

**THE WORLD BANK**

**PROVISION OF VOLUNTARY PRIVATE PENSION SCHEMES IN UKRAINE:  
REVIEW AND RECOMMENDATIONS**

**March 2008**

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The World Bank wishes to thank all participants from the side of Ukrainian authorities and industry who attend meetings and provided valuable comments at the basis of earlier versions of this report.

## Executive Summary

- **The voluntary pension provision industry is at its early stage of development in Ukraine. Assets under management in non-state pension funds (NSPFs) are growing fast but they still represent a minor part of the financial system. During the last two years of operations, substantial experience has been accumulated. Regulatory improvements need to be built upon this experience in order to enable future growth of voluntary schemes for the benefit of Ukrainian people.**
- **Fast entry to the market was associated with some new NSPFs which attracted members and disregarded financial contributions. While this is not necessarily bad to the extent that it helps to promote a new financial product, regulators may wish to understand this business model better in order to estimate potential risks associated with it. The practice of having funds with a mass of members and close to zero assets under management is not known in other countries.**
- **The regulation of the conflict of interest is well designed in the law in Ukraine except in relation to parties affiliated to founders of NSPFs. NSPFs can invest in securities issued by such entities without limits. Regulators should perform a thorough investigation in order to understand in detail which (if any) NSPFs invest in such securities. The very next regulatory change initiative should be used to propose a limit to such investment. As regards to enforcement of the law the World Bank is not convinced that there are sufficient regulatory powers to trace the ultimate controllers of asset managers, administrators, custodians and founders and to disclose the conflict of interest. Enhancing capacities to trace the ultimate controllers and reveal / prevent conflicts of interest should be a priority for regulators.**
- **The achievement of optimum risk-return combinations in NSPFs portfolios for the benefit of members of NSPFs is limited due to underdeveloped capital markets in Ukraine. Carrying out a capital market development program by the Ukrainian government would provide significant benefits for members of voluntary pension schemes who represent 0.5% of the Ukrainian population at present with a strong potential to grow. For that reason the Government should recognize the importance of the voluntary pension provision industry and initiate/coordinate regulatory advancements proposed here as a part of a broader capital markets development program.**
- **Such a program should start from developing markets for government debt instruments. Government debt instruments are practically absent from the market, so NSPFs – which may invest up to 50% of their portfolio in such instruments – look for alternative investments, which are of lower quality. This problem is aggravated further because foreign exchange regulation prevents NSPFs' cross-border investment in safer instruments listed in**

- Besides corporate bonds, the asset class of “other assets” has most probably benefited from the aforementioned forced investment into lower quality instruments. The definition of other assets eligible for investment is very wide and for that reason regulators should inspect thoroughly what type of assets are invested in this class. Regulators should allow investment only in the assets where valuation methods can be applied consistently across funds. Any class of assets for which this condition cannot be met should not be allowed for investment.
- Portfolio management can also be improved by: (a) allowing investment in derivatives for hedging purposes only, (b) introducing general risk management provisions in the Law, and (c) introducing limits to shares a Fund can take in equity and / or individual securities issue of individual issuer. The latter serves two purposes. Firstly, it prevents the transformation of NSPF as an institutional investor into a direct investor. Secondly, it prevents “cornering the market”. The problem of cornering the market is not alarming at the moment due to the small size of NSPFs.
- Monitoring of investment limits should be done more frequently and on the basis of monthly averages. The present practice of end quarter point-checks should be substituted for more frequent checks which would enable averaging approach to the enforcement of investment limits.
- Voluntary pension schemes are facing non-transparent competition from the side of public sector sponsored schemes, the insurance industry and banks. Non-transparent competition reduces the abilities of Ukrainian people to make a free and informed choice of the pension scheme. Such a choice should be based on understanding of benefits, such as: (a) the isolation of pension assets from bankruptcy, (b) the ability of asset managers to generate returns at desired level of risk and (c) flexibility to change the scheme according to personal preferences. In order to create a level playing field for voluntary pension provision the following actions should be taken: (a) a gradual transformation of the Arkada Bank Kyivmiskbud Experiment should be performed in order to adjust the characteristics of this pension scheme with the requirements of the *Law of Ukraine on Non-State Pension Provisions*; (b) public sector entities should give up launching special schemes such as schemes for central bank staff and/or schemes for public sector employees (that is, such schemes should be designed according to the *Law of Ukraine on*

- **Market transparency has been very weak in Ukraine. As the first two steps, all major players in the industry should begin to implement IFRS. Information prospectuses for NSPFs should also be introduced.**
- **The introduction of IFRS and information prospectuses are necessary but not sufficient measures to deal with the most pressing problem of infrequent and imprecise asset valuation and absence of reliable unit value calculations. A number of additional remedial measures are required to solve these problems, such as:**
  - **technical solutions for valuations in illiquid markets should be implemented immediately,**
  - **rules on the distribution of profits and losses to members' accounts should be implemented immediately,**
  - **daily calculations of pension unit values should be implemented as soon as possible,**
  - **a stronger role of custodians in valuation and monitoring should be implemented immediately.**
- **Resources for on-site inspections and horizontal cooperation between regulatory agencies should be significantly expanded in parallel with the enhancement of regulators' powers to deal with the conflict of interest in an efficient way.**

## Background

1.

**The voluntary private pension scheme is at its initial stage of development in Ukraine.** As of end September 2007 total assets under management in the pension schemes (non state pension funds – NSPFs) that are regulated by the *Law of Ukraine on Non-State Pension Provisions* amounted at 216.9 million UAH<sup>1</sup>. In addition, approximately 180 million UAH were managed by the Arkada Bank in a voluntary pension scheme called the “Kyivmiskbud experiment” which is regulated by special legislation. Unless specifically stated otherwise, the notion of the “private voluntary pension scheme” will be reserved for denoting pension schemes regulated by the *Law of Ukraine on Non-State Pension Provisions*.

2.

**Assets in such schemes were distributed among 51 operational non-state pension funds (NSPFs) of which 41 were open voluntary pension funds, 7 were corporate and 3 were occupational (professional) funds as of end September 2007.** There were 246.122 participants in such schemes (approximately 0.5% of the total population of Ukraine). In addition, the special scheme of the “Kyivmiskbud experiment” had around 31.000 members. A detailed explanation of this special scheme is presented in a separate chapter below (the chapter title: Non-transparent Competition).

3.

**According to the 2003 Law of Ukraine on Non-State Pension Provisions, the functions of fund administration, asset management and custodians are separated with a custodian function strictly separated from the other two which may be performed by the same company.** There were 6 entities operationally doing only fund administration and 22 managers having licenses for both administration and asset management (not all of them performing both functions operationally): 55% of total assets under management were managed by the entities which performed administration and asset management simultaneously, while the rest of 45% of total assets were managed and administered by separate companies. Out of 203 licensed custodians 107 were banks. 30 of them performed custodian services for NSPFs as of November 2007. Only banks can be custodians for NSPFs.

4.

**Non-state pension funds are incorporated entities founded not for profit (for their founders).** Founders of NSPFs have to be legal entities except in a special case of occupational / professional fund. Such a fund can be founded by an association of individuals (e.g. a trade union). The founders’ role is to draft a Statute, obtain a license and appoint the Board of the fund. The board is responsible for selecting and contracting an administrator, asset manager and custodian as well as for adopting the Investment Policy Declaration of a NSPF.

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<sup>1</sup> EUR 30.3 million at exchange rate 7.169 EUR/UAH prevailing on September 30th 2007.

*Main Figures as of September 2007*

Total assets under management in NSPFs in UAH million	216.9
Total assets under management in the Kyivmiskbud experiment managed by Arkada Bank* in UAH million	180.0
Total assets under management in both schemes in UAH million	396.9
Number of participants	246.122
Number of participants in the Kyivmiskbud experiment*	31.000
Total number of participants in both schemes	277.122
Total number of active NSPFs**	51
Average size of NSPFs (without the Kyivmiskbud experiment) in UAH million	4.25

\* Number based on management's statement

\*\* 51 regulated under 2003 Law. There is 1 additional fund managed by Arkada regulated by special legislation.

5.

**Supervision of voluntary pension schemes is fragmented.** NSPFs and administrators are licensed and supervised by the State Commission for Regulation of Financial Services Markets of Ukraine (SCRFSM). Asset managers are licensed and supervised by the Securities and Stock Markets Commission of Ukraine (SSMC). Custodians are licensed and supervised by the National Bank of Ukraine and SSMC in their different capacities.<sup>2</sup> The provision of pensions (pension contracts and pension schemes) is licensed and supervised by the SCRFSM only.

6.

**Voluntary private pension provision emerged around the end of the last decade mainly on the basis of defined benefit schemes. The first attempt to thoroughly regulate the industry was made in 2003.** The *2003 Law of Ukraine on Non-State Pension Provisions* (which became effective as of 2004) put a ban on new offers of defined benefit schemes and initiated a transition period for the transformation of such schemes into defined contribution schemes. The transition was successfully completed and no defined benefit schemes are operated and/or offered any more. There are no regulatory restrictions on modes of contribution payments, but there are detailed provisions on pension pay-outs such as: (i) lump sum pension benefits are allowed in special circumstances such as serious health injury or death (such provisions are standard in similar legislations around the World); (ii) defined period pension benefits should be paid for at least ten years; (iii) lifetime annuities can be paid only upon conclusion of contract and transfer of pension assets to an insurance company. The Law contains a number of additional provisions which represent international standards (e.g. limitations on pledges on pension assets, inheritance provisions etc.). Mainly technical draft amendments to the Law were submitted to the Parliament in 2007 and at present it is not clear whether and when these amendments shall be enacted.<sup>3</sup>

<sup>2</sup> Regulatory responsibilities, practices and coordination are discussed in a separate chapter.

<sup>3</sup> A more detailed discussion of amendments is presented in paragraph 44 of this document.

7.

**Given the size of the market and the expected increase in financial wealth over the long run, voluntary pension schemes are expected to grow at a rapid pace in Ukraine.** NSPFs effectively began to operate in 2005 due to a time lag since the adoption of the Law in 2003. Additional time was needed to adopt necessary by-laws. Total assets under management amounted to 46.2 million UAH by the end of 2005 and the cumulative growth rate of total assets under management between December 2005 and September 2007 was 370%. This figure indicates a strong growth potential. A number of other indicators point out at high market potentials. On top of 51 operational NSPFs, there are 31 licensed funds with concluded contracts for administration, asset management and custodianship. These funds are ready for the commencement of operations. In addition, there are 13 more registered NSPFs without concluded contracts as yet.<sup>4</sup> Next, on top of 6 single licensed administrators and 22 double licensed administrators and asset managers, there are 2 additional single licensed administrators and 2 more double licensed entities which concluded contracts with funds. There is one more single licensed and 4 more double licensed entities without contracts with funds agreed as yet. Such dynamic entry to the market with low volumes is an indication of strong expected growth. In addition, there is an obvious tendency to start up NSPFs with symbolic amounts of paid-in contributions indicating that investors in these businesses attach high probability to strong future growth of the market (and/or related markets such as the market for the 2<sup>nd</sup> pillar pension funds)<sup>5</sup>. In conclusion, it seems that there are many players in the industry which are taking market positions before stronger growth of private pensions takes off. They obviously apply low risk premium in the discount factors used for net present value calculations of their investment in administration and asset management. In summary, figures suggest that the voluntary pension system is still in its early entry stage. *Consolidation usually follows after the entry stage in financial markets. Hence it is very important to regulate the market in a way to manage consolidation risks and maintain trust of people in the voluntary pension scheme throughout the phase of initial growth and consolidation.*

8.

**The present system is burdened with risks which – if not managed at this stage – may prevent fulfillment of voluntary pension system’s fundamental role that is the provision of safe and well capitalized lifetime savings as a basis for income in the age of retirement.** It is a happy coincidence that substantial experience related to functioning of the present system emerged before more substantial assets accumulate in NSPFs. This happy coincidence created a “window of opportunity” - a sufficiently long time slot of about a year which should be used for quick improvements of the present system. Increased transparency, reliability and effectiveness can be achieved by streamlining by-laws and fixing technical and/or operational procedures (such as procedures applied by custodians in checking valuations of NSPFs as well as regulatory rules and procedures). Regulators’ active approach shall be required in this respect. Also, structured professional

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<sup>4</sup> Referring to the period of the World Bank mission (10<sup>th</sup> – 14<sup>th</sup> of December 2007).

<sup>5</sup> Currently there are discussions to launch the 2nd pillar pension funds in 2009/10. Probably some service providers are currently establishing strategic presence in markets for private pension provision in expectation of the launch of the 2nd pillar pension reform.

dialogue and operational work of joint teams composed of regulators and representatives of organized industry will be very helpful to reach this goal.<sup>6</sup>

9.

**The main risks that are present in the voluntary pension system consist of:** (i) risks of non-transparent competition (publicly sponsored schemes, insurance companies' quasi-pension products and bank pension accounts may reduce market transparency and prevent customers to make free and informed choice that would maximize their pensions in the long run); (ii) Funds governance and transparency risk (a system needs to be upgraded in order to make sure that funds are operated exclusively for the benefit of pension scheme members – higher standards of information dissemination and transparency can be helpful in this respect), (iii) asset valuation risk (related to practices of accounting and audit, discovery/transparency of securities prices used for asset valuations and the role of custodians in the valuation process which all have to be upgraded urgently); (iv) problems with pension unit value calculations (as members and potential members cannot follow values of their pension units at high frequency they are not informed properly about the performance of asset managers and they do not have a proper basis to make free and informed choice of the pension scheme that would meet their personal needs); (v) risks arising from a narrow spectrum of possibilities for achieving optimum portfolio diversification (inadequate supply of liquid securities issued by the government and/or transparent corporate issuers), and (vi) consumer protection: cross-selling and marketing risk (risk that lack of information, wrong information or undesirable incentives diminish the scope of free and informed choice of the pension scheme). The remainder of this document contains detailed discussions of each of these risks followed by recommendations aiming at management of these risks.

10.

**Given these risks and a very small size of institutions in the industry, urgent firming up of standards and regulations as well as streamlining procedures for the benefit of insured people has to be carefully balanced against the cost of regulation in order to avoid disorderly consolidation process.** Despite of very low minimal capital requirements by international standards (200,000 EUR for administrators and 300,000 EUR for asset managers = 500,000 EUR for entities with both licenses), industry representatives expect fund management and/or administration business to break even after 5-7 years on average.<sup>7</sup> Expected payoff period is normally long for this type of business. However, it is particularly long having in mind the very high fees that are charged on funds at this early stage of market development. Total fees may amount as high as approximately 10% of asset value (administration fee plus custodian fee plus management fee plus costs of securities trading and other eligible documented costs)<sup>8</sup>.

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<sup>6</sup> It should be noted that both regulators (the SSMC and SCRFSM) are already open to the dialogue with the industry.

<sup>7</sup> Draft amendments on the Law envisage a symbolic increase in minimum capital (see the box in paragraph 44) which makes no change to this conclusion.

<sup>8</sup> Different fees are applied to different basis and for this reason the total fee approximation in % of total assets is indicative only, based on talks to representatives of the industry. The World Bank is of an opinion that the industry's informal estimates as specified in the main body of the text are realistic. Asset management fee is capped at 4.2% p.a. Custodian fee can reach up to 0.5%. Administration fee is capped at

Hence there is an obvious tension between minimum capital requirement (which is too low by prudential standards) and the payoff period (which is too long given the size of fees). Forced consolidation by an abrupt increase in minimal capital requirements or some other hasty change in regulation (e.g. the imposition of a minimum threshold for a number of participants in the fund) would speed up consolidation. However, the question remains whether this process would be manageable from the side of regulators and whether it is desirable at all.<sup>9</sup> For this reason consolidation will have to be gradual in order to allow eligible market players to adjust to higher standards of transparency and regulation (which inevitably imply higher costs of regulation) and for the regulators to prepare for managing the consolidation process. At the same time consolidation will have to be fast enough to allow for orderly exit of market players who may lack systems, know-how or independency from other conflicting commercial interests. This may look like a harsh trade off. Nevertheless, it calls for a balanced, well designed, well organized and decisive regulatory action along the lines depicted by the recommendations presented in this document.<sup>10</sup>

11.

**A number of benefits would arise from a more focused capital markets development program of the Ukrainian Government.** Implementation of such a program is a necessary condition for the successful launch of the 2<sup>nd</sup> pillar pension reform, but it would benefit members of the voluntary pension schemes as well. Widening the scope of financial instruments eligible for investment based on their liquidity and issuers' transparency is "a must" for the further development of voluntary pension schemes. The main reason lies in the fact that the investment opportunities are limited at present. Securities prices are volatile and most probably subject to occasional manipulations due to low liquidity. The same reason stands behind fund managers' fears to find themselves lock-in with unwanted positions. These are the positions they cannot liquidate in reasonably short periods of time.

12.

**The remainder of the document is organized as follows:** after the presentation of the structure of the industry and the discussion of risk management in the next chapter, the remainder consists of the presentation of the aforementioned six types of risks. There is a separate chapter discussing regulatory practices. The summary of recommendations concludes the document.

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6% of annual contributions in open funds and 5% in corporate and occupational funds indicating that these percents can be very high when expressed in total assets as long as the funds are small but growing rapidly. For this reason regulator should monitor closely calculation of fees.

<sup>9</sup> Regulators have limited resources too and it would be hard to allocate significant regulatory resources to an industry which is miniscule compared to other segments of the financial industry.

<sup>10</sup> The summary of recommendations is presented at the end of the document.

## **Voluntary Non-State Pension Funds in Ukraine: Market Structure**

13.

**Voluntary pension savings is a relatively new financial product in Ukraine.**

**Although non-state pension funds do not have an important role yet in the financial system, the industry has an excellent growth potential.** Total money supply M3 (total deposits with banks plus currency in circulation) as of September 30<sup>th</sup> 2007 was estimated at UAH 330 billion while total assets under management in voluntary pension schemes regulated under the *Law of Ukraine on Non-State Pension Provisions* amounted at UAH 217 million representing less than 0.1% of M3. There were around 250,000 members in voluntary pension schemes. They represent 0.5% of the total population of Ukraine. Growth potential exists both in terms of the number of participants and also in terms of growth of paid-in contributions and assets under management in NSPFs.<sup>11</sup>

14.

**Ukrainian NSPFs are very small financial institutions by international standards in asset management.**

The largest individual fund has total assets of 41.2 million UAH (approx. 5.7 million EUR) with a market share of 19%. Only 11 asset management companies have more than a million Euro under management (some of them have it summed up over several funds). Since the market for the provision of private pension schemes is obviously in the early accumulation phase which will last for years to come, the remainder of this chapter is focused on the assessment of the market structure from the perspective of asset accumulation, not from the perspective of pension schemes and payments of benefits.

15.

**Market structure is very fragmented from asset managers' viewpoint.** In the following figure, 40 active asset managers (active in a sense that they managed at least some assets in at least one pension fund as of September 2007)<sup>12</sup> are sorted from the largest to the smallest on x axis from the left to the right. The criterion for the ranks of market shares is total assets under management. Left y axis measures the number of funds under management for each asset manager (bars). Most managers manage only one fund. 13 managers manage more than 1 fund. The largest number of funds managed by one management company is 7. However, there is no link between the number of funds under management and the value of assets under management. Evidence in this respect is obtained by looking at huge variability of assets per participant in NSPF(s) for each active asset manager (right y axis). Assets under management per participant range from

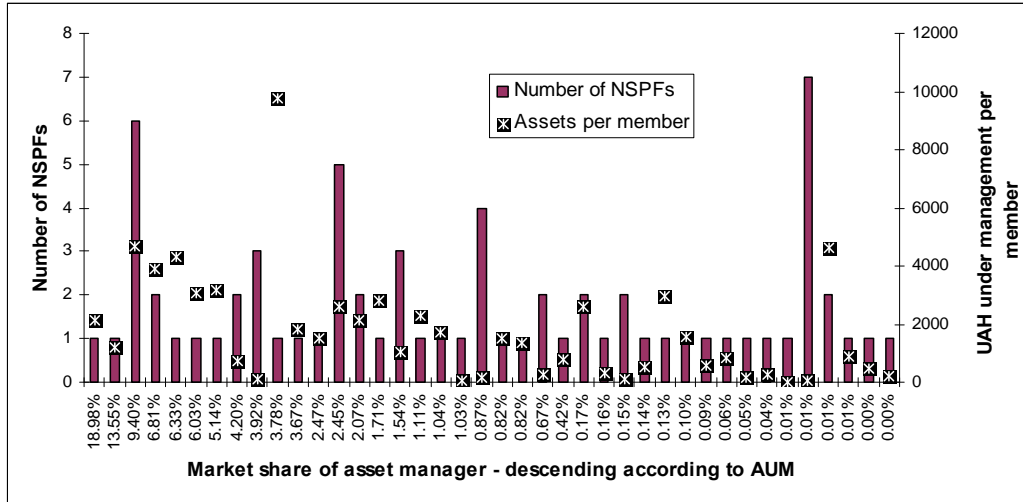
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<sup>11</sup> Cross-country comparisons are of a limited use in forecasting future growth potential. The belief in growth potential is rooted in growth during initial two years of operations and in the expected financial deepening of the Ukrainian economy (much faster growth of financial than real assets once the economy reaches its medium level of development).

<sup>12</sup> The smallest asset manager managed around 6,000 UAH assets of 28 members as of September 2007 meaning that it just started the business. 16 out of 40 active asset managers managed less than 400,000 UAH total assets (approx. 54,000 EUR).

as low as 7.6 UAH ( $\approx 1$  Euro!) up to 9,876 UAH.<sup>13</sup> It is easy to see that there is no strong correlation between the size (measured by the market share shown on x axis) and assets per member (right y axis).<sup>14</sup> This is a consequence of the fact that the industry finds itself in the early initial stage of development.

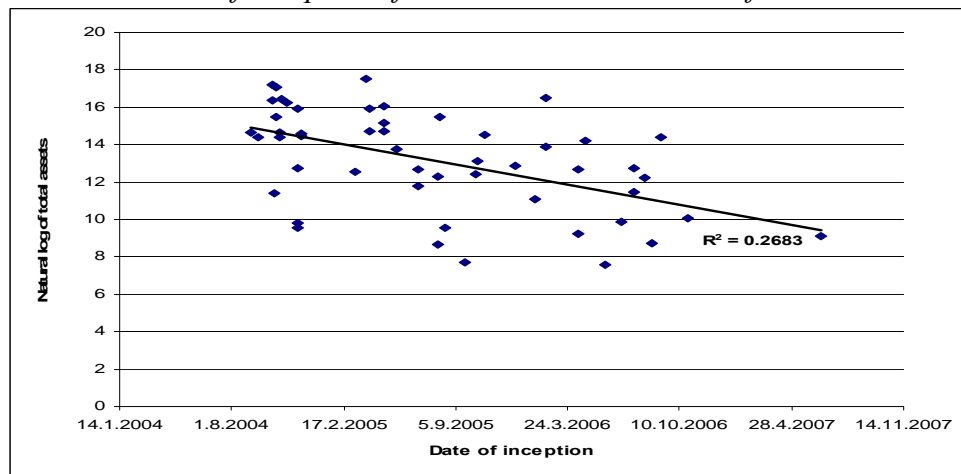
*Market Structure – Asset Managers’ Perspective*



16.

**High variability of assets per member across asset management companies can be explained by two factors. Firstly, “older” asset managers (i.e. those which manage “older” funds) manage more assets.** This relationship is shown in the figure below.<sup>15</sup>

*Date of Inception of Fund’s Business vs. Size of Fund*



<sup>13</sup> Please note that assets per participant are measured at the level of asset management companies, not at a fund level. Measurement at a fund level would show lower per fund figures for managers that manage several funds.

<sup>14</sup> This is confirmed by the correlation coefficient of only 0.31.

<sup>15</sup> The figure does not contain the special scheme of the Arkada – Kiyvmisgbud experiment which started before other schemes (see the special chapter further in the text). With average assets per member of around 5,800 UAH this scheme confirms a positive link between the date of inception and size.

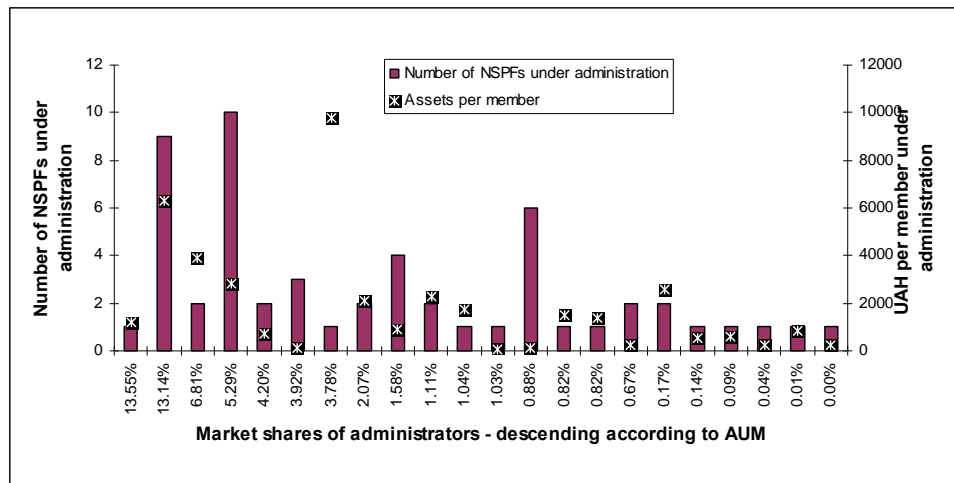
17.

Nevertheless figure above shows that the age of a fund explains only a smaller part of variability in funds' size. The other explanation may be related to the fact that different funds (i.e. administrators on behalf of funds) employ a different marketing and sales strategy. Different corporate or occupational funds belong to different industries which pay out different average wages. This means that different funds of this type may experience very different speeds of accumulation of assets. Some open funds may target affluent customers but some other, especially “younger” NSPFs, may put more emphasis on acquisition of a mass of clients in order to build-up goodwill (an intrinsic value) contained in a large client database. For example there are three funds managed by one asset manager with close to 100,000 members and average asset per member of around 90 UAH ( $\approx 12$  Euro).

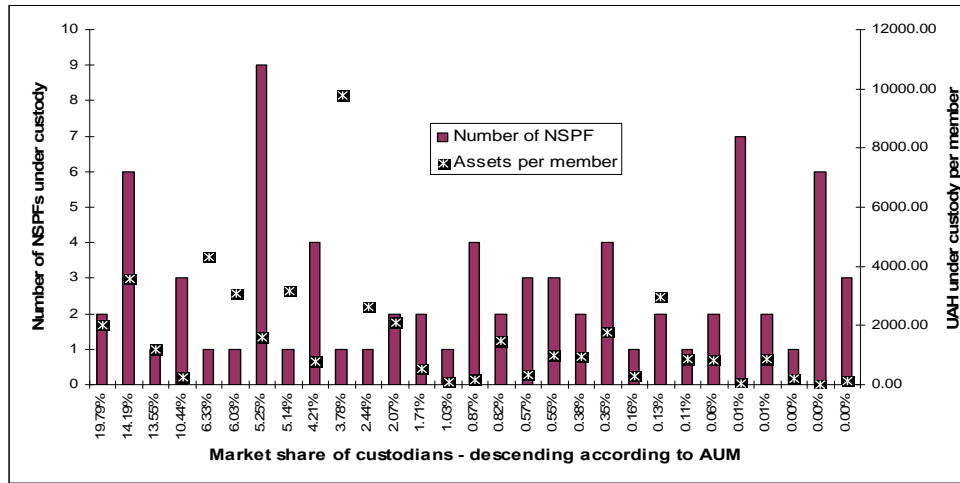
18

From the perspective of administrators and custodians the industry structure looks the same as from the managers' perspective. The figures below are self-explanatory.

*Market Structure – Administrators' Perspective (According to Assets Under Management – AUM)*



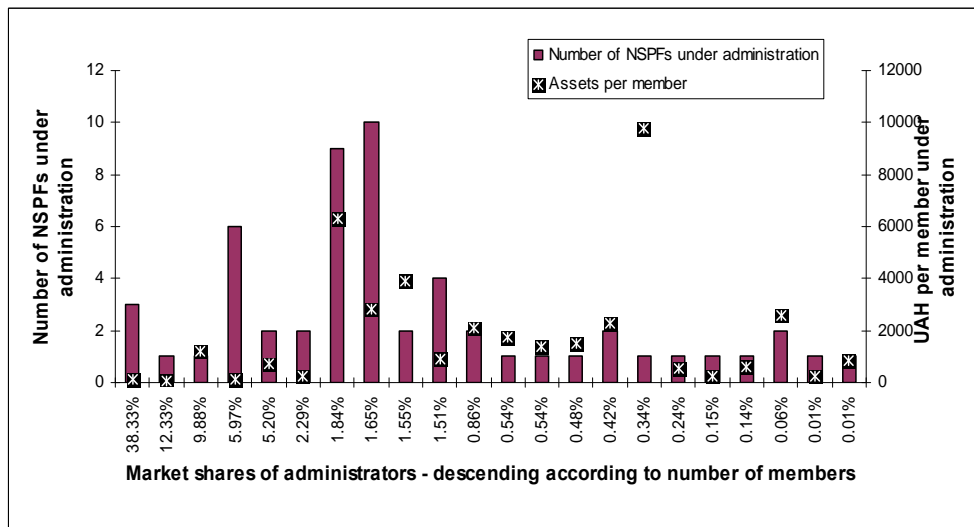
*Market Structure – Custodians’ Perspective*



19.

**A different perspective on the market structure is shown when administrators are ranked according to size measured by number of participants as against the assets under management (as shown above). X axis in the figure below shows descending (from left to right) market share measured by a number of participants in funds administered by one administrator.**

*Market Structure – Administrators’ Perspective (According to Number of Participants)*



Main difference compared to graphs above emerged due to a specific case of one administrator which administers 3 funds embracing 38% of the market in terms of the number of participants, with total assets under management close to zero (please compare the values of the first observations to the left on the x axis in the two graphs shown on this page). This paradoxical situation with funds that are large in terms of members but very small in terms of assets (see assets per member for top 6 administrators to the left on

x axis in the figure above) can only partly be explained by the age of funds (see the date of inception vs. size above). Main explanation lies with strategies regarding payments of contributions. Contribution payments are not regulated in details. That has opened room to aggressive competitors who attach a high value to the client database (collection of participants) and attract members without significant immediate contributions. A possibility to follow such a business strategy may have brought some benefits in terms of promotion of previously unknown voluntary pension schemes. Nevertheless it may also have created a reputation risk for the scheme as a whole. In particular, even without significant financial exposure a member may become sensitive to any information related to an affiliated party to a fund (be it a founder, a board member, a manager, a custodian, an administrator). Under such circumstances, any failure or mismanagement by a party affiliated to a fund may affect members' view on the pension scheme. *Regulators may wish to estimate why some funds gather new members with insignificant contributions. Regulators should think through real reasons for emergence and potential risks that may emerge out of having funds with large number of members and negligible assets, and consider potential regulation of contribution payments if estimated risks outweigh expected benefits from having such funds present in the system.*

20.

**In conclusion, fast entry, absence of dominant players, aggressive competition for new members, small size and strong growth are typical in a young industry at its infancy stage. Optimistic expectations formed by many managers and/or administrators at this stage regarding future market growth and their own ability to make long-run profits drive investment and acquisition efforts at present.** Infancy phases usually do not last long. Such is the case in the financial industry in the region of New Europe. A predictable evolutionary pattern has emerged in different markets in different countries and at different times around the region. Optimistic phase of rapid entry is usually coupled by weak regulatory practices which opens entry for investors who are either overoptimistic about their future success or incapable to meet clients' long term demand (because of lack of systems, know-how or capture in a network of conflicting commercial interests - e.g. founding such a scheme not for the benefit of members but primarily for the hidden benefit of founders or persons affiliated to them). The consolidation phase always follows after an early entry stage. It happened in banking, currently it is going on in securities trading, asset management and other segments of the financial industry throughout New Europe. Financial history of the region favored regulators who were the most prepared for the consolidation stage to come.

### **Risk Management**

21.

**In this early stage of development of the industry, risk management is determined by legislative quantitative limits on portfolio investment as well as by limits on the instruments eligible for investment.** NSPFs are allowed to invest in stocks and bonds of Ukrainian issuers listed in organized exchanges (only at the exchanges with the volume of trade of at least 25% of the total volume of trade at organized securities markets). Only

securities listed at “PFTS” stock exchange meet this condition. NSPFs are allowed to invest in securities listed in the 1<sup>st</sup> and the 2<sup>nd</sup> quotation. In addition, there is an explicit provision which prohibits investment in securities issued by a custodian, asset manager, administrator, auditor and persons rendering consulting, agent and advertising services with who the pension fund has concluded relevant contracts. Limits apply to persons affiliated to them, too.

22.

**Regulation contains no explicit prohibition or limits for investment in the securities issued by the entities affiliated to founders of NSPFs.** There is an explicit prohibition for investment into founders’ securities. A corporate fund can invest up to 5% of its assets into founders’ securities (up to 10% during the initial five years). Gradual abolishing of this provision may be considered in the medium run in order to minimize potential conflict of interest and related risks. However, *it is far more important to introduce limits to investment in the securities issued by the entities related to founders. The absence of such limits raises a number of concerns because it may lead to the development of “in house” captive funds with distorted incentives. Such funds would not maximize members’ net wealth but rather some other commercial interest. Regulators should pay proper attention to this problem.*

23.

**Number and capitalization related to securities eligible for investment seems to be adequate but lack of market liquidity raises a number of concerns.** There are ten stocks in the 1<sup>st</sup> quotation of the PFTS of which five are from the energy sector. Three bond issues are listed: two municipal (Kiyv and Kharkiv) and one corporate (a bank). There is no government bond listed in this quotation. In the 2<sup>nd</sup> quotation there are 26 additional stocks from sectors of utilities and basic materials. In addition, there are 10 certificates issued by entities from the financial sector, 7 municipal bonds and 93 corporate bonds. With 149 securities in the first two quotations (of which 94 are corporate bonds) and average daily number of transactions in all quotations of around 350 in the last quarter of 2007, lack of market liquidity represents a serious problem.<sup>16</sup> Three concerns are acute: (i) there is a limited maneuvering space for funds to change the composition of their portfolios in a response to changes in relative risks and returns due to the inability to sell securities at prevailing marginal (closing) market prices; (ii) assets may be mis-priced due to potential for price manipulation and/or imperfect discovery of securities prices,<sup>17</sup> (iii) lack of government bonds which offer a “safe heaven” for investors may force asset managers to invest in riskier instruments. In this respect, *implementation of an effective program for capital markets development is a necessary condition for successful development of the provision of private pension schemes in Ukraine. An additional risk is related to securities settlement risk as there was no secure DVP (delivery-vs.-payment) system. As regulators are planning to implement the DVP*

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<sup>16</sup> According to opinions expressed by SSMC's representatives, the number of securities eligible for investment by NSPFs may vary in the next half a year, so it may be too early to draw any conclusions about it.

<sup>17</sup> In an illiquid market, problems can also be related to missing reporting of transactions which are executed outside organized exchanges.

*requirement very soon, only securities that are settled in this way may be declared eligible for investment. Nevertheless the approach to this measure should be cautious because early implementation of such a measure may deprive NSPFs from some of existing investment options that are not necessarily bad.*

24.

**Quantitative investment limits are well-designed to support the present stage of market development. The limits allow for the following investment:**

- securities of one issuer (except for banks and claims on, or guaranteed by, the Government) up to 5% of total assets,
- claims on banks up to 40% of total assets whereas claims on one bank cannot exceed 10% of total assets,
- central government securities up to 50% of total assets,
- local government securities up to 20% of total assets,
- foreign issuers' securities up to 20% of total assets
- corporate bonds issued by Ukrainian issuers up to 40% of total assets,
- stocks issued by Ukrainian entities up to 40% of total assets,
- mortgage instruments up to 40% of total assets,
- real estate up to 10% of total assets,
- bank metals (de facto gold) up to 10% of total assets,
- other assets not prohibited but not specified in the Law up to 5%.

Aggregate portfolio allocation of 51 NSPF as of end September 2007 is shown in the Table below:

*Allocation of NSPFs' assets (aggregate for all active funds) per asset classes included under quantitative investment limits in %, end September 2007*

Asset class	Percentage allocation - aggregate	Quantitative investment limit in % of total assets
Domestic corporate bonds	41,19%	40%
Bank deposits	29,33%	40%
Domestic stocks	17,97%	40%
Other assets	4,33%	5%
Gold	3,08%	10%
Municipal bonds	1,83%	20%
Real estate	1,18%	10%
Domestic government bonds	0,94%	50%
Mortgage securities	0,15%	40%
Foreign stocks	0,00%	20%
Foreign corporate bonds	0,00%	
Foreign government bonds	0,00%	

Source: The World Bank.

25.

**Data show that NSPFs have seriously underinvested in domestic government bonds.**

This has occurred due to underdeveloped market for government debt instruments. Development of the government bond market should be the main pillar of the capital market development program of the Ukrainian Government. *The development of the Government bond market should not be subordinated to short term fiscal considerations only. It should be seen more broadly, as a program for the development of the instruments and markets which shall offer safe and liquid investment in transparently priced instruments that would provide benchmark yields for pricing of other financial instruments.*

26.

**NSPFs do not invest in foreign assets.** There are two reasons for this. Firstly, foreign exchange regulation requires special permission for cross-border investment in securities which has to be obtained from the National Bank of Ukraine. Secondly, *the Law of Ukraine on Non-State Pensions Provision* requires the SSMC to issue regulation on ratings of foreign securities allowed for NSPFs' investment. The SSMC has not issued such regulation so far. There may be an implicit understanding among policy makers and regulators that capital outflows via NSPFs' cross-border investment is not desirable from the perspective of public interest due to balance of payments considerations. This view – if it exists - should be changed because investment in high quality, liquid and correctly priced foreign securities can substantially improve risk-return combinations of Ukrainian NSPFs. This is especially important in an environment without comparable domestic markets for safe, liquid and correctly priced securities - for government bonds especially. At the same time, macroeconomic consequences of potential capital outflows shall remain negligible for the years to come due to relatively small size of NSPFs compared to the rest of the financial system. *The authorities may wish to amend foreign exchange regulation and the SSMC may consider regulation which would allow Ukrainian NSPFs to invest in high quality liquid securities in developed international markets.*<sup>18</sup>

27.

**NSPFs over-invested in domestic corporate bonds; bank deposits also represent a significant share of NSPFs portfolio.** Absence of opportunities to invest in government bonds and foreign securities coupled with a limited liquidity of domestic stocks forced Ukrainian NSPFs to invest in domestic corporate bonds and bank deposits. Moreover, the aggregate limit for investment in corporate bonds has been breached. Given the (large) number of corporate bonds and the (small) number of transactions in illiquid markets (see above), NSPFs are largely exposed to the risks of domestic corporate issuers. Therefore NSPFs are largely exposed to the issued securities that may be subject to miss-pricing

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<sup>18</sup> Pension funds in the Central and Eastern Europe were investing significant amounts cross-border 2-3 years after the inception of their businesses (5%-20% would be considered normal). However, the dominant type of investment was the government bond. In most countries government bonds represented more than 50% of the portfolio at initial stages. Therefore, using other CEU countries as benchmarks, Ukrainian funds underinvested primarily in these two asset classes.

due to rare trading and related potential for price manipulation.<sup>19</sup> A part of excessive exposure to corporate bonds may be related to some NSPFs that may hold significant exposure to a group of affiliated persons (see 22 above for details). Data in the table below support this view: breach of a corporate bond limit has occurred due to only one fund which violated the limit for more than 5%. Moreover, this fund holds significant market share hence causing violation of the investment limit for the industry as a whole. This situation is very different compared to violations related to bank deposits. Large number of funds (8) are in significant violation of more than 5 percentage points but the joined market share of such funds is very small (1.2%) indicating less of a problem (due to dispersion) compared to the violation of a corporate bond limit. A relatively large number of very small NSPFs may have violated bank deposit limit due to early stage of investment cycle in the small funds, lack of investment know-how as well as due to lack of government bonds that motivated fund managers to look for bank deposits as substitutes for missing safer instruments. The only other violation which is comparable to corporate bond infringement is related to the violation of the limit on investment in other assets. The Law provides a very vague definition of other assets<sup>20</sup> so *the authorities may wish to describe this asset class in a more precise way. Leaving it as it is raises a number of concerns related to risk, liquidity and valuation methods of other assets.*

*Estimated Breaches of Investment Limits as of End September 2007  
Number of Funds in Non-compliance  
(Joined Market Share of Funds that Breached the Limit)*

Asset class	Breach over limit in %			
	Up to 1%	1-3%	3-5%	5% +
Domestic corporate bonds	0	0	0	1 (18.6%)
Bank deposits	1 (0.2%)	0	0	8 (1.2%)
Domestic stocks	0	1 (5.9%)	1 (0.0%)	1 (0.1%)
Other assets	2 (0.3%)	1 (5.0%)	5 (31.5%)	5 (1.8%)
Gold	1 (6.2%)	0	0	0
Municipal bonds	0	0	0	0
Real estate	0	0	0	0
Domestic government bonds	0	0	0	0
Mortgage securities	0	0	0	0
Foreign stocks	0	0	0	0
Foreign corporate bonds	0	0	0	0
Foreign government bonds	0	0	0	0

Source: The World Bank.

<sup>19</sup> Recall the discussion in paragraph 23.

<sup>20</sup> Article 49(14) of the Law defines other assets as assets which are not prohibited by the Ukrainian legislation but not specified in this legislation.

28.

**The Law prohibits investment in derivatives.** This is not an obstacle for development of private pension schemes in Ukraine for the time being. Nevertheless, market growth will be coupled by increased sophistication of both investors and financial instruments. Forward looking authority should *consider allowing limited investment in derivatives for the purpose of hedging NSPFs' positions*. Since asset valuation problems are the most serious short-run problem for the industry as a whole (see below), introduction of derivatives among eligible instruments for investment should be coupled by an education program and regulatory amendments which shall ensure a proper valuation of derivatives.

29.

**Regulatory improvement that would aim to resolve valuation problems should also address the problem of “cornering the market” – controlling the price of security by holding a major share of a quantity of a given security.** Most probably, this is not a big problem for the time being due to small size of NSPFs. However, as NSPFs would grow, the problem may grow, too.<sup>21</sup> Legislations regulating institutional investors in some other countries introduced a *limit on the share a Fund can take in equity of one company and/or, on more general grounds, a limit on the share a Fund can take in individual securities issue*. Besides preventing price manipulation, the purpose of this provision is to prevent transformation of an NSPF - which is an institutional investor, into a direct (strategic) investor in any company. This limit can be applied selectively at different stages of market development. For example a limit may not apply and/or a limit may be relaxed if the authorities want to promote NSPFs' investment in venture capital / private equity funds.

30.

**Regulators may envisage relaxation of investment limits in the long run. In anticipation of such developments general risk management provisions should become a part of the body of regulation.** Though this future may seem distant (because investment limits represent a prudent method for promoting risk management during the early stages of the industry development), the authorities may wish to consider implementing general risk management provisions in the *Law of Ukraine on Non-State Pension Provisions*. General risk management provisions may: (i) assign responsibility and broadly describe organizational framework for risk management; (ii) make organization of middle office obligatory part of the organization, (iii) set the terrain for issuing the relevant by-laws in the future when the investment limits may be relaxed or eliminated.

31.

**In the short to medium run it is far more important to extract lessons and reduce risks that became obvious after the first several years of operations.** Main risks that are discussed further in the remainder of text are the following: (i) risks of non-transparent competition (publicly sponsored schemes for public administration and staff

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<sup>21</sup> This problem may be aggravated if NSPFs' asset managers belong to larger asset management groups that manage investment funds and/or individual portfolios.

of the central bank, insurance companies' quasi-pension products and bank pension accounts); (ii) funds governance and transparency risk, (iii) asset valuation risk (related to practices of accounting and audit, discovery of securities prices used for asset valuations and the role of custodians in the valuation process); (iv) problems with pension unit value calculations; (v) risks arising from a narrow spectrum of possibilities for achieving optimum portfolio diversification (inadequate supply of liquid securities issued by the government and/or transparent corporate issuers), and (vi) consumer protection: cross-selling and marketing risk.

### **Non-transparent Competition**

32.

**Consumer protection is the main pillar of a safe, sound and effective voluntary pension scheme.** Consumer protection is based on principles of (a) *clarity / transparency* - so that consumers i.e. participants in the scheme can understand the pension product and differentiate it from other similar savings products, and (b) *simplicity* - so that consumers i.e. participants in the scheme can make an informed free choice in order to try to maximize long run incomes and remain responsible for their choice. If these two principles are not obeyed, confidence shall erode and the general public would allocate part of the blame for potential problems on policy makers and regulators. Transparency and simplicity can be achieved only if all participants who take part in the production of the voluntary pension scheme are regulated in the same way. *Level regulatory playfield contributes to product standardization and helps differentiate voluntary private pension products from similar savings products.* It also strengthens competition and leads to a higher quality of service at a lower cost. Finally, it clearly allocates regulatory responsibility, thereby minimizing regulators' reputation risk and maximizing regulatory effectiveness. At present there are four main impediments to the realization of the aforementioned basic principles. These impediments are related to four financial products or potential financial products which are either under-regulated or wrongly regulated or not well thought through. Although they interfere with voluntary pension schemes to a varying degree and none of them represents an immediate threat to the credibility of private voluntary pension provision in Ukraine, all of them violate fundamental principles described above. Hence they represent a potential threat. It is recommended that the four non-transparent competitive products should be re-regulated and/or re-designed and/or plans should be abolished. The four non-transparent competitive products are discussed in turn in the remainder of this chapter:

- The Bank Arkada –Kyivmiskbud experiment,
- corporate pension schemes sponsored by the public sector entities,
- voluntary pension schemes related to bank pension accounts,
- quasi voluntary pension schemes ran by insurance companies.

33.

**The Bank Arkada – Kyivmiskbud experiment started in 1997 in order to boost construction and housing finance in Ukraine.** Capital markets were practically non-existent at that time, macroeconomic risks were immense and there were no long term

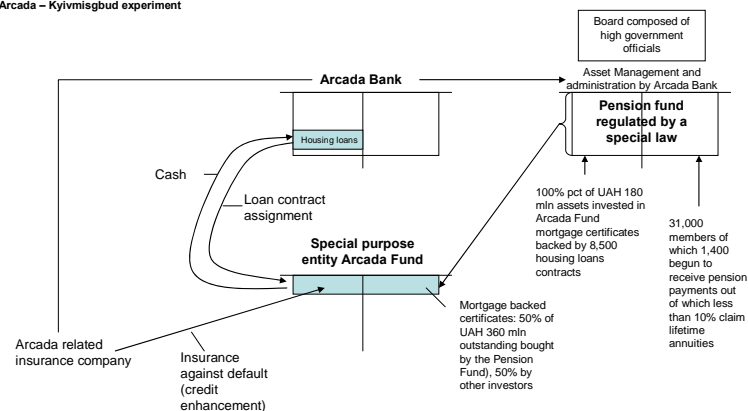
sources for housing finance. In order to bridge the maturity gap, public sector construction company Kyivmiskbud (predominantly owned by the City of Kyiv) designed a financial structure consisting of three institutions: (a) Bank Arkada, (b) special purpose entity Arkada Fund and (c) a voluntary pension fund. Both the Arkada Fund and the pension fund are administered and managed by the Bank Arkada. The Bank Arkada originates housing loans that are primarily used for financing purchases of new apartments built by construction company Kyivmiskbud. The Bank Arkada has a negligible market share in housing finance overall (which includes old apartments), but management’s estimate is that Arkada’s market share in financing of purchases of new apartments is around 30% due to its exclusive relationship with one of the largest residential developers Kyivmiskbud.

34.

**The Arkada Bank sells segments (“pools”) of its housing loans portfolio to the Arkada Fund for the purpose of issuing mortgage backed securities. This is just one of the strategies the bank is using for its financing.** The Arkada Fund issued mortgage backed securities that were mainly sold to the voluntary pension fund. The pension fund allocates close to 100% of its portfolio to the Arkada Fund mortgage backed securities. Such securities in the portfolio of the voluntary pension fund represent half of total liabilities of the Arkada Fund (see the scheme below for details). So-called mortgage backed securities are not backed-up by mortgages but rather by cash flow arising from the portfolio of housing loans originated by the Arkada Bank and assigned to the Arkada Fund. If a final debtor defaults, Bank Arkada buys back the loan contract (effectively “cleans up” the Arkada Fund portfolio) and initiates the foreclosure procedure. Given this provision to “clean up” the underlying credit portfolio, the Arkada Bank is not only a servicer but also a guarantor in the securitization scheme. So the risk is never effectively transferred away from the Bank Arkada.

### Main Features of the Bank Arkada – Kyivmiskbud Experiment

Bank Arkada – Kyivmiskbud experiment



This is a securitization scheme without actual transfer of risk. Arcada Bank is originator of housing loans insured by mortgages. When the bank runs out of cash it sells the loan contract to Arcada Fund which issues mortgage certificates and passes cash payments to the bank. Payments of certificates are insured by the cash flow of interest and principal at the basis of portfolio of assigned housing loans. Arcada Bank continues to act as a servicer in this transaction. If the final obligor defaults Arcada Bank buys back bad loans (“clean up”) and tries to collect late payments effectively.

There are 4 issues of certificates in Fund’s portfolio. 3 of them have been private placements fully subscribed by the Fund and 1 has been a public placement. Certificates are issued with fixed coupon rates below parity and revalued every three months according to prices of benchmark bonds which are rising. So the total return is higher than the coupon rate in order to achieve guaranteed return which is equal to inflation rate + 200 bps. Allegedly average return is 500 basis points above inflation.

35.

**The Arkada Bank – Kyivmiskbud experiment is a combination of securitization and a voluntary pension scheme with four major problems.** Firstly, assets of members of the voluntary pension scheme are exposed to the risk of one entity – the Arkada group, and one market – housing loans market (because all assets of the pension fund are invested in Arkada Fund’s mortgage backed securities). The scheme has been functioning well during this decade due to robust macroeconomic growth, declining interest rates and subsequent increase in real estate prices. Nevertheless the scheme remains exposed to a number of risks, especially market risks related to changes in real estate prices and interest rates. Secondly, functions of management, administration, custody, valuation etc. - which are always separated to some extent in a well-designed scheme, are not separated here at all because the Experiment operates under a special law, separately from the *Law of Ukraine on Non-State Pension Provisions*. Therefore main functions are performed within a group of affiliated entities one of which (the Arkada Fund) issues investment instruments to the pension fund. Thirdly, similar to the UK Master Trust schemes for residential mortgage backed securities, the Arkada Fund serves the purpose of an open-ended vehicle that can change the composition of its underlying assets in asset compartments which serve as collaterals for different fixed income securities issued by the same legal entity. Such schemes lack transparency in terms of legal risks and in terms of disclosure of credit quality about underlying assets in more developed markets such as the UK, so it would be heroic to assume that the problem is small in the case of Ukraine. Fourthly, the voluntary pension scheme of Bank Arkada – Kyivmiskbud enjoys a number of advantages which create potentially uneven competitive play field in the market for voluntary pension schemes:

- the experiment enjoys favorable tax treatment compared to the pension schemes regulated under the *Law of Ukraine on Non-State Pension Provisions* because pensions are not subject to taxation when they are paid out.
- a fee charged on the voluntary pension fund is negligible (3% of investment return) because effectively there is no cost of asset management (portfolio is allocated to one issuer and one type of security) and the indirect financing benefits for the Arkada Bank in terms of financing of its lending operations are so high that the Arkada probably does not see the management of the pension fund as an important profit centre;
- mortgage backed securities are issued by the Arkada Fund at better than market terms and revaluated quarterly in order to ensure a steady growth of pension fund’s return above inflation rate because the scheme guarantees the return of at least 200 basis points above inflation rate – in this way, it would not come as a surprise if real return of this fund is higher than in some funds regulated under the *Law of Ukraine on Non-State Pension Provisions*;
- besides a guaranteed return, Kyivmiskbud is a name (a well known brand in Ukraine) associated with the public sector; high government officials are represented at the supervisory board of the pension fund which may distort peoples’ incentives when making a choice of a pension scheme by creating an

impression that the scheme is supported by the public sector thereby inducing a moral hazard problem.<sup>22</sup>

36.

**A favorable macroeconomic environment (which sometimes hides risks) and an early start of the business in the late 90's followed by a number of supportive elements have helped the Kyivmiskbud experiment pension fund to grow up to approximately 180 million UAH (24.4 million EUR) in terms of assets under management.**<sup>23</sup> This pension fund alone represents around 83% of total assets under management in 51 NSPF regulated by the *Law of Ukraine on Non-State Pension Provisions*. It is four times larger than the largest of 51 NSPFs. Due to a relatively small number of participants in the Kyivmiskbud scheme (around 31.000 as reported by the Arkada Bank management team), assets per member stood around 5.800 UAH compared to 866 UAH on average in the scheme regulated by the *Law of Ukraine on Non-State Pension Provisions* as of September 2007. A fund of this size is a relatively important source of external finance to the bank of the size of Arkada which is a small bank with an estimated market share of around 0.5% at maximum in terms of total assets of the banking system.

37.

**The Arkada – Kyivmiskbud pension scheme seems to be properly designed (except for the guaranteed return) and marketed.** It is a defined contribution scheme with a minimum period of pay-out of five years. Contractual obligations and formulas for calculations of pensions are disclosed.<sup>24</sup> There seem to be no cross selling or forced selling effort by Arkada: according to management information, only a negligible portion of people who raised housing loans are participants in the scheme. On the basis of anecdotal information it was confirmed that there was no direct cross selling or forced selling of pension insurance to credit applicants and vice versa (besides using the same brand names of Arkada and Kyivmiskbud in two separate marketing campaigns).

38.

**As the credit and capital markets develop, alternative ways of providing housing finance emerged, so the initial political support for the scheme may decline.** By the same token, as the capital markets develop, the Arkada Bank may find alternative sources of funding for new housing loans, as witnessed by a public issue of Arkada Fund mortgage backed securities which met demand on the side of institutional investors. Furthermore the process of maturation of market participants and regulators may lead to higher disclosure requirements of underlying assets and a better pricing of risk. As a consequence, pressures to restructure the scheme may continue to grow. *Hence the time*

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<sup>22</sup> It should be emphasised that there is no explicit direct support from the side of the government but rather the support may be understood as an implicit one because the Board involves representatives of five ministries, city administration of Kyiv and Kyivmiskbud.

<sup>23</sup> Information obtained from the Arkada Bank management team.

<sup>24</sup> Formulas were not subject to an actuarial review so this statement should not be interpreted as a statement of professional verification by the World Bank. The facts presented by the management were the following: the scheme pays out life annuities at the basis of parametrized formula which assumes life expectancy of 90 years.

*is ripe to initiate restructuring of the Kyivmiskbud experiment by amending the existing regulatory framework with a purpose to:*

- define the time frame for a transformation of the pension fund / scheme into the scheme regulated by the *Law of Ukraine on Non-State Pension Provisions*, with a special emphasis attached to:
- change the governance structure of the fund (abolishing seats of government officials on the board, separating functions of management/administration<sup>25</sup> and custodian),
- regulate the process of selection and contracting an asset manager, administrator and custodian during the gradual transformation period,
- define milestones for gradual transformation of composition of assets in order to reach the structure according to regulatory limits provided by Article 49 of the *Law of Ukraine on Non-State Pension Provisions*,
- provide a legal solution to the abolition of the guaranteed return and equalizing tax treatment across all pension schemes, and
- regulate other important issues for achieving an orderly transformation.

A dialogue should be initiated in order to define gradual and orderly transformation of the scheme. Abrupt termination by a hasty legal action may prove to be legally impossible and/or may impose overly high cost to the members of this scheme.

39.

**Two additional corporate or occupational voluntary pension schemes, potentially outside the existing legal framework, are currently being debated within the public sector.** A bigger scheme (in terms of the number of prospective members) is being debated for public sector employees. A smaller scheme is under consideration for the employees of the National Bank of Ukraine. In both cases it is not clear whether public sector founders are going to design the schemes according the *Law of Ukraine on Non-State Pension Provisions*. Public sector entities should refrain from designing any new scheme under special regulations or under exemptions from existing regulation.

Experience of the Kyivmiskbud Experiment shows that the sustainability of special schemes is usually questioned in the long run. In addition, a launch of any special scheme may be interpreted as a lack of support and trust in a pension model that the public sector itself decided to design and regulate. Lack of consistent behavior of public sector entities in this respect may be detrimental for the future of the pension system reform in terms of its eroded credibility in the eyes of the general public.

40.

**The *Law of Ukraine on Non-State Pension Provisions* (Article 2) allows banks which have concluded agreements on opening pension deposit accounts to be recognized as “subjects of the non-state pension provision system”. This provision opens a series of questions.** A number of articles (e.g. Articles 58.2(3), 58.3(1)) suggest that a member

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<sup>25</sup> This does not mean that management and administration should be separated in the new setup. For example, Arkada may continue to manage and administer the Fund if other functions shall be clearly separated from Arkada.

can open a pension deposit account with a bank upon transferring money from an NSPF for the purpose of pension pay-out. Such interpretation implies that banks may enter insurance business and offer pension insurance schemes. However, no bank has applied to the respective regulator (SCRFMS) to obtain a license for a pension scheme. Anecdotal information points to the fact that market participants do not interpret this provision as suggested above. Some banks marketed “pension deposit accounts” as a special type of term deposit. *Dubious interpretations and unclear lines of differentiation between bank, insurance and pension products should be eliminated in order to prevent non-transparent competition from the side of banks. The National Bank of Ukraine as the bank supervisor may also be interested in clarifying this regulatory ambiguity in order to prevent banks entering the business which bears insurance-type risks that banks usually do not understand and manage properly.*

41.

**Participants in the pension scheme can transfer pension assets to an insurance company offering lifetime pension insurance contracts rather than leaving the assets with an NSPF which can provide only a definite period pay-out. This is a proper way to regulate the pay-out phase.** Nevertheless, it seems that insurance companies may offer products that are very similar to private voluntary pension insurance in the accumulation phase like “pension rents”. One should view such insurance products as quasi-pension products. This means that individuals’ pension assets may accumulate directly with insurance company without using bankruptcy remote intermediary structures like NSPFs and special regulatory advantages associated with them. According to a preliminary investigation, a bit less than 10% of life insurance products are positioned as pension products towards clients. This “co-mingling” of products opens new types of risks. Firstly, insurance policy holders are exposed to a risk of default of an insurance company. Secondly, participants would not enjoy freedom to change pension schemes as provided by the *Law of Ukraine on Non-State Pension Provisions* but, rather, terminations and similar contractual changes would be governed by insurance regulation. Finally, quasi-pension insurance products diminish market transparency and obstruct informed choice. *The SCRFMS may wish to analyze both financial and legal aspects of unclear lines of division between voluntary pension schemes as regulated by the special Law and quasi-pension insurance products regulated by the Law on Insurance in order to upgrade regulatory solutions of both so as to avoid aforementioned risks and support free and informed choice by future Ukrainian pensioners. Regulators may wish to organize education campaign in this respect once the problem of “co-mingling” of products shall be successfully resolved.*

42.

**Any failure to resolve the problem of non-transparent competition would create long-term problems and higher costs** due to: (i) lower consumer confidence; (ii) weaker understanding of the product among larger population; (iii) slower speed of development of voluntary pension schemes, and (iv) increased demand for exceptional treatment of new public sector supported schemes.

## Governance and Transparency of Non-State Pension Funds

43.

**Non-state pension funds are incorporated entities founded not for profit (for their founders).** Founders of NSPFs have to be legal entities except in a special case of occupational / professional fund. Such a fund can be founded by an association of individuals. The founders' role is to draft a Statute, obtain a license and appoint the Board of the fund. The Board is responsible for selecting and contracting an administrator, asset manager and custodian as well as for adopting the Investment Policy Declaration of a NSPF. Such governance structure represents an attempt to integrate funds governance structure originating from the common law systems into a European legal system based on the civil law. In common law systems with developed financial markets a number of regulatory and self-regulatory practices have been devised to attempt to control the conflict of interest. It is inherent in a governance structure with dispersed investors (members in this case). Within civil law systems alternative legal solutions have been devised. An example is the German model of a fund as a collection of assets without legal personality and representation which is managed and represented by a fund management company. Ukraine applied a hybrid model which raises concerns regarding separation of funds from founders as well as regarding the role of a board which should represent investors'/members' but not other parties' interests. Absence of limits for investment in the securities issued by the entities related to founders confirms that concerns about the conflict of interest may be justified.

44.

**Besides the enforcement of limits on investment in securities issued by parties related to founders, there are three additional key problems related to governance and transparency of NSPFs:** (i) how to ensure the enforcement of the provision that NSPFs should be managed not for the profit of its founders, (ii) how to ensure independency and accountability of a board which should act exclusively for the benefit of fund members, (iii) how to isolate / segregate any legal risk for the NSPF that may emanate from bankruptcy and/or liquidation of founder(s)? The SCRFSM is aware of the complexity of these problems. This is reflected in the fact that the *Draft Law of Ukraine on Amendments to the Law of Ukraine on Non-governmental Pension Provision*, which has been sent to the Parliament recently, contains a number of provisions in this respect (see the frame below). Draft amendments provide a useful guidance in the right direction but it is not at all sure that the conflict of interest shall be successfully prevented due to proposed amendments only. In this respect it is useful for the SCRFSM to use the new wording of Article 6.1. (see the frame below) and simulate the process of regulatory action in case of breach of the non-profit provision. Finding answers to the following set of questions would be helpful in this respect: (i) do legislative provisions provide the SCRFSM with adequate powers to discover the entities related to founders that may be used as special purpose vehicles for hiding profits arising from dealings with a NSPF? (ii) do legislative provisions provide the SCRFSM with adequate powers for introducing prompt corrective measures and/or actions aiming at elimination of the conflict of interest? (iii) do legislative provisions provide the SCRFSM with adequate powers for implementation of decisive punitive measures including revoking the license and/or

forced re-organization of a NSPF if previous prompt corrective measures brought no resolution to the problem? *The regulatory framework should be updated in order to provide support for decisive regulatory action along these lines. Also, as the conflict of interest may be an issue in relation to tracing ultimate founders and affiliated entities to other stakeholders (asset managers, administrators, custodians, board members), regulatory powers to discover and deal with the problem should be broadened significantly.*

**Selected excerpts from the Draft Law of Ukraine on Amendments to the Law of Ukraine on Non-governmental Pension Provision**

Art. 6.1. NSPFs may be established by decision of a founder (a meeting of founders) and do not aim to make a profit for the benefit of an individual founder or for its subsequent distribution among the founders.

Art. 6.3. The assets of a pension fund shall comprise pension holdings that are formed through contributions to the pension fund and a profit (loss) ...

Art. 11.2. The fund board members are approved by the SCRFMS under a procedure set by it.

Art. 27. Contains increased minimum capital requirement: 300 ths Euro for administrators and 500 ths Euro for asset management companies.

This is not meant to be a comprehensive review of all relevant draft provisions because the draft contains an exhaustive set of technical amendments in several areas of the Law including the provisions on liquidation.

45.

**Market discipline is a key aspect of good governance but it has been very weak in Ukraine and needs to be improved urgently.** There are two facets to this problem. Firstly, the regulatory framework is very weak in terms of regulating the scope and the dissemination standards for information that may be relevant for participants prior to the choice of the scheme.<sup>26</sup> Offerings of collective investment schemes are usually accompanied by documents such as prospectuses and/or offering the circulars / memos which contain relevant and updated information on important aspects of the business (not on the investment policy only), such as board structure, charges and fees etc. Additional information such as compliance reports may contribute to overall transparency. Production and dissemination of such documents in regular time intervals may increase the cost of regulation. Nevertheless, internet technologies substantially reduced such costs and broadened the reach of information so *the authorities may wish to update the regulatory framework in this respect in order to increase transparency while keeping the right balance between costs and benefits of tighter disclosure regulation.* Secondly, free and informed choice is the main pillar of market discipline. Such choice is dependent upon exact, prompt and comparable information on NSPFs' performance. Up to now measurement of NSPFs' performance has perhaps been the weakest point of the

<sup>26</sup> The Law contains provisions on ex post information for members.

voluntary pension system in Ukraine. A detailed discussion of this problem is presented in the next chapter.

#### **Transparency in the Case of Croatia: Prospectus as an Information Dissemination Tool**

Pension funds have to publish a prospectus in Croatia. So-called “Information prospectus” has to be issued each year no later than on March 31<sup>st</sup> on the basis of data as of December 31<sup>st</sup> the previous year. Information prospectus has to contain statutory details on the Fund, Management Company and Custodian, details on managing and supervisory board members in the Fund Management Company, description of responsibilities for investment decisions, investment policy document, audited annual financial statements and a list of shareholders of the Fund Management Company. As far as the Fund itself is concerned, a detailed portfolio breakdown is required as well as details on calculations and amounts of the fees charged on the Fund and the details on tax treatment. This is just a short description of the content of the prospectus which may be shorter or longer in other regulatory environments. Nevertheless it is a useful base to start thinking about possible ways to enhance market discipline by upgrading information dissemination in the case of NSPFs in Ukraine. It may be especially useful regarding disclosing details on fees to members and potential members. Prospectuses in Croatia have to contain detailed descriptions of calculation methods for all types of fees: an entry fee, exit fee, management fee and custodian fee.

#### **Problems Related to Asset Valuation and Calculation of Pension Unit Value**

46.

**There are several facets to this problem:**

- lack of common accounting practices applied for valuation of most asset classes,
- uneven practice and/or the complete absence of distribution of profits and losses to accounts of individual members,
- long time intervals for calculations of unit values and/or absence of such valuations,
- lack of reliable prices for securities valuations and the absence of guidance for valuations of infrequently traded securities,
- a weak role of custodians in the valuation process.

These issues are discussed in turn. Taken together, they represent the most significant risk to the operations of the pension schemes in Ukraine. Comparisons of funds performance and monitoring of investment limits is very opaque if data inputs are not trustworthy. The basis for development of market transparency and free and informed choice by the Ukrainian population may be severely eroded. Regulators may have unreliable information for making judgments whether NSPFs perform for the benefit of individual members or in favor of some hidden commercial interest (e.g. for the benefit of persons related to founders). In particular, arbitrary valuations in an industry which is at its early stage of development and which charges high percentage fees to low bases and volumes in an environment lacking standards, codes and regulatory strength, raises a concern regarding objectivity of fees charged on funds. Such a scheme can easily become a vehicle for distribution of new entrants’ money for the benefit of related parties (this

may happen to the extent that some asset classes and/or instruments may be overvalued). Similarly, if there is asymmetric information among potential new entrants about the true valuation of assets (some new entrants may be related persons hence more knowledgeable about true values of assets), private information about undervaluation may attract better informed new entrants (this may happen at the expense of old members who decide to change the scheme because of seeming under-performance and also at the expense of potential entrants without access to privileged information who decide not to enter the scheme). If such a system persists, managers, administrators and custodians who invest less in operations, perform infrequent valuations and record larger departures from fair values would have superior performance because they would incur lower operation costs. In this respect, potential new members have no basis to judge the reputation of companies providing services to the Fund. It is not the opinion of the World Bank that the description above is a fair description of actual functioning of the present system. Nevertheless, the description should be interpreted as a warning because the World Bank has identified some flaws which – if not eliminated on time – may lead to developments as described above. For this reason the flaws described in this paragraph should be eliminated as quickly as possible. Besides limiting the scope of investment in other assets only to those asset classes which can be valued properly (see paragraph 27) the following actions should be taken immediately:

- common accounting practices should be applied in valuation of asset classes,
- profits and losses should be distributed to individual accounts,
- time intervals for calculations of unit values should be shortened in order to reach the best practice of daily valuations as soon as possible,
- guidance for valuations of infrequently traded securities should be issued,
- roles and responsibilities of custodians in valuations and reporting should be strengthened.

47.

**International Financial Reporting Standards (IFRS) should be applied in the industry as soon as possible.** Both regulators and industry associations may wish to accompany its implementation by education programs and campaigns.

48.

**As problems primarily emanate from infrequent valuations of assets, illiquid markets for financial instruments and breaches of investment limits, the introduction of IFRS will solve nothing per se.** There is a long menu of options regulators may choose in order to improve asset valuations in illiquid markets, such as:

- Definition of “total assets” and “net asset value” may be introduced and values of the instruments that breach investment limits or that are not eligible for investment may not be counted in NSPFs’ total assets as recognized by the regulator.<sup>27</sup>

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<sup>27</sup> This is a drastic measure that may be introduced only if regulators develop a transparent and well established practice of reacting to breaches of investment limits, whereas fundamental breaches shall be distinguished from technical breaches and some form of averaging shall be applied.

- As closing prices may not be representative (and may be manipulated) due to illiquid markets for financial instruments, some form of average pricing for domestic securities may be introduced (e.g. weighted average daily price for the last trading day may apply).<sup>28</sup>
- The regulator would generally like to avoid allowing investment in stocks that are infrequently traded, but if such investment is made eligible anyway, the regulator should be responsible for issuing and enforcing common valuation guidelines for the stocks that are not traded for longer than a trading day. In this respect, the regulator should develop good understanding of underlying forces of supply and demand for each individual stock which is made eligible for investment if illiquid, and implement stop trading rules<sup>29</sup> in order to avoid infrequent but large swings in stock prices.
- Fixed income instruments should be valued according to the linear amortization method if an instrument was not traded for more than several (up to 30) days, in which case a starting value should be a fair value for the last trading day (taking the daily average not the closing price as a starting point fair value for valuation).

49.

**Part of opposition to daily calculations (and public dissemination) of unit values was inspired (rightly so) by fears of displaying irrelevant unit values due to problems related with asset valuation.** When the rules for asset valuations improve, unit values should be calculated and displayed daily implying that profits and losses should be distributed to individual accounts at the daily frequency, too. Regulators should prescribe detailed instructions how to account for fees and how to calculate units in a daily based system. No room for different interpretations should be left. It should be clear that the unit value is calculated by dividing net asset value for a day by the number of units for the same day, whereas the number of units for a day equals the number of units for a previous working day plus the units issued during a day minus the units withdrawn for a day. It should be made clear that the issued and withdrawn units should be recorded in individual accounts by the same working day.

#### Calculation of Fees and Other Charges in Systems with Daily Valuations

In systems with daily valuations fees that are calculated on the basis of NAV (e.g. a management fee, custodian fee) should be calculated on a daily basis in order to make them comparable to the other fees such as entry, exit and transaction fees. A simple linear method of bringing the annual percentage fee down to daily level should be applied. Fees that are calculated on the basis of assets should be calculated on the basis equal to net asset value (total asset value minus any liability arising on the basis of investment) for a trading day. The period of fee payment can be less frequent (e.g. monthly).

50.

**Roles and responsibilities of custodians need to be improved.** The regulation of the conflict of interest seems to be proper because a custodian cannot be an affiliated person,

<sup>28</sup> Traded quantity should be used for constructing weights.

<sup>29</sup> Trading can be stopped if intraday price changes by more than a threshold of +/-%, say, by 10%.

NSPF cannot invest in securities issued by a custodian and a custodian should not provide securities trading services to the fund. Nevertheless, asset segregation provisions need to be upgraded. Article 44(7) contains an explicit prohibition for the use of pension fund assets as “credit resources”, but perhaps the authorities would wish to firm up segregation of assets by stating that pension funds assets should be kept on separate accounts, isolated from assets of a bank and/or custodian and used only for the purposes as specified in the *Law of Ukraine on Non-State Pension Provisions*.

51.

**The custodian “checks” calculations of the net asset and unit values and files reports. This is a relatively weak definition of custodian’s responsibility that needs to be upgraded.** The Law contains a number of provisions which suggest a broader role for the custodian: (i) the custodian should carry out instructions of the SSMC on suspending asset manager’s instructions on grounds determined by the legislation, (ii) in the event of detecting violations of the law with respect to management of pension assets the custodian has to notify the board, the administrator and both regulators within 24 hours, (iii) the custodian may be held liable for any damages it may have caused. At present it seems that filing the quarterly reports on net value of NSPF assets (under the Procedure for Determination of the Net Value of NSPF Assets) and safekeeping of securities is the main job custodians do. According to the information available to the World Bank, up to now custodians have not suspended asset manager’s instructions and/or reported violations of any legal provision. Neither has any custodian been held liable for any damage it may have caused. Most probably this is a consequence of an overly formalistic view taken in an environment where valuations are infrequent and custodians are responsible only for “checking” valuations (not for valuations per se). This will have to change during transition to daily valuation. The custodian should bear prime responsibility for valuation and reporting. It does not mean that a custodian has to work out valuation on its own without any responsibility on the side of the asset manager. Custodian’s responsibility can emanate from “confirmations” of valuations. The best practice is that both the administrator (and/or the fund manager)<sup>30</sup> and the custodian work out separate valuations of assets and unit values and reconcile their first estimates, with the custodian having a final say on valuation. The registry of pension contribution units may also be managed by the custodian. *Custodians, asset managers, administrators and the SSMC should develop open professional communication in order to set up details for valuation rules. Extending the roles and responsibilities of a custodian within the context of a daily valuation system would require significant efforts and investment on the side of custodians also involving some innovations in the licensing procedure which is discussed in a separate section on regulatory practices below.*

52.

**The World Bank understands that the joint working group of regulators and industry representatives has been established in order to resolve issues of valuation.** The World Bank strongly supports this way of organization of productive public-private

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<sup>30</sup> In some jurisdictions administrators and fund managers cannot be separated and they perform fund management business through a single legal entity – a fund management company.

dialogue and stands ready to provide concrete technical support to the working group in order to implement solutions which represent the best practice.

### **Additional Aspects of Consumer Protection: Cross selling, Forced selling and Marketing**

53.

**Given very high potentials for long run return (and risk) in the business of managing and/or administering pension schemes, service providers in many countries tend to engage in aggressive marketing and sales activities. Such activities may reduce the possibility to make a free and informed choice. Marketing activities seem to be well regulated (Article 53) but provisions regulating sales are much weaker and need to be upgraded.** There is a provision (Article 53.6(4)) prohibiting advertisers to give or promise to give gifts, prizes or offer any incentive measures that may influence a potential participant's choice of one or another pension fund. In addition, Article 54 regulates agent service providers in a very formal manner, without specifying anything on how they may advertise and sell pension funds, but rather specifying conditions of legal competence and non-conviction for pursuing the task of a sales agent. The Law is not clear regarding multi-level marketing schemes which may be organized in a way that roles of members and sales agents intermingle in one person so it is not possible to distinguish between (illegal) prize for membership and (legal) sales fee for an agent. Also the authorities may wish to analyze whether any hidden cross-selling benefits occur in cases where managers and/or administrators are members of larger financial groups (e.g. easier access to a housing loan and/or life insurance for members of voluntary pension schemes administered and/or managed by the same financial group). Finally, the Law is not clear regarding negative incentives (forced selling) that may occur in the context of corporate and/or occupational funds, whereas membership in the pension scheme may be an explicit or implicit condition for obtaining some other benefit such as employment and/or the benefits arising from membership in a trade union or professional association.

54.

**Regulators may wish to raise awareness about this potential problem among the Labor and Consumer Protection authorities** if an analysis and anecdotal information reveal that the problem may be widespread.

### **Regulatory Practices and Policy**

55.

**Supervision of voluntary pension schemes is fragmented. Regulators' horizontal cooperation and a political support are keys to effective regulation.** NSPFs and administrators are licensed and supervised by the State Commission for Regulation of Financial Services Markets of Ukraine (SCRFSM). Asset managers are licensed and supervised by the Securities and Stock Markets Commission of Ukraine (SSMC). Custodians are licensed and supervised by the National Bank of Ukraine and SSMC in

their different capacities. The provision of pensions (pension contracts and pension schemes) is licensed and supervised by the SCRFMS only. Although the industry files reports to both the SCRFMS and SSMC, the cost of reporting does not seem to be a problem. Regulators have developed horizontal cooperation in sharing the data. The horizontal cooperation needs to be strengthened and broadened on the basis of *common strategic plan for a regulatory reform and its enforcement as a common platform for improved regulatory practice*. Regulators alone shall not be able to initiate a regulatory reform without stronger political support. *The Ukrainian government needs to recognize importance of voluntary pensions' provision (it can be seen as a strategic financial product linked to the forthcoming 2<sup>nd</sup> pillar pension reform) in order to support a comprehensive plan for future development of voluntary pension provisions. Recognition of its importance should be a part of a broader plan aiming at rapid development of capital markets in Ukraine.*

56.

**The SSMC monitors investment limits on a quarterly basis. The monitoring of investment limits has to improve.** Infrequent monitoring is usually rigid but regulatory treatment of any breach of the limit and it usually has no impact on industry development as long as more fundamental problems are not resolved. In an environment with illiquid securities markets, the positions that are hard to liquidate and prices that are volatile, the monitoring of limits should be done on the basis of the phasing out approach based on averaging (e.g. *a limit needs to be obeyed at the level of quarterly averages of monthly data instead of end period measurement point*).

57.

**The SSMC licenses and monitors asset managers and custodians.** There have been five refusals of licenses and 3 suspensions because asset management companies did not conclude agreement with NSPFs. No suspensions have occurred due to repeated violations of legal provisions. Asset management companies are included in quarterly plans of on site inspections. Up to now 53 asset management companies (out of 320 with licenses) have been inspected, out of which 9 have been managing pension funds. *Regulators and custodians should pay special attention to how managers and administrators calculate fees (see para 10). Collaboration in on site inspections by the two regulators should be developed.*

58.

**An SSMC's special department deals with the licensing of custodians. A bank – custodian obtains a license from the National Bank of Ukraine but in order to perform services according to securities markets regulations the bank needs an additional license from the SSMC.** Any licensed bank can conclude a contract for performing custodian services with a board of a fund. A problem is related to the fact that the role of custodians – as specified by the *Law of Ukraine on Non-State Pension Provisions* and as proposed in this document (paragraph 51) – goes far beyond mere safekeeping of securities and reporting. Deposit bank has to play the key role in valuation. Significant investment in know-how, manpower and systems shall be required in order to perform the envisaged role. Transition from the present simplified role of

custodian – safekeeper and rapporteur to a future complex role of a custodian – depository who shall be able to assume full responsibility for valuations and compliance of asset managers shall require the SSMC’s active engagement (in cooperation with the National Bank of Ukraine). So far there have been no on site inspections of custodians working for NSPFs. For that reason promoting a new role for custodians should come to the focus of the SSMC’s activities. On site inspections shall be required to check know-how, IT systems and flow of information used in the valuation process in order to make sure that custodians perform their present role properly. In this respect it is useful to simulate the sequence of events that may happen if the SSMC finds out that a licensed custodian lacks know-how and/or IT systems and/or information to perform their role properly.

Answering the following sequence of questions may be helpful in this respect: (i) does the SSMC have adequate regulatory / legal powers for introducing prompt corrective actions with custodians, and (ii) does the SSMC have adequate regulatory / legal powers for implementation of decisive punitive measures such as revoking the license and/or forced change of custodian? *Regulators may propose improvements in the regulatory framework if they think that present legal backing is not strong enough for initiating prompt corrective actions towards custodians.*

59.

**Regulatory resources (with both regulatory agencies) should shift from formal controls to more substantive reviews aiming at identifying the market players who may be abusing or disregarding the main principles as specified by the Law (see paragraph 44 above) and eliminating the most pressing issues such as valuation problems.** A significant learning effort on the side of regulators is required for proper monitoring of the industry. Regulators should invest resources into learning and regulatory development. Purely formal checks and balances are important but have limited powers in promoting effective supervision and regulation. *In this respect it is of critical importance to increase on site resources and on site inspection collaboration between two regulatory agencies.*

60.

**The SCRFSM should analyze and understand the behavior of NSPFs which attract members without significant financial contributions.** The SCRFSM should understand whether presence of such funds in the system represents any risk. In case of a positive answer, the SCRFSM should actively propose legal innovations aiming at stronger regulation of pension contracts and pension schemes in order to regulate only those schemes that ensure some critical minimum level of contributions payments.

61.

**The SCRFSM should conduct a thorough in-depth investigation of founders and affiliated persons in order to discover any potential financial and/or commercial links between NSPFs and founders/affiliated persons and investigate whether such links may violate the provision acting not for founders’ profits but for the benefit of members.** In doing so the SCRFSM should identify any obstacles it may face in terms of: (i) access to ownership data; (ii) legal powers (intervention rules) to undertake prompt corrective actions. In case of identifying any obstacle of this kind, the SCRFSM should

propose legal amendments to overcome these obstacles. Efforts aiming to trace ultimate controllers and reveal conflicts of interest should be broadened to include all relevant stakeholders including asset managers, administrators and custodians. Such an action at an early stage of industry development would benefit stability and growth of private pension schemes for the benefit of Ukrainian people.

### Summary of Recommendations

*Recommendations are presented as they appear in the main body of the text but the column to the right indicates actions which should be taken immediately*

	<b>Recommendation</b>	<b>Reference in paragraph no.</b>	<b>Urgency indicator</b>
1	Estimate how many funds are disregarding financial contributions and emphasizing growth of client base at this stage; think through potential risks that may emerge; finally, reconsider potential regulation of contribution payments if risks of the present situation outweigh eventual benefits.	20,60	X
2	Gradual abolishing of corporate funds investment in founders' securities may be considered in the medium run. However, it is far more important to introduce limits to investment in the securities issued by the entities related to founders. Complete absence of such limits raises a number of concerns because it may lead to development of "in house" captive funds with distorted management incentives which would not maximize members' net wealth but rather some other commercial interest determined by the founder and/or a related party.	22,61	X
3	Implement an effective capital markets development program, starting with development of government securities markets. Strategy for improving the voluntary pension provisions industry and its regulation in Ukraine should be a part of this plan. One of the cornerstones is implementation of DVP securities settlement system. Only securities that are settled in this way may be declared eligible for investment.	23, 25	X
4	Complete absence of investment in foreign assets is worrisome. Investment in high quality, liquid and correctly priced foreign securities can substantially improve risk-return combinations of NSPFs. This is especially important in an environment without comparable domestic markets for safe, liquid and correctly priced securities, especially government bonds. At the same time, macroeconomic consequences of related capital outflows shall remain negligible for the years to come due to relatively small size of NSPFs compared to the rest of the financial system. <i>The authorities may wish to amend foreign exchange regulation and the SSMC may consider a regulation which would allow Ukrainian NSPFs to invest in high quality liquid securities in developed international markets.</i>	26	X
5	Other assets should be regulated in a more precise way. Leaving this asset class defined as "anything which is not prohibited for investment by Ukrainian laws" raises a number of concerns related to risk, liquidity and valuation methods of such assets.	27	X
6	Market growth will be coupled by greater sophistication of both investors and financial instruments. Allowing limited investment in derivatives solely for the purpose of hedging NSPFs' positions is a logical step in the next stage of the regulatory reform. It should be coupled by a program (and regulation) that shall ensure a proper valuation of derivatives.	28	
7	Consider introducing a limit to a share in equity and/or to a		

	<b>Recommendation</b>	<b>Reference in paragraph no.</b>	<b>Urgency indicator</b>
	share in individual securities issue an individual fund can take. Problem of “cornering the market” is not pressing for the time being (since NSPFs are small financial institutions), but the problem may emerge as NSPFs will grow. In this respect, a limit can be introduced gradually and selectively.	29	
8	Consider implementing general risk management provisions in the regulation.	30	
9	Restructure the Kyivmiskbud experiment by amending the existing regulatory framework with a prime purpose to define the time frame for transformation of pension fund / scheme into the scheme regulated by the <i>Law of Ukraine on Non-State Pension Provisions</i> .	38	X
10	Public sector entities should refrain from designing any new scheme under special regulations or under exemptions from existing regulation.	39	X
11	Dubious interpretations and unclear lines of differentiation between bank, insurance and pension products should be eliminated in order to prevent non-transparent competition from the side of banks. The National Bank of Ukraine as the bank supervisor may also be interested in clarifying this regulatory ambiguity in order to prevent banks entering the business which bears risks that banks usually do not understand properly and manage well.	40,41	
12	Improve corporate governance and increase transparency of NSPFs by introducing prospectus and innovating provisions that regulate conflict of interest and regulatory intervention aiming at its elimination. Powers of regulators to trace ultimate controllers and acting against the conflict of interest should be enhanced significantly.	44,45	X
13	IFRS should be applied in the industry as soon as possible and both regulators and industry associations may support their implementation by offering seminars and campaigns.	47	X
14	Technical solutions for valuations in illiquid markets should be implemented as soon as possible.	48	X
15	Unit values should be calculated and displayed daily implying that profits and losses should be distributed to individual accounts at the same frequency.	49	X
16	Segregation of NSPFs assets with a custodian should be upgraded.	50	
17	Roles and responsibilities of custodians need to be upgraded in order to reaffirm the role of deposit banks in valuations. Deposit banks should be held liable for valuations.	51,58	X
18	Cross-selling benefits and forced sales practices should be watched closely and regulated in a more specific way. Cooperation with the Labor and Consumer Protection authorities should be developed in this respect.	53,54	
19	Horizontal cooperation and political support to regulators need to be strengthened using a shared strategic plan for regulatory reform and enforcement as a common platform for improved regulatory practice. This shared strategic plan should be a part of a plan for capital markets development in Ukraine.	55	X
20	The SSMC should monitor investment limits more frequently		

	<b>Recommendation</b>	<b>Reference in paragraph no.</b>	<b>Urgency indicator</b>
	and enforce investment limits on the basis of multi-period averages not on the basis of infrequent end-period monitoring.	56	X
21	Increase resources and collaboration in on site inspections with both regulatory agencies, pay attention to how fees are calculated.	59	X

## Statistical Annex

### Main Statistical Facts per Asset Management Companies

Asset management company	No. of funds	Assets in UAH	Members	Market share - assets	Market share - members	Assets per member
1	1	41,170,562	19,148	18.98%	7.64%	2150.123
2	1	29,398,844	24,305	13.55%	9.70%	1209.58
3	6	20,388,460	4,372	9.40%	1.75%	4663.417
4	2	14,774,134	3,813	6.81%	1.52%	3874.674
5	1	13,733,344	3,186	6.33%	1.27%	4310.529
6	1	13,073,951	4,269	6.03%	1.70%	3062.532
7	1	11,157,500	3,510	5.14%	1.40%	3178.8
8	2	9,114,540	12,807	4.20%	5.11%	711.7
9	3	8,501,807	94,339	3.92%	37.66%	90.1
10	1	8,200,744	838	3.78%	0.33%	9786.1
11	1	7,959,481	4,372	3.67%	1.75%	1820.6
12	1	5,367,869	3,613	2.47%	1.44%	1485.7
13	5	5,306,605	2,037	2.45%	0.81%	2605.1
14	2	4,480,922	2,124	2.07%	0.85%	2109.7
15	1	3,716,900	1,323	1.71%	0.53%	2809.4
16	3	3,338,019	3,155	1.54%	1.26%	1058.0
17	1	2,409,456	1,046	1.11%	0.42%	2303.5
18	1	2,261,240	1,319	1.04%	0.53%	1714.4
19	1	2,236,165	30,358	1.03%	12.12%	73.7
20	4	1,891,056	11,512	0.87%	4.60%	164.3
21	1	1,787,567	1,179	0.82%	0.47%	1516.2
22	1	1,784,268	1,318	0.82%	0.53%	1353.8
23	2	1,457,553	5,645	0.67%	2.25%	258.2
24	1	917,768	1,177	0.42%	0.47%	779.8
25	2	362,985	140	0.17%	0.06%	2592.7
26	1	350,430	1,141	0.16%	0.46%	307.1
27	2	320,713	2,484	0.15%	0.99%	129.1
28	1	312,343	586	0.14%	0.23%	533.0
29	1	288,449	98	0.13%	0.04%	2943.4
30	1	216,830	140	0.10%	0.06%	1548.8
31	1	199,620	340	0.09%	0.14%	587.1
32	1	128,811	153	0.06%	0.06%	841.9
33	1	98,294	567	0.05%	0.23%	173.4
34	1	91,953	368	0.04%	0.15%	249.9
35	1	24,100	3,173	0.01%	1.27%	7.6
36	7	20,000	446	0.01%	0.18%	44.8
37	2	18,547	4	0.01%	0.00%	4636.8
38	1	13,876	16	0.01%	0.01%	867.3
39	1	9,007	19	0.00%	0.01%	474.1
40	1	6,133	28	0.00%	0.01%	219.0

### Main Statistical Facts per Administrators

<b>№ п/п</b>	<b>Number of Funds</b>	<b>Members</b>	<b>Assets in UAH</b>	<b>Share - members</b>	<b>Share - assets</b>
1	1	19,148	41,170,561.67	7.8%	19.0%
2	1	24,305	29,398,843.74	9.9%	13.6%
3	9	4,529	28,495,298.75	1.8%	13.1%
4	10	9,597	14,928,917.19	3.9%	6.9%
5	2	3,813	14,774,133.71	1.5%	6.8%
6	2	4,327	14,083,774.58	1.8%	6.5%
7	1	4,269	13,073,951.07	1.7%	6.0%
8	10	4,070	11,465,948.73	1.7%	5.3%
9	2	12,807	9,114,540.24	5.2%	4.2%
10	3	94,339	8,501,807.06	38.3%	3.9%
11	1	838	8,200,743.73	0.3%	3.8%
12	2	2,124	4,480,921.88	0.9%	2.1%
13	4	3,722	3,436,312.51	1.5%	1.6%
14	2	1,046	2,409,456.22	0.4%	1.1%
15	1	1,319	2,261,239.67	0.5%	1.0%
16	1	30,358	2,236,165.25	12.3%	1.0%
17	6	14,685	1,915,155.90	6.0%	0.9%
18	1	1,179	1,787,567.15	0.5%	0.8%
19	1	1,318	1,784,267.73	0.5%	0.8%
20	2	5,645	1,457,552.97	2.3%	0.7%
21	1	1,177	917,768.22	0.5%	0.4%
22	2	140	362,984.65	0.1%	0.2%
23	1	586	312,343.09	0.2%	0.1%
24	1	340	199,619.54	0.1%	0.1%
25	1	368	91,952.56	0.1%	0.0%
26	1	16	13,876.26	0.0%	0.0%
27	1	19	9,007.05	0.0%	0.0%
28	1	28	6,132.77	0.0%	0.0%