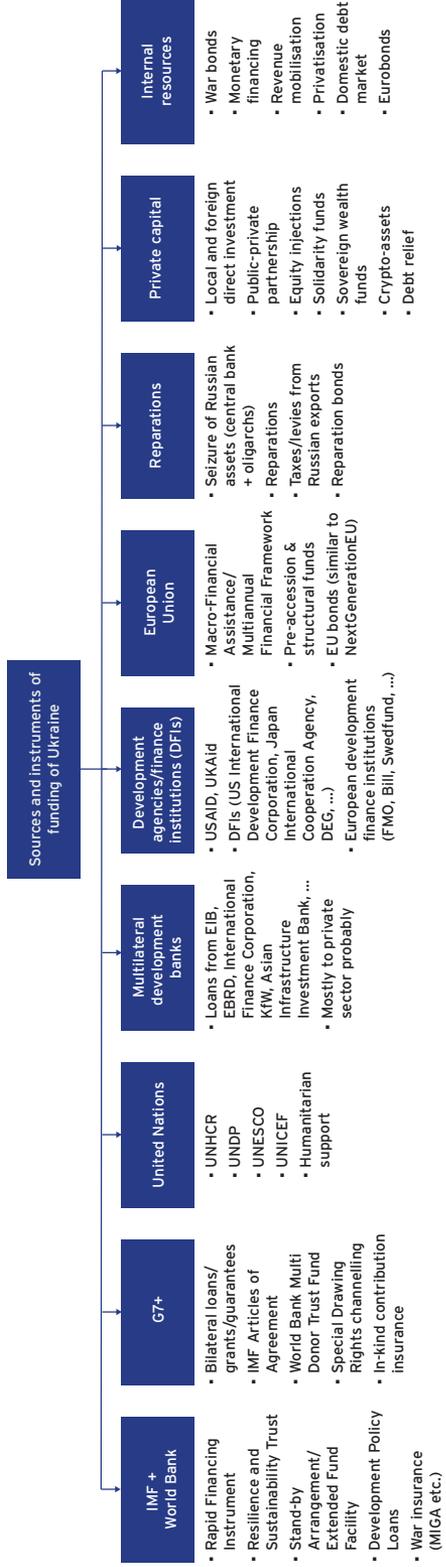
Reconstruction will require massive funding over more than a decade. Figure 3.3 shows that there are many potential sources of financing for Ukraine. But these funding sources all have their own constraints and limitations. Most of this funding cannot be used directly for reconstruction projects. We will focus here on the sources of funds and how to ensure that funds are used in the most effective way. The issues around what form this capital should take, whether grants, debt or equity, in what combinations, and whether for budget support or project finance, will be discussed in later chapters, but we allude to some of these issues here as they cannot be fully separated from the institutions involved (most institutions are constrained in terms of what type of capital they can provide).

IMF funding has provided an important backbone for macroeconomic support for Ukraine, but its main instruments are available only for budgetary support, not for reconstruction. World Bank funding to Ukraine is limited by the constraints of the World Bank balance sheet. Bilateral funding from G7 countries is also mostly used for budgetary purposes, as is current EU funding via Macro-Financial Assistance (MFA)/MFA+ programmes (although the Ukraine facility has an investment component of approximately €8 billion). EU structural funds, the key channel to support the development of EU members, are typically not available for Ukraine. United Nations agencies mainly cover humanitarian needs.

The process of EU accession provides an anchor for Ukrainian efforts to become a modern, democratic and prosperous country by aligning with Europe and ensuring sustained external support. Consequently, it serves as an important guide for decision-makers and reduces the need for other conditionality. The process of EU accession may be, following past experiences, associated with significant transfers of funds to candidate countries (subject to meeting some conditionalities), even before the accession decision itself, in the form of pre-accession funds and substantial structural and cohesion funds available, which can be used to leverage other funding from bilateral and multilateral financial institutions. Yet the most important financial flows – both portfolio and direct investment – must come from the private sector, and improving the investment climate then becomes essential for attracting private and institutional capital.

EU funds to member states mostly come in the form of grants, but most other flows will use various financial instruments, including debt, guarantees and equity received from bilateral and multilateral donors and international organisations. It is important that in the end, a significant component of the money transfers is in the form of grants – a country devastated by war is unlikely to be able to service and repay additional debt, at least in the short term. Excessive reliance on loans will raise the risk of debt solvency and potentially distort investment decisions. The aim must be to design financing structures that are helpful and come with proper governance without undermining the ownership and incentives of Ukrainian decision-makers.

FIGURE 3.3 SOURCES AND INSTRUMENTS OF FUNDING



While providing grants has many advantages, the amounts needed to build the new Ukraine will by far exceed available concessional resources globally, so solutions will have to be found to combine them with debt and equity. Debt has the distinct advantage in that it disciplines the contracting parties while equity shifts risk to its owners. The problems associated with debt – debt overhang, etc. – are real, but while difficult, they can be resolved by restructurings or extensions, as illustrated by the EU experience. Debt can also be linked to economic performance or to the delivery of important public goods, such as climate change mitigation and adaptation or nature conservation and biodiversity. Equity, while more difficult to attract, also has an important role to play, particularly foreign direct investment and governance-rich institutional capital.

Multilateral development banks like the EBRD, the EIB and the International Finance Corporation (IFC) of the World Bank fund their existing customers and, to date, they do not go beyond the narrow circle of the Ukrainian blue-chip companies that have passed their strict integrity checks. Development agencies like USAID and UKAid or development financial institutions like the US Development Finance Corporation and the Japan International Cooperation Agency do support reconstruction projects, but the amounts are well below the reconstruction needs of Ukraine.

Debates are still continuing within the G7 and the EU on the usage of frozen/immobilised Russian assets for Ukraine's reconstruction. Private capital (both internal and FDI) will find it hard to finance reconstruction until security concerns are addressed, and existing war insurance mechanisms (mainly the MIGA) are too small to cover the investment risks. Thus, despite so many 'promising financing opportunities', Ukraine has only managed to consolidate around \$7 billion of financing for reconstruction, half of which came from the internal budget resources of the Ukrainian government.

### **The governance architecture**

We believe that the existing financing framework is not well-suited for reconstruction: the amount of funding is not enough; coordination across sources is poor; there are no long-term commitments and budgeting; the structure of funds is tilted towards loans rather than grants; there are insufficient incentives and protection for foreign direct investment; and so on. Ukraine's reconstruction requires a different financial architecture that centres on durable, properly funded and well-run *institutions* with clear missions.

In the rest of this chapter, we discuss the role of three institutions essential to the reconstruction and reform effort. The National Reconstruction and Reform Council (NRRC), as a consensus-building accountability mechanism, builds on the National Reform Council established in 2015. In addition, to support and channel funding, we recommend establishing a separate Ukraine Development Bank (UDB), dedicated to and designed for financing Ukraine's post-war reconstruction (the details are described in Chapter 5), and a Ukraine Development Platform (UDP), building on the existing multi-agency donor coordination platform.

## The National Reconstruction and Reform Council

The planning of reconstruction is impossible without a shared vision, which needs to be created within Ukraine – this is an essential element of the Ukrainian ownership of the process. A vision cannot be imported: it should emerge within Ukrainian society based on an internal consensus. Ukraine needs both reconstruction and reform, building on the achievements of previous reform efforts but also recognising the failures and the remaining challenges.

The war experience has shifted the relative positions of stakeholders, but pre-existing obstacles to reform have not gone away completely. New special interests are also emerging from the war experience and the reconstruction effort. Sustaining the reform momentum will require maintaining broad support internally, but also externally. Designing a robust reconstruction and reform architecture will be critical. Fortunately, some existing arrangements can be repurposed, but we also suggest a new institution.

After the Revolution of Dignity in 2013-14, Ukraine engaged in an experiment in how to build an inclusive process of building the shared vision of the reforms. A gathering of more than 200 Ukrainians representing different parts of society met for three days in July 2014 – at a time when the country found itself thrust into a war with Russia. Among other elements, the group backed a proposal for a coordination body generated by reformers inside the government. This was later supported by the country's leadership, which established a National Reform Council (NRC), supported by 100 reform-oriented experts in different ministries trained under the EU-financed Ukraine Reforms Architecture programme.

The NRC provided a platform for dialogue that included representatives from all relevant stakeholders: economic officers of the president's administration; ministers in economic fields (economy, finance, infrastructure and agriculture); the central bank governor; members of the economic committees and heads of the coalition parties of the parliament (the leaders of pro-Russian parties did not participate); and representatives of civil society. Considerable donor resources for technical assistance were channelled to support a permanent running secretariat of the NRC that incorporated at least one or two people from its project implementation unit in each of the line ministries.

The NRC was envisaged to become a platform to discuss the key reforms that Ukraine needed with the main stakeholders. All major reforms of the financial and fiscal sectors, the energy sector, public procurement, health and education during 2014-2017 were discussed at NRC meetings every three weeks. Parts of the meetings were televised. The responsible minister was tasked with presenting his or her vision and the measures planned to achieve the goals set out. But from 2017 onwards, the NRC was less useful as the country had run out of steam for reform, and reforms continued at a slower pace.<sup>1</sup>

1 See the index of reforms constructed by VoxUkraine at <https://reforms.voxukraine.org>.

Ukraine's governance institutions have developed considerably since the NRC was first conceived. There is not the same need to accommodate 'cohabitation' of the presidential administration and the government, and civil society has been further strengthened. But there is a need to bring together the different elements of Ukrainian society to focus on a shared vision for the reconstruction effort and monitor its implementation.

We believe that the NRC could be repurposed into a National Reconstruction and Reform Council (NRRC) as a consultative body – think of climate councils or fiscal councils – which could help to provide visibility, analytical input and other scrutiny into the difficult choices faced during reconstruction and to monitor implementation.

To emphasise its significance, the NRRC could be led by the president or prime minister and carry out hearings with economists, political counsellors, local and global think tanks and other experts to ensure the content of the reforms themselves. It should provide systematic tracking and regular communication of achievements and gaps to both domestic and international stakeholders.

The NRRC should consist of several layers. First, the political level, which should unite the president or prime minister, key economic advisers of the president's office, economic ministers within the government (finance, economy, infrastructure, agriculture, strategic industries, digital), leadership of the ruling party or a parliamentary coalition, heads of the economic and financial policies committees of the parliament, the governor of the NBU, the head of the agency of reconstruction, representatives of the civil society and business associations. This level role is to ensure the inclusive process of the reconstruction and reforms, shared vision formulation and its control in the latter stages.

The second level should include the reform and reconstruction project management teams led by the respective deputies of ministries and government agencies. This group should be able to offer its ideas and contributions to the process of shared vision formulation within the political level of the NRRC. After approval, this level would be responsible for implementation of the vision.

In between the political and project management level, there should be a 'filter' level represented by the group of key domestic and foreign thinktanks and civil society organisations, which is targeted to filter and stress test the ideas of the reforms and reconstruction plans coming from the bottom up (political level). The filter level should be able to analyse the proposals, test their cost-benefit analysis, model the impact on the economy, and provide recommendations and comments to the political leadership of the NRRC.

The NRRC should meet regularly. Its meetings should be prepared by a dedicated secretariat working directly with the head of the NRRC (the president or the prime minister). The NRRC should also be able to control the implementation of the ideas and projects approved by its members.

## The Ukraine Development Platform

Accumulated post-World War II development experience, manifested in the Busan principles of aid effectiveness, emphatically states that donor coordination will only work when owned by the recipient country. Thinking has recently coalesced around 'country platforms', which would bring together all major stakeholders to ensure that financing and associated conditionality are internally consistent and in line with government policies. Country platforms were originally conceived in the report from the G20-initiated Eminent Person Group on Global Financial Governance as a tool for the country-led coordination of international financial institutions to increase their efficiency and effectiveness (G20 EPG, 2018). The parties to a country platform would agree to meet certain common core standards (e.g. environmental, social and governance standards, procurement and transparency) to help to coordinate efforts and facilitate collaboration, but also to reduce the scope for corruption and other governance problems.

In a first effort to coordinate outside stakeholders for the reconstruction of Ukraine, the leaders of the key international financial institutions – the EBRD, the EIB, the IMF, the World Bank and the European Commission – established a temporary coordination mechanism in the spring of 2022. The country representatives of these organisations have been holding coordination meetings of the EU and international financial institutions to discuss Ukraine's short-term financing needs, the first important stage for the reconstruction. While these meetings have been instrumental for sharing information and coordinating operations, they have never envisaged more strategic discussions.

The first major strategic coordination platform for Ukraine was created at the end of 2022 when the G7 established a multi-agency donor coordination platform. This platform is aimed at supporting the country's immediate financing needs and its future economic recovery and reconstruction. The platform has a small secretariat with two seats: in Brussels at the European Commission, and in Ukraine within the government. Since being established, the platform has worked with Ukrainian authorities to define, prioritise and sequence strategic needs. It envisages the coordination of international efforts to support a sustainable, resilient, inclusive and green economic recovery that enhances strong democratic institutions, the rule of law and anti-corruption measures.

On top of that, at the G7 summit in Hiroshima, Japan, in April 2023, the development finance institutions of the G7 countries and the EBRD agreed to establish the Ukraine Investment Platform. The Japan Bank for International Cooperation (JBIC), the Japan International Cooperation Agency (JICA), Cassa Depositi e Prestiti (CDP, Italy), FinDev Canada, PROPARCO (France), the US International Development Finance Corporation (DFC), British International Investment (BII), and Deutsche Investitions und Entwicklungsgesellschaft mbH (DEG, Germany) became its founding members, together with the EBRD. This platform focuses on the private sector, aiming to strengthen cooperation and promote information exchange on the question of co-

financing. The parties, in close consultation with respective governments, will address the lack of financial capacity, especially in the private sector, and contribute to the recovery of the economy, industry and infrastructure, and the reconstruction of people's lives.

Another EU coordination mechanism has been established to coordinate a further part of international aid to Ukraine. The European Development Finance Institutions (EDFI) coordination group brings together the continent's institutions fostering private sector finance in countries outside the EU. The EDFI group includes the Belgian Investment Company for Developing Countries (BIO), Compañía Española de Financiación del Desarrollo (COFIDES, Spain), Finnfund (Finland), the Investment Fund for Developing Countries (IFU, Denmark), Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO, the Netherlands), Norfund (Norway), Sociedade para o Financiamento do Desenvolvimento (SOFID, Portugal), Swiss Investment Fund for Emerging Markets (SIFEM), Swedfund International (Swedfund, Sweden). It also includes respective development finance institutions from G7 countries: CDP, PROPARCO, BII and DEG. This group has been a good mechanism of coordination, but with limited impact on recovery and firepower to date. Instead, EDFI members are likely to focus on technical assistance to existing clients, disbursing grants, portfolio restructuring and offering forbearance, rather than providing strategic guidelines for the post-war reconstruction.

The question is whether any of these arrangements fully respect the key principle for the governance of country platforms, i.e. genuine country ownership. For this to be achieved, the arrangements must be integrated into domestic economic decision-making and subordinated to the overall priorities of the government and the democratic governance of the country.

A good example for the country platform to follow is Egypt's Nexus of Water, Food and Energy (NWFE), where the country's government displays a pipeline of renewables projects, mainly solar and wind, and its programme for phasing out fossil fuel assets. The participating international financial institutions, which include the EBRD, the EIB and the Asian Infrastructure Investment Bank, as well as national development finance institutions such as Germany's Kreditanstalt für Wiederaufbau (KfW), are then invited to collaborate in the financing of these projects.

The NWFE platform has attracted concessional resources from the US, for the retraining and potential early retirement of workers connected to fossil assets, and from Germany, in the form of performance-linked debt related to fulfilment of climate policy commitments. The platform has also helped to bring in equity capital in the form of FDI in the production of intermediate goods for renewables. Attracting parts of the renewables value chain should also be an important objective for the design of the reconstruction effort in Ukraine.

The country platform concept is now also being used by the G7 in the form of Joint Economic Transformation Platforms (JETPs) to implement climate policies in collaboration with individual countries in the developing world. The first platform was a collaboration between the UK and the US in South Africa, and this example is now being followed with collaborations in Indonesia and Vietnam. It is questionable whether these arrangements have adequate country ownership, but there should be rich opportunities to learn lessons for Ukraine's reconstruction and reform from these experiments in donor coordination on climate policy, as also the Brazilian G20 Presidency is trying to do in the "Joint Taskforce on Climate Action"

## AN IMPLEMENTATION ENGINE

To manage the enormous task of reconstruction, the proper institutional arrangements must be prepared. Ukraine needs to put in the place the organisational structures, policies and procedures to plan, manage and implement recovery. The country has already taken the first steps to build the implementation mechanism: in December 2022, the parliament created a Ministry for Restoration – the government body responsible for policies in the field of physical infrastructural recovery and setting policies for the restoration process. A vice prime minister leads this ministry. In January 2023, the government also created a State Agency for Restoration and Infrastructure Development of Ukraine (the 'Restoration Agency'), which is responsible for the effective and transparent implementation of the country's rapid recovery and post-war reconstruction projects.

The Restoration Agency is a merger of the State Agency of Motor Roads (Ukravtodor) and the State Agency for Infrastructure Projects (Ukrinfraproyekt). While the latter had delivered several large-scale construction projects involving both budgetary and external financing, its expertise was mostly lost after the UEFA Euro 2012 football tournament, which took place in Poland and Ukraine. The Restoration Agency inherits the strong capacity in road construction built by Ukravtodor in partnership with international financial institutions over the past three years. Building on this capacity should help the agency to gain credibility among key stakeholders.

Despite tangible achievements, this implementation mechanism is too narrow and underpowered. The top government leaders must be engaged to ensure political support and resources. Modernisation of the country also is not only about rebuilding roads and other infrastructure; institutional reforms are equally (if not more) important. An agency with a mandate to implement infrastructure projects cannot carry out this broader reform agenda. For example, the current Restoration Agency does not have powers to reinforce the decentralisation of decision-making initiated in earlier reform efforts after the Orange Revolution in 2004. Local authorities have been merged and given stronger mandates, but the war will limit options for them to finance themselves. One way to strengthen their ability to raise resources would be to pool their funding efforts. The Restoration Agency does not have authority to organise these models.

The current Restoration Agency can be an implementation arm of the government, but the reconstruction and reform must cover a much wider agenda, including education, healthcare, regulatory environment, taxation, and so on. The government must learn from the good and bad experiences of agencies created to support recoveries after wars or natural disasters – such as the Economic Cooperation Administration of the Marshall Plan and today’s US Federal Emergency Management Agency – and to avoid the mistakes in principles and design. The Ukraine Development Bank, discussed in Chapter 5, will be an important institutional reinforcement of the government’s implementation capacity.

## **AN ACCOUNTABILITY MECHANISM**

The reconstruction of Ukraine requires robust accountability mechanisms to ensure the efficient and ethical use of taxpayers’ resources, fostering public trust and inclusivity. First, in designing the accountability mechanisms and maintaining fiscal discipline, the Ukrainian government prevents corruption and misuse of funds, which is a common risk in large-scale projects involving significant financial flows. Second, it ensures that the reconstruction efforts are aligned with the country’s long-term development goals and the immediate needs of its people. Third, it helps maintain international confidence and support, as many reconstruction projects in Ukraine are funded by foreign aid, particularly from the US and the EU.

The US government has introduced several elements of the accountability framework for monitoring the use of funding provided to Ukraine. First, they have launched a system of Inspectors General (IGs) – independent officials within several federal agencies tasked with preventing and detecting fraud, waste, abuse and mismanagement of funds. The IGs’ role includes conducting audits and investigations, ensuring compliance, reporting to the US government and public, and recommending corrective actions for the funding programmes.

Second, the World Bank multi-donor funds, through which the US and other countries route their funds to support Ukraine, is subject to audit by leading audit companies. On top of that, the World Bank provides a separate service on checking, controlling and certifying to the US government.

Third, and most importantly, Ukraine’s own accountability mechanisms must be strengthened. The EU accession process will require significant reinforcement of the Accounting Chamber and Audit Service of Ukraine (included in the EU Ukraine Facility and the IMF programme). The NRRC, reinforced by a secretariat, can play an important role in creating transparency and public debate around the implementation challenges.

## LESSONS FOR UKRAINE

Starting from a set of principles for reconstruction and reform, in this chapter we have examined some of Ukraine's own attempts to establish a reform architecture, including the most recent changes in the ministerial set-up and the establishment of a Restoration Agency. In this section, we summarise the conclusions for Ukraine's reconstruction and reform efforts and point to potential improvements to meet the objectives of the government more effectively.

The EU accession process and the conditionality involved in any financing should help to point the way, but the Ukrainian people must do the hard work of shaping and implementing the overall reconstruction and reform effort. Evidence from previous EU enlargements suggests that operational independence and judicial capacity are at the core of the institutional reforms supported by the accession process. Building these elements must also be central to Ukraine's reconstruction and reform architecture.

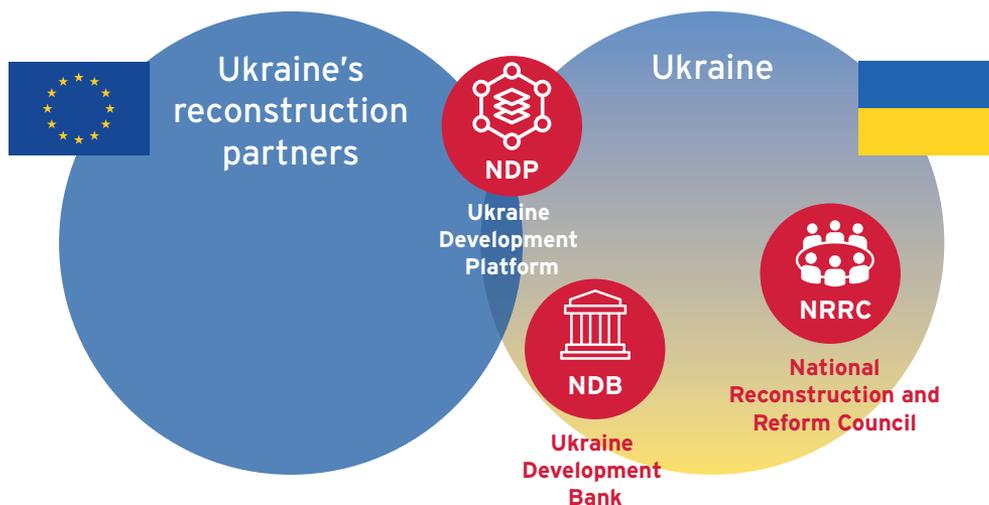
We have suggested three important additions to this architecture: the National Reconstruction and Reform Council, the Ukraine Development Platform and the Ukraine Development Bank. The NRRC should generate the vision, strategy and priority list of projects based on its superior local knowledge. This process, including implementation and exercising accountability, must involve all branches of the Ukrainian government, civil society and other internal stakeholders.

The multi-agency donor coordination platform launched in January 2023 was a step in the right direction, but currently we believe it does not fully reflect the principles of proper country ownership and inclusiveness. The UDP would reweight this institution in favour of the Ukrainian side and provide more space for non-EU stakeholders (the recent expansion of the membership of the multi-agency donor coordination platform to include the Netherlands, Norway, South Korea and Sweden and a set of observers should be welcomed).

When it comes to implementation, the current Restoration Agency could be strengthened along several dimensions, but we believe there is a need for a UDB with participation from multilateral and bilateral development banks. The details of this institution are discussed in Chapter 5. It can serve as a credible co-financing partner for multilateral and bilateral institutions. Special attention should be paid to the need to strengthen the finances and implementation capacity of local authorities.

We summarise these institutional proposals in Figure 3.4, with the two circles representing the international community and Ukraine, respectively. They overlap to some extent, but with EU accession these circles and this integration will strengthen. We have drawn the proposed 'new' institutions as ovals with their place in the figure reflecting the varying extent of Ukraine ownership. They are all Ukraine-owned institutions, but only the NRRC is a purely Ukrainian institution, and the UDP has the greatest role for the international community.

FIGURE 3.4 PROPOSED ARCHITECTURE: NEW INSTITUTIONS FOR FINANCING RECOVERY



**Ukraine Development Platform (UDP):** A repurposed and expanded G7 donor coordination platform.

**National Reconstruction and Reform Council (NRRC):** A repurposed and expanded National Reform Council.

**Ukraine Development Bank (UDB):** A state-owned development bank, with multilateral banks as key shareholders, mobilising funds domestically and abroad.

With all these elements, the reconstruction and reform of Ukraine could become an important proof of concept for similar efforts elsewhere in the world. The staff involved could be used to transfer experience and work with representatives of recipient countries to adjust the model to fit local conditions and the regional context. The lessons could be applied not only to post-conflict situations, but also to other countries with deep fragilities and to achieve broader development objectives in developing economies more generally.



# A reform agenda for Ukraine's banking sector

This chapter develops a set of reform proposals for the banking system in Ukraine. These are guided by the idea that only a system that is seen to be trustworthy by international investors, foreign policymakers and multinational institutions will be able to do the heavy lifting required for Ukraine's economy following the damage inflicted by the war since Russia's annexation of Crimea in 2014.

The first section looks at the status quo of Ukraine's banking system and takes all reform planning from there. Reform steps are presented one by one in the following section. The final section then puts the pieces together for the big picture, discussing priorities and suggesting a sequence of reform steps.

### **BASIC DIRECTIONS OF FINANCIAL SYSTEM REFORM**

The overall objective of these reform proposals is to enhance the financial sector's level of trust enjoyed domestically and internationally (e.g. vis-à-vis multilateral banks, institutional investors from around the world, and foreign governments).

Although trust can only be established over the long run, achieving this goal is paramount for Ukraine's future. This report assumes that the design and performance of Ukraine's financial architecture will eventually be decisive in achieving a worldwide trusted financial system.

Without a widely perceived increase in trust, it will remain difficult, and perhaps impossible, to secure the required funding for the country's ambitious plan of economic reconstruction. Moreover, access to international capital markets may help to lower dependence on the international donor community. That is why the conclusions of this chapter and the following chapters on institution building and capital market development complement each other.

In general terms, what should a suitably designed financial architecture be able to achieve? First, the financial architecture needs to be defined as corresponding to the complete set of financial institutions in an economy, encompassing banks – both private and state-owned – as well as specialised institutions that serve specific financial markets, such as life and property insurance, and savings and loan associations. Capital market institutions such as asset management firms, stock and bond exchanges, and custodies and central counterparties are also part of the financial system, as are supervisory institutions, central banks and regulatory rules (Krahnert and Schmidt 2004).

Here, the focus is on Ukraine's banking sector, with some attention paid to outside institutions that may have a formative impact on how financial operations are carried out in the country. This last aspect, spelled out in more detail below, refers notably to regulatory and supervisory institutions that may, in the course of the EU accession process, become role models, standard setters or even partners in an evolutionary process.

The key ideas here are the sustainability and effectiveness of a financial system. A financial system is sustainable if its institutions – banks, insurance companies, exchanges, clearinghouses, payment platforms, securities firms, and so on – are *viable*, i.e. capable of surviving over long periods of time without outside injections of money or capital, while offering their services to firms, households and the state – by transforming risky loans into safe deposits, and activating primary and secondary markets for bonds and shares. In a sustainable system, weak institutions are allowed to exit the sector without triggering systemic risk or default elsewhere.

On an operational level, a financial system is *effective* if it performs a number of fundamental economic services that, ultimately, define its contribution to the welfare of the country in which they are operating. These services include mobilising sufficient financial resources; channelling these resources into promising projects; monitoring project performance over time; and enforcing and recovering the due amounts properly. If full repayment is not to be expected, i.e. if default looms, financial institutions can engage in workouts of client firms, thereby increasing payback expectations (and decreasing losses given default).

The reform proposals in this report aim for the viability of financial institutions and the effectiveness of the financial system. We will explain both characteristics in turn.

## **INSTITUTIONAL VIABILITY**

The long-term survival of the financial system requires that individual institutions are typically capable of preserving or increasing their franchise value. In other words, financial firms manage earnings and costs, including provisioning for expected losses, such that an expectation of positive profits prevails. The present value of expected future profits is defined as the firm's franchise value. If the institution is exchange-listed, the franchise value equals the market value of equity.

The *viability of individual institutions* has to be at the top of the list of requirements for a sustainable financial system. Without viability, an institution has not reached a status that guarantees its existence as a going concern. Viability is comparatively easy to measure, and therefore a powerful guide for management, investors and supervisors.

Conversely, non-viable institutions with little expectation of improvement are not only shrinking (eating) their equity capital over time, but they also tend to burden the profit expectations of competitors if kept alive artificially. Profit expectations of competitors are affected because failing institutions tend to cut prices and to increase risk when trying to win new business and to 'reach the shore'. If those companies receive subsidies, or are being rescued by the government, there are negative effects on competitors that have not received a subsidy.

That is why non-viable institutions should leave the market, either by being restructured or liquidated. Firm exits are the other side of the coin to new firms entering the marketplace. If established firms can exit without being held back by government intervention, there is room for innovation and firm entry.

A financial system comprising viable financial institutions may be labelled 'sustainable' in the following sense: the institutions are able to survive over extended periods of time, creating enough value added to compensate stakeholders (owners, creditors, tax authorities) adequately, and garnering the necessary support from society and politics to develop as a going concern.

The emphasis on sustainability suggests that the banking system is more than simply a set of channels that allocates investible funds to different users. In fact, the transfer of monies from depositors to investors is perhaps the simplest of banks' tasks in the economy. There are further roles to be fulfilled, such as the search for and analysis of information about projects' prospects (due diligence) prior to approving loan transactions, followed by monitoring of debtors and their underlying business over the life of the loan. At maturity, the bank needs to enforce repayment of the amounts due, and if the debtor cannot pay back in full, it strives to maximise payback, within the legal rules of the relevant bankruptcy regime.

The insolvency code therefore is an important legal basis in reference to which all financial contracts are designed. It determines how claimholders, such as creditors, can expect to be treated when a contract is not honoured in full.

Certain features of the insolvency code, such as an automatic stay or the extent to which courts can alter contract terms in default (e.g. debtor-in-possession finance in the US Chapter 11 regulation; Dahiya et al. 2003), are likely to have a formative impact on the operations of the financial system.

For example, *ceteris paribus*, there is likely to be higher corporate leverage in a country with stronger creditor rights and, conversely, a stronger role for equity markets in a country adopting stronger debtor rights.

As discussed in Chapter 1, creditor rights in Ukraine have been rather weak since independence in 1991. Some reform effort has been exerted to change the role of creditors and their ability to seize collateral in a credit relationship. For example, even if agricultural land were privately owned, it could not be sold to third parties until very recently. Despite the ensuing lack of pledgeable assets, credit has established itself as the main form of external financing in the country.

A plausible explanation for this trend is that investor rights are believed to be even more contestable than loan contracts. Thus, it is the *relative stance* of creditor and debtor rights in a particular financial system that influences both the availability and the price of debt finance (Sautner and Vladimirov 2018). That way, creditor rights influence not only the economy's cost of capital, but also the volume of loanable funds.

All three features just mentioned – cost of capital, loanable funds and the growth potential of the economy – are interconnected and constitute the virtues of a sustainable financial system. Such a system comprises viable institutions and delivers effective financial output – for example, it triggers an intermediation cycle, linking savings to loans and old loans to new loans, allowing an economy to develop and grow, stimulated by its financial system.

Viability is not necessarily a matter of size. An economy with many small banks and one with a few large banks may both have viable business models. But the structure of industry and that of the banking system may be interdependent. A decentralised financial architecture may prove more supportive of a decentralised and regional structure of industry than its centralised counterpart. For example, in countries with decentralised financial architecture, such as Germany and Italy, the role of mid-sized, family-owned businesses (*Mittelstand* as hidden champions) may have become so important because of, rather than despite, the dominance of regional banking (Audretsch and Elston 1997, Behr and Schmidt 2016).

## FINANCIAL SYSTEM EFFECTIVENESS

Trust-building has two directions: the international investor community, and the domestic community of households and firms. This requires investors abroad as well as those at home trusting in the proper working of the country's financial system – its banks, markets, supervision and judicial system – according to law and contractual arrangement.

The role of trust is also relevant for dealing with international institutions like the EBRD, the IMF and the World Bank – although to a lesser extent because multinational agencies tend to have political and economic power that private investors lack.

Because investors' trust relates to payback expectations, the viability and effectiveness of banks and other financial institutions play a central role, if not *the* central role, in Ukraine's economic projections. The better the system's ability to identify profitable projects, to monitor lenders and their projects overtime and to ensure repayment at maturity, the lower will be the cost of capital required by foreign investors and the larger will be the amounts of capital made available in the market at any given price.

The concept of trust in capital markets is key to mobilising the enormous amounts of money needed for Ukraine's reconstruction, and it is worth noting that domestic policy action can contribute greatly to the formation of trust – enabling or wrecking it.

This leads to a pragmatic question: what is likely to increase or decrease the perceived trustworthiness of banking and financial markets? The previous section described several elements of trust-building. Among them, the proven viability of financial institutions ranks particularly high. Enforced by their internal governance models, viable institutions are obliged to operate constantly with an eye on their bottom line. They are thus less likely to engage in zombie lending, because prolonging loans with low payback expectations reduces future profits. Similarly, viable institutions are less likely to take excessive risks because expected profitability is reduced.

This section focuses on additional contributors to trust-building: regulatory rules, supervision, creditor rights and competition (entry and exit).

### **Consistent regulatory rules**

The regulatory framework within which financial institutions are operating should be transparent, credible, non-negotiable and internally consistent. In particular, the regulatory approach should aim for a set of rules that strengthens the orientation towards the viability of its financial institutions.

Elements of this approach entail transparency about financial firms' performance – their accounting rules, disclosure policy and the implementation of risk-based minimum capital requirements, including bail-inable debt instruments. All of these policy instruments are part of an emerging European regulatory rule book, of which the Bank Recovery and Resolution Directive (BRRD) of 2012 is the best-known element, now relevant for all systemically relevant banks in the EU.

While several of its elements are under construction or incomplete, the general philosophy of the regulatory order in EU banking is well known (for a general introductory description with indications of further reform requirements, see Beck et al. 2022).

### **Effective banking supervision**

It should be ensured that a powerful supervisory process is in place – one that is as technical and independent of outside interference or political subordination as possible. In that way, the formation of trust in the reliability of regulatory rules and their enforcement is strengthened. A credible supervisory process requires qualified staff and an agency that has the power and the incentive to earn a reputation for acting in an unbiased, non-corrupted way. There is more on this in a later section.

### **Strong creditor rights**

The role of creditor rights in financial contracting is paramount. Financial products define relationships between providers and users of funds (e.g. a lender and a borrower). These relationships are tested when the borrower does not return the funds as promised in due time. Whether an attempt to recoup funds will be successful is heavily influenced by the prevalent corporate insolvency code.

The legal code should define clearly and unwaveringly the strength of creditors' legal title. While creditor rights may be strong (as in much of Europe) or weak (as in the US), what really matters is whether their strength can be anticipated reliably by both parties – the creditor and the debtor. In the former case (strong creditor rights), work-out incentives prior to bankruptcy proceedings are strong for creditor banks, while they are strong for owner-shareholders otherwise (Brunner and Krahnert 2008).

Conversely, if creditor rights are ambiguous or conditional on some uncertain event, such as the subjective interpretation of a court, work-out incentives are weakened since the expected return is lowered. As a consequence, the out-of-court restructuring of a precarious borrower will be inhibited.

The differences between creditor-friendly (e.g. Germany) and debtor-friendly (e.g. the US) insolvency codes lead to different institutional developments as far as the distribution of tasks between banks and capital markets is concerned. But no straightforward welfare statement can be derived from this comparison, except one: the legal rules of the insolvency code need to be transparent and stable over time, allowing institutions and business practice to adapt and evolve in an efficient way.

### **Transparent exit policies**

Banks are particularly prone to bailouts by governments. Several reasons suggest a significant hold-up risk. Governments may fear contagion and systemic risk spreading from a single bank failure to other financial institutions, forcing a bailout; they may want to protect a 'national champion' bank against competition in the market; or they may simply give in to heavy lobbying for increased deposit insurance and the fear of losing electoral support.

No matter what the motivation is, bank bailouts undermine the consistency of the regulatory regime, and because of the anticipatory effect they have on bank behaviour, expected bank bailouts give incentives for excessive risk-taking, increasing the likelihood of a government rescue operation.

Bank failures tend to happen during periods of market turmoil. In order to avoid betting on government bailouts, banks should reckon with being forced to exit the market when they are nearing default, without causing further panic and failures in markets. Supervisory agencies have to prepare well in advance for those interventions. In a nutshell, this is the main lesson from the global financial crisis in Europe (Liikanen Group 2012). To achieve this goal, supervisory bodies define intervention points, typically capital-related, and develop an individual contingency plan, or 'last will', for each financial institution.

Transferring these concepts to Ukraine would suggest the use of testaments at a dedicated specialised resolution agency, the Deposit Guarantee Fund in Ukraine, and a push for a sufficiently high level of loss-absorbing capital. Total loss-absorbing capital (TLAC) at larger banks (and minimum required eligible liabilities, or MREL, at smaller banks), in turn, consists of two components: equity and subordinated debt. The latter typically takes the form of 'bail-in capital', i.e. long-dated bonds held by institutional non-bank investors that are, due to their own long-dated liability structure, capable of absorbing sudden losses of value without triggering contagion to other banks – or so goes the argument underlying the prevailing European regulation of the BRRD.

Bail-in bonds allow the supervisor to diminish or eliminate their face value when there is a looming default of a bank. Bailed-in debtors lose their claim, which typically will be swapped into an equity position, usually with a considerable haircut. This prepares the ground for a timely bank exit.

Self-restraint of governments is probably the most demanding among all requirements listed above. Germany and Italy are examples of countries that have repeatedly put lobby interest above the spirit of today's resolution framework. It is therefore advisable to design the supervisory mandate concerning bank restructuring in a clear way – such that technical standards applied by the agency cannot easily be toppled by (opportunistic, or lobby-driven) government intervention.

This chapter now turns to a list of options and actions designed to improve financial sector performance in Ukraine. The emphasis is on reform steps that go beyond symbolic changes, attempting to influence the trust that people can have in the operations of the financial system as a whole.

## IDENTIFYING REFORM OPTIONS AT BANK LEVEL

### The baseline situation

A look at the aggregate balance sheet of the banking sector reveals three potential problem areas, evidenced in an unusually high proportion of balance sheet total: NPLs, government debt holdings and state ownership. Taking these potential problem areas as starting points, there are several policy interventions that could help to improve the banking sector's contribution to the growth and quality of banking services.

### Non-performing loans

In October 2023, the industry-wide share of NPLs of total loans outstanding had reached 37.9% in Ukraine – a value well above the 32.2% recorded one year earlier (October 2022) and somewhat below the post-invasion peak in May 2023 of 39.3%. These numbers reverse a multi-year decrease in NPLs over the period prior to the full-scale war.

The NPL situation differs significantly across banks, with PrivatBank topping the list (61.5% as of 1 November 2023), followed by OschadBank (48.3%). The NPL distribution is top-heavy: the four largest Ukraine banks by assets – PrivatBank, OschadBank, Ukrexim Bank and Sense Bank – all have NPL ratios above 30%, whereas smaller banks tend to have NPL ratios in the range of 10–25%. For comparison, bank NPLs in Western Europe are typically an order of magnitude smaller, rarely exceeding 2–3% in any given year.

According to a recent regulatory change in Ukraine (from April 2020; see KPMG 2023), NPLs can be sold to other financial institutions. In this case, depreciations will be realised immediately, and equity is diminished – unless an offsetting 'bad will' item is entered into the balance sheet. Only net equity (book equity minus bad will) is a meaningful metric for the viability of an institution.

While loan-level data are limited, NBU statistics as of December 2023 suggest that 42.4% of the NPLs have been provisioned at the four largest state-owned banks. The fraction of provisioned NPLs across the whole banking sector is 83.6%.

As usual, these provisions reflect the fact that banks recognise losses on loans ahead of time and use their capital to absorb them. In other words, by booking a provision, banks take losses and reduce their capital by the amount that is effectively assumed to be irrecoverable. But banks usually expect to recover some fraction of an NPL and are thus not obliged to book provisions for their full value.

As mentioned above, the portion of NPLs covered by provisions – the NPL coverage ratio – is high in Ukraine's banking system and stands at 83.6%. This ratio demonstrates to what extent Ukrainian banks have already recognised the losses they expect from NPLs. In that sense, Ukrainian banks would benefit from an efficient resolution mechanism for

their old (pre-invasion) NPL portfolios, at least so that they can reap some income from recovering a fraction of their bad loans. Given the wide-reaching provisioning efforts over the years before 2022, it is conceivable that much of the downside stemming from the NPLs has already been realised.

In any case, should a major recapitalisation effort be undertaken, as suggested in this report, a credible, up-to-date AQR would precede any equity infusion in the different banks.

When NPLs are at such a high level, even after writing off expected losses, a positive intermediation cycle, where additional loans and deposits develop in sync, is difficult to achieve. This means that banks will find it difficult to break even from their ordinary business activities, because depositors and bond holders, holding fixed claims, are remunerated in full, while some borrowers (those with NPLs) are not paying back as contractually agreed. When the share of NPLs rises, earnings will shrink, eventually depleting the equity capital of the bank.

Thus, a basic condition of institutional viability is violated: the generation of a sufficiently high level of bank earnings from its ordinary business to cover the cost of capital. Negative net earnings thus threaten the very existence of the institution.

### **Off-balance sheet bad banks**

The question arises what can be done when NPLs have reached a level that threatens the survival of a bank? De Haas and Pivovarsky (2022) describe one possible path to NPL management. They suggest *asset segregation* by transferring NPLs from banks' balance sheets to a dedicated asset management company – a *bad bank* – which is expected to organise and oversee debt collection and collateral liquidation.

The evidence on bad banks is mixed, and not directly applicable to Ukraine given the differences in debt markets. Nevertheless, findings from neighbouring EU countries may provide a cautionary tale.

Analysing European data on 135 bad bank cases during the period 2000–2016, Brei et al. (2020) find that asset segregation *by itself* does not reduce future NPLs, nor does it increase lending. Conversely, asset segregation does contribute positively if several conditions are met – namely, NPL portfolios are not too large relative to total assets; the relevant legal system is efficient; and most importantly, asset segregation is combined with a significant recapitalisation. Finally, bad banks tend to work better if funded privately.

If these findings are applied to the *status quo* in Ukraine, one has to consider the war damages on the one hand, and on the other hand the political legacy of a society in which lending decisions are related not only to the viability of projects but also often following politicised considerations. While the former may be due to weak supervision, this latter type of 'legacy loans' (e.g. related-party transactions) may be seen as an element of corruption in an otherwise market environment. Typically, not much repayment can be expected from those loans.

Moreover, war damages have produced NPLs for which the redemption prospects are closely related to the outcome of the war itself. Consider underlying assets located in occupied territory. Repayment of these loans will depend on the outcome of the war; but no matter what the eventual outcome, additional restructuring financing will be required before any redemption can possibly be expected.

The war has thus produced a sunk cost-type of losses, which one day may be counted towards a nation-wide burden-sharing arrangement, as was practiced after 1945 in some European countries. For example, after World War II, West Germany introduced a sweeping burden-sharing legislation (*Lastenausgleichsgesetz*), redistributing war-related losses and damages among all citizens then living in West Germany by creating a long-dated debt scheme that allowed redemption over more than 30 years. These losses included the former industrial and agricultural heartlands in the eastern part of the country (almost 50% of the pre-war territory). Under international law, West Germany was identical to pre-war Germany (*Deutsches Reich*), though only 'partially identical' as far as the land mass was concerned (Hughes 1999, Hauser 2011).

Against this background, is a bad bank a sensible solution to Ukraine's NPL problem? The economic argument in favour of an asset management company dealing with NPLs entails specialisation benefits (economies of scope and scale) in trading on markets for collateral assets. For example, property, passenger cars and industrial equipment may all be tradable on secondary markets, thus generating sale proceeds. But sector expertise may be necessary to ensure reasonable liquidation values.

Another argument in favour of segregation (bad bank) is lower reputation costs of a lender that vigorously demands loan repayment, enforcing their claim via legal action against the borrowers. The reputation argument may be particularly acute in a country with limited experience with private contract enforcement.

But these positive specialisation and reputation values need to be weighed against the loss of relationship capital that typically goes hand in hand with asset segregation. The initial lender that originated the loan has presumably kept the relationship and all information pertaining to the borrower active, thereby increasing the likelihood of loan repayment, and thus loan present value.

War-related losses of pre-2014 legacy loans will probably not be recouped easily if ever, which suggests that banks' management attention should be exclusively on the segment of their NPL portfolios that has recovery potential, i.e. post-2014 lending in the government-controlled territories of Ukraine. For the rest of the NPL portfolio, segregation may remain the preferred solution.

### **On-balance sheet workouts**

For the other part of the portfolio – post-2014 loans with a higher probability of turnaround and repayment – the question arises of how to manage NPLs without losing the relationship capital of the lender. A straightforward way is to keep NPLs on the lender's balance sheet, expecting reasonable returns from investing (and getting involved) in future workout activities. In this case, the lender may use their long-standing business relationship with the borrower to engage in reforming the business model, thereby regaining viability and, ultimately, repaying the loan.

In the case of multiple lending relationships, as it is typical for mid-sized and large businesses, the lender may coordinate with other lenders to leverage their efforts (Brunner and Krahn 2008).

The workout (and building back better) route entails additional options, relative to the bad bank model, that help to push up the value of the firm from its current low level, thereby decreasing provisions and increasing the value of the outstanding loan. Note that a serious workout effort may entail the prolongation of outstanding loans, plus the granting of new loans to raise the firm's survival prospects. But the lender will be careful not to throw good money after bad in a NPL case. It may therefore attach strings to any fresh money offered, such as requesting a change of investment strategy.

A major argument behind the inhouse NPL resolution model derives from the informational advantage ('informational rent') attributed to lending relationships, which is, as many studies have shown, particularly acute in lending to small and medium-sized enterprises (SMEs) (Brown et al. 2011). Moreover, keeping loans on the balance sheet rather than transferring them to a bad bank will have a positive effect on future origination decisions: it conveys the message that future bad loans will not magically disappear from the balance sheet. This message will strengthen a longer-term view on project viability when doing the due diligence exercise.

On the other hand, if a bad bank were formed, banks may price in future government rescue operations, thus lowering loan-screening efforts and loosening monitoring practice. Both effects reduce today's cost of doing bank business; but on the other hand, they increase the likelihood of future loan defaults.

### **Asset depreciation risk**

Irrespective of which NPL model is adopted – off-balance sheet bad bank or on-balance sheet workout – the effective risk for Ukrainian banks today derives from asset valuation risk: the potential gap between the fair (estimated) value of these loans and the historical (reported) value in the books. An AQR exercise would reveal this gap, requiring banks either to write it off against equity or to enter a valuation allowance on the liability side that is offset by a reduction of book equity.

How to account for this valuation gap due to unrealised loan losses in the balance sheet is an important issue for banks in Ukraine today. The risk of equity write-down can be life-threatening, given the low equity ratios in bank balance sheets – which rarely exceed 10%. The pending question is therefore: what is the size of unrealised losses?

If unrealised expected loan losses turn out to be large, then fresh capital (immediate injections of capital or a credible plan of rebuilding capital over time) is required to bring the bank back as a going concern, otherwise it is undercapitalised and will have to be liquidated. In most real-world situations – in particular if, as in Ukraine, general economic and political conditions have changed greatly in the recent past – a credible estimate of expected unrealised losses requires a fresh AQR.

Typically, an AQR will be carried out by the central bank or some other competent agency, with the help of finance and accounting experts. They will use up-to-date valuation standards, applying them uniformly to banks with significant NPL positions.

If the AQR reveals valuation gaps that are not covered by equity, or diminish equity below the regulatory minimum, the competent authority has to make a triage decision: whether to recapitalise the bank in question, or to resolve it (i.e. take it apart, merge it into other existing institutions, or liquidate it). Only recapitalised institutions will be able to survive as a going concern. The business model of an institution and its current and future viability are the most important inputs in the triage decision.

This chapter now turns to the ownership structure of the banks, an issue that is closely linked to the recapitalisation decision. As will become clear, the AQR-triage moment represents not only an existential threat to the survival of a bank but also a valuable opportunity to recapitalise and, in the process, consciously to redesign the ownership structure of some banks in Ukraine.

### **Recapitalisation and privatisation**

Subsequent to the AQR exercise, which covers all major banks in Ukraine market, any major valuation gap identified in bank balance sheets will require a triage, as outlined above: a decision on whether or not recapitalisation with fresh equity should happen, or whether liquidation/resolution is imminent.

In 2015, the NBU allowed banks to function with zero or even negative capital for some time, and each bank developed a recapitalisation plan. This time, however, something similar to the self-liberation strategy of 2015 will not do the job.

This is because the onset of the EU accession process will require, and increasingly so over time, adopting standards compatible with current EU practice – actually with euro area practice for that matter. There is no role for insufficiently capitalised banks in the EU rule book. In fact, a major characteristic of that rule book is the creation of a sophisticated mechanism – the European Systemic Risk Board (ESRB) – of forced bank exits for undercapitalised banks.

That is why we suggest adopting a proactive strategy of comprehensive bank recapitalisation, thereby achieving two goals at once: empowering the banking system to finance restructuring and growth, and fulfilling visibly important conditions for the EU accession process – a viable and market-oriented financial system.

How should recapitalisations be put into practice? There are different ways to implement a recapitalisation process, and there is ample research describing historical experiences with bank recapitalisations – often done in parallel with privatisations or in preparation for them (Guriev and Megginson 2006).

It is worth emphasising a potentially positive restructuring opportunity that emerges from the NPL problem in Ukraine: a necessary measure (the recapitalisation of undercapitalised banks) can be combined elegantly with a widely desired measure (the reshaping of the ownership structure of the national banking system).

Moreover, a wider distribution of bank ownership titles may be seen as an element of democratisation, making bank managers accountable to investors who invest their own capital. Investor-owners may be individuals, private institutions or public entities. Candidate ownership structures may be listed on an exchange or non-listed, based on a corporate or a cooperative charter, involving a top-down organisational set-up or bottom-up decentralised groupings.

In a nutshell, we are suggesting a compact, institutionalised approach to the capitalisation-cum-privatisation process. The basic idea is simple: mandate an institution to recapitalise and subsequently privatise banks. That mandate should be subject to a strict sunset clause, i.e. it will cease to exist once the privatisation process is completed, or an upper limit (say, ten years of operation) is reached.

In the rest of this chapter and Chapter 5, we discuss three processes that should be implemented in parallel: recapitalisation and then privatisation of banks; buy-out of government bonds from banks' balance sheets to help them restart lending; and support of development projects, i.e. providing co-financing to banks that lend money to projects beneficial for Ukraine's development. We suggest that these three processes are run by one institution – the Ukraine Development Bank (UBR) – described in more detail in Chapter 5. One part of the UBR would be a holding company which we discuss next; this company would recapitalise other banks (both public and private) in exchange for their shares and then would sell those shares either to strategic investors or to the general public.

### *Holding build-up for recapitalisations*

The holding company could become a stand-alone institution, similar to a special-purpose investment bank. But in our view, the model in which this holding company is a part of the development bank is preferable – mostly because the desired sunset rule, itself important for a swift privatisation process, can be carried out much easier if the responsible privatisation expert team can be integrated smoothly in other divisions of the development bank, once the sunset clause for privatisation activities sets in.

The governance system of the holding entity should reflect political representation, in order to ensure legitimacy, and technical expertise, to ensure proper management of the privatisation process – and to contain as much as possible any appearance of nepotism, corruption or any form of self-dealing.

Funding is of course a critical element in this recap-cum-privatisation plan. It may come from the government budget and/or from capital provided internationally. A story can be told that putting international grant money into the holding entity, accompanied by technical assistance in terms of management expertise, is a particularly effective way of putting multilateral aid money to work – thus engaging in instant financial system empowerment.

Using international/multilateral funds, via an intermediary vehicle, for capitalising viable banks with capital shortfalls also allows multilateral institutions to become partners in the intermediary, giving them a control function in the new institution.

Prior to privatisation, banks with a negative valuation gap, as identified in the AQR process (i.e. with a need for recapitalisation), would receive an amount of fresh equity from the holding company. The amount would be sufficiently large to compensate banks for unrealised losses and the equity write-downs revealed in the AQR exercise. Following the triage, recapitalisations are reserved for institutions deemed to have a viable business model.

It may be reasonable to start the AQR process as soon as possible, once the political decision about how to do the NPL resolution has been taken – in order to avoid any strategic equity carve-out. That could well be the AQR process initially suggested by the IMF, and now scheduled for 2024. In return for the recapitalisation, the holding company becomes a shareholder, or co-owner, of these banks. Depending on the size of the valuation gap, the holding company would be one shareholder among many 'old' shareholder-owners, or it may be the sole owner of the bank – if the valuation gap is sufficiently large.

### *Holding sell-off for privatisation*

Once the recapitalisation has happened, the holding company would be able to sell its shares strategically to investors, while aiming for a certain degree of heterogeneity and dispersion of ownership titles in the economy. For example, the holding entity may sell some of its bank equity participations in the form of shares or tokens to the wider public, relying on some form of auction mechanism.

Blockchain technology could be used to keep track of ownership changes, and a special segment of the emerging capital market may be devoted to a secondary market for these tokens or shares. These are specific design issues of the issue process that need special preparation – the details of which are beyond the scope of this report. Nevertheless, the targeted direction of the recapitalisation-cum-ownership allocation process should now become clearer.

A wide range of possible ownership structures is conceivable. One is private ownership, i.e. Ukrainian or international private investors/households buying these shares. Another is some form of public ownership, where public entities like communities buy shares in a particular bank whose business model may serve particularly the financing requirements of the communities. Or there may be cooperative banks where clients – depositors and borrowers – acquire a legal ownership title in the net worth of the firm, by using the form of cooperative membership titles.

As a result, the holding company may close its books (according to the sunset clause) with positive or near-zero profit, after repayment of the funds issued. Under these benign conditions, the recapitalisation and privatisation process as a whole does not require government money. The only thing required is bridge financing over the life of the holding firm.

### *The holding entity, privatisation and the role of capital markets*

Depending on the process, and circumstances, the proceeds from the sale of tokens, shares and other forms of ownership titles raised by the holding company may fund the recapitalisation exercise partly, or in full. Note that since the refinancing of the holding company would happen after the initial bank recapitalisation, the holding company would need bridge financing in order to carry out the recapitalisation. Ukraine's government, supported by international entities (the shareholders of the Ukraine Development Bank as discussed in Chapter 5, IMF or the World Bank) will have to provide the necessary temporal funding.

The holding entity's debt may also be guaranteed partly by some public agency or a specialised development bank (see Chapter 5).

Taken together, a potentially desirable intervention would be the creation of a temporary bank-equity holding entity, preferably a part of Ukraine Development Bank, that takes care of the necessary bank recapitalisation process, and later plans and oversees the sale of bank ownership titles to prospective owners. The holding entity, which is

essentially a fund holding stakes in a number of formerly fully state-owned banks and private banks, would operate under a sunset clause, i.e. it is expected to solve its mission within not more than, say, ten years. The overall mission of the holding entity should be clearly defined – for example, establishing a diverse, national and international, durable ownership structure in Ukraine's banking sector.

As a corollary, the current rule according to which all banks with majority state ownership remain under the responsibility of the Ministry of Finance would have to be adjusted, allowing shift of majorities.

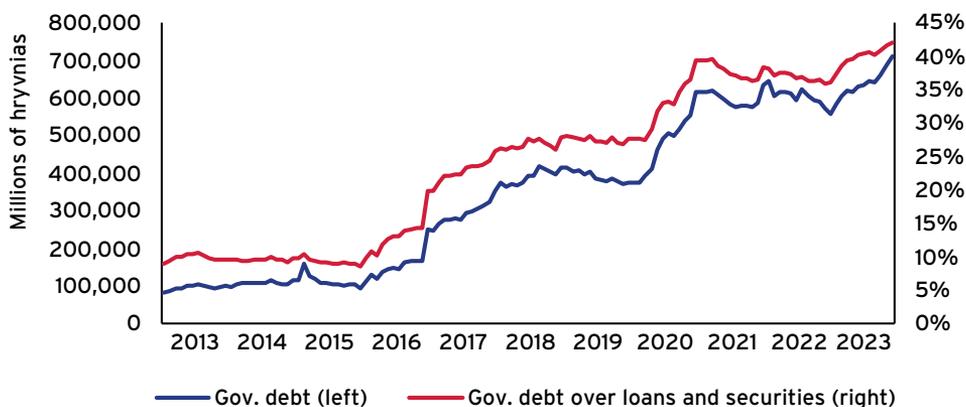
### Bank assets: Government bonds and corporate lending

#### *Government bonds as bank assets*

Apart from the unusually high value of NPLs on Ukrainian banks' balance sheets, there is a second outsized and eye-catching position: sovereign debt made up around 40% of total assets in July 2023. These holdings consist mainly of Ukraine's short-term government bonds.

That number was much lower in 2013, at 9%, but it has been rising ever since (see Figure 4.1). From a macroeconomic perspective, high values of (Ukrainian) treasuries on balance sheets mirror a significant, and increasing, transfer of national private savings into the government budget. The strong role of government spending may – understandably – be attributed to a series of crises, including the enormous military efforts following the 2014 annexation of Crimea, and then again since the Russian full-scale invasion in 2022.

FIGURE 4.1 GOVERNMENT DEBT ON THE BANKING SECTOR'S BALANCE SHEET, 2013-23



Source: NBU.

While there is nothing particularly wrong with holding treasuries on bank balance sheets, and indeed a certain amount of treasuries is required for responsible liquidity management, it nevertheless seems unavoidable that a path back to economic growth and private corporate investment will require banks to refocus their asset allocation away from treasuries, and back to regular corporate and household lending. At today's extremely elevated levels of government debt on Ukraine banks' balance sheets, there is barely any room for expanding lending to firms or households.

Why do banks in Ukraine invest so heavily in debt instruments issued by the national government? One possible answer is that treasuries offer comparatively high returns, crowding out corporate and private lending. The elevated levels of NPLs suggest that lending to businesses or households is risky under present circumstances. In order to achieve a desired level of expected return, loan rates have to cover expected loss, the return on government debt and a risk premium. High coupons on government debt, therefore, negatively affect the demand for loans, driven by an increase in minimum required return on loans.

Another reason for holding excess liquidity is a difficult economic outlook. This argument is closely connected to the crowding-out argument: if the economy is in dire straits, and repayment risk is significantly higher than usual in several regions and industries, then prudent banking stands in the way of increased corporate lending.

Finally, a complementary explanation for large government debt holdings is pressure, or persuasion, from high places in Ukraine policy circles, basically forcing financial institutions to use mobilised savings for refinancing public debt. This is not uncommon for countries during times of war. But substituting government bonds for corporate loans curtails the power of financial intermediation, ultimately leading to narrow banking.

What all these arguments have in common is that bond holdings of banks are seen as a response to the general economic situation in Ukraine today. A redirection of bank assets away from government bonds towards corporate loans, desirable as it may be, requires the political will to increase financial deepening, and a parallel effort to reduce corporate default risk perceived by investors. What can be done?

#### *Substituting loans for bonds*

A policy option that arises from this scenario requires two levels of action: first, increasing the liquidity of the banks' bond portfolios; and second, reducing loan default risk at the bank level. Apart from allowing the government debt to mature without rolling it over, how can these two issues be addressed?

First, government bonds may be sold on a liquid secondary market, to the extent that such markets exist. In the absence of such a market, as in Ukraine today, an asset management firm set up specifically for that purpose, or a development bank with a mandate to overcome market frictions (as suggested in Chapter 5), may purchase these bonds directly from the banks ('over the counter'), thereby transforming banks' 'frozen' bond assets into cash.

One may legitimately ask at this point where the money is expected to come from to carry out the transaction just described. Is this not simply left pocket to right pocket? The answer is: yes and no.

On the one hand, yes – losses that have accumulated on the balance sheets of publicly owned banks will have to be covered by fresh public money, because private investors will not be willing to cover past losses.

On the other hand, no – this is not simply a 'left-pocket to right-pocket' transaction, because of the governance implications that the new ownership structure, following the recapitalisation and subsequent privatisation, may exert on the decision making of these banks. Therefore, one may look at the proposed transaction first and foremost as a swap of corporate control rather than a swap of public money.

Given the riskiness of corporate lending, how can it be stimulated? One possibility relies on financial engineering to give banks the incentives to engage in more lending to firms and households, and risk-sharing. There are different ways to tailor risk-sharing among parties: tail-risk insurance, co-insurance arrangements, specific seniority rules or senior layers of asset-backed structured finance transactions (Krahnert and Wilde 2022).

The reason for offering risk reduction is that ending a period of narrow banking is beneficial if and only if the lending activities of banks can be stimulated. This activates the core capacity of banks to screen projects, identify promising borrowers, and advise and monitor them over the life of the lending relationship. Today, the powerful, growth-enhancing role of bank financing is largely left idle, because financial institutions are forced to limit their role to narrow banking.

Conversely, these qualities are put to work when banks reallocate their funds from government bonds to corporate and/or infrastructure lending. There may be a conflict of interest (crowding out) here, if the government needs those funds for its own budget. Governments should make every effort to shift their own debt to international capital markets rather than borrowing through the domestic banking system, because the crowding-out of business investment is likely to be more serious in the latter case.

In that way, indirectly, the development of a bond market allows domestic banks to be more supportive of growth and innovation at home. Now, access to international bond markets does not necessarily require a government bond market in Ukraine. Instead, *access to a reputable international bond market* suffices, and may even be the superior path to external funding because it opens the door to funds beyond Ukrainian's domestic savings.

Clearly, in those cases, currency risk will be a major cost factor, the management of which is closely related to the overall economic and political development in the country. While the currency risk issue is beyond the scope of this report, smooth progress in the EU accession process, and that process itself, will be likely to reduce currency risk, lowering funding costs (for research on the currency risk, if any, in EU accession processes, see for example Ilzetzki et al. 2022).

Ultimately, joining the euro area will eliminate currency risk, replacing it with internal competitiveness adjustment costs that arise as part of a single market.

#### *Promoting bond-to-loan substitutions*

In most countries in the EU and elsewhere, a government bond market is an *institutional market*. Banks, money market funds, dealer-brokers and asset management firms interact 'over the counter', i.e. in direct, bilateral transactions without using an exchange or a formal marketplace when issuing debt or trading among themselves. What is needed in Ukraine is one or several financial institutions that are capable of intermediating trustfully between international investors and the domestic corporate sector.

One possible institutional design for the intermediary role is a bank-like, publicly owned, prudently governed institution that serves, through its balance sheet, as the connective link between Ukraine's economy and world capital markets. We sketch a possible design for such an institution in the next chapter, when introducing a national development bank – the Ukraine Development Bank.

Irrespective of the institution that eventually connects Ukraine's corporate sector to the capital markets, the high level of fundamental uncertainty that currently prevails in Ukraine will keep investment interest low – unless some form of subsidised interest rate, or added insurance cover, is introduced, thereby bringing down lending terms from today's elevated levels. Without some form of credit enhancement, loan demand will likely remain at a rather low level.

Insurance schemes may enhance credit market conditions if extreme, war-related risks are covered at moderate premiums. There may be no market to offer these insurance products, in which case subsidised services are needed.

For example, debt may be issued in the form of collateralised loan obligations. Given a certain level of equity and mezzanine claims, the remaining senior tranches achieve high levels of safety ('investment grade') and may therefore be sold more easily to international investors than unstructured, ordinary bonds. Multilateral development agencies may also help in providing, or participating in, the necessary credit enhancement.

The upshot is that a large block of treasuries on bank balance sheets in Ukraine are curtailing reconstruction activity as far as non-government business activities are concerned. Government bond portfolios at banks, therefore, can be seen as a *source for further corporate lending* in the private sector. Reallocating this reservoir is a task that can be addressed using financial instruments and policy action.

The rest of this chapter is dedicated to additional reform options that may help to further strengthen the credibility and integrity of Ukraine's financial systems. These concern the quality of the bank supervisory processes, and the impact of training and international cooperation on human capital in banking. Both are highly relevant in financial system development and, perhaps just as important, both reform options translate straightforwardly into required activities by policymakers in Ukraine and the EU.

### *Quality of supervision*

After the most basic attributes of a credible financial system – namely, the respect for private property rights in society and its legal system and judicial practice – the quality of banking supervision is perhaps next in line. It is a key determinant of trustworthiness for outside investors.

Domestic supervisors need a long time to establish a reputation for being unbiased, tough, non-corruptible and technically up to date. A proven level of agency independence from political influence, long periods of peer monitoring and an elevated franchise value are features that tend to increase the credibility of a supervisory regime. Building a trusted regime needs time, and the political will to develop a rules-based market infrastructure where the operational standards and rules are enforced without much exception.

New markets in young countries typically find it difficult to set up a trusted market infrastructure. What is true for trusted markets is equally true for trusted banks: because of the opacity of their day-to-day business, trust in banks is highly correlated with trust in the relevant supervisory processes. Again, young supervisory agencies and regulatory regimes may find it hard to convince international investors of the quality of their work, not least because poor supervisory quality may be revealed only much later.

The difficulty of conveying information about supervisory quality to domestic and international investors and depositors is a reason to establish, to the maximum extent possible, an alignment of domestic supervisory standards and operations with established, international standard-setting bodies. Operationally, coordination or alignment with an internationally established and respected organisation on supervisory standards may be an opportunity to leapfrog.

For example, supervision of large banks in Ukraine may be aligned with European banking supervision as designed and overseen by the ECB's supervisory arm, the Single Supervisory Mechanism (SSM). The alignment of supervisory standards and policies is not only a meaningful step towards EU accession, it also makes it possible to enhance supervisory standards and gain credibility in international markets at a faster pace.

It is a matter of high-level decision-making in what way and to what extent early adoption of European supervisory standards (with all the consequences this may have for bank capitalisation, liquidity requirements and risk-management practice) is politically desirable and technically feasible. But from the viewpoint of international investors, any step towards SSM rule alignment could have a strong impact on investor confidence in Ukraine's banking system in general, and on some banks in particular.

Even multinational organisations like the IMF and the World Bank, the European Commission and foreign governments are expected to respond positively to an early adoption of international supervisory standards. With these standards we do not merely mean the type of regulatory framework adopted, such as Basel II and Basel III, but rather the rigour and technical expertise with which these rules are implemented in day-to-day supervisory practice.

That said, it is also apparent that a change of supervisory standards requires well-prepared, highly qualified personnel on the side of the supervisory agency, and equally on the side of the banks, to become effective. This leads to an important element of financial system upgrade in Ukraine, namely, education, technical training and the 'human factor'.

### **THE HUMAN FACTOR AND A ROLE FOR EDUCATION AND TRAINING**

At the end of the list of reform options for the operational side of Ukraine's banking system is the human factor, encompassing economic and technical expertise, and market integrity. These characteristics are of great importance if financial institutions in Ukraine are to become competitive in a more integrated, European market environment. Together, expertise and integrity are prerequisites for an internationally trusted financial system.

Education, transparency and the establishment of reliable governance models at the level of firms and markets constitute important elements of market integrity. One potentially productive option would be to develop a *tailored education and training programme based* on experiences of business schools and industry training centres across Europe. The idea is to expose practitioner-experts to financial system practice in other European economies that have achieved a high level of integrity in their financial systems.

For example, one could invite finance practitioners from Ukraine to visit their peers in other European countries (Germany, say), attending structured executive training at various industry training centres there. Large banks and most, if not all, *pillars* of the banking system in Germany – savings banks, cooperative banks, private banks, public sector banks and the Bundesbank – have established their own sector-internal, university-type training institutions, which could open their programmes, in the form of technical cooperation agreements, to Ukraine employees/experts from banks and supervisory agencies. Similar programmes exist in accounting, finance and law.

A role model for such an international learning initiative was started some time ago by ProCredit Bank, which has subsidiaries in Ukraine and other East European countries. The ProCredit Academy offers advanced training courses for its Ukrainian and other international employees, using its own campus in southern Germany.

Academic institutions, business schools and law schools could get involved too – and they will probably stand ready to do so if the advanced programme is coordinated at some higher level, offering new experiences and a gain of reputation to the providers. Coordinating institutions could be selected/mandated by the G7, together with an overhead budget.

In a parallel way, a systematic training programme could be offered to Ukraine's supervisory agencies, through a network of European supervisory institutions, involving the SSM (i.e. the ECB) and training hubs like the European University Institute, the Florence School of Banking in Milan and the European Banking Institute in Frankfurt.

Together, these training initiatives would also help the building of professional networks as part of the EU accession process.

# The Ukraine Development Bank: A catalyst for economic modernisation

## A PROBLEM OF FIXED COSTS AND THE CASE FOR A UKRAINE DEVELOPMENT BANK

While there is broad agreement that large investment sums are needed to rebuild the Ukrainian economy, its cities, its infrastructure, its factories and its houses, there is much less agreement on how to channel the money into its best uses. The funds may directly feed into a government budget, or they may directly target ultimate recipients downstream, notably private firms and public entities (districts, communities, state-owned and private firms, and other institutions). Alternatively, channelling could happen in an indirect way, where local banks interlink between a central funding agency and the ultimate borrower.

There would be considerable value in creating a central funding agency in the form of a Ukraine Development Bank. On the refinancing side, an internationally recognised, government-backed infrastructure and development bank is likely to enjoy significant advantages over domestic and private financial institutions when tapping international capital markets. The advantages relate to visibility, accountability, reputation and – most importantly – explicit or implicit government guarantees, the latter of which will need considerable time to develop and acquire credibility.

Credibility and trust are essential for being able to raise funds domestically and abroad, and at low rates. As far as international financiers are concerned, trust-building can be seen as the outcome of a conscious building process rather than a random event. Trust follows from institutional integrity and stability, generating foreseeability of actions and reliability of outcomes. Trust-building costs money, since it requires significant amounts of equity – capital that will be lost if the trust of investors is taken advantage of. That's why trust in banking typically builds on equity and similar forms of guarantees that provide a loss-cushion for investors.

An efficiency argument can be made in favour of a single, national development bank, as opposed to a set of smaller institutions with a similar mandate (Beck 2013, Mertens 2021). The main reason is that building trust vis-à-vis international investors is essentially a fixed-cost operation that requires not only capital, but also time to build. For Ukraine, a

case can be made in favour of a single refinancing institution serving many commercial (tier-1) banks in the home country – as opposed to delegating international trust-building to several smaller institutions at the same time. In fact, international trust-building at the level of individual banks may fail altogether, at least over the short to medium term.

In the following sections, we describe the role of the development bank in more detail. In fact, it will have two functions: modernisation of the financial sector (recapitalisation and privatisation) and permanent promotional services (tier-2 banking).

### **FUNCTION 1: INITIALLY, A BANK FOR MODERNISING THE FINANCIAL SECTOR**

The previous chapter described a reform agenda for Ukraine's banking sector that aims to accelerate the effectiveness of the country's financial institutions. Top of the list of proposed reform items is the 'unfreezing' of the lending of large banks, given that they are severely restricted in their lending activity today. Three constraining factors have been identified – a large portfolio of NPLs; an even larger portfolio of government bonds; and a lack of equity capital – each of which can be addressed directly.

Several interventions were proposed, which aim together to strengthen the performance of the banking sector. Most importantly, NPLs and government bonds on bank balance sheets should both be decreased, while lending to private and public businesses should rise. Fresh equity would not only recapitalise banks but also support their modernisation agenda. It would also open up the sector for broad-based bank privatisations in the sense of out-placing bank ownership stakes to a broader public.

These interventions – revaluation of NPLs, bank recapitalisation, equity placement and government bond out-placement – require sophisticated planning, qualified monitoring and coordinated execution. Implementation should render Ukraine's banking system more resilient, more productive, more trusted internationally, and on the way to becoming a connected and integral part of an enlarged European financial market.

Thinking about these high demands together suggests the establishment of an intermediary institution that is capable of carrying out such interventions and, at the same time, is prepared to act as a link between Ukraine's banking system and international capital markets. That new intermediary institution should technically be a bank itself, and it should be free from legacy problems, enjoying credibility in international markets and among investors worldwide.

That new financial intermediary, provisionally named the Ukraine Development Bank (UDB) in this report, is one of our key reform proposals, introduced briefly in Chapter 4. The UDB could be registered in a foreign jurisdiction (Brussels, London, Paris, Vienna, Warsaw, etc.) to ensure proper creditors rights protection but with a subsidiary or co-headquarters in Kyiv. It should understand its role as a promotional (development) banking institution. It would have established capital market players as shareholders, such as the EBRD, the EIB, the IFC and KfW (see below), to ensure an excellent credit rating and hence access to funds. It should also have Ukraine as one of the owners.

As a multilateral institution with a Ukrainian ownership stake, the UDB would not only shape the reform process of the banking industry in the coming years, as sketched above, it would also act as a sort of ‘joint’ – connecting Ukraine with global capital markets, in particular the European market, over the medium to long term.

As a recognised financial institution in international capital markets, the UDB would be in a position to attract highly qualified staff from Ukraine and abroad. Its operations could follow established practice in international institutions, thereby importing sound management procedures. Far away from well-worn paths and old boys’ networks, this would contribute to the UDB rapidly becoming a respected institution.

Technically, the UDB would be designed as a tier-2 institution, i.e. offering funding or co-funding to commercial and other banks in Ukraine, and also to firms funding significant reconstruction projects in the country. It would thus typically have no direct contacts with end-customers – relationships with small, medium and larger firms are primarily cultivated by commercial banks (i.e. tier-1 institutions). That way, the UDB would pose only limited antitrust issues, because it would complement rather than compete with existing banks in their respective markets, be those markets households or private firms.

In the framework defined by its lending programmes, the UDB would enable cheap refinancing via national and international capital markets. It would then lend these funds to tier-1 banks, setting certain eligibility conditions that ensure efficient screening and monitoring decisions at the level of the borrowing banks – for example, a certain level of co-financing by recipient banks. The following discusses this proposal in more detail together with potential alternatives.

## **FUNCTION 2: A BANK FOR REVIVING THE ECONOMY**

The UDB will start recapitalising Ukrainian banks that lend money for reconstruction projects with the funds that it will attract in the international market.

Rebuilding Ukraine’s public infrastructure and strengthening its corporate sector after the war, or even while the war is still waging, will require immense investment (e.g. Gorodnichenko and Rashkovan 2022, Becker et al. 2023). Current estimates range from €500 billion to €1,000 billion.

These sums will need to be raised largely outside the country, and then channelled wisely domestically. Potential sources of funds are supranational entities such as the EBRD, the EIB, the IMF and the World Bank, and to some extent, governments abroad, including the EU – as well as international capital markets.

Public discussion in the West, although basically supportive of Ukraine's case, saw some cracks in late 2023 to early 2024. To be clear, things may develop much more favourably, but prudence dictates preparation for the worst. In this worst case, international public money for Ukrainian restructuring will be thin, falling way short of the sums required to build back better – in a country devastated by a long and extremely destructive war. The thin flow of public money has to be invested effectively. This should be leveraged with international private money.

The latter – private capital – is far more abundant globally. It can be attracted for investment in Ukraine's rebuilding under one condition: that it is reliably shielded from those risks that private investors abroad can neither observe well, nor influence at all. The proposed new institution is supposed to address the request by investors for accountability, safety and a clear policy to deal with agency problems at the level of banks and firms.

The UDB would offer exactly this. As a bank, it would act like a principal, drawing up lending programmes – e.g. house-building, production lines for factories, machinery for agro-industry and energy production – whose execution, in the sense of project screening, monitoring and repayment, is overseen by commercial and other banks in Ukraine. These banks are the UDB's tier-1 partner banks, carrying out lending programmes with small- and medium-scale industry. For big-ticket investment projects such as infrastructure, the UDB may interact directly with private or state-owned entities, engaging in co-financing arrangements.

Refinancing would be primarily with private money raised in international capital markets. Public money is needed at the level of the tier-2 bank, together with the own capital of the agent banks, to shield private investors from extreme losses. That way, large parts of the refinancing instruments will trade at or above investment grade. Co-investment by agent banks (i.e. tier-1 banks) is the key for signalling incentive alignment to investors, i.e. setting the right incentives for bankers to avoid excessive risk-taking.

In the language of modern finance, the UDB together with its agent (tier-1) banks would jointly engage in the equity piece (i.e. first loss) of project funding, while international investors, which are needed to provide the bulk of financing, would take a less risky, senior tranche.

This model of structured development finance requires a respected and recognised bank located 'between' domestic (tier-1) institutions and the international investors. This is why it makes most sense to build the UDB as a proper, Ukraine-centred bank.

## Alternative models

There are alternative candidate models for bridging between domestic banks and international investors. Building a strong sector of foreign banks, the most common way to connect domestically active banks to international investors, is one option; direct international funding of Ukraine's tier-1 commercial banks (without the UDB as an intermediary) is a second option; and a Ukraine Development Fund, as suggested by Blackrock and JP Morgan, may be a third option (Reuters 2024). The following discusses these alternatives, stressing complementarity with the proposed UDB approach.

First, expanding the role of *foreign banks* in the financial system is commonly done in emerging financial markets, their role typically being to mobilise savings from within the country rather than connecting to international capital markets. There is already a fair number of foreign banks active in Ukraine but they have not garnered a significant market share to date. That is why the potential role of foreign banks is probably rather limited as far as closing Ukraine's huge funding gap is concerned.

Second, in a *direct debt funding model*, larger banks that are operating in Ukraine may try to raise funds internationally in the future, just as the UDB would do. But trust in the institutional capacity of today's commercial banks in Ukraine is probably not high enough to generate positive investment flows anytime soon and at tolerable costs. Raising the reputation for trustful banking at a level needed to access international capital markets is not only high, it also represents a fixed cost. Thus, if many banks want to adopt the direct funding model, these costs have to be paid as many times as there are active institutions. It is an additional advantage of the UDB model that these costs of reputation-building are invested in one institution, whereas in the case of direct debt funding, each individual institution would have to invest in reputation that can be recognised internationally.

Third, there is a *direct equity funding model*. Large investment companies like Blackrock have announced raising money for a UDF, which is supposed to partner with local entrepreneurs in developing new firms, in different industries, or to restructure existing companies. The UDF would follow an established model of venture capital and private equity firms, offering not only financial capital but also human capital: management expertise, technical know-how and international networks. This strategy also nests potential entry of foreign banks into Ukraine.

All three alternative models are probably complements to the UDB model, rather than substitutes. For example, the UDF model may raise equity and debt in capital markets abroad, and invest the proceeds in Ukrainian firms. The UDB, instead, will focus its relationships at the bank level. Moreover, the UDF would invest small amounts of equity in any given project, relative to investment total, covering the rest via additional debt financing – which is the moment in which local banks and, indirectly, the UDB could come in, and do the co-financing.

## LESSONS FROM KfW'S EXPERIENCES

Within the EU, there are many national development banks, all serving similar purposes. The oldest and most visible recognised national development bank is Germany's Kreditanstalt für Wiederaufbau (KfW), which was established in 1948 as a state-owned bank. Its equity was issued against Marshall Plan counterpart funds, i.e. using the payback from bestowed goods, in particular foodstuff and machine tools, that were delivered by the US to several European countries after World War II (see Chapter 2). The recommendations here draw partly on lessons from KfW's experiences over the past seven decades.

### Multiplier effect

A first lesson from KfW's history is its multiplier effect: by redefining the ERP-counterpart funds as equity of a new, state-owned bank, KfW was able to leverage the funds initially granted by the Marshall Plan by an order of magnitude. Thus, the initially received counterpart funds allowed KfW to raise additional monies, by issuing bonds in the capital market and thereby increasing the scale of its operations.

The bank could then lend its equity plus the leveraged funds out, again and again, multiplying its economic impact. Over the years, the bank has refined its operating strategy in a way that may offer insights for a newly created UDB. Among other activities, KfW has developed programmes targeting specific industrial sectors (e.g. steel, energy, agriculture), regions (border zones, deindustrialised areas) or firms (e.g. SMEs, including the *Mittelstand*).

Other lines of business are trade finance for Germany's export industry (in 2019, 17% of total assets); development finance ('technical assistance' and budgetary assistance) for developing countries and institutions worldwide (in 2019, 13% of total assets); funding of municipalities and other state-related institutions (in 2019, 40% of total assets); and SME-related promotional finance programmes (in 2019, 30%).

### Tier 2 and conditionality

A second lesson from KfW's history is that to avoid crowding out private or other incumbent financial institutions, a development bank should operate exclusively as a tier-2 institution, i.e. it should have no branch offices in the country, and it should conduct no direct lending to end-clients such as firms or households. Instead, the development bank merely offers refinancing services to the banks in the country.

The third lesson is that as a matter of policy, the development bank conditions its refinancing activity on certain features of the ultimate loans. These *conditionalities* are the essence of KfW's role as a promotional financial institution in the economy. For example, refinancing to banks is conditioned on a loan to firms or households that fuels the energy transition, or that enhances communal digitalisation. In a similar way, the UDB could be tasked with channelling funds to strengthen the transformation of Ukraine's economy, or fostering the expansion of industrial or agricultural SMEs.

The main advantage that KfW can offer to its clients, which are all eligible tier-1 banks in the domestic financial sector, is its access to cheap funding. It can issue bonds in international capital markets at extremely favourable rates. These bonds differ from outright government bonds (bunds) in their liquidity premium – which in this case is only marginally above that for bunds. The level of funding costs is also low because KfW is known to maintain a high level of monitoring of users of the on-lent funds, apart from its own credit enhancement (equity buffer and government guarantees).

An example of a conditional lending programme is an Enterprise Lending Scheme (*Unternehmenskredite*) that KfW introduced in Germany during the 2020 Covid-19 pandemic. To receive cheap refinancing from KfW, tier-1 banks throughout the country could earmark individual loans that met well-defined end-user criteria (size, solvency, use of funds, etc.). Moreover, eligible banks had to provide a certain level of ‘skin in the game’. These self-commitments by the tier-1 bank may be in the form of an additional loan to the same client, wholly financed by the recipient bank. Alternatively, it could subordinate existing ‘old’ outstanding debt to the ‘new’ loan, funded by KfW.

From a more theoretical stance, KfW contracts are designed with a situation of two-level asymmetric information in mind. There is asymmetric information between the development bank and its customers, the tier-1 banks. And there is asymmetric information between the tier-1 banks and their own customers, firms and households, who will be the final recipients of the funds provided by KfW.

The two-level asymmetric information problem is solved by conditioning KfW’s funding approval on a verifiable end-use of funds, and simultaneously requiring tier-1 banks, to which screening and monitoring has been delegated, to co-invest along with KfW. Co-investment can take different forms – for example, actual co-financing (taking a percentage of the entire loan *pari passu* on the bank’s own book), taking a subordinate loan or augmenting an already existing loan.

### **Incentive alignment**

The final lesson from KfW is that as a result of these contractual design details, a positive level of incentive alignment between the tier-2 principal and the tier-1 agent (as delegated monitor) can be reached. It enhances responsible project selection at the time of loan approval, proper project monitoring during the term of the loan, and self-interested principal collection at the time of expiry. Moreover, the tier-1 bank is motivated to intervene early when customers’ default risk is rising, thereby facilitating workout attempts prior to formal, court-based bankruptcy proceedings (Brunner and Krahn 2008).

### Why a new institution?

Founding a new institution with a distinct and new mandate – namely, serving as a development bank that interacts between world capital markets on the one hand, and the universe of Ukraine commercial and state-owned banks on the other hand – has advantages and disadvantages.

For one, the UDB would need highly qualified staff who are well versed in international capital market transactions. Rather than lending to end-borrowers, such as households and firms, the new bank would refinance other banks. Thus, a skill set is needed that differs from traditional lending business, one that resembles the expertise available at international development banks, supervisory or rating agencies.

Arguably, these specific requirements are easier to meet when the institution is newly founded, can hire its staff *de novo* and need not care about legacy staff with a different expertise set. If, on the other hand, the UDB is carved out of an existing institution, the implementation needs to consider how to attract the right expertise, and how to set up the organisational structures such that the remaining institutional organisation can thrive independently from the new one.

Second, the new institution needs to do business with all tier-1 banks in the country. A transformed existing institution may find it difficult to reinvent itself in a way that completely abstracts from its earlier life as a competitor of other banks. Furthermore, an existing bank that reorganises itself as a tier-2 bank has to disinvest its subsidiaries and its branch network. These split-off parts may find it difficult to remain competitive as a new institution, given that much of their central and back-office services have been separated out to form the new bank.

This all suggests formation of the UDB from scratch. The advantages of this strategy are apparent. There are no financial or human capital legacies that may limit the speed and the quality of the new institution. But since mistakes can also be made at this stage, great care is needed to pick good people and to design operations well.

A new institution has another advantage: it starts without any legacy owners that one would need to integrate or buy out. Instead, the desired governance structure can be constructed on the whiteboard. The precise details would need to be widely discussed, but some starting considerations would include a strong role for the Ukrainian state among the bank's shareholders, as well as multilateral institutions such as the EBRD, the EIB, KfW, the World Bank, other governments, sovereign wealth funds, and so on. These institutions can bring in technical expertise.

Moreover, these 'external' shareholders can hold board positions, exerting some internal monitoring of the UDB's operations. The multiple eyes that watch UDB operations would translate into quality as a lender, and by implication, into credibility as a borrower. This last characteristic, which would be reflected in the UDB's credit rating obtained from

major credit rating agencies like Moody's or Standard & Poor's (S&P), is particularly important for gaining access to capital markets. Gaining market access would clearly be the key determinant of the UDB's longer-term potential as an enabler for domestic commercial and other banks.

### **The early days of the UDB as a quasi-investment bank**

There is a link between a UDB that acts as a tier-2 institution, refinancing and steering development initiatives in Ukraine, and the fundamental restructuring initiatives among Ukraine tier-1 banks outlined at the beginning of this chapter. Could the UDB be instrumental in implementing the unfreezing of commercial banks' balance sheets?

As outlined before, there are several activities that could kick-off the restructuring of Ukraine's commercial banking sector: revaluing banks' NPL portfolios, recapitalising banks commensurate with NPL depreciations, and facilitating banks selling off their government bond portfolios. All these activities are more or less complex banking that could be overseen and implemented either by the government, or by the newly founded UDB.

Moreover, following the recapitalisation of the banking sector described in the previous chapter, the UDB would hold a portfolio of bank shareholdings. It would be obliged to sell these shareholdings in the market over a given period – until it is resolved. The UDB would have to develop a strategy for how to conduct the sale of bank shareholdings. Typical considerations concern the need to have at least one anchor investor who gets actively involved in that bank's governance.

Moreover, the UDB would have to take into consideration the many pitfalls that characterised earlier attempts at privatisation in East European countries. This part of the UDB assignment, assisting in the restructuring of Ukraine's big state-owned banks, is hugely important for the future of the country's economy and it needs to be under the control of the government. The advantages of the UDB's early involvement in the reformation of bank ownership structures at the tier-1 bank level have to be weighed carefully against a possible conflict of interest.

The grand picture of the banking landscape may well be characterised by a mix of different ownership types, from community-owned to privately owned to cooperative-owned. The resulting picture of the ownership architecture may also be part of the process of identity-finding in Ukraine's financial economy.

### **SUMMARY AND PRIORITIES FOR POLICY**

This chapter and the previous one have developed a set of reform options for the institutional restructuring of Ukraine's financial sector, starting from its current set-up. The results and recommendations may be summarised as follows.

## **A Ukraine Development Bank**

As a key step in the reform process, a new financial institution would act as a bridge between international financiers (multinational banks, governments and institutional investors) and Ukraine's economy. The UDB would be a classical development bank, acting as a tier-2 bank vis-à-vis commercial and retail banks in Ukraine, and as a direct financier of public infrastructure projects. While it is conceivable that an existing Ukraine bank may be transformed into a new UDB, it seems to be more practical and probably more effective to create this new institution with its highly specialised staff basically from scratch.

### **Funding**

Endowed with equity capital from the Ukrainian government and multilateral partners, the UDB would start operations by raising debt funds on national and international markets. Further capital could and should also come from multilateral institutions located abroad, and from some other countries – inspired by the experiences of the Marshall Plan.

### **Supporting bank sector reform as the inception mandate**

#### *Recapitalisation*

These quasi-Marshall Plan funds may preferentially be used to recapitalise banks with positive valuation gaps. Such gaps occur if banks have left non-provisioned expected loan losses that still sit on their books. Current estimates of NPLs are just below 40%, on average, with significant variation cross-sectionally. New equity should be injected into viable banks only, with the UDB becoming owner or co-owner of these banks for a limited period. In that way, the banks would regain the regulatory capital required to start lending to firms and households again.

#### *Government bonds*

The second activity that a new UDB might consider, after collecting proceeds from selling banks' shares or in parallel with this if it has enough funding, could aim for a reduction of the extensive government bond holdings on Ukraine's bank balance sheets. Again, this operation would enable banks to restart their ordinary lending business, which has largely been dormant over the past two years. For this purpose, the UDB would offer competitive prices in the over-the-counter bond market. The NBU could assist in this transformation process (an asset swap from government bonds to corporate loans) by opening a discount window for quality loans as collateral.

### *Privatisation and governance*

Over the next few years, the UDB would try hard to sell its shareholdings in major Ukraine banks in the market or as negotiated sales. The aim would be to end up with a banking system, for all banks in the portfolio, which meets certain conditions set out at the beginning. In that way, a diverse ownership structure can emerge, with some banks being privately and/or foreign owned, some state- or community-owned, and others cooperative-owned. The key point would be that banks have owners that care responsibly for their institutions.

### **Promotional finance as key mandate**

Having divested its initial equity stakes in some of Ukraine's banks, the UDB could focus fully on its proper role: raising money on the capital market or from the donor community, and allocating these funds according to its intended end-use. For example, if funds can be raised for rebuilding houses and infrastructure in some regions of Ukraine, the UDB could design a lending programme that banks active in the stipulated regions can use for their own refinancing.

*Finally, a caveat:* several variants of this 'pure UDB' are conceivable, with different institutions taking over the role played by a single institution in the model. But the most desirable would be to commission a single, new institution with the tasks described. The reason is that these different steps all fit together, so a unified, coherent agenda and work plan is paramount. Similarly, the expert knowledge required to implement the big plan is significant. Finally, a fixed-cost argument also supports the claim that the tier-2 bank should stand alone as a single institution.



# Capital markets in Ukraine

Stock markets have many potentially productive roles. They aggregate information, mobilise savings, allocate resources, create an ownership class, provide incentives to innovate, diversify risks and so on. At the same time, establishing a well-functioning stock market is a difficult task as many pieces have to fall into place. Indeed, many emerging economies have tried to emulate the success of the New York Stock Exchange and other advanced platforms, but the success rate has been rather modest.

Although the proposed playbooks (e.g. Levine 2005, Chami et al. 2009, Laeven 2014, Beck et al. 2020) convey a high degree of consensus on what is needed (rule of law, economic growth, etc.), since the 1970s only a handful of countries have been able to launch a deep market. But this long-standing challenge has a new sense of urgency after Russia's full-scale invasion of Ukraine and the need to resuscitate capital markets in the latter to support post-war reconstruction. This chapter provides Ukrainian context and historical perspective, and outlines some policy recommendations for the way forward.

Ukraine's experience highlights the many difficulties that emerging economies face on the path to creating effective capital markets: the tough initial conditions, political constraints, state capture, high sensitivity to external shocks, corruption, fragile institutions, etc. Overcoming these obstacles becomes even harder when a country is invaded by a neighbour.

The brief review of the history of Ukraine's financial sector in Chapter 1 argued that each of these factors have played a role in constraining progress. While some were common to all East European economies, some were specific to Ukraine. For example, the global boom-bust cycle in the 2000s lifted the Ukrainian stock market and then crashed it. The depth of the crisis was amplified by a weakened banking system that suffered from related-party lending, opaque ownership structures and poor supervision. And the weak rule of law and poor corporate governance encouraged allocation of resources that minimised the role of capital markets.

In addition, Russian aggression in 2014 depressed Ukraine's financial markets and broader economy, both directly – some listed firms were in territories occupied by Russian forces – and indirectly – banks had to absorb huge losses in their loan portfolios, and security concerns radically reduced the attractiveness of Ukraine for investors. By 2022, Ukraine's stock market was on life support, but Russia's full-scale invasion delivered the fatal blow.

The behaviour of Ukraine's 'blue chips' – firms that largely create liquidity, convey market sentiment and set standards, and thus are vital for any stock market – indicates the state of the country's capital markets. The largest firms in Ukraine are held privately or listed on foreign exchanges. For example, Kernel, one of the largest Ukrainian agribusiness firms, is a joint stock company but its shares are not traded on a Ukrainian exchange. It was listed on the Warsaw Stock Exchange and issued shares there four times: an initial public offering (IPO) in 2007 and then additional issuances in 2008, 2010 and 2011. After the Russian aggression in 2014, Kernel's stock price plummeted and the company is in the process of going back to being privately held. MHP, another leader in agribusiness, when through an IPO on the London Stock Exchange in 2008 rather than a Ukrainian exchange. Metinvest, the largest private company in Ukraine, listed parts of its holdings on Ukrainian exchanges in the past but it has zero presence now.

This *status quo* has a flavour of the chicken-or-egg problem: the stock market should offer tangible benefits (net of costs associated with listing) to firms potentially interested in listing, but the market cannot deliver unless these firms list their shares. Indeed, why would a large Ukrainian owner have a transparent ownership structure, strong corporate governance and important disclosures if the upside is so limited? Furthermore, direct buyouts or investments by foreigners offer an easy way to exit (for example, Raiffeisen Bank acquired Aval Bank in Ukraine rather than starting a greenfield investment; and MHP listed in London rather than Kyiv), thus diminishing incentives to list shares in Ukraine.

One may think that it is impossible to resurrect capital markets in a country with a baggage of previous problems and ravaged by war. But Singapore, South Korea and others demonstrate that proper policies can help capital markets to thrive even in highly adverse environments. The prospect of joining the EU and the commitment of Ukraine's allies to supporting the country not only during the war but also in post-war reconstruction gives hope that radical changes are possible and that some day, Ukraine can have well-functioning capital markets. But how can this be delivered?

The best model for Ukraine is to focus on organic growth of capital markets. This strategy is based on the realisation that many changes are needed to address previous problems, and certain sequencing of reforms is required (e.g. banks go first, the bond market is next and then it is the turn of the stock market). In other words, the complexity of challenges is such that there is no silver bullet that can restart capital markets quickly. Instead, it should be a broad set of reforms that will create pre-conditions for developing capital markets.

These reforms include: improving the judicial branch of government; restructuring the pension system; resolving NPLs in the banking system; liberalisation of economic and financial activity; and privatisation of SOEs, or at least modernising their corporate governance. Each of these elements is a long-term project and so these reforms are likely to bear fruit only in ten years or so.

There are other strategies that may yield results faster. For example, the government could commit resources to jump-starting a stock market (e.g. a new wave of privatisation) and creating strong incentives for companies to list. But this and similar alternatives carry high risks and may lead to another bad experience. Indeed, privatisation in the 1990s was intended to launch deep capital markets, but it failed to achieve this objective in Ukraine and several other East European countries.

There are also strategies that effectively give up on the stock market in Ukraine. For example, raising capital may be outsourced to other exchanges in the region. This and similar policies could help large firms to raise capital quickly, but Ukraine would largely be left without the long-term benefits of capital markets (especially for medium-sized firms). Clearly, the country faces enormous uncertainty and some mixture of policies as well as experimentation (especially in fintech and venture capital) may be needed, but the risks associated with these alternatives should be calculated.

## WAYS FORWARD

As discussed above and in Chapter 1, there is no single factor that determined the fate of the Ukrainian stock market. This indicates that no easy fixes, such as changing one or two regulations, are on the table. Instead, the resurrection of the stock market should be a long game, and one should be prepared for a financial system that may not have a deep stock market for a while. Given path dependence in how financial markets develop, the death of the stock market in Ukraine could open up opportunities for alternative arrangements where, for example, fintech and other forms of financial innovation could help to develop and diversify the financial system. One can imagine a number of broad strategies for financial development in Ukraine.

First, Ukraine could outsource its stock market to established exchanges in other countries. For example, Ukrainian firms can list in Frankfurt, Warsaw or other regional exchanges. The main advantage of this approach is that large Ukrainian firms could gain immediate access to liquid capital markets. This approach would be aligned with the global trend of consolidating exchanges. Indeed, the Netherlands, Belgium, and France merged their exchanges in 2002 to form a pan-European exchange called Euronext. Other countries joined Euronext later. It is also consistent with the idea that the Marshall Plan was successful by creating linkages across European economies. Thus, one may view this approach as a part of a broader strategy to integrate Ukraine into European capital markets. On the other hand, smaller firms will be forced to operate in a shallow, illiquid capital market, thus deepening the divide between large and medium-sized firms in Ukraine (e.g. Grygorenko and Schnitzer 2022).

Within this strategy, Ukraine could follow the European bank-centred model (with the stock market as a supplementary source of funding for firms) and use fintech and venture capital to fund high-risk projects. This approach would build on the fact that Ukraine already has an established network of banks, and debt may be a stronger tool to assure investors that they will get their money back. To compensate for the inability of banks to fund an innovative economy (which tends to have little to no collateral) that is needed for Ukraine to grow rapidly, the financial system could rely on fintech and venture capital.

Second, Ukraine could try to reboot its stock market with radical institutional, economic and financial reforms. This approach may involve regulatory and tax incentives/restrictions that encourage firms to list (e.g. Thailand offers tax advantages to firms if they list on the local stock market) and households and other players to invest – directly or indirectly (e.g. via pension funds) – in shares.

The government could use another round of privatisation or its holdings of SOEs to jump-start the market in this way; and the NBU or another government body (potentially jointly with a consortium of international investors) could be a market-maker and provide liquidity. But while this strategy of resolute government intervention could stimulate rapid development of capital markets, the strategy carries huge risks. Just as transition in the 1990s failed to create a deep stock market anywhere in Eastern Europe (no market in the region is even in the top 20, and Iran has a larger market cap than Poland), this 'big push' strategy could yield a molehill rather than a mountain.

Third, the philosophy could centre on organic growth of various parts of the financial ecosystem, with the focus shifting over time as markets mature and prepare for the next stage of development. For example, equity markets tend to develop later than banks. Hence, one may need to concentrate on banks first and then equity markets as the economy accumulates demand and supply, and other pre-conditions for a stock market. This suggests that the government should be patient and recognise that its work towards developing a stock market – improving corporate governance and the judicial system, establishing a liquid money market, enhancing competition in the provision of financial servicing, strengthening financial literacy, etc. – may only bear fruit with a significant delay.

This list is clearly not exhaustive, and one can envision various combinations of these and other strategies. The following reviews some ingredients that would facilitate the development of a viable stock market in Ukraine.

## **PILLARS OF FUTURE SUCCESS**

In determining the most suitable path forward for the revival of Ukraine's stock market, it is essential to consider various strategies and the potential implications of each approach. The options range from international outsourcing of stock market operations to comprehensive institutional reforms and the gradual, organic growth of financial ecosystems.

Each strategy comes with its own set of challenges and opportunities, and the choice will have a significant impact on the long-term financial landscape of Ukraine. These choices should be made strategically, bearing in mind the characteristics of the country's financial history and its rather turbulent local political environment, which is distinguished by several political economy constraints typical for the region (e.g. low trust in institutions and leadership, and limited expertise among key policymakers). Myopic decision-making has often been the result.

This section delves into multiple pillars that underpin the potential success of Ukraine's stock market revival. In particular, it explores factors that previous research (e.g. Albuquerque de Sousa et al. 2023, Ho and Iyke 2017, Laeven 2014, Chami et al. 2009) has identified as being important for developing capital markets. To be clear, this line of work tends to report correlation rather than causation, but even correlation can be informative in supporting or ruling out some options.

### **Macroeconomic stability**

Numerous studies document the fact that macroeconomic volatility and high inflation are associated with less-developed stock markets. While this correlation is salient in the data, the causality is less clear (for example, weak institutions can result in poor macroeconomic policies and poor protection of the property rights that are necessary for stock markets to function). At the same time, one can argue that the macroeconomic environment can affect investors' risk appetite as well as the amount of funds available for investment. In a similar vein, the level of economic development (often measured by GDP per capita) is positively associated with more developed stock markets.

The near-fatal blow of the global financial crisis to the Ukrainian stock market underscores the importance of macroeconomic stability and macroprudential policies for financial development. Fiscal dominance will be a prominent feature of the macroeconomic landscape in Ukraine not only during the war (Becker et al. 2022b) but also in the early stages of reconstruction. Massive requirements for rebuilding infrastructure and supporting people affected by the war will put an enormous strain on public finances. As a result, fiscal imbalances could lead to high inflation, crowding-out of private investment and other detrimental outcomes. The prevalence of NPLs and high public debt pose additional obstacles for financial development. Even the expected inflow of foreign aid after the war could create pre-conditions for a boom-bust cycle, with potential damage to the economy and the financial sector similar to what was experienced during the global financial crisis.

The priority of maintaining macroeconomic stability can have a negative short-term effect on the growth of credit and other metrics of financial activity. For example, tight monetary policy with high interest rates to keep inflation in check would make credit expensive. Capital controls may be needed to minimise fluctuations in capital flows and exchange rate. Such controls can slow down foreign (mostly portfolio) investment into Ukraine.

To resolve NPLs, De Haas and Pivovarsky (2022) propose a relatively centralised approach that offers speed, scale and quality in managing distressed assets. Becker et al. (2023) advocate a rapid restricting of Ukraine's public debt (with potential haircuts as high as 90%) to give the government an opportunity to focus on rebuilding the country rather than servicing debts accumulated during the war. More generally, Becker et al. (2023) observe that sustainable public finances, sound monetary policy, a predictable and fair regulatory framework and flexible labour markets will be the cornerstones of successful reconstruction. In practical terms, this means that, for example, the NBU should implement inflation targeting as the policy regime and allow the currency to float.

Although potentially costly in the short run, macroeconomic stability in the early post-war stage should have strong positive long-run effects for the economic and financial development of Ukraine. For example, minimising the chances of currency and banking crises should strengthen the confidence of Ukrainian households and firms in banks and other elements of the financial system. Improved sovereign debt ratings should lower the cost not only for the government but also for private players.

As the economy recovers and markets stabilise, the restrictions on financial activity should be gradually lifted. Although some restrictions may persist for a while (for example, limits on the ability of households to borrow in foreign currency may be needed to reduce dollarisation in the economy and minimise the exposure of households to exchange rate fluctuations), macroprudential regulations should be generally aligned with those in the EU.

### **Bank development**

As discussed, Ukraine's banking sector is at an important juncture, with several priorities on the reform agenda which, if effectively implemented, would contribute to a healthier and more competitive financial landscape. Achieving these goals requires a comprehensive approach that considers what has been accomplished, identifies remaining challenges and leverages evidence-based policies and legislative changes. Given our extensive analysis of the banking sector in Chapters 4 and 5, we focus here on the elements that should contribute to developing capital markets.

As of 2022, the share of the state in the banking sector amounted to about 53% based on total assets. It has only risen since then – for example, by July 2023, the government had effectively completed the nationalisation of the formerly fifth-largest Ukrainian bank, Alfa Bank, because of its links to Russia and sanctioned Russian oligarchic beneficiaries (for background on Russian oligarchs, see Guriev and Rachinsky 2005).

Ukraine should proceed with the privatisation of state-owned banks to enhance competition, minimise corruption and boost efficiency in the banking sector more broadly. Efforts should be directed towards attracting strategic investors, including foreign owners, who can infuse capital and bring modern banking practices. Although

causal links are hard to establish, research on foreign ownership of banks has suggested that it can boost efficiency and help to reduce corruption (e.g. Panizza 2023). This might be because foreign-owned banks are more likely to have access to better technology, healthier management practices, and stricter regulations and oversight.

Additionally, partial stock listings through IPOs can bolster transparency and accountability. PrivatBank, the largest bank in Ukraine based on assets, is frequently mentioned as a potential candidate for an IPO. Key legislative changes and policies involve bills that will help to streamline the privatisation process, ensuring fair and transparent auctions, and establishing clear governance standards to attract strategic investors. The experiences of neighbouring countries such as Poland, which successfully privatised its state-owned banks, can offer insights into best practices.

Encouraging foreign banks to enter the Ukrainian market should help to inject new expertise, technology and capital. Privatisation can serve as a catalyst, but additional incentives may be necessary. Legislation should be designed to facilitate foreign bank entry, providing clear regulatory pathways that would lead to the ultimate removal of licensing requirements for foreign banks that are willing to open branches in Ukraine. Incentives such as reduced capital requirements for foreign banks willing to invest in the local market could also be provided. Experiences from countries like Estonia, which succeeded in attracting Nordic banks, offer valuable insights.

While much has been done to improve the corporate governance practices of state-owned banks in Ukraine, modernising risk-management policies is a continuous process that requires commitment from both banks and regulators. Those improvements are necessary to support the resilience of the banking sector, minimise financial instability, foster investor trust and contribute to long-term economic development. The outstanding priorities include making the transition from a compliance-based to a risk-based supervision approach; refining credit risk assessment systems and monitoring by encouraging banks to adopt advanced credit-scoring models; promoting the use of robust collateral management systems and valuation techniques; and encouraging banks to conduct regular stress tests and publish the results to increase transparency. Finally, one could think of establishing training programmes and initiatives to enhance the risk management skills of bank staff at all levels.

As stressed earlier in this report, maintaining robust banking supervision is crucial for preventing another banking crisis. The NBU should continue to strengthen its supervisory capabilities, emphasising risk-based assessments and modernising regulatory frameworks. Legislation should make sure that the NBU remains empowered with sufficient regulatory authority and independence. Ukraine's banking reform agenda demands a multi-faceted approach that considers the intricacies of each priority. Legislative changes and policies should be evidence-based, drawing from successful practices in other countries.

## Institutional investors

Various studies (e.g. Laeven 2014) emphasise the importance of institutional investors for capital markets that not only generate demand for equity but also have long time horizons for holding. As discussed in Chapter 1, neither pension funds nor insurance companies have become major players in Ukraine's financial system to date. What can be done?

Establishing institutional investors has a number of cross-cutting issues with the development of capital markets. For example, Ukrainian pension funds have miniscule asset holdings and thus cannot have a material effect on the financial system. With a rapidly ageing population and millions of people as refugees in other countries, Ukraine has an unsustainable PAYGO system that does not stimulate savings and investment. Reforming this solidarity system into an at least partially funded system should generate resources that may be invested in domestic equity. It is important that *mandatory* capitalised savings should be a key part of a new pension system. It may take a long time – probably at least ten years – to accumulate significant funds in the pension system, but the groundwork for such a system should be laid out at the earliest opportunity to launch this process.

Insurance companies are another potential source of long-term funding, but immediate, significant capital from this source is unlikely too. With the continuing war, it is hard to quantify the exact exposure of insurance companies to various risks, but it is clear that their assets are only a small fraction of the damages inflicted by Russia (Repko 2023). In other words, current assets may have been depleted and insurers themselves need injections of fresh capital.

Furthermore, security concerns are likely to persist for some time after the war is over, which makes insurance very expensive. Yet there is an urgent need to develop affordable insurance for businesses and households in Ukraine. Indeed, Becker et al. (2022a) and subsequent proposals on Ukraine's reconstruction emphasise de-risking of investment as a core requirement for attracting capital. MIGA-style insurance (see Chapter 1) subsidised by Ukraine's government and allies appears to be a popular policy proposal.

But Ukrainian insurers alone would not be able to do heavy lifting in this context. Given the nature of the risks, access to international reinsurance and credible guarantees from other governments are needed. If MIGA-style insurance takes off, reconstruction could spur entry of foreign insurance companies and thus accelerate financial development. This expansion should be closely supervised by the NBU, which was designated to regulate and supervise the insurance market in 2020 to avoid the mistakes of the previous supervisor. Just like banks, insurance companies need to have adequate capital and liquidity, strong corporate governance and transparent ownership structure. Further deregulation (e.g. prices for auto insurance have been set by the government) can stimulate more entry and competition.

A sovereign wealth fund (SWF) may be a somewhat non-standard option for Ukraine, but it may be a useful element of the broader objective of developing capital markets. Specifically, two sources for such a fund have been discussed.

First, unlike many countries with large SWFs, Ukraine does not have massive oil or gas reserves, but it does have other natural resources. Inspired by the experience of Chile, which uses its revenues from copper exports to fund an SWF, perhaps Ukraine could use revenues from mining rights and commodity exports for an SWF. In theory, a major sale of mining rights (e.g. lithium) could create a windfall that may provide resources necessary to launch a meaningful SWF.

Second, the government continues to have large stakes in many companies. The Soviet legacy assets are controlled by the State Property Fund of Ukraine (SPFU). Some assets are also controlled by the Asset Recovery and Management Agency (ARMA). If SPFU/ARMA assets are not privatised, these assets may be transferred to an SWF, which could manage government property, sell partial stakes to private investors, take partial/minority stakes in private firms and invest in other assets. In principle, the transfer could quickly provide capital to an SWF and thus allow the fund to commence operations.

But is this not simply transferring assets from the left to the right pocket? Not necessarily, because the main advantage of involving an SWF is to use government-owned assets as collateral in capital market transactions, thereby raising new money for development projects.

Although the latter option may bring results relatively soon, a realistic horizon for major domestic institutional investors to emerge probably measures ten years or so. The limited domestic resources underscore the need to attract foreign institutional investors to Ukraine. Potential candidates could be foreign pension funds, insurance companies, public development corporations (e.g. members of the European Development Finance Institutions Coordination Group), sovereign funds, index funds that specialise in emerging economies, and so on. This will require financial liberalisation and institutional reforms, which are discussed below.

### **Legal origins**

A large body of research documents the fact that the legal system can have a fundamental effect on the development of stock markets. La Porta et al. (1998) and others argue that countries with common law (the UK, the USA, etc.) tend to have more developed stock markets relative to countries with civil law (France, Germany, Sweden, etc.). The latter set of countries has some variation (Nordic countries have legal systems that are more conducive for stock markets), but broadly the divide is between the UK system and the continental system. This factor is unlikely to explain the variation in stock market development across East European countries as all of them follow the continental system. Furthermore, given that legal systems typically display high inertia, a radical change in this dimension is improbable in Ukraine. If anything, EU accession should make Ukraine's laws closer to the continental model.

But bold experimentation may be possible. Some countries create 'islands' of regulatory environments that mimic the UK system. For example, Kazakhstan hired UK judges to make rulings on economic matters for one enclave ('island') to help to launch the country's stock market and, more broadly, to attract investment. The jury is still out on this experiment, but such 'islands' are hardly silver bullets: while UK judges can improve the quality of their courts, the divergence of legal environments can exacerbate misallocation of resources between the 'mainland' and 'island' economies. Moreover, legal systems tend to evolve over time in response to economic and political pressures. It is not clear how 'island' legal systems can adapt to the changing landscape and, more generally, how they can co-exist with the mainland.

### **Privatisation**

As discussed in Chapter 1, transition economies in the 1990s tried to use privatisation to create capital markets, but these attempts yielded rather modest results. It seems highly unlikely that privatisation of SOEs in itself will be successful in resurrecting Ukraine's stock market. Many institutional reforms as well as other pre-conditions (e.g. economic recovery and the prospect of joining the EU and NATO) are needed to create a viable stock market.

But privatisation can contribute to financial development. For example, private companies may hesitate to list and thus enforce the equilibrium where the stock market remains shallow. To change this equilibrium, the government can list some SOEs and sell some shares on the exchanges. For example, ARAMCO, a state-owned oil producer in Saudi Arabia, was listed in 2019 and accounts for more than two-thirds of market capitalisation in the local exchange. While the fraction of ARAMCO shares traded on these exchanges is small, ARAMCO's presence in itself puts a blue chip on the market and encourages investor interest and participation. This path requires corporatisation of SOEs and upgrades in their corporate governance to maximise the effect not only for the value of firms but also for stock market development. Potentially, these SOEs may be cross-listed to increase liquidity and diversify the pool of investors.

### **Corporate governance and institutional reforms**

Ukrainian SOEs, which historically were embarrassing symbols of government waste and corruption, have been a source of hope. Independent boards, competitive searches for chief executives, transparent reporting and the like have turned loss-making giants into profit-generating powerhouses. For example, Naftogaz, a state-owned monopoly in natural gas, was losing money on a massive scale (losses were  $\approx 6\%$  of GDP in 2014), but the SOE was reformed in 2015 and started to generate profits (to be fair, tariffs were also aligned with market prices). Furthermore, Naftogaz defeated Gazprom in courts and got \$2.6 billion compensation from the Russian monopolist in 2018. Unfortunately, these changes collided with the realities of under-reformed Ukraine (e.g. Andriy Kobolev, a former chief executive of Naftogaz, is being sued for the bonus that he got from winning the case against Gazprom and which was in his contract).

In addition, many SOEs remain problematic (see the case of Ukrnafta in Chapter 1). But progress is undeniable and these successes set standards for the private sector. Indeed, if Naftogaz can have an independent board and transparent reporting, why would a private corporation not follow suit? The positive externalities from reformed SOEs can be further strengthened by Ukraine's reconstruction, where donors will surely demand transparency and efficiency from contractors. The prospect of joining the EU should stimulate changes in the private sector as doing business in the EU will require the same things. This consideration calls for rapid alignment of Ukrainian regulations and standards with those of the EU.

Reducing corruption and reforming courts are often the top items on the list of changes needed in Ukraine. Again, there is no silver bullet that can eradicate corruption, but there is also no need to reinvent the wheel. Becker et al. (2022c) and Rose-Ackerman (2006) discuss at length how opportunities for corruption can be shrunk and how benefits from engaging in corruption can be reduced. For example, disclosure of ultimate owners in the banking sector was highly instrumental in radically reducing related-party lending. A wider application of these requirements could diminish the scope for potential conflicts of interest. The NBU requires senior bank executives to have a solid business reputation. If a top-echelon banker is caught doing something improper, the central bank can put this officer on a 'blacklist' and effectively end their career. This makes reputational costs much more tangible and thus discourages bad behaviour.

In a similar spirit, no single change in the judicial system is likely to reboot the courts, but comprehensive reforms can deliver results in the long run. For example, Ukrainian courts notoriously take a long time to give verdicts. These delays can reflect the Byzantine elements of the judicial system where plaintiffs can obstruct the due process (for example, nationalisation of PrivatBank is still disputed in the courts), but they also reflect the fact that courts are hugely understaffed and hence overwhelmed with caseloads. To unclog the system, one may need to set up more specialised courts (e.g. courts to handle small claims) and invest heavily in training and appointing judges. Establishing modern case management systems can also help to reduce case backlog, streamline processes and expedite court proceedings.

Further measures geared towards achieving judicial effectiveness, efficiency and fairness first involve updating and clarifying civil and commercial laws to reduce ambiguity and improving legal predictability. Clearer laws have been associated with increased compliance and effectiveness (La Porta et al. 2008).

Second, alternative dispute resolution (ADR) mechanisms, such as arbitration and mediation, serve as prominent substitutes for court litigation and can improve the efficiency of the judicial process by substantially expediting dispute resolution (Voigt 2016). Successful ADR experiences are widespread. For example, Singapore's government actively promotes ADR as a means of enhancing its status as an international dispute

resolution hub. The Singapore International Arbitration Centre and the Singapore International Mediation Centre have been established to provide world-class ADR services, and, as a result, the country has succeeded in attracting multinational firms and legal professionals.

Relatedly, Ukrainian bankruptcy proceedings are long and often end in a small share of assets being recovered (about 10%). Better staffing of courts should help to address these issues, but Ukraine also needs to change its bankruptcy laws and more broadly laws enforcing contracts that contain elements of the Soviet legal system and past populist urges (e.g. blanket moratoria on evictions).

### **Working with the people**

Fostering active and inclusive participation in stock markets should be a key component of Ukraine's efforts to revitalise its dormant stock market. Achieving this objective requires enhancing financial literacy among the general population and perhaps leveraging online platforms to promote broader participation.

Improving financial literacy is a fundamental step in empowering individuals to engage with stock markets knowledgeably and confidently. Several countries have implemented comprehensive financial literacy programmes, offering valuable insights. Likewise, Ukraine could establish nationwide financial education programmes that provide citizens with accessible and structured resources on financial concepts, including saving, investing and risk management. MyMoney.gov in the US and Australia's MoneySmart are two practical real-world cases that may demonstrate the effectiveness of such approaches.

Furthermore, financial literacy concepts could be integrated into school curricula to ensure that young generations acquire essential financial knowledge. Studies like Bernheim et al. (2001) emphasise the long-term impact of early financial education on individuals' financial behaviour. Public awareness campaigns to promote the importance of financial literacy and the benefits of participating in stock markets can be similarly effective. For example, the UK's Financial Capability Strategy demonstrates the impact of a coordinated public awareness effort.

Online platforms have the potential to 'democratise' stock market participation by lowering barriers and increasing accessibility. Ukraine could build on its relatively successful digitalisation experience and existing infrastructure (the Diia App) to facilitate the development of digital investment platforms that allow individuals to buy and sell shares easily, even with small investments. But for online investment platforms to be of help in raising financial inclusion, Ukraine needs to implement a clear and favourable regulatory framework for such portals, addressing licensing, compliance and investor protection. Establishing strong consumer protection measures to safeguard investors from fraudulent schemes or unscrupulous practices would be essential. All of those initiatives will entail amendments to the current Securities Market Law.

## Financial innovation

Unlocking the potential of financial innovation – including fintech, insurtech, venture capital, advanced trade finance and factoring products, as well as other cutting-edge solutions – could be a pivotal strategy for Ukraine to develop its stock market and financial ecosystem. Since financial innovation has the potential to substitute for traditional financial markets that never came into being due to a series of local and global crises over the years, policymakers may want to devote particular attention to efforts in this direction.

Ukraine should foster the growth of digital banks and payment platforms, including through transparent and efficient regulation. These user-friendly services enable seamless transactions and financial access, with the potential to lower the barriers to stock market participation. In fact, Ukraine can already praise itself with a few prominent fintech success stories. For example, monobank, a popular neobank, offers a host of retail banking products to individuals entirely via its mobile app. As of 2023, monobank had more than seven million active customers and was in the process of applying for a banking licence in Poland.

Second, promoting crowdfunding or peer-to-peer lending platforms to provide alternative sources of funding for start-ups and small businesses should help to alleviate credit constraints. Third, the development of ‘robo-advisers’ that offer automated, low-cost investment services could assist novice investors in making informed decisions about stock market participation (DeFiore et al. 2019).

Insurtech is another form of financial innovation that has the potential to streamline and modernise insurance markets in Ukraine, especially in light of the constraints on traditional insurance companies discussed above. By reducing the complexity and cost of insurance, insurtech can both provide insurance to a broad spectrum of markets and generate the necessary pool of savings to generate demand for equities. Through companies like Lemonade and Metromile, the insurtech sector has enhanced the accessibility and affordability of insurance.

Again, regulation and compliance need to be modernised to take advantage of innovation of that kind. In addition, encouraging the development of advanced factoring products and trade finance platforms that enable companies to leverage their accounts receivable as a source of working capital is important for Ukraine, given a high degree of openness in the economy: the share of imports and exports in GDP in Ukraine is relatively high, at about 29.5% and 32.2% in 2022, respectively; and the country is a major exporter of agricultural products, steel and other goods, and a major importer of energy and other products. As in other cases, regulation needs to be adopted to allow for modern factoring tools and not simply antiquated debt buyout options or primitive working capital loans that are common among banks right now.

To embrace financial innovations effectively, Ukraine should invest in its digital infrastructure and connectivity to ensure that fintech and insurtech services can reach a broader audience. Programmes and incentives that support financial start-ups, offering them a platform to flourish and disrupt traditional financial services, should be devised. Investors need to be further protected against potential risks associated with these innovations and implement mechanisms to resolve disputes swiftly and fairly. Lastly, promoting collaboration between regulators, industry players and academic institutions to enable research, innovation and the continual evolution of these financial technologies is key.

### **Regulations, financial infrastructure and openness**

Henry (2000), Levine and Zervos (1998) and others document that financial market liberalisation can spur development of the domestic stock market. The channels vary from enhanced competition (thus reducing the cost of raising equity) to improved liquidity to better corporate governance and risk-sharing. More broadly, liberalisation sends a signal that the government is committed to a market-oriented economy and thus stimulates investment. Financial liberalisation – internal and external – did not materialise in Ukraine.

To elaborate on the discussion in Chapter 1, consider FDI. As discussed in Movchan and Rogoff (2022), Ukraine was a success story in terms of international trade (redirecting its trade from Russia to other markets and occupying an important niche in agribusiness, metals and information technology) but a failure in terms of FDI. This is a missed opportunity: although FDI may be viewed as a substitute for stock markets as it can bypass issues associated with underdeveloped capital markets, it creates stronger links between a local economy and global markets. It can also introduce foreign investors to a country and provide liquidity to the local equity market (as foreign investors may be interested in buying and selling domestic firms or raising capital via a local market).

Another potential source of development is remittances from abroad, which can help to improve various socioeconomic outcomes (e.g. alleviating poverty, increasing school enrolment or providing capital to nascent entrepreneurs) and, as some studies argue (e.g. Billmeier and Massa 2009), even contribute to financial development. Although there seems to be a positive correlation between financial development and remittances, the mechanisms behind this correlation are poorly understood. For example, remittances can facilitate the development of payment systems and encourage the unbanked to use financial instruments, but remittances can also reduce the need to use credit. Which channel is quantitatively important and what is the net effect remains unclear.

More generally, there is even a debate on whether remittances are good for economic growth (in a nutshell, the ‘brain drain’ that creates remittances lowers human capital domestically). Consistent with this ambiguity, Ukrainian surveys (e.g. Khomutenko 2016) seem to suggest that households use international remittances to buy housing (for example, they may be used for down payments and thus help the mortgage market to take off) rather than investing them in financial instruments (for example, remittances do not necessarily create loanable funds or equity).

Furthermore, remittances in Eastern Europe appear to be correlated with poverty and displacement of people due to wars. For example, countries with high remittances (Croatia, Georgia, Moldova and Ukraine) have all experienced wars and refugee crises. Georgia, Moldova and Ukraine are among the poorest countries in Eastern Europe. On balance, although one cannot rule out remittances as a source of financial development, their contribution is unlikely to be the driving force of capital market development.

Openness to capital flows can have other important benefits. As discussed in Chapter 1, Ukraine’s stock market was not particularly liquid even in its best days, but the low liquidity applies largely to all stock markets in Eastern Europe. The inability to create a critical mass of trades adversely affects the ability of these markets to mobilise more interest in listing and so the problem becomes a self-enforcing equilibrium.

One solution is to pool resources across countries. This path is already contemplated by other exchanges in the region. For example, facing low liquidity, exchanges in Baltic countries have considered merging into a pan-Baltic platform (EBRD 2022). To benefit from this trend, Ukraine needs to harmonise its regulatory framework with its partners. In part, this process will be facilitated by EU accession and liberalisation of the economy in general and capital markets specifically. But the government needs to play a more proactive role in pushing through the necessary changes.

To support the internationalisation of the capital market, the government will also need to introduce more infrastructure and encourage entry. For example, encouraging Clearstream to do business in Ukraine has been highly instrumental in lowering the barriers for foreign investors to purchase Ukrainian government bonds. Similar efforts for other financial assets combined with an improved cross-border payments system could also be highly effective in attracting foreign capital.

Alignment of financial regulations with those of the EU can further support integration and cross-border capital flows. In this spirit, Ukraine should adapt its legislation to accommodate financial instruments available in more sophisticated markets. For example, it is not unusual to offer non-voting shares in start-up businesses where the founders and other incumbent owners would like to retain control over firms.

Since confidence in the reforms of corporate governance can build up rather gradually, privately held firms in Ukraine may be interested in non-voting shares or ‘preferred stock’ as a way to protect the investments of the incumbent owners. At the dawn of the US stock market, many firms in the Dow Jones index were traded with preferred

stocks. Indeed, these shares used to be much more popular than common stocks, as they provided a fixed dividend and seniority in the event of bankruptcy. Various companies in the Dow Jones Industrial Average in the late 19th century issued preferred stock, including General Electric, American Tobacco and AT&T.

At the same time, it is important to maintain transparent clearing houses and a certain degree of standardisation of financial instruments for macroprudential reasons so that the appropriate regulators can have a clear picture of risks and vulnerabilities in the system. This is especially important in the context of foreign exchange markets, as the domestic currency is likely to fluctuate significantly vis-à-vis other currencies after the war and the real sector should have robust access to hedging these risks.

It would be unwise to use overpowered incentives or mandated requirements for firms to list. Legislative requirements to list create many listed companies, but the experience of Croatia and Georgia suggests that such policies do not create deep stock markets (i.e. liquidity and volume remain low).<sup>2</sup> Tax incentives to list can be also problematic because such preferential treatments for some firms lead both to a non-level playing field in the economy and to reduced fiscal revenues, an important consideration given Ukraine's high fiscal needs to pay for reconstruction. Apart from creating distortions, differential tax treatment opens more opportunities for abuse and corruption.

## CONCLUSION

The task of establishing a well-functioning stock market is monumental. International experience suggests that few countries succeed in this endeavour. But the benefits of deep capital markets are so large that it would be unreasonable not to try.

Careful analysis suggests that Ukraine should play a long game, with the focus on setting up pre-conditions for a thriving stock market. Alternatives, such as ramming through the obstacles or giving up on the stock market, carry significant risks and costs for Ukraine in the long run. Instead, step-by-step reforms and patience are necessary to use the current window of opportunity to resuscitate capital markets. Integrating Ukraine's capital markets into European capital markets can help large Ukrainian businesses to attract investors. But integration processes may take a while to align Ukraine's legislative framework and regulatory practices. These considerations mean that one should not expect immediate breakthroughs in the near future. Instead, a likely horizon for tangible results is in the order of ten years.

<sup>2</sup> Georgia's Securities Market Law requires all public limited companies with more than 500 shareholders to list their shares on a stock exchange. Croatia has similar regulations and most public limited companies with more than 500 shareholders or with a market capitalisation of more than HRK1 billion are obliged to list.

Given the complexity of reforms needed to achieve the desired outcome, it is important that government agencies coordinate their activities closely as well as actively involving the business community and other stakeholders. Because financial markets are globalised, it is equally critical to make best use of the goodwill and expertise that the EU and other allies can provide. Being part of a big ecosystem offers enormous benefits to an emerging economy, but it also requires accepting the rules and adapting the regulatory framework.

Having overcome much adversity and long odds in its history, Ukraine, in the words of its anthem, has not perished yet and nor have the country's capital markets. In fact, the future of post-war Ukraine has enormous opportunities. Although betting on the stock market is a highly risky business, one can be confident in giving Ukraine a chance to create a successful stock market.



# Mortgages in Ukraine

To provide some context for discussion of Ukraine's housing market, consider what the country was like in 1991 after regaining its independence (Mylovanov and Sologoub 2021). In line with the communist ideology of the previous seven decades, private property was practically absent: people owned personal things, houseware and sometimes a car. People living in villages owned their home and some city dwellers owned summerhouses with small plots of land. Some form of entrepreneurship (cooperatives) was allowed only in 1986. To obtain their own housing, people had two options:

- The majority waited in line for many years until they were allowed to move into a state-owned flat. One of the legacies of the Soviet past (but also the result of poor land market regulation) is that in Ukraine, a relatively larger share of people lives in apartment blocks rather than in individual houses (Green et al. 2022).
- Some invested in a housing cooperative and when the house was constructed, owned the flats in it. Such housing cooperatives no longer exist. Instead, until recently, people could 'invest' in construction of houses (discussed below) or save for a flat or house. Sometimes, construction companies allow deferred payments (e.g. 50% payment upfront and the rest over the following few years).

Moreover, since in the Soviet Union all prices (including interest rates and salaries) were regulated by the state, and economic and financial literacy was practically zero, people did not know how to invest, what a bank does, what a security market is, and so on. But they did remember a few 'monetary reforms' (the most recent one in early 1991) aimed at confiscating 'excess' money from the population. This, together with the hyperinflation of the early 1990s, led to widespread and persistent distrust of banks; even today, more people do not trust banks than trust them (Razumkov Center 2023).

This has resulted in two peculiarities of Ukraine's housing market: the majority of people want to own a house or flat rather than rent one; and many people use property as an instrument of saving.

At the same time, during the 1990s, several important prerequisites for the development of a mortgage market were implemented:

- Millions of state-owned flats were privatised rather rapidly, so that state ownership of housing declined from 13% in 1993 to 3% in 2005.
- The land of 'collective farms' was distributed between former collective farm workers (although they were allowed to sell this land or use it as a collateral only in 2021).
- Tens of thousands of small state and communal enterprises were privatised.

Voucher privatisation failed to underpin the emergence of a stock market, and large privatisation resulted in the emergence of oligarchs. Nevertheless, the privatisation of enterprises created a class of entrepreneurs and owners, and the privatisation of land and housing provided people with an endowment that they could use to extract some revenues (e.g. renting out a flat) or lower their living costs (as there was no need to pay rent on their own house).

At the same time, despite the introduction of elements of the market economy, government intervention in the economy was high in the 1990s, and it remains substantial today. Specifically, the Ukrainian state has been constantly trying to provide an extensive safety net (e.g. 'free' healthcare or education, low communal tariffs, privileges to some categories of people) to meet the paternalistic expectations of citizens.

Provision of 'free' housing is one part of this safety net and the issue on which many politicians used to speculate (specifically, populist politicians often told people that "Ukraine should have 2% mortgage rate as in Europe"). Thus, various programmes of subsidised housing (for young people, public servants, those in the military and security services, etc.) have been a permanent element of Ukrainian public policy.

At the same time, macroeconomic policies that would make housing more affordable for everyone received much less attention from policymakers. For example, inflation targeting that would lower interest rates was introduced only in 2015 (VoxUkraine 2019). It was abandoned after the full-scale invasion when the NBU tried to stabilise the situation. But since 3 October 2023, the central bank has introduced a managed float of the currency and at some point it will return to inflation targeting.

Creditor protection remains weak (starting from a non-functioning judicial system to the rules prohibiting expulsion of people from a mortgaged flat or house if children are registered there); and there are no clear and transparent rules for housing and non-agricultural land markets. These markets are largely in the shadows because of vested interests and for tax evasion, with the government and market participants not seeing many deals since they are performed in cash.

The next section provides an overview of relevant legislation. The following three sections then consider recent developments in the mortgage market, outline policies on subsidised housing and provide some policy recommendations.

## **LEGISLATION ON MORTGAGES AND THE CONSTRUCTION MARKET**

The law 'On Collateral' that allowed the use of property or land as collateral was adopted in early 1992. But the law on mortgages was not adopted until 11 years after that, in 2003. This law states that not only property but also the rights to property can be used as a collateral for mortgages, and in 2022, objects under construction were included in the list of eligible mortgages.

The law allows refinancing of mortgage loans, including by issuing covered bonds (i.e. bonds secured by a pool of mortgage loans). A separate law on covered bonds was adopted in 2005, but these bonds have not been very popular. A few series of them were issued by the Agency for Refinancing of Mortgages, which is owned by three state banks and two persons, currently under liquidation (between 2012 and 2016, the agency issued bonds worth UAH1 billion, or about \$110 million).

Two laws adopted in 2018 were important for the development of mortgages: the creation of a single credit registry; and strengthening of creditor rights protection. The latter law clarified how a mortgage issuer can obtain property rights over a mortgaged property or the money from the sale of the property.

On 30 August 2023, Ukraine's president signed the new version of the law 'On credit unions' (these unions are similar to savings and loans associations in the US or credit cooperatives in other countries in that they provide financial services to their members). Although credit unions were introduced into Ukrainian legislation in 2001, they were never very developed: their share in the assets of non-bank financial institutions declined from the maximum of 0.6% in 2008 to 0.1% in 2023 (NBU 2023). At the end of November 2023, their assets were UAH1.4 billion, or about \$37 million; the share of non-bank financial institutions in financial sector assets is 12%, roughly the same as it has been since 2019.

The global financial crisis and later the Russian invasion adversely affected both banks and non-bank financial institutions. For example, between 2021 and 2023, the number of credit unions declined from 278 to 151.

The new law introduces several changes to the regulation of credit unions: not only individuals but also enterprises and entrepreneurs are allowed to join them; credit unions are allowed to make profit (before they were required to be non-profit only); requirements on the quality of corporate governance and capital are strengthened; and the types of activities that a credit union is allowed to implement will be explicitly stated in its licence.

Thus, under the new law, the money of credit union members will be better protected. But given their small number and size, they are unlikely to have a substantial effect on the market for loans. Currently, slightly over 50% of loans issued by credit unions are consumer loans, and the rest are roughly evenly split between loans for business needs and loans for purchase, construction or renovation of housing.

International experience provides mixed evidence on the usefulness of credit unions or savings and loans associations. In theory, these institutions should have a low liquidity gap – i.e. unlike banks, they would finance long-term loans with long-term deposits. This arrangement would also reduce interest rate risk if interest rates on these loans and deposits are fixed for a substantial period (several years).

At the same time, the US government had to bail out savings and loans associations after the 1980s crisis, when high interest rates made them unsustainable. Thus, before taking steps to create incentives for greater mortgage provision by credit unions, it is worth seeing how these entities operate under the new rules and whether they increase the share of mortgages in their portfolios.

After the 2014-15 crisis, Ukraine's monetary policy and the banking sector were significantly reformed (VoxUkraine 2019). These reforms allowed the banking sector to withstand both the Covid-19 crisis and the full-scale Russian invasion of 2022 relatively easily. From 2019, the NBU started to introduce proper oversight over non-bank financial institutions, gradually creating prerequisites for the development of the securities market. The war significantly increased uncertainty, and an inflow of investments is unlikely until Ukraine wins the war. But institutional prerequisites for this inflow (e.g. fixing the law enforcement) can be implemented today.

A few changes aimed at introducing more transparency and reducing opportunities for corruption in the construction sector have been implemented since 2014. These were aimed at digitalisation of licensing and obtaining construction permits, transparency of city planning documents and procedures for developing and evaluation of urban development documents (for example, now there is an e-portal on construction<sup>3</sup> that contains information on construction projects and provides services to construction companies in electronic form).

Despite these steps, the government agency that provided construction permits remained rather corrupt and it was therefore replaced by another agency, State Construction Inspection, in 2020. Whether this will solve the problem remains to be seen.

The government has somewhat simplified the process of obtaining construction permits during martial law (Cabinet of Ministers Decree 722 of 24 June 2022). But a comprehensive reform of the construction sector remains stuck: the relevant draft law (#5655) was adopted by the parliament in December 2022, but is not yet signed by the president due to the opposition of the professional community, civil society organisations and representatives of local governments. They point to the risks of monopolisation of the construction market and ignoring the opinion of local communities if the draft is signed into law. Ukraine's international partners support these concerns.

A positive development is the regulation of property rights on unfinished construction adopted in August 2022. This guarantees the property rights of people who bought a flat in a house that is *being constructed*. This will rule out schemes in which people invest in a construction project and then the construction company disappears and investors are left with neither property nor money (there were quite a few instances of this fraud some time ago).

3 <https://e-construction.gov.ua/>

One of the best-known examples of these schemes was the Arcada bank case. The bank was resolved in 2020, but about UAH9 billion of ‘investment’ in construction projects was lost: the bank collected money in a ‘fund’ (basically a special off-balance sheet account within it) and financed construction projects of related companies (before banking regulation and oversight was significantly tightened in 2014-16, related-party lending was a large problem in the banking sector).

In March 2023, the parliament adopted the law on compensation for destroyed or damaged housing. According to this law, people whose house has been damaged or destroyed by Russia since February 2022 have the right to receive a housing certificate with which they will be able to buy a new home, buy construction materials or pay for construction.

Currently and for up to one year after martial law is lifted, people can apply for compensation. Three years after martial law is lifted, the certificates will be issued, and people will have to use them within five years of issuance. Local governments will create special commissions that will decide whether a person (household) is eligible for compensation or not (this creates corruption risks, so these commissions should be properly selected and overseen).

Given the scale of destruction (over 160,000 residential buildings have been destroyed or damaged, and the number grows every day) and probable post-war financial constraints, the established time limits do not seem to be reasonable. But since an immediate end to the war is not yet in sight, the parliament has time to revise this law.

On 10 May 2023, this compensation programme was launched on the Diya e-government application.<sup>4</sup> In the first stage of the programme, only compensation for damaged housing of up to UAH200,000 will be provided (since January 2024, owners who have already repaired their houses are also able to apply for compensation). In the second stage, the government will start paying compensation for destroyed houses. From December 2023, the programme began to cover not only ‘quick’ renovation but also capital renovation – up to a maximum of UAH350,000 for a flat and UAH500,000 for a house. In January 2024, the programme was extended to construction of houses on land plots owned by people.

As of January 2024, over 38,000 claims for compensations had been submitted and the government had approved disbursement of UAH7 billion under the programme. The compensation fund is made up of money from seized Russian assets and 50% of the central bank’s profit.

4 <https://erecovery.diia.gov.ua/>

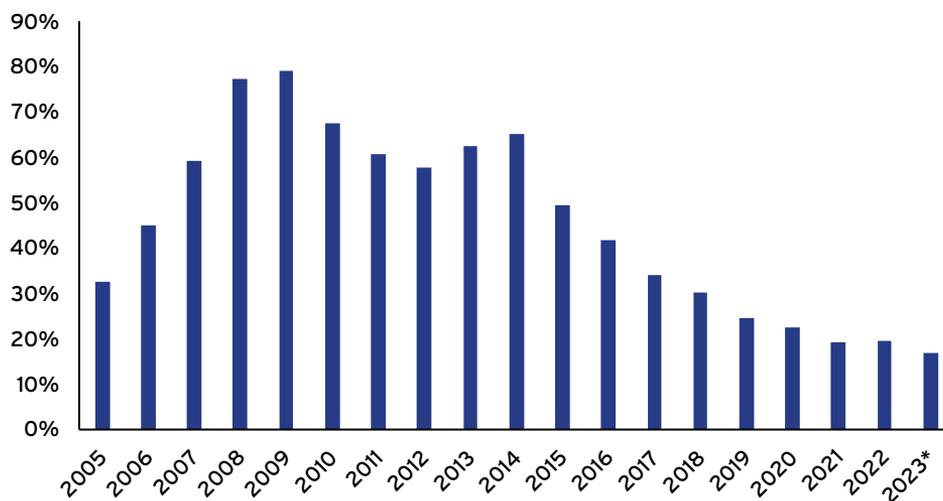
On a more strategic level, the government published the procedure for the development of reconstruction strategies for communities, cities and oblasts.<sup>5</sup> Despite some inconsistencies in this procedure, it may kick-start the discussions around the country on how different communities or regions are to be rebuilt.

### MORTGAGE MARKET DEVELOPMENT SINCE 2005

As Figures 7.1 and 7.2 show, loans in Ukraine have skyrocketed since 2005 alongside the housing boom across the world. The crisis of 2008 considerably reduced the ratio of loans to GDP, although a proper clean-up of the banking sector was performed only in 2014-15.

After that, requirements for loans were significantly tightened. Specifically, the NBU stopped ignoring violations of related-party lending and capital adequacy norms by banks and strengthened requirements for the integrity and qualifications of bank managers and the rules for identifying related-party lending. In turn, the parliament introduced a few important laws on the banking system: on uncovering the final beneficiaries who own more than 2% of a bank's shares (previously the threshold was 10%); on the responsibility of bank owners for bank performance (an article 'On driving a bank to insolvency' was added to the Criminal Code of Ukraine); and others.

FIGURE 7.1 SHARE OF LOANS TO RESIDENTS (NON-FINANCIAL COMPANIES AND HOUSEHOLDS) TO GDP (%)



Data source: NBU and Ukrstat.

Note: 2023 = forecast.

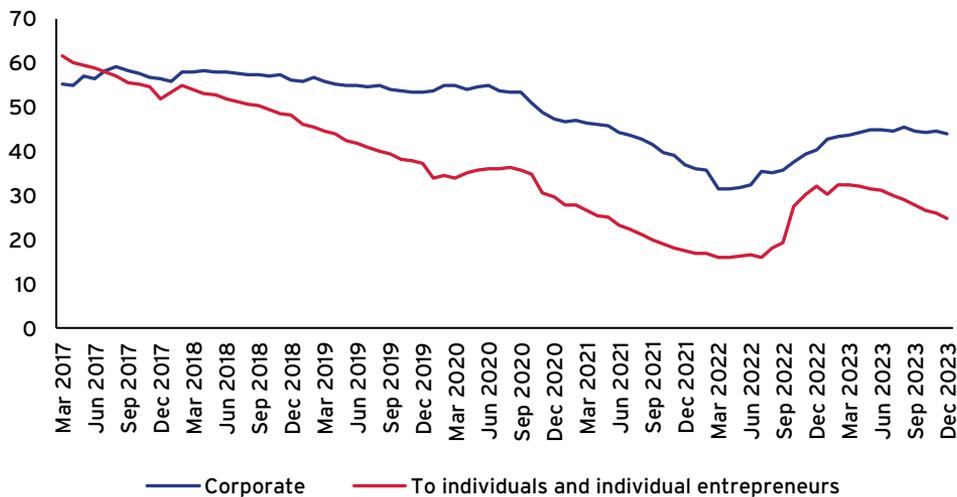
5 <https://mtu.gov.ua/content/strategichne-planuvannya-regionalnogo-rozvitku.html>

The rapid reduction in the loans-to-GDP ratio after 2015 can be explained by several factors:

- First, the clean-up of the banking sector (over a half of banks that existed in 2013 were closed) and elimination of many related loans.
- Second, the imposition and enforcement of stricter accounting and reporting standards, and prudential ratios for banks (Basel II); many loans that were previously reported as ‘good’ were correctly reclassified as ‘bad’.
- Third, the Russian invasion in 2014, which resulted in the loss of assets and a spike in inflation; many loans granted to enterprises in the occupied territories were written off or restructured.

Therefore, the share of NPLs increased from about 16% in 2013 to nearly 60% in 2017, and it has gradually declined afterwards (see Figure 7.2). Naturally, it started to rise again after the full-scale Russian invasion in early 2022.

FIGURE 7.2 SHARE OF NON-PERFORMING LOANS IN TOTAL VOLUME OF LOANS (%)



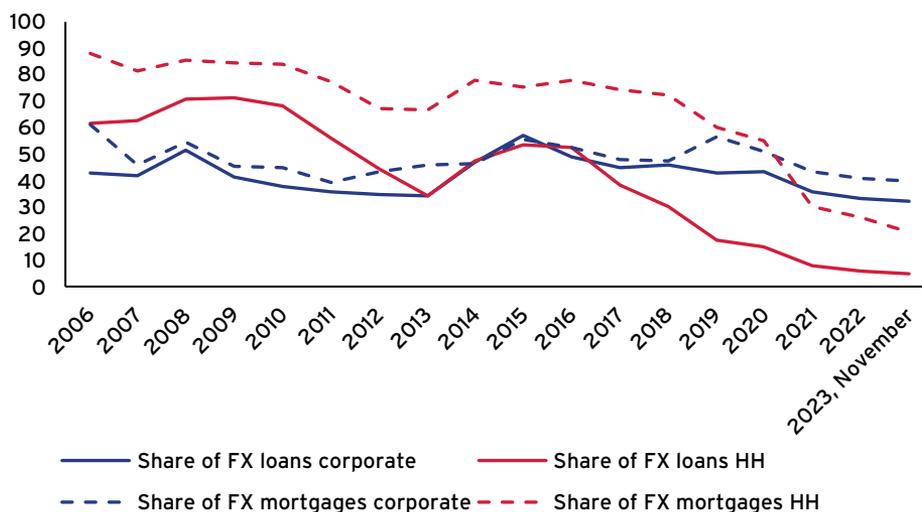
Data source: NBU.

Note: The majority of NPLs are concentrated in state-owned banks, notably Privatbank, which was nationalised in 2016.

The adverse effect of the 2008 bust was amplified by depreciation of the national currency. Prior to 2008, many households took loans in foreign currencies because the exchange rate was fixed and interest rates for foreign exchange loans were lower. After 2008, many of these loans became unsustainable. To prevent this happening in the future, the law prohibited the issuance of foreign exchange mortgages to households, and issuance of foreign exchange loans to enterprises that do not have currency revenues became more complicated – banks need to assess the credit risks of such loans adequately.

As Figure 7.3 shows, the share of foreign exchange loans in household loans has declined considerably since that time. Despite this, legacy loans remained a problem, and after the next major devaluation in 2014-15 the share of non-performing household foreign exchange mortgages reached 90% (NBU 2017). The majority of these mortgages were restructured via negotiations by banks with their clients, although the government tried to intervene on the side of the borrowers.

FIGURE 7.3 SHARE OF GROSS FOREIGN EXCHANGE LOANS IN TOTAL LOANS, END OF PERIOD (%)

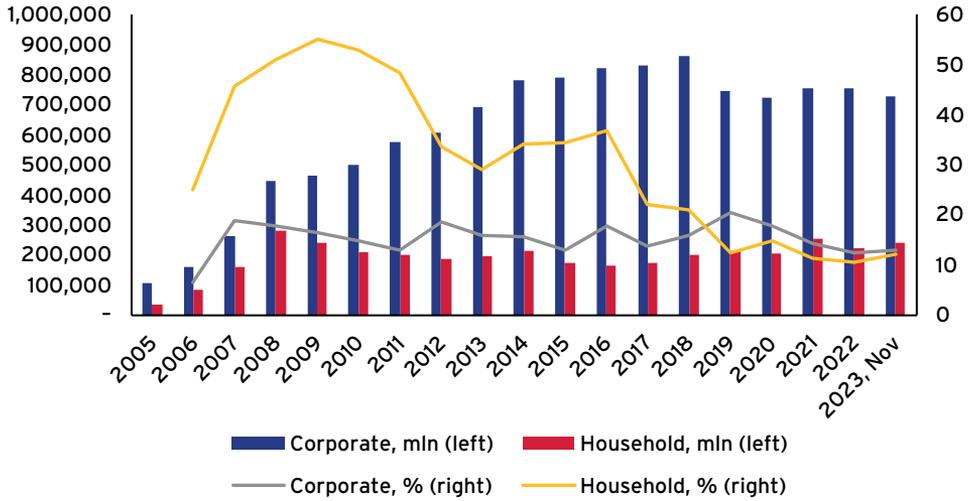


Data source: NBU.

In 2014, the parliament adopted a moratorium on foreclosure on housing that was used as collateral for foreign exchange mortgages if this housing was the only place for a family to live and was smaller than 140 square metres for flats or 250 square metres for houses. This law was abandoned with the introduction of the Bankruptcy Code in 2018, which, among other things, provides procedures for household bankruptcy. Within the adjustment of its legislation to the EU norms, Ukraine will review the bankruptcy procedures in the next few years.

Relatively high interest rates (see Figure 7.5) and unofficial incomes (in Ukraine, receiving salaries ‘in an envelope’ or working in the informal sector are still quite common, and banks cannot verify the financial situation of these people) prevent many households from buying housing with the use of a mortgage. In 2019-22, according to NBU data, only about 2% of housing deals were concluded using mortgages. Generally, the ratio of mortgages to GDP in Ukraine was less than 1% in 2020, compared with 9% in Romania, 22% in Poland and 44% in Germany.

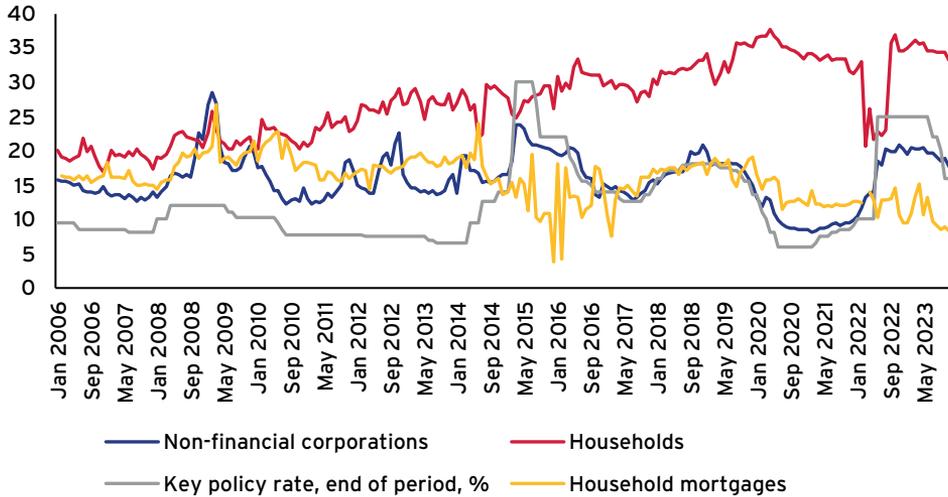
FIGURE 7.4 CORPORATE AND HOUSEHOLD LOANS, END OF PERIOD



Data source: NBU.

Note: Bars present total volume of loans in UAH million (LHS); lines present shares of mortgages in total volume of corporate and household loans, respectively (RHS).

FIGURE 7.5 INTEREST RATES ON NEWLY ISSUED LOANS IN DOMESTIC CURRENCY (WITHOUT OVERDRAFT) AND THE CENTRAL BANK'S KEY POLICY RATE (%)



Data source: NBU.

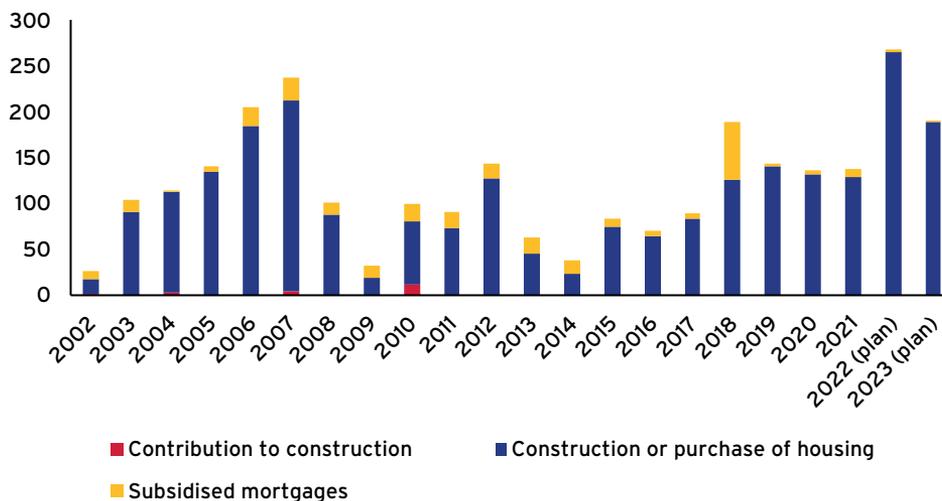
## SUBSIDISED HOUSING

'Affordable housing' has been one of the 'must-haves' in the programmes of all political forces in Ukraine. Two main instruments to provide this are provision of housing by the state and subsidised mortgages. Low mortgage rates have been one of the country's political hallmarks. Various politicians at different times have celebrated "cheap mortgages at 2-3%, as in Europe" as a sign of prosperity.

But instead of fixing the fundamental issues that cause high interest rates, such as by introducing inflation targeting or reforming the judiciary, for a long time the government tried to fight the symptoms by implementing subsidised mortgage programmes.

The first of such programmes were launched in 1994 and managed by the Youth Housing Fund; from time to time the design of these programmes was changed. The good news is that state capacity to finance these programmes has always been much lower than demand for them. Therefore, they did not largely distort the market. At the same time, when these programmes are implemented via SOEs, there is always a risk that the management will pursue their own interests rather than the interests of the state. As Figure 7.6 shows, the Ukrainian government did not spend very much on these programmes: about \$2.2 billion during 2002-21.

FIGURE 7.6 STATE BUDGET EXPENDITURES ON SUBSIDISED HOUSING (\$ MILLION)



Data source: NBU, Treasury.

Notes: Data converted to US dollars using the average exchange rate for the year (or for seven months in the case of 2023). For years up to 2021, actual expenditures are provided; for 2022 and 2023, planned expenditures are provided because detailed data on budget execution are not published. 'Subsidised mortgages' include covering the difference between market and subsidised rates and injections of taxpayers' money into the statutory capital of the Youth Housing Fund, which amounts to \$30 million over the considered period. Green bars in the figure show the amounts spent by the government on construction or purchase of housing that afterwards was provided to privileged categories of people.

Local governments can provide subsidised housing using local budget funds. Previously they could also provide flats - they could receive a certain share of flats in a newly built house or their monetary equivalent. Since this 'contribution' was a large source of corruption, it was cancelled in 2019.

Another \$1.8 billion was invested in statutory funds of the state mortgage institutions (of this, UAH50 billion, or \$1.67 billion, was invested in 2022-23 in the form of government bonds). At the end of 2020, the loss-making State Mortgage Agency, created in 2004, was merged into a new SOE, Ukrfinzhytlo. This new enterprise received statutory capital in the form of government bonds. To be able to operate, it has to convert these bonds into money. Over 2006-20, \$1.75 billion worth of public guarantees had been provided for bonds issued by the state mortgage institution.

Figure 7.6 also shows that a major part of the public spending was directed towards the construction or purchase of housing. Over time, the categories of people for whom housing was purchased included employees of some ministries, judges, military servants and combatants, people who suffered from the Chernobyl disaster, foster families and others.

In addition, orphans who do not have their own house, people with disabilities and the poorest households have the right to subsidised housing. The number of families in the housing queue declined from 2.6 million in 1990 to 657,000 in 2015, and in early 2021, it was about 500,000, according to the Youth Housing Fund. Certainly not all of these families received state-funded housing; the majority of them have probably coped with the problem on their own. (Since its launch in 1994, the Youth Housing Fund has helped nearly 41,000 families to get housing, while other institutions have provided housing or subsidised loans to fewer than 20,000 households; these numbers are much smaller than the housing queue.)

The current YeOselia programme,<sup>6</sup> which provides subsidised mortgages, initially limited participation to the army, police and other law enforcement agencies, and healthcare and education workers that were displaced from the occupied regions or regions with heavy fighting who own a house that is worth less than a defined threshold.

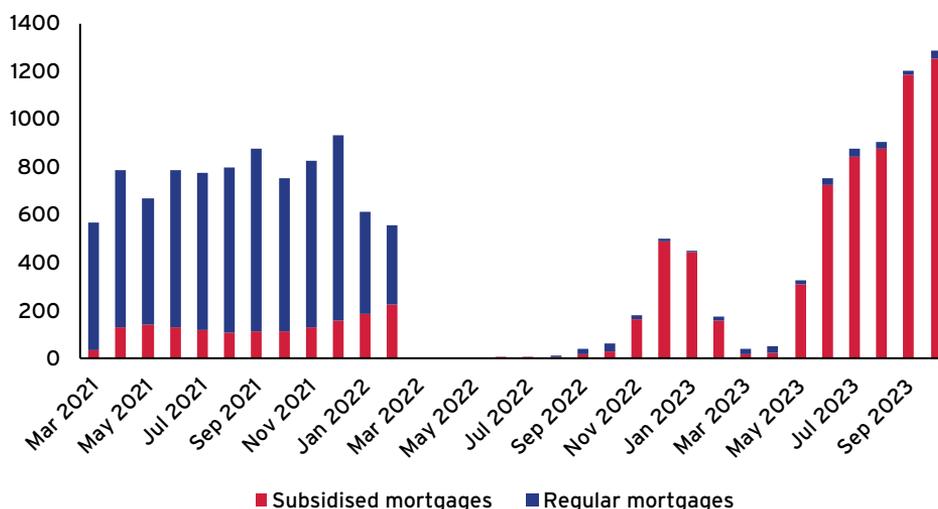
Since July 2023, anyone who does not have their own housing, or who owns housing smaller than a specified threshold, is allowed to participate in the programme. Participants in the programme should be able to service their loans. The number of people in the listed categories is much higher than the government can support (and much higher than the number supported by the government housing programmes before).

In 2021, subsidised mortgages constituted about 15% of all issued mortgages, while in 2023 practically all new mortgages are subsidised (see Figure 7.7). Although the share is large, the absolute amounts are small: between October 2022 and August 2023, subsidised loans were issued to 2,679 families for a total sum of UAH3.77 billion (\$99 million).

6 <https://eoselia.dii.gov.ua>

At the same time, the government should beware of crowding out market-based mortgages with subsidised ones. For example, today over a quarter of corporate loans (and 90% of new loans) are subsidised under the '5-7-9' programme, although real interest rates are not that high.

FIGURE 7.7 NEW MORTGAGE LOANS TO HOUSEHOLDS (UAH MILLION)



Source: NBU Financial Stability Report, December 2023

## RECOMMENDATIONS

The war has exacerbated the housing problems that existed in Ukraine before the full-scale invasion. Today, even fewer people can afford housing because it has become more expensive while real salaries have declined and unemployment has increased; and even fewer people can or want to take out a mortgage to buy a home.

The same is true for loans in general: the volume of outstanding loans to both enterprises and households has been declining since the invasion began, even in nominal terms. Until the territory of Ukraine is more or less safe from Russian attacks, there is not much to be done about it. Thus, the more weapons Ukraine receives, the faster reconstruction will start.

This section presents recommendations, starting with a look at general principles, followed by institutional issues and the handling of subsidies.

## General principles

There are a few things the government can do in anticipation of future reconstruction. The fundamental one is judicial reform, which would protect property rights, lower country-specific uncertainty and support investment. It is also a prerequisite for stock market development and a necessary condition for the issuance of mortgage-backed securities. More broadly, law enforcement reforms (of the police, prosecution and security service) should continue along with deregulation to provide a more favourable environment for businesses and investment.

A return to inflation targeting with the gradual lifting of capital controls is advisable when possible. This policy is more favourable for long-term planning than the fixed exchange rate regime with volatile inflation and abrupt devaluations that Ukraine used to have until 2015. Such a policy will reduce dollarisation and extend the planning horizons of both borrowers and lenders.

### *Rules and regulation*

As far as the legal environment is concerned, particularly for mortgage finance and property markets, the government should not try to protect borrowers by weakening creditor protection (e.g. forbidding seizure of mortgages for certain categories of borrowers) because this is likely to reduce the availability of mortgages to such 'privileged' borrowers in the first place.

Clear market rules are needed for non-agricultural land (especially land in cities). These should be established together by local and central governments, construction companies and experts (technical support from a neutral party would be very helpful). The preferable procedure would be for local authorities to have local development plans and then auction off land plots to construction companies for building houses or infrastructure.

Adopting these development plans was politically complicated even before the war because of many vested interests, and it is even more complicated today because of many new unknowns. How many people will live in Ukraine? Where will they settle? Where will they work?

For now, the best solution is probably to provide the most necessary infrastructure to people who are already there. Nevertheless, it would be useful for community leaders to start discussions with their citizens (including those who relocated) about probable plans for community development.

As emphasised earlier in this report, viability is important when it comes to a sustainable and resilient banking sector. The same is true for the mortgage industry. In the light of historical experiences, which have found sudden changes in house prices as being all too often at the epicentre of financial crises, the government and the NBU may want to consider implementing robust safety measures to prevent the inadvertent basis for a boom-bust cycle.

Drawing lessons from prior crises around the world, including the global financial crisis, it is sensible to use macroprudential regulations as a regulatory strategy, incorporating tools like loan-to-value (LTV) and debt-to-income (DTI) ratios, among others. These ratios should be fixed at levels that allow borrowers – often households – to withstand financial stress without filing for personal bankruptcy. For example, the LTV ratio may have an upper bound of 70%, and the DTI maximum may be commonly set at a level at or below 30%.

These tools would address systemic risks and vulnerabilities within the property and construction market. Prudent LTV ratios restrict the amount that can be borrowed relative to the property's value, thereby preventing borrowers from taking on excessive debt and mitigating the risk of a housing bubble. Meanwhile, DTI ratios limit the proportion of an individual's income that can be allocated to debt repayment and ensure that borrowers are not overleveraged, promoting financial stability and reducing the likelihood of mortgage defaults.

#### *Transparency*

As discussed, the construction market today is mostly in the shadows. It is hard even to collect data on prices at which property is sold, which complicates analysis of the market situation and risks. Therefore, construction market reform aimed at transparency and setting correct incentives for market participants will be a big step forward.

To date, attempts to reform the construction market have failed; too many interests need to be balanced and too much money is involved (generally, construction is one of the most corrupt spheres in many countries). Therefore, Ukraine would benefit from technical assistance and a nationwide dialogue on market design.

To make this dialogue evidence-based, data collection for construction and property markets should be considerably improved. For example, banks that provide mortgages could supply anonymised data on housing prices to a single database; property companies could also report to the Ukrainian statistical agency, Ukrstat, the prices at which properties are actually sold rather than the advertised prices (Ukrstat would then depersonalise and aggregate this data to avoid an adverse effect on competition).

#### *Anti-corruption measures*

Finally, it is important to push anti-corruption policies further, making the property market more accountable and trusted, including internationally. An essential measure for increasing the transparency of the municipal (community) land market and a step towards fostering a fair and corruption-resistant environment is to subject city and municipal council members, along with other local authorities, to enhanced declaration scrutiny.

Currently, city council members and local parliamentarians are not classified as civil servants with an elevated corruption risk when they file income and asset declarations with the National Agency on Corruption Prevention (NACP). While some may submit more comprehensive declarations, this is usually contingent on holding additional government or public sector-related positions that require more in-depth disclosures, such as roles in SOEs. Unfortunately, this exemption leaves a gap in accountability, especially for those council members who wield decision-making power over land allocation, approval of local construction plans that lead to building permits, privatisations and other crucial matters without officially disclosing their entire asset and income sources.

This situation creates a conflict of interest, allowing unchecked decision-making that could potentially serve personal gain at the expense of public welfare. To address this disparity and ensure the integrity of local governance, it is imperative to mandate that all city and municipal council members involved in land allocation and construction policy file comprehensive high corruption-risk income and asset declarations with the NACP. Alternatively, restrictions on their involvement in issues related to land and construction should apply if they opt not to fully disclose their financial interests. This would help to bring about much-needed transparency, accountability and ethical standards within local administrative structures, contributing to the overall success of housing and construction market reforms.

## **Institutional issues**

### *Covered bonds*

As far as the financing side of property is concerned, it would be valuable to strengthen the role of covered bond markets. To this end, the existing law on covered bonds may need an overhaul, the details of which go beyond the realm of this study – but it seems worth doing.

An undervalued benefit of a covered bond market, where bonds are understood to be issued by the banks originating the mortgage loans, is the high degree of incentive alignment implied by the bonds being a liability of the issuing bank – i.e. in covered bond markets, the respective lending risks remain with the originator, and are not passed on to some uninformed third party. This is a significant advantage over outright loan securitisation where a large part of the default risks may be passed on to outside investors – at least unless strict retention rules have become part of the relevant regulatory rules.

That is why *securitisation of mortgage loans* (and other types of loans) is likely to happen in Ukraine only in the rather distant future. Issuing mortgage-backed securities requires a sufficiently deep mortgage market and proper controls of macroprudential risks. At the moment, Ukraine could develop necessary legislation so that legislative conditions do not become a constraint on the market when the situation improves. Currently, there is a concept for this legislation,<sup>7</sup> but a proper draft law should be developed, including minimum requirements for transparency and retention (Krahnen and Wilde 2022).

### *Banking*

A simpler instrument – covered bonds – has already been tried in Ukraine. They were issued by the state mortgage institution about ten years ago and did not attract a lot of attention. But if covered bonds were to be issued by commercial banks, they may attract the attention of investors.

Credit unions or other non-bank financial institutions are barely developed, and they are unlikely to become significant players in the mortgage market (or in the credit market in general). On the other hand, the banking sector now has excess liquidity and can handle the demand if other issues, such as transparency of the construction market and creditor rights protection (today, it is still nearly impossible to foreclose an apartment if someone is not servicing their mortgage), are addressed.

Ukraine does not need a special development bank that would specialise in issuing mortgages. First, Ukraine has a largely unsuccessful history of state-owned mortgage institutions.

Second, the government's share of the banking sector today is well above 50%, and there is an understanding that existing state-owned banks will be privatised when conditions allow. Further increases in government involvement in the sector do not make sense. In short, looking for some 'creative' solution to increase the volume of mortgages will only distract the government's attention from the fundamental problems that together increase the risks of mortgages well above an acceptable level.

When reconstruction starts, Ukraine is likely to face a shortage of construction materials. Therefore, some unorthodox solutions (e.g. using post-war rubble) could be allowed. If this requires a revision of construction norms, this revision should start today.

### *The role of subsidies*

Subsidised housing programmes may remain for the poorest households. A few principles for their design would be useful here.

7 <https://zakon.rada.gov.ua/rada/show/v0139863-23#Text>

Providing money or vouchers is a better solution than buying flats and providing them to households, especially since for many people, their desired place of living and/or family situation has already changed or may change in the near future. In this respect, the recently adopted mechanism of compensation for destroyed housing seems reasonable, if corruption risks are addressed. Since the government may not be able to meet the demand for monetisation of vouchers, their use as collateral for housing loans should be considered.

Providing subsidised mortgages via commercial banks rather than specialised SOEs is a better solution because it will help to bring the property market out of the shadows. Subsidised insurance for property used as collateral may be a better solution than subsidising interest rates. Moreover, the use of commercial and other banks for originating mortgages may vastly leverage the volume, and hence the impact, of the programme. For example, commercial banks may be co-financing construction, thereby allowing for alignment of incentives between banks and the provider of the subsidy. This latter institution may be the government or a specialised tier-2 development bank (as outlined in Chapter 5).

Scaling up the programme of subsidies for renting rather than buying a home may be a good solution because it makes people more mobile. It can also bring to light a greater share of the house rental market, which is largely in the shadows. Support for internally displaced people since 2014 can be considered a pilot project for such a programme.



# War insurance<sup>8</sup>

Ukraine's aspiration to join the EU has received a boost during wartime. Ukraine applied for membership in February 2022, was granted candidate status in June 2022, and obtained EU leaders' decision to open accession negotiations in December 2023. Just like the speed of these decisions, Ukraine's EU accession is likely to be a unique process, as it will be the first country to prepare for joining the bloc while engaged in a full-scale war with uncertainty over its duration, a future peace settlement outcome and prospects for the durability of this.

Hence, beyond the difficult process of regulatory alignment and the achievement of objective accession criteria lies the structural question of integrating a less advanced economy, severely affected by a full-scale war, while achieving economic convergence. With estimates of the investment needed to rebuild Ukraine as high as €1 trillion over the next 10 to 15 years, it is clear that the country will need to leverage public and donor resources to crowd in private investments to accelerate economic growth and convergence with the rest of the EU.

Before the war, Ukraine's level of economic development and potential growth rate were hampered by its difficult business environment, weak foreign investor perceptions, geopolitical tensions, and structural factors such as a declining population. On top of these structural impediments, potential investors are now facing uncertainty about the likelihood of recurring violent conflict in which their assets in Ukraine would be at risk.

Hence, apart from the importance of strengthening Ukraine's defence, institutional and rule of law reforms, both the private sector and the authorities regularly refer to the need to protect economic activity from damages caused by the recurrence of war as a pre-condition for future investments and increasing trade flows. A recent survey of Ukrainian businesses sponsored by USAID found that demand for political risk insurance (PRI) and political violence insurance (PVI) has increased four- to five-fold since the full-scale war started, and two-thirds of respondents declared that they would seek such cover even after the war ends (USAID 2023).

Since the period between the two World Wars, war risks have been progressively excluded from all standard non-marine policies. As a result, investors and trading companies seeking to protect their assets in economies subject to social unrest or (geo) political turmoil can only do so by purchasing PRI or PVI policies. The two are usually

<sup>8</sup> This chapter is based on a working paper co-authored by Matthieu Riolacci entitled "War insurance: lessons from history".

complementary, but PRI provides cover against arbitrary government decisions such as expropriation, nationalisation or prohibition of profit repatriation, while PVI focuses on material damages caused by acts of terrorism, sabotage, war or civil war. Hence, what is commonly referred as 'war insurance' is one of the perils covered by PVI.

The global supply of PVI policies is relatively modest compared with the overall size of the insurance market. Combining an estimate of investors' demand for war risk insurance in Ukraine with the country's overall investment needs, the estimated potential annual demand for such coverage would be very large. It would perhaps exceed what all the leading global insurers participating in the Berne Union (a diverse mix of government-backed official export credit agencies, multilateral financial institutions and private insurers of credit and political risk) currently offer around the world.

For war insurance to be credible and effective without undermining the whole insurance sector, it requires greater transfer of risks across the global insurance sector compared with standard insurable events, such as car accidents. This is because, like natural disasters, full-scale conflicts have a large, concentrated impact on entire economies that the local insurance sectors may not be able to cover or which would require charging and accumulating fees at levels that would not be affordable to most investors or traders.

For this reason, primary insurers typically seek to sell a large portion of their war-related risk to global reinsurers. Global reinsurers can withstand systemic blows to their protected assets thanks to their large balance sheets that are well diversified geographically. Before the full-scale war started in February 2022, global reinsurers had a significant exposure vis-à-vis Ukraine and Russia. According to an S&P Global Market Intelligence analysis, in May 2022 the global insurance industry disclosed roughly \$1.3 billion in collective losses and reserve charges related to the war in the first quarter of 2022. S&P also estimated that by the end of the war, aggregate losses of reinsurance companies could exceed \$10 billion (S&P Global 2022).

Following the outbreak of the war, the reinsurers resolved to cut their losses and adopted a blanket exclusion of war risk insurance in Ukraine. Anecdotally, primary insurers operating in Ukraine have been able to offer war risk cover in very small volumes for expensive war-related insurance policies where such cover is mandatory, such as short-term stays in Ukraine by foreign officials and key personnel. The provision of war risk insurance for maritime cargo and its placement on international risk markets was possible in the context of the Black Sea Grain Initiative treaty, which was terminated unilaterally by Russia in July 2023. Following the termination of the initiative, the availability of maritime policies suffered and, when available, such policies became very expensive (although some evidence suggests that premiums declined somewhat once Ukraine established effective naval control over the Black Sea corridor).

In the meantime, after the most difficult first months of the war, the Ukrainian authorities have focused on alleviating impediments to operations of the insurance market. The NBU eliminated most foreign exchange restrictions on reinsurance payments introduced at the beginning of the war to help prevent capital flight. The NBU and the government also started designing solutions to facilitate the provision of war insurance cover, in particular by allowing the domestic export credit agency to insure and reinsure investments of both international and Ukrainian companies. At the end of 2023, the Ukrainian government, with the support of a global insurance broker, set up a small fund using budget resources that could be used to cover some of the losses related to potential marine insurance claims to reduce the cost of maritime insurance policies.

International publicly supported institutions, such as foreign export credit agencies and the MIGA, have been able to provide war insurance cover for some of the trade flows and international investments, although their supply remains limited in scope and eligibility.

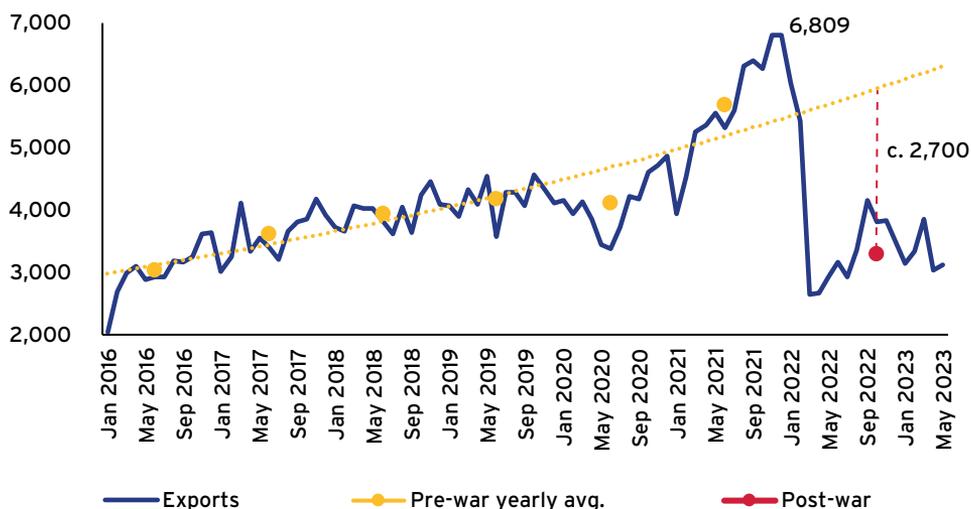
Considering the magnitude of the potential need and very limited supply, it appears that the Ukrainian government and the international community have a role to play in creating a market that the global risk industry has exited. If so, the natural question is what can be done by the authorities and the international community to help Ukraine develop insurance solutions that would serve the country during and after the war in a sustainable and flexible way without substituting for the market indefinitely.

The rest of this chapter develops a few guidelines that policymakers and market participants could consider when designing potential solutions, taking account of past experiences while also considering Ukraine's local characteristics.

### **WHY IS A SCHEME NEEDED TO SUPPORT THE PROVISION OF COVERAGE AGAINST WAR-RELATED RISKS?**

Past experience suggests that the longer a violent conflict lasts, the longer its consequences will be felt by the affected economy. For example, an IMF study of conflicts in sub-Saharan Africa showed that the effects of conflicts are dynamic, lasting at least five years after the onset of the conflict (Fang et al. 2020). Among the channels of crisis propagation are the decrease in trade activities and lower flows of investments, in particular FDI. The EBRD's *2022-23 Transition Report* substantiates these results with a novel dataset of conflict episodes, observing that only in 29% of cases does GDP per capita return to the trend levels observed for comparator countries without wars within five years; in almost half of all instances, it remains below those levels 25 years later (EBRD 2023). In Ukraine, the impact of the war on exports was immediate: exports plunged then recovered somewhat, but remained far behind their pre-war growth trajectory, on average \$2.7 billion below their five-year pre-war trend on a monthly basis (see Figure 8.1).

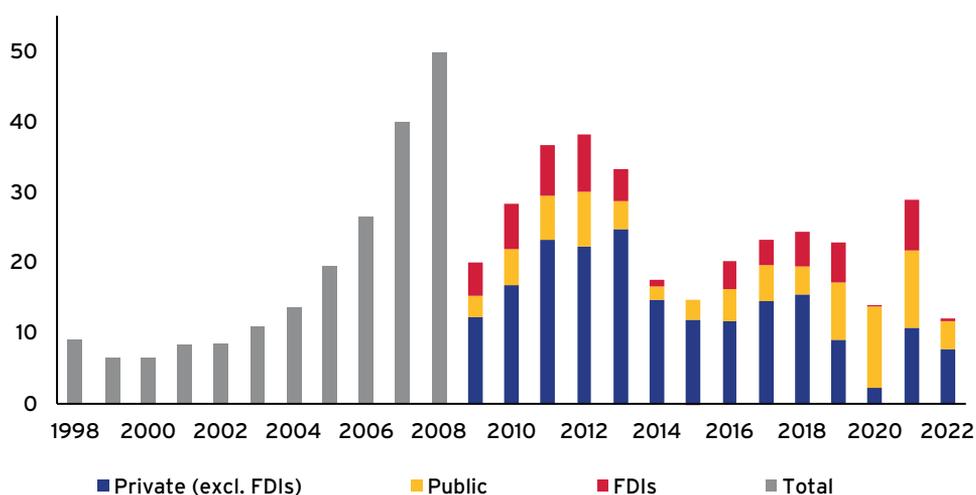
FIGURE 8.1 MONTHLY EXPORTS FROM UKRAINE, NOT SEASONALLY ADJUSTED (\$ MILLION)



Source: NBU; authors' calculations.

The long-term impact of the war on Ukraine's economy is even starker when based on investment data (see Figure 8.2). Following the global financial crisis, overall investment decreased, but recovered at a strong pace, keeping a balanced mix of public and private investment (including FDI). The same happened following the Covid-19 pandemic. But following the annexation of Crimea in 2014, investment never reached its pre-war level, and the share of FDI in the investment mix declined permanently.

FIGURE 8.2 INVESTMENT FLOWS IN UKRAINE (\$ BILLION)



Source: IMF; authors' calculations.

Such a significant decline of FDI after 2014 is somewhat surprising given Ukraine's very large size. A common explanation for this stagnation is the limited appetite of investors to put money at risk in a country subject to a frozen conflict with a residual probability of recurring violence. But this could also be a sign of a failure of the market to assess risks properly. For example, even during the war, the UK Foreign, Commonwealth & Development Office (FCDO) recommends lighter travel restrictions for the western regions of Ukraine (including Zakarpattia, Ivano-Frankivsk, Ternopil and Chernivtsi) compared with the rest of country (FCDO 2024). Some risk industry specialists assess that more than 80% of Ukraine's territory displays a 'moderate' risk profile for specialised lines such as travel risk management, which includes protection against kidnapping, ransom or extortion (Inherent Risks 2024).

Therefore, an indiscriminate blanket exclusion for war risk by reinsurers of the whole Ukrainian territory leads to missed commercial opportunities and a sub-optimal allocation of risks. Identifying public solutions that could help the insurance industry (and potential investors and exporters) accumulate data on actual loss events and improve their understanding of each region's risk profile could help to increase economic activity over time and bring international reinsurers back into Ukraine.

## THE STATE OF DEVELOPMENT OF UKRAINE'S INSURANCE SECTOR

Like the banking sector, during the Soviet period Ukraine's insurance sector was very small, with most risks in the economy *de facto* socialised. Following Ukraine's independence and the liberalisation of its economy, a commercial insurance sector emerged. But it remained small and segmented into a group of stronger, internationally owned and well-governed companies, and a large group of smaller, less transparent and locally owned companies.

Following the global financial crisis, insurance penetration in Ukraine declined to around 1% of GDP per year. (Financial figures in this section are from the NBU's "Non-bank Financial Sector Review" from November 2023, and may rely on non-audited financial statements and information from insurers). This translates into gross written premiums per capita of around €40, compared with an average of around €3,000 for OECD economies. Notwithstanding such a small degree of insurance penetration, as of 2019, the insurance market included a very large number of companies (233 in total), many of them with very small balance sheets unable to offer market insurance products at a reasonable scale.

Since then, supervision of the insurance sector has been transferred to the NBU, which has pursued an ambitious transformation of the sector, based on the earlier experience of consolidation of the banking sector that had served Ukraine very well during the first months of the war. The market clean-up was facilitated by the Law on Insurance,

adopted in December 2021. The main provisions of the new law, which are aligned with the EU's Solvency II Directive, took effect in January 2024 (European Commission 2023a, 2023b). As a result, the market appears to be stabilising at around 100 companies, still dominated by the strong presence of international groups.

In the initial weeks of the full-scale invasion, concerned about the risk of capital flight, the NBU introduced limits on cross-border reinsurance payments. But as soon as macroeconomic conditions stabilised, the authorities took steps to remove impediments to normal functioning of the insurance market. In December 2022, the NBU undertook measures facilitating the insurance business (NBU 2022), responding to requests from financial market representatives, state authorities and businesses, and taking into account the task of securing macro-financial stability and protecting Ukraine's international reserves. This was done notably by relaxing foreign exchange restrictions, including to allow cross-border reinsurance payments.

In this complex operational and policy environment, the insurance sector has been able to grow since the beginning of the war. Insurance assets increased by around 4% year-to-date in the third quarter of 2023. After declining by almost one-third at the start of the war, gross premiums collected increased markedly to catch up with their pre-war levels. Both the life and non-life insurance segments have significantly increased premiums compared with the trough experienced in early 2022. For example, non-life insurers' gross premiums rose by 18% between September 2022 and September 2023 (or 10% in real terms), to some extent reflecting a large increase of Green Card insurance for Ukrainians using their cars in the EU.

Claims paid also increased, but by significantly less than premiums: by 6% between June and September 2023 for non-life insurers; and by 9% for life insurers. Investment income, increasing by 26% compared with the same period in 2022 for non-life insurers, also boosted the bottom line. The good performance of non-life insurers translated into a 9% return on equity as of the third quarter of 2023, above the pre-war level of 6%. The overall profitability of the sector therefore also increased. But the return on equity remained below the 15% registered in the third quarter of 2022, which is partly explained by a deteriorating underwriting result.

At the same time, the global insurance market has deteriorated since 2022. Thus, the January 2023 reinsurance policy renewal season was particularly difficult worldwide, with reinsurers hiking prices as much as 200% in some business lines (Cohn 2023). It was particularly difficult for insurers in Ukraine to source global reinsurance capacity even for risks not related to war. For example, 'machinery breakdown' and 'loss of profit' policies have been almost impossible to obtain (Griffiths & Armour 2023).

Unable to offload their risk to international reinsurers, local insurers have remained prudent. In September 2023, loss reserves for voluntary insurance increased by 5% for the first time after a steady decline in the previous four quarters. For compulsory insurance, loss reserves grew by 20% year-on-year. With some reinsurers exiting the market, local insurers saw their retention share rise from 80% pre-war to around 90% and growing.

Following recent changes implemented by the NBU, a number of primary insurers in Ukraine can be seen as reliable and prudent partners operating in a very difficult environment. But their growth is constrained by the lack of reinsurance capacity following the international reinsurers' exit after the full-scale invasion in 2022. In particular, their ability to underwrite war insurance risk remains close to nil.

### **THE ROLE OF THE INTERNATIONAL COMMUNITY IN WARTIME**

The international community has some tools to provide insurance support in wartime, including via domestic export credit agencies, national development finance institutions and international financial institutions.

A number of national export credit agencies offer PVI, sometimes including war risk, to their national investors for investments abroad or to their countries' exporters. Although there was no formal withdrawal of export credit agencies and other public insurers from covering the Ukraine risk, there is limited activity at present, with the exception of a handful of export credit schemes that tend to offer one-off and bespoke investment insurance and do not always cover transit activities.

Several national development finance institutions are also offering, or preparing to offer, war risk cover via different channels. For example, the US Development Finance Corporation offers war risk cover to both US and local investors, including in partnership with international institutions such as the MIGA.

The MIGA is a multinational institution set up to protect cross-border investments against non-commercial risks. To help support economic activity in wartime, it established a specialised, donor-funded trust fund to increase its own capacity for investment insurance in Ukraine, aiming for an overall volume of the trust fund of \$300 million. It has also expanded its cooperation with international partner institutions, such as the EBRD, to help to mitigate commercial risks in Ukraine. In September 2022, the MIGA allocated funds to Ukraine for a PRI pilot project with the EBRD by issuing a first-loss guarantee to support trade transactions made through Ukrainian state-owned banks.

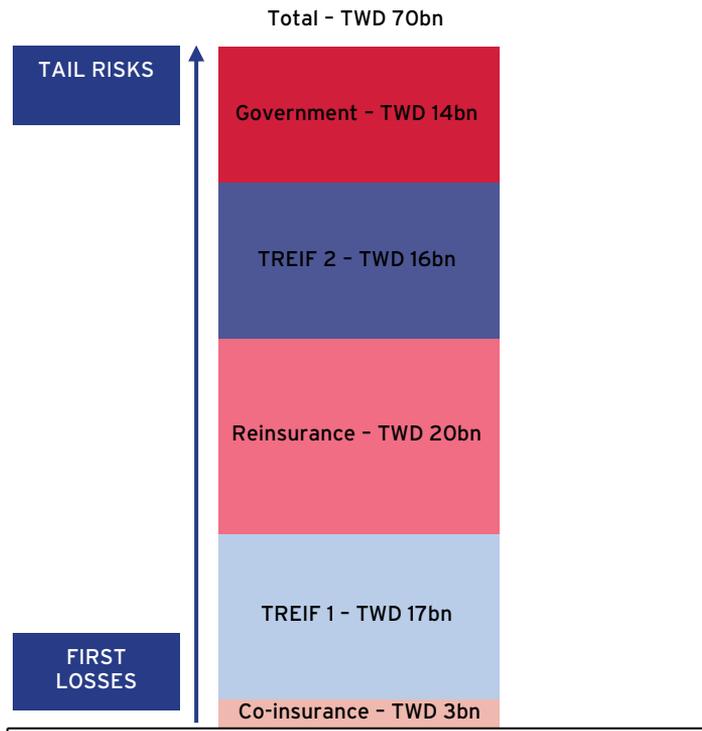
Despite continuing efforts, the offer of insurance against war risk remains limited and available to only selected investors. None of the schemes described above relies on the traditional market risk transfer structures, therefore limiting the role of private sector risk-retention capacity.

## THE HISTORY OF PUBLIC ENGAGEMENT IN CONFLICT-RELATED INSURANCE SOLUTIONS

International experience suggests that pooling risks with government support can be an efficient way to crowd the private sector into supporting economic recovery after conflicts, as well as in the wake of natural disasters or terrorist attacks. Governments have supported schemes in a variety of sectors, acting as coordinators, risk sharers or insurers of last resort.

Government pools are especially popular in the natural catastrophes segment. The Taiwan Residential Earthquake Insurance Fund (TREIF) is a working example of such a structure: by tranching the risk, the TREIF attracts private sector risk retention (see Figure 8.3). Other sectors where such government-sponsored structures exist include harvest insurance in the agricultural sector and, of course, terrorism and war risks.

FIGURE 8.3 TREIF LOSS ALLOCATION STRUCTURE (BILLIONS OF TAIWAN DOLLARS)



Source: AXA (2018).

Loss events insured with government involvement differ from traditional insurable risks across two key dimensions. First, their very large magnitude can pose serious financial shocks to even the largest insurers and reinsurers. Making provision for such events could tie up a significant portion of an insurer's capital and hamper its growth in other segments.

Second, the frequency of such events is hard to predict and they are highly correlated, which makes them very difficult to model. This in turn makes it unattractive for insurers and reinsurers to dedicate resources for relatively niche products, save for some specialised syndicates that expect very high rates of return. Hence, having a government backstop that could be triggered when losses hit a certain threshold could cap potential losses and add a degree of predictability to the insurance industry, as well as a clear measure of their maximum exposure in a worst-case scenario.

There is some international experience with government-sponsored solutions for war and terrorism insurance. In most such cases, the governments funded the insurance pools after the risks to be covered had materialised. For example, Australia, France, Germany and the Netherlands set up their terrorism insurance pools in the aftermath of the terrorist attacks of 11 September 2001, even though those attacks had no direct impact on these countries. The aim of launching such schemes outside the US, which was directly affected, was to help to fill the gap that emerged after large reinsurers had scaled back their exposures or exited the terrorist insurance market both in the US and elsewhere. The attacks led to the adoption of the Terrorism Risk Insurance Act by the US Congress, signed into law in November 2002. Most, if not all, major government-sponsored terrorism insurance programmes remain in place more than 20 years after the attacks.

The nature of such schemes is very much dictated by the nature of the risk that the economies faced at the time they were established. For example, the only two countries with a scheme dedicated to war risk cover are Spain and Israel. In both cases, these countries had experienced protracted military conflict. For Spain, the scheme was set up in 1941 to help the industry to cope with losses from the Civil War. For Israel, the scheme took a permanent form to accommodate the chronic regional instability.

Even though it does not benefit from state support, the Arab War Risks Insurance Syndicate (AWRIS) was originally established in 1981 to protect local markets and it accumulated mutualised profits to offer financial reserves to its members, which include investment grade-rated insurers from the Gulf states (Willis Tower Wilson 2022). In contrast, the UK Pool-Re scheme, established in response to restrictions of UK commercial property insurance for terrorism risk in the context of acts in Northern Ireland, explicitly excludes war risk from its coverage.

There are a few lessons to draw for Ukraine from these past experiences. First, all the available examples are reactive, so it is not too late for Ukraine to work on launching a war insurance scheme.

Second, these schemes vary widely in different characteristics such as price, coverage level, franchise or funding model; they are all unique and tailored to the local conditions. A key factor to consider is the level of activity of the private sector. The AWRIS is a good example of where pooling the risk and the profits was needed to address the market failure, but government support was not necessary because the private sector remained operational.

Third, in all the cases where the pools were established with public support, the sovereign sponsor benefited from strong fiscal credibility. As the current war puts significant pressure on Ukraine's fiscal position, investors and traders may not consider state support credible enough. Most likely, Ukraine would need to resort to support from the international community for the foreseeable future.

### **THE CASE FOR A PUBLIC-PRIVATE WAR RISK INSURANCE SOLUTION FOR UKRAINE**

Although Ukraine's insurance sector fared reasonably well during the first two years of the war, it remains too small, poorly diversified and financially weak, at least from the perspective of the international markets. Recent evidence suggests that a number of Ukrainian insurance companies have been offering war insurance products to their clients covering a small proportion of the value of their movable and immovable assets. But the amounts offered and the values covered are expected to remain very small for the foreseeable future.

Another possibility is to scale up substantially the purely public initiatives with the support of the Ukrainian government and international donor community. In light of the very limited fiscal space and the need to prioritise social programmes and military expenditures, it may be difficult for the Ukrainian government to establish a guarantee programme at required scale. Such an initiative would require setting aside valuable cash to ensure that it is viewed as credible by international reinsurers. This approach is being tested with the recent initiative to help ensure availability of war insurance for vessels navigating the Black Sea to reach Ukraine's ports. Ad hoc solutions of this kind may be needed to address specific and urgent needs, but they are unlikely to be sustainable over the very long run or to reach a significant scale.

Public entities seeking to facilitate the provision of war insurance against a supply shortage may encounter a number of pitfalls. First, it is difficult to assess the demand for the product ahead of launching operations. While the 2023 USAID study and other market signals indicate that there is strong demand, the lack of systemic information makes it difficult to precisely calibrate the support required. Second, in the absence of a functioning market, price discovery could be challenging. This comes with uncertainty around the key parameters, such as the loss ratio, which complicates the determination of a break-even premium level. While this uncertainty can be mitigated by enhanced communication with the insurance industry and the market, potential donors for any publicly intermediated solution would need to accept a degree of risk that is difficult to

quantify. This could be partly managed by introducing a prudent operational framework, flexible enough to evolve over time. A good practice, for example, would be to start by insuring assets of relatively small value, as protecting larger goods such as industrial properties may precipitate the depletion of available capital on risk materialising. As market experience and data accumulate, coverage could extend to new segments, based on a process of regular consultations with the insurance industry.

To succeed, an effective scheme that aims to support trade and investment will have to rely on primary insurers and brokers. First, the scheme will require at least one international broker with significant market presence to increase demand for the insurance products being offered. Second, primary insurers have to be willing and able to distribute the product. Indeed, they may need some technical support to improve their risk management (including information on actual and potential losses), pricing capacity and underwriting processes.

Finally, any initiative must consider how to involve reinsurers. Even if they do not take financial risks at the inception, reinsurers must have access to the data generated by the scheme to become familiar with its economic fundamentals and potentially comfortable with its risk profile. In the medium to long term, public support would have to focus on riskier segments or tail risks where private reinsurance capacity will not be available. In the short term, involving one or two reinsurers will also be key for creating a demonstration effect for other market participants to follow. In the medium to long term, as reinsurers start taking risk on their balance sheets, they would bring most of the financial leverage.

The insurance solution set up by the Red Cross Disaster Response Emergency Fund (DREF) is a working example of how public money can crowd in private reinsurers. The DREF has worked as a central pot of money, funded by donors, which can be distributed quickly and transparently to support community action in countries facing disasters before or when they hit. Under this new structure, reinsurers provide a backstop for the tail risk of annual crisis response expenditures deviating significantly from historic performance, thus ensuring that the Red Cross is able to scale up its expenditures when unusual risks materialise. Essentially, once the DREF's allocated funding for natural hazards hits €34 million in a given year, the reinsurance is triggered to replenish the DREF's reserves (IFRC 2023).

## **BUILDING AN ECOSYSTEM WITH THE SUPPORT OF THE INTERNATIONAL COMMUNITY**

To operationalise the public-private partnership, an international financial institution may need to serve as a conduit between the public and private actors supporting the initiative. On the public side, donors will require an independent and credible institution to manage their funds and report on their utilisation. Donor finance comes with

stringent financial, environmental and social reporting requirements. Donor funds may come in the form of different instruments, including funded and unfunded guarantees and grants that would need to be blended before they are converted into reinsurance instruments acceptable in the market.

International financial institutions and development banks are familiar with the use of blended finance instruments and benefit from the donors' trust. International financial institutions are generally agnostic about the nationality of private sector beneficiaries and enjoy very high creditworthiness and governance standards. They also seek to promote competition and would, for example, encourage the dissemination of valuable data that could be used by all the market players.

An international financial institution that would undertake the project of establishing a mechanism for channelling donor funds into a war insurance product would have to address several challenges.

### **Blending donor finance into a simple guarantee**

Although donor funds are scarce, they are also diverse. Hence, one of the main challenges to channelling funds will be blending them effectively. Some donors will consider providing support in the form of large unfunded guarantees, while others will consider funded contributions. Leveraging these funds requires transposing the guarantee into an insurance/reinsurance contract.

In theory, this is done by transforming some of the economic characteristics of a risk transfer mechanism to another one. For example, the premiums collected in a reinsurance contract become a cash flow to pay the guarantee fee. In practice, this is done by setting up a dedicated vehicle, a 'transformer', which uses the guarantee as capital to issue reinsurance contracts.

The concept of transforming donor guarantees into PRI products has already been the subject of successful experiments in the insurance industry. One example is the African Energy Guarantee Facility (AEGF). Under the AEGF, the EIB transforms an EU-backed guarantee to support reinsurers of PRI covering energy projects in sub-Saharan Africa, in partnership with a major international reinsurance company. The partner reinsurance company covers the first-loss exposure of the reinsurance portfolio, the EIB guarantees the second loss under the reinsurance portfolio, and losses above the maximum amount of the second loss are covered by the reinsurance company. It is important to note though that PRI does not cover war risk, and the AEGF operates in a market where some private reinsurance capacity for PRI is available (Omoju et al. 2022).

### **Ensuring that any solution is consistent with best regulatory practices**

The main driver for insurers seeking reinsurance is to free capital tied with the risk of underlying policies by transferring it to a reinsurer. This transfer needs to be recognised by the regulator, otherwise the primary insurer receives no capital relief. The regulator will only recognise such a transfer if policies are shared with an accredited reinsurance

company, accounting for its creditworthiness, track record, domiciliation, and general financial health and good governance. In this case, it is particularly important that, in the eyes of the international regulator, the reinsurance contracts issued by the structure benefitting from the international financial institution's backing carry the same value as a reinsurance contract issued by a standard reinsurer.

### **Resource implications**

Channelling donor funding to the reinsurance sector can also be challenging as donor resources come with various strings attached. The supporting international financial institution would need to provide donors with adequate reporting on the project, covering financial, integrity, environmental and social aspects, as well as measures of the impact of the initiative. In practice, the international financial institution may have to operationalise dedicated accounting systems and processes.

### **Adapting to demand**

To be effective, a structure would need to be adaptable to the market needs. One of the key functions of private sector participation is to inform the coordinating international organisation about markets where support is needed the most. In essence, this means that all the initial documentation and structuring decisions must accommodate these future changes, which also need to be discussed with donors.

As development banks would operate outside of their comfort zone and must account for their own limits during such discussions with both sides of the equation, opening this distribution channel or structure may be a lengthy process. The time taken to open this distribution channel adequately, while the situation demands rapid action, is necessary to ensure any initiative will be efficient, sustainable and relevant beyond the end of the conflict.

## **CONCLUSIONS**

With reinsurers avoiding war risk coverage in Ukraine since the start of the war, a significant gap has emerged that local insurance companies are not able to fill.

Faced with similar withdrawals by reinsurers after previous crises, especially after the 11 September 2001 attacks, other countries set up government-backed pools to crowd the reinsurers back in, but also offered a backstop in case losses exceeded a certain amount. In Ukraine, replicating such sovereign-backed structures would be difficult at this stage due to the fiscal position and broader uncertainty. The Ukrainian authorities are pursuing efforts to develop a state agency facilitating the provision of war insurance (NBU 2024). But this is likely to materialise and reach scale over a longer time frame once the country is able to re-establish the fiscal buffers and investor confidence that it needs.

Therefore, a public-private structure coordinated by a trustworthy and financially credible international agency could be established in the interim to offer war insurance products for trade facilitation and, over time, other segments of the economy, including capital investments.

International public support would bring the seed capital needed to attract private partners. The latter would be in charge of distributing the policies in a unique and complex market and bringing additional resources to create a leverage effect over time. Planning the long-term coordination of this partnership would be a time- and resource-consuming process, which should result in stable, flexible and long-term support for the Ukrainian economy.

Mobilising the private sector means that the full ecosystem or value chain of the risk transfer is included: the insurer, the reinsurer and the broker. Reopening the reinsurance market for war risk would not only allow the insurers to sell this product, it would also maintain the relationship between insurers and reinsurers, and make the latter more comfortable providing capacity for traditional risks.

Establishing a market-based mechanism that operates through reinsurers and insurers, instead of insuring assets directly, would increase the likelihood that the solution becomes self-sustaining and is able to leverage scarce public resources over time, offering significant additional capacity to help the Ukrainian economy through reconstruction and recovery.

# EU accession: Conditions and prospects

## EU ACCESSION: BASIC SETTING

In the week after Russia's full-scale invasion of Ukraine on 24 February 2022, Ukraine submitted a formal application to join the EU. On 17 June 2022, the European Commission issued Opinions where it set the conditions and steps that Ukraine (as well as Georgia and Moldova, two other applicants) should fulfil and follow before the opening of a formal accession negotiation process. The Opinions on Ukraine recommended the granting of candidate status 'on the understanding' that the enumerated conditions would be met. On 23-24 June 2022, the European Council confirmed the European Commission's recommendations both in terms of required steps and the granting of candidate status.

Importantly, the conditions imposed by the European Commission are restricted mainly to political fundamentals, to the exclusion of economic issues, in line with the current EU practice of making political priorities a prerequisite in the accession process. But all three countries have already made significant progress in many economic chapters within the implementation of the deep and comprehensive free trade areas (DCFTAs) in their association agreements with the EU (Emerson et al. 2023). In addition, it remains the case that any country wishing to become an EU member has to uphold the general obligations of membership, i.e. the full body of EU law as expressed in the Treaty, secondary legislation and the EU's policies – what is known as the *acquis* of the EU (European Commission 2023a). This requirement clearly refers to all subject matters of the EU, including economic and financial ones.

Following the European Commission Opinions in June 2022, Ukraine put in place extensive actions towards fulfilment of the required conditions, in particular concerning the fundamental and political rule of law criteria for membership, and the economic conditions. In November 2023, the European Commission issued a report within the 2023 Communication on EU enlargement policy, where it monitored the progress relative to the conditions set in June 2022. Following this report, the European Council decided formally in December 2023 to open the process of Ukraine's accession to the EU.

Ukraine's EU accession path also embeds the process of the country's recovery, reconstruction and reform once the war ends. To support this process and ensure the required investments, the European Commission, together with Ukraine and G7 partners, established the multi-agency donor coordination platform following a decision

of G7 leaders in December 2022. The platform's mandate is to coordinate support for Ukraine's immediate financing needs and future economic recovery and reconstruction across different sources and established instruments for financing, complementing existing tracks (e.g. the G7 finance track, the G7 coordination group on energy infrastructure, and the coordination group of international financial institutions).

Also in June 2023, the European Commission proposed a dedicated medium-term financing instrument that will provide Ukraine with coherent, predictable and flexible support for the period 2024-27. The new Ukraine Facility will support efforts to sustain macro-financial stability and promote recovery. The Facility is to be endowed with €50 billion in grants and loans.

### **The seven steps required for Ukraine accession: The state of play as of November 2023**

The European Commission Opinion issued in June 2022 contained a large set of conditions for Ukraine's access to the EU, as complemented by the analytical report on the *acquis* alignment of Ukraine in February 2023. The seven conditions imposed for Ukraine can be split into political and technical categories. The former includes conditions related to judicial reforms, the fight against corruption and anti-oligarchic law, where decisions require strong political will to overcome vested interests. The latter covers conditions requiring implementation of EU and international best practices to Ukrainian norms (Emerson et al. 2023).

**TABLE 9.1 STATE-OF-PLAY OF UKRAINE'S ACCESSION PROCESS AS OF NOVEMBER 2023, RELATIVE TO THE STEPS REQUIRED IN THE EUROPEAN COMMISSION OPINION IN JUNE 2022**

<b>Steps</b>	<b>Status as of February 2024</b>	<b>Main actions still required</b>
1. Reform of the Constitutional Court	Completed	-
2. Justice system reform	Completed	-
3. Anti-corruption	More to be done	Increase staff of the National Anti-corruption Bureau of Ukraine (NABU) and improve verification powers of the National Agency on Corruption and Prevention (NACP)
4. Anti-money laundering and law enforcement sector reform	Completed	-
5. De-oligarchisation	Completed	-
6. Media environment	Completed	-
7. National minorities	Completed	-

Table 9.1 summarises the seven steps required by the European Commission in its Opinion in June 2022, with the relative advancement as evaluated in the European Commission report in November 2023. It has to be emphasised that the adoption of a particular rule is not the same as its implementation. The latter, however, is what matters. Civil society (and the EU) need to pay attention to implementation speed after the adoption of rules.

### **A functioning market economy and the EU *acquis***

While the conditions required by the European Commission mostly concern political fundamentals and the rule of law, in line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union. In turn, this requires well-functioning and stable financial institutions (banks, insurance companies, pension funds, investment services, exchanges, etc.) as well as fair competition among them. To ensure these conditions, proper rules on the authorisation, operation and supervisions of these institutions should be introduced (European Commission 2023b).

Concerning the banking sector, in recent years the NBU has taken numerous steps in the direction of ensuring a stable and competitive banking sector, despite the Russian invasion. In particular, the NBU has incorporated the main recommendations of the Basel Committee on Banking Supervision and of the European Systemic Risk Board, as well as the main provisions contained in the EU Banking Capital Requirements Regulation (CRR) and the Capital Requirement Directive (CRD), into Ukraine laws. Thanks to these initiatives, Ukraine has made some progress in implementing the *acquis* on corporate governance in banks, conducting risk-based supervision of banks and introducing legislation to promote sustainable and digital finance (European Commission 2023b).

Currently, the NBU is in the process of implementing the provisions of the CRD and the CRR within a comprehensive roadmap to be completed in 2025 (European Commission 2023a). This should ensure alignment with the EU *acquis*. To the same end, in the coming year Ukraine should in particular prepare an AQR of the banking sector to be better positioned to deal with increasing NPLs. In addition, it should continue efforts to align with the EU *acquis* related to bank resolution and deposit insurance.

All in all, given the importance of a well-functioning financial sector in transition economies (Berglöf and Bolton 2002), Ukraine should aim to meet the requirements of the EU's banking union, even before joining the euro area. This would provide a roadmap for policymakers, in terms of making use of the European Single Rulebook, adopting all adequate provisions for capital requirements, deposit insurance schemes and resolution

schemes as foreseen in the Bank Recovery and Resolution Directive (BRRD) I and II. Importantly, not only would it provide a roadmap, but it would also shift some of the burden away from the Ukrainian regulators and supervisors, as they could follow already well-defined regulatory frameworks.

## THE EU ACCESSION PROCESS AND THE RECOMMENDATIONS IN THIS REPORT

Here, we look at the recommendations in this report through the lens of the EU accession process. The ultimate goal of EU membership creates a strong pull effect in Ukraine, as far as regulatory reform is concerned. The intended structural alignment with regulatory and other EU standards of doing business will increasingly shape the reform debate in Ukraine. To put it differently, reform proposals of all sorts will be screened by local and foreign authorities according to their fit with the list of accession conditions formulated by the European Commission.

The list of accession conditions, its elements, ordering and timeline are not set in stone. Instead, there are likely to be adjustments over time, depending on inherited structures and current conditions. Therefore, the reform agenda cuts both ways: conditions that are stipulated in the accession documents will influence the reform agenda in Ukraine; and conversely, reform items that are strongly desired by Ukraine may shape the list of accession conditions.

Thus, even if some elements of the list of reform proposals discussed in this report would fall outside the current version of the accession requirements list, they may enter at a later stage of the process – in particular, if the Ukrainian side pushes for it and can offer a plausible economic or governance-related justification.

We offer an assessment of the proposals in this report in light of the existing accession documents. As far as the financial sector is concerned, these documents call for the alignment of the legal and institutional structure in several areas (see European Commission 2023a, 2023b for details):

- Strengthening the basic institutional framework for a market-based economy – rule of law, business and insolvency law, competition law, and the Financial Action Task Force (FATF) agenda on money laundering and terrorism finance.
- Strengthening corporate governance at the bank level – a non-state ownership model, shareholder engagement, disclosure, and competition.
- Strengthening financial stability in banking and capital markets – regulation and capital standards, supervision, and resolution.

These conditions may all be grouped under a single headline: ‘alignment with EU *acquis*’, where the term *acquis* stands for the accumulated regulatory and institutional architecture that has been developed and implemented in the EU over the past 40 years. Several of those rules have emerged as a response to contemporaneous crises; others reflect the attempt to create, or to extend, a common internal financial market that deserves the name.

Looking at the accession conditions in more detail, we find that the long wish-list of reform proposals (as in European Commission 2023a) is for the most part highly compatible with the proposals made in this report. We will explain this congruence in the subsequent section, invoking the three areas of reform emerging from the EU accession documents: the institutional framework; corporate governance and market-based allocation; and the regulatory and supervisory regime.

### **The institutional framework**

The European Commission’s working documents on Ukraine’s accession (European Commission 2023a, 2023b) emphasise other aspects that during the accession process have to be fulfilled. Among them is the need to strengthen the general framework of a market-based economy – for example, the rule of law in general, insolvency law in particular, as well as the FATF agenda of money laundering, terrorism finance and corruption. Some of these items can also be directly or indirectly addressed by granting a stronger role to the supervisor, particularly if there is voluntary subsumption under European supervisory standards, for example, by a formal agreement with the SSM that grants rights of inspection and sanctioning to a European supervisory agency.

The main proposals in this report relate to building trust in Ukraine’s financial system, particularly in its capacity to allocate funds for reconstruction efficiently and reliably. To that end, we propose to strengthen the role of two existing institutions and to create a new one. The existing ones are the international platform for donor coordination and the domestic council for reform planning. The new institution, the Ukraine Development Bank, is intended to serve as a channel for financial funds flowing to Ukraine, and for the allocation of funds within Ukraine.

An institution like the UDB can be pivotal in achieving the strategic goals of the EU accession process, namely, enabling Ukraine to achieve economic strength and finding a path to increasing productivity, growth and, ultimately, wealth within the competitive landscape of the EU’s internal market.

The particular design of these institutional innovations resonates with the historical uniqueness of Ukraine accession, which is both triggered, and expedited, by the war and its ever-larger economic and physical destruction. Ukraine’s war-torn economy requires significant transfer payments to rebuild the economy and its infrastructure. That is why the establishment of strong, high-level institutions that will coordinate international

efforts, ensure efficient project coordination within Ukraine, and allow mobilised funds to be channelled effectively and subject to market rules to the Ukrainian end-user are, in our view, essential to overcome the critical economic situation in which the country finds itself.

To facilitate channelling of funds, we have proposed in this report to complement Ukraine's financial architecture, helping to master the massive restructuring effort that lies ahead. The idea is to establish three institutional pillars for multi-country, large-scale restructuring and development efforts: the Ukraine Development Platform for donor coordination; the National Reconstruction and Reform Council for unified reform process planning; and the Ukraine Development Bank for connecting international capital and domestic investment projects via the banking system.

The first two institutions extend the work of already existing establishments, building on the institutional set-ups they have produced. They were known under the names of the Ukraine Reform Council and the multi-agency donor coordination platform. The role we suggest for these institutions refers to an extended inclusiveness, giving voice to donors beyond the G7 circle. Both institutions would let Ukraine take ownership of the ensuing post-war reconstruction process in a more efficient and more balanced way. The process would be more efficient because the negative consequences of donor competition can be avoided, and complementarities in overall project planning can be exploited more fully and more consciously. The process would also be more balanced because there is a more straightforward way to discuss and settle issues of joint interest for donor countries and the Ukrainian government.

The third institution, the UDB, has to be newly created as there is no existing institution that could reasonably take over the catalytic role intended for it to play. Its role consists of contributing importantly to the funding side of rebuilding Ukraine – mobilising funds at the national and international level, and pooling, distributing and monitoring those funds. Moreover, the UDB will assist in implementing other parts of the financial sector reform agenda, relating to governance reform at the bank level.

The proposed set of institutions depicted in Figure 3.4 in Chapter 3 contribute in more than one way to fulfilment of the EU accession agenda. Importantly, the FATF agenda, including money laundering and terrorism finance, requires financial flows to be recognised and followed up over time. These disclosure-related issues are greatly enhanced if financial flows happen in a well-defined channel, with specified reporting obligations.

Moreover, the UDB's role as a co-financier of funds that are allocated via the tier-1 banking system, one of the main activities that the UDB will carry out once established, will extend transparency of the eventual use of funds even further in the future. Together with the bank's role in reforming the ownership and governance of today's large state-owned banks, it will strengthen market-based allocation of capital throughout the Ukrainian economy.

Lastly, the co-financing role of the UDB will enhance banks' ability to lend to riskier projects without sacrificing a desired minimum level of financial stability. Both aspects – increased risk-taking at the portfolio level, and extended caution at the level of individual loans – are consistent with an emphasis on financial stability and good corporate governance, expressed at some length in the EU accession document.

The proposed institutional innovations will together contribute to the design and implementation of financial sector reform that appears to be necessary for the accession process. In this formulation, the UDB represents the institution with active business relations with Ukraine's tier-1 banking sector, suggesting a key role in the reform process.

### **Corporate governance and market-based allocation**

We have addressed issues of corporate governance in several chapters of this report. In the chapter on banking (Chapter 4) the emphasis is on the institutional viability of individual banks, and how to provide incentives for banks to orient their portfolio towards rebuilding and developing industry and business in Ukraine. Fully accounting for NPLs and shifting away from a role as financier of government are two policy directions that resonate positively with bank privatisation – suggesting a policy of adequate capital ratios and sustainable business models. These policies are closely related to the EU *acquis* of bank regulation and market development. It should be emphasised that a positive restructuring opportunity emerges from the NPL problem in Ukraine: a *necessary* measure, i.e. the recapitalisation of undercapitalised banks, can be combined elegantly with a widely *desired* measure, i.e. the reshaping of the ownership structure of the national banking system.

Examples of governance-related topics in the accession agenda are annual financial statements and disclosure of company reports, including statutory audits; improving corporate governance of banks; strengthening of ownership rights and encouragement of long-term engagement of shareholders; pro-active competition policy; and strict limits on state aid transfer payments. All of these topics are consistent with, and some are directly reflected in, the measures on banking reform outlined in this report.

With a recapitalisation process as suggested in Chapter 4, and a subsequent privatisation of large and state-owned banks, the corporate governance of banks will be significantly altered, depending on the privatisation strategy adopted. The details of an upcoming privatisation process may be discussed and developed by an expert team together with the institution managing the ownership stakes. The latter may be a temporary subsidiary of the UDB. These bank ownership stakes are acquired in the course of the recapitalisation process; their sale is supposed to happen over a defined period.

After privatisation, the banking market in Ukraine will look quite different from today. The share of state-owned banks will decrease significantly, there may be more diversity in terms of ownership structures and business models (stock corporations, coops, regional banks, universal and specialised banks, such as property financiers), and there may be more competition. All of these aspects may strengthen the market-based approach to banking reform, as desired for the EU accession.

Following the war, there is likely to be a more important role for mortgage finance in Ukraine, both in housing and commercial property. We have suggested a number of reforms and improvements in Ukraine's property finance that would help to lower the private cost of building to a level consistent with a significant volume of building activity throughout the country. Given current uncertainties, an acceleration in building investment will require significant amounts of subsidy or state aid, which could be an element in a broader scheme of war insurance.

### **The regulatory and supervisory system**

When speaking about financial services, the EU accession documents refer to general characteristics of a sound banking system, including the stability of institutions, the presence of competent supervision and the gradual transition to a regulatory regime compatible with EU standards. These standards include the supervisory side and, as a consequence, the ability to resolve banks that are insolvent, even if they are systemically relevant.

Several of the proposals in this report go in a similar direction and can therefore be interpreted as steps towards EU accession. To give a few examples: we propose to carry out a broad asset quality review at all major banks, and use the outcome as the basis for deciding on NPL offloading and recapitalisation. This will help to free existing banks from legacy losses and offer simultaneously fresh funds to re-engage in lending for corporate reconstruction and development.

Moreover, the counterpart claims to the recapitalisation operations should be re-sold to a more general public, thereby achieving a privatisation of the respective banks. The emerging banking architecture would go some way towards the desired competitive banking market in the EU accession documents. At the same time, newly privatised banks are supposed to have trusted and effective governance models, and build up bail-inable debt capital, thereby fulfilling another demand expressed in the EU documents, namely, alignment with EU capital requirement rules.

Similarly, several macroprudential instruments mentioned in the chapter of this report on mortgages (Chapter 7) contribute to financial stability, such as the use of mandatory limits on debt relative to collateral value (loan-to-value ratios) and to disposable income of borrowers (debt-to-income limits).

Finally, supervision and regulation play an important role in the EU accession documents. A strong and credible banking and market oversight regime will be an important element of the accession evaluation. As noted above, an experienced supervisor with no legacy commitment in Ukraine may well be a valuable, self-imposed commitment to abiding by international standards of supervision and, importantly, resolution of failed institutions. International experience suggests that foreign involvement, like by the SSM, can increase the credibility of the supervisory process, thereby increasing its real value.

*Mutatis mutandis*, similar thoughts apply for the development of capital markets, which we also discuss in this report (in Chapter 6) and which plays an equally important role in the accession documents. All in all, most if not all of the reform proposals described in this report count positively towards fulfilment of the accession conditions. This should imply tailwinds for our proposals.

### **A FINAL NOTE**

The debate about EU enlargement is taking place at a crucial moment of transition in the whole of the international system. Many people are worried that the world is segmenting into competing and hostile trading blocs. The vision of European integration underlying the European Economic Community and then the EU always included cooperation that was not just restricted to a small group of countries – the original six members. Instead, each wave of enlargement would bring a new emphasis, and substantial gains as well as transition costs. It was also a peace project, and a project about overcoming the legacy of war and dictatorship.

When the European Coal and Steel Community was created, only seven years had passed since the devastating conflicts and betrayals of WWII. All the original member states had been invaded and/or defeated, and their elites discredited. The enlargements of the 1980s, with Greece and then Portugal and Spain joining, involved countries that had only very recently emerged from military dictatorships. The EU enlargements of the 2000s brought former centrally planned economies out of the Soviet-dominated eastern bloc.

All of the new members brought a new dynamism, but one which some people in existing member states found uncomfortable. French wine farmers worried about the competition of Spanish growers, in much the same way as Polish and French farmers today are concerned about Ukrainian grain exports. German companies worried about competition from cheaper wage economies in Central and Eastern Europe. But the fact of new competition also brought new possibilities, including the integration of the new member states into value and production chains.

Today, the same sense of possibility will come through the need to redesign financial systems – including supervision and regulation – to support greater effectiveness, and to emphasise improving and extending the operation of the capital market. Countries like Ukraine, which need considerable reforms, can offer a blueprint of how to leapfrog stages of development, and avoid inefficiencies and inequities that have over time crept into existing mechanisms. There are advances in e-government, but also in electronic and AI applications in finance, where Ukrainians offer a pioneering model.

Currently, some Europeans are worried and disillusioned, subject to disinformation and fake news, and some are sceptical about whether democracy works and can produce results. They need to be reassured. It is precisely the heroism of Ukrainians that can offer a positive model of the centrality of freedom and democratic values.

At present, in consequence, a profound rethinking about Europe and its meaning is underway, not least because of fears about what may change in the international position of the US after the presidential election of November 2024. Whatever happens, Europe will have to spend more on its security, and to spend more in a coordinated way. By 2024, European countries have realised that they too are vulnerable, and that Ukraine is fighting a proxy war for them – especially for Danes, Estonians, Finns, Latvians, Lithuanians, Poles, Romanians and Swedes. Some non-members of the EU – Moldovans and Norwegians, as well as the UK – also saw the terrifying extent of their vulnerability.

One of the most dramatic transitions has occurred in Germany. Soon after 24 February 2022, Chancellor Olaf Scholz proclaimed a new age, a *Zeitenwende*, in which Germany would be obliged to take a more resolute position in defence of both German and European security. Since then, the German path has been bumpy. There were hesitations and fears about sending more than the military helmets that the Germans rather feebly initially offered to Ukraine. There was an insistence that Europe and the US should move together. The tank deal was a massive change, with Germans overcoming a historically grounded fear of using force in international relations (with the Panzer, the tank, occupying a powerful symbolic role as the Nazi instrument of conquest) and a historical sense of guilt towards Russia (even though, as many Ukrainian historians have pointed out, a large part of the victims of Nazi aggression were Ukrainians). But this is only the beginning of a process of recognition of how a common defence and security system needs effective economic integration – for example, in the design, development and production of military equipment – that had been substantially lacking in the European past.

In this sense, Europeans should draw on lessons that were applied in the very early stages of European integration, in the immediate aftermath of the destructive conflict of World War II. Envisaged as the path to a generalised and global prosperity, the Marshall Plan was not directed at one specific country. It was also running in parallel with the creation of new general agencies, such as the United Nations Relief and Rehabilitation Administration (UNRRA), and indeed with the Bretton Woods institutions.

As it is, Western engagement in and support for Ukraine are often contrasted unfavourably with the absence of effective support for democracy and against Putin's agents in Syria and in Africa, and there is an accusation of Western one-sidedness or hypocrisy. There is thus a strong case for building a general programme for the management of post-conflict societies, rather than a special Ukraine-oriented effort.

A reconstruction project in Ukraine will not work if the money is seen as a way simply of advancing a narrowly focused agenda of donor countries. It also needs to avoid any impression of teaching or preachiness. There is no need to teach Ukrainians lessons about democracy and democratic values. On the contrary, Ukraine has a great deal to teach Europeans in this respect – to help Europeans to recreate the value of the project on which they have been engaged since their own cataclysmic conflict.

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It is now over two years since Russia launched its brutal full-scale invasion of Ukraine. Ever since those early days, a broad network of CEPR economists has been working intensively with colleagues in Ukraine and across the international research and policy communities to explore how to tackle the big economic challenges of the war and how to plan for the country's post-war reconstruction.

This report, the latest contribution to the pressing debates surrounding Ukraine's future, addresses a major precondition for the country's reconstruction and development: a healthy and widely trusted financial system. The team of authors – which combines leading Ukrainian economists with experts from CEPR's Research Policy Network on “European Financial Architecture” – starts from the status quo of Ukraine's banking and capital market, and suggests policy options for improving effectiveness and increasing international trust in the system.

Key messages relate to institution-building: a National Reconstruction and Reform Council should develop and communicate a broadly shared vision for reconstruction, strive for agreement on the reform agenda and monitor its implementation; a Ukraine Development Bank could leverage the capacity of existing banks in the country's reconstruction and ambition to build back better; and a Ukraine Development Platform would be a multilateral venture, with strong Ukrainian ownership, that is dedicated to strategic planning and donor coordination relating to the reconstruction effort during and after the war.

Further reforms would focus on the recapitalisation and subsequent privatisation of banks, the liberation of bank assets for lending purposes, and the future role of capital and housing markets. The policy options described in this report draw on historical experiences in other countries, aiming for a sea change in Ukraine's attractiveness for international investors, both public and private.

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