

Giving Ukrainian Capital Markets New Options

USAID Capital Markets Project expert John Crowley proposes innovative ways to energize investment opportunities – in particular concerning potential pension capital – in Ukraine. He recently led a round-table discussion with Ukrainian regulators, market professionals, and financial authorities about the possibility of introducing new financial instruments into the market. This would broaden the Ukrainian capital markets at a crucial moment, ahead of possible implementation of pillar II of the reformed pension system which would bring billions of hryvnyas in investment-hungry capital to the market.

John Crowley is currently working for the Capital Markets Project, a five-year program designed to assist Ukraine in developing an effective and transparent financial sector, supported by the United States Agency for International Development (USAID). Crowley's scope of work includes developing new financial instruments for the Ukrainian financial market and advising on the establishment of a single Depository. Crowley has been working in capital markets since 1978, and has witnessed major global events – the crisis of 1987-88, as well as the emergence of post-Soviet Eastern European companies on leading world stock exchanges. Working in the London city, "doing" emerging markets in the nineties, Crowley was on of the architects of the privatization of Russian Sviazinvest, and major projects in Serbia and Pakistan. In Ukraine, John organized the financing of "Life" in 2003. John retired last year after successfully raising 3.2 billion dollars in financing for a company listed on the New York Stock Exchange. He first contributed to a USAID project in 2004 and joined USAID Capital Markets Project earlier this year to consult on a financial instruments development program.

Q: Recently talk has been mainly about investors leaving the Ukrainian capital markets...But you say that actually Ukraine may face yet another challenge: that its markets may eventually not be big enough for potential investment. Why is that?

If pension reform is taken one step further, as is the plan through the introduction of the pillar II accumulation system, this will mean that a lot of retirement funds will be looking to place billions in retirement contributions on the market.. And it has become clear that domestic markets aren't really big enough to handle such large investments. The equity market is really small. The estimated free float on the PFTS is only about 15,5 billion UAH which is very small in itself and the size of the domestic fixed income market is also very small. Hryvna-denominated government bonds represent only about 8 billion and the domestic corporate bond market is only about 54 billion. So my view is there just simply is not enough "depth" in the market for an investor to take the plunge. An additional point I want to make is that obviously you don't invest with the intention of it being a permanent placement: you want to get your money out at some point. And, as a rule, it's even more difficult to get your money out, than it is to get it in. So investors usually have an exit strategy before they invest in a market. The problem with investing in Ukraine is that the exit strategy is quite questionable because of the market's small size, making it very un-liquid – in other words it'll be hard to sell your shares, making a potential investor all that much more nervous about placements.

Q: How does the high inflation rate in Ukrainian affect potential investors and their decisions?

Indeed, the structures of the specific investments that are available in Ukraine aren't very suitable for a long-term investor, because of the inflation-linked risk. In a highly inflationary economy, you can't consider a fixed income investment because the nominal yields do not reward you for taking inflation risks. Inflation is running at 23% while the typical corporate bond pays 20%, and government bonds even less. Also, when considering placements in an inflationary market, investors try to place their capital in equities of companies that are able to adapt their earnings to inflation. This means that companies need to be able to raise the prices on their products, ideally faster than inflation. You're not going to invest in a company where there is a structural impediment to earning a decent amount of money. But look at Ukraine - the energy companies are highly regulated, the gas companies that are highly regulated, they cannot set their prices at will. Also it is difficult to get good research about anything but top tier companies – a lack of information that worries the investor even further, especially if he's looking to set up a broad portfolio.

Q: So you have developed several new approaches that you believe could help lessen these difficulties?

On the fixed income end, the Government is putting out bonds at less than 15%. So what we propose is to issue inflation-linked bonds. The bonds would be adjusted on probably an annual basis. This is how it works: inflation being 23% this year, on a thousand hryvna bond at the end of the year, you would have a 1230 hryvnya bond. In other word, you don't lose to inflation. The Ministry of Finance argues that this type of security would become very expensive for them. But the argument that I make is that the inflation rate is there, regardless. You can't make it go away. In other words, whether or not inflation is taken into the equation of the bonds, someone will have to take the inflation risk on the bonds market. Currently this risk is being passed on to the investors. So the natural response of the investors is to want a very high rate of return. If they believe that inflation will be at 23%, they'd want at least a 25% rate of return.

Q: Some leading Ukrainian investment bankers have even said that foreign clients would want a rate of return of even 50%....

That's because when an investor decides to take the risk of inflation, he will calculate his risk assuming the worst. Let me explain: if you're going to the investor, a three-year bond and inflation already looks like it's running at 23%, he's going to assume the worst. The investor is going to have to assume that inflation is going to continue to go up, and will not take a 25% yield, he'll want it to be substantially higher. Not because the

investor's greedy but because he's thinking that inflation is going to get worse. That's why I believe is that it's probably in the Government's interest to take the risk, instead of trying to convince the investors' of taking it. As the Government, you have to believe that the reality can't be as bad as other people think. And that if anyone is in the position to do anything about inflation, it's the Government, right?

Q: How does an inflation-adjusted bond work exactly? Would it completely balance out inflation-linked risks for the investor?

There are two ways of linking the bond to inflation: either the coupon rate would be just one or two per cent above inflation, or alternatively adjusting the principal balance every year by the inflation rate. That way, like I said, on a 1000 hryvna face value bond, the investor will have 1230 at the end of the year with inflation at 23% on which he will be paid some small percentage. In this way the inflation risk is substantially taken away from the investor, substantially muted, though never completely eliminated. A risk can never be completely eliminated, as the past year and a half has shown. In the case of inflation-linked bonds the risk is reduced but not eliminated. The investor doesn't take the inflation risk, but indirectly still does because if the bonds really grow a lot due to very high inflation, the Government can end up not being able to pay them. But there is no other way to avoid the inflation risk when you're investing in this country.

Q: What about adjusting the bond to a currency like the dollar or the euro?

A lot of people have said that adjusting bonds to a certain currency would have the same effect as an inflation-linked bond. I disagree: if you have currency-linked bonds instead of inflation-linked bonds, then you would be vulnerable to the inflation in the economy whose currency you have linked the bonds to. Especially in emerging markets, people have a tendency to assume that the dollar is a stable currency....but it isn't always! What if you have denominated your bonds in US dollars and there is high inflation in the US? There is no inflation in the United States right now, but if you buy a long maturity bond....as soon as we get through the present crisis, we will have high inflation in the United States, I'm pretty sure of that.

Q: You are also suggesting another new strategy in order to make investing in Ukrainian capital markets more attractive...

I'd like to suggest ways to lift certain limitations on investments abroad. Non-state pension funds are not allowed to invest more than 20% of their investment capital outside Ukraine. This is a problem, I will explain. Ukrainians are denied to right to invest their retirement savings in 99.4% of what is on offer in the world. 99.4% of what I am allowed to buy into for my pension as a foreigner, Ukrainians are not allowed to place their pension money into. I'm not necessarily suggesting to lift these caps permanently. I'm suggesting some transition period, 5 years maybe during which investments into foreign markets by Ukrainian pension funds would be allowed. Later the money invested abroad is going to flow back to Ukraine anyway. Once things get better here, investors will be thinking: why invest in the EU where growth is around 2%, when in Ukraine growth will be back to 7 or 9%?

Q: But the cap on investment imposed by the Ukrainian government is also meant to stem capital flight.

If the Pillar II in the reformed pension system goes into effect, in other words that everyone under 40 will pay into individual accumulation accounts for the money to be placed on capital markets, then that would represent 20 billion hryvnias of pension contributions that need to be placed. And there is no way that you can put 20 billion hryvnias responsibly into the Ukrainian capital markets. Even if in the end it's not 20 billion but less, there is a problem. The total trade on the PFTS so far this year has been only about 12 billion hryvnias and the total trading on PFTS in corporate bonds has been about 20 billion hryvnias! So you have a situation where the pension funds would buy up everything available on the market, which would be a disaster. So my suggestion is the following: to create a closed end fund to issue Global Depository Receipts. This would address both concerns: placing pension contributions and keeping capital flight in check.

Q: How does such a fund work? What are the advantages?

The pension funds would pay money into this fund that would then be converted into dollars. The closed-end fund then buys 3 billion worth of the Dow Jones Industrial Index. Then the receipts of these acquisitions would be traded here in Ukraine, in hryvnias. So the amount of capital flight would be capped but the securities would be highly liquid. Why am I suggesting a closed end fund? Because of the controversial nature of this proposal: the Government is worried about capital flight and a closed end fund is more controllable. And you would attach a feature to it that the underlying investment could be liquidated: this is because closed end funds usually always trade below their net asset value. If there are 3 billion hryvnias invested in the Dow Jones Industrial, on the secondary market in might trade for 2.4 billion hryvnias, the real value and the trade value don't necessarily coincide because in a closed end fund you can't get your money out easily. So I'm suggesting is a feature where the investor has the right to take back his share out of the fund without penalty.

Q: But there exists an underlying ideological or political argument speaking against investments abroad: many view investments abroad as capital that should rightfully stay in Ukraine to help capital hungry Ukrainian companies develop. Why not keep it from going abroad if the money is needed domestically?

A good example in a Western situation is to say that the state of Michigan needs money right now because of the car industry's troubles. So we're going to tell every retiree in the US to invest in the auto industry? It's not appropriate. If the Government wants to subsidize a certain industry, then it can do that, of course, but shouldn't make the population subsidize with its retirement savings. In other words, if you think you should be investing in Ukrainian cars, make the Ukrainian cars better and attractive to investors. Same thing for capital markets: make Ukrainian investments more attractive, liquid, and high-yielding! //