Focus Group project evaluating the Association Agreements and DCFTAs in Georgia, Moldova and Ukraine

Focus Group No 4: Financial markets

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In March 2019 we began a series of monthly focus group meetings on key aspects of the Association Agreements and DCFTAs between the EU and Georgia, Moldova and Ukraine. Focus group sessions are held in each of the three capitals with a range of stakeholders (government, business, civil society, etc.) using a standardized questionnaire. The focus groups are organised and moderated by our partners in the three capitals: IER in Kyiv, Expert-Grup in Chisinau and Reformatics in Tbilisi.

The objective is to get fresh views on how the Association Agreements and DCFTAs are progressing in practice. This may lead to recommendations to policy makers in the three capitals and the EU institutions.

While the views of individual participants are treated as confidential, reports are published drawing together a synthesis of the findings.

Focus Group No 4 concerned financial markets, took place in June 2019, and was organised around four questions submitted to participants in advance. Written and oral replies to the questions were collected, and are reported on below.

There were between 14 and 21 participants in the three country sessions, consisting of representatives of the central bank and other regulatory authorities, business interests and associations in the financial sector, and think tanks/NGOs.

[1] Of respectively CEPS, Brussels; Reformatics, Tbilisi; Expert-Grup, Chisinau; IER, Kyiv.

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This publication is prepared within the framework of the CEPS-led '3DCFTAs' project, enabled by financial support from Sweden.

Question no 1: Legislation. *Is the schedule of legislation in the Annex to the Association Agreement and DCFTA, covering the Basle principles for banks, and Solvency 2 the major instrument for the insurance sector, being fulfilled…*

a. *correctly on time, or*
b. *substantially, but with some time lags/blockages/problems,*
c. *with big problems?*

In **Ukraine** there are big differences between the major sub-sectors. Legislation on bank regulation in accordance with Basle principles progresses reasonably well. However there was little progress in the non-bank financial and insurance sectors. The Rada is seen as the main point of blockage, with failures to adopt submitted draft laws. The Rada "was not interested in issues of the financial market". There are among others draft laws for Deposit Insurance, but this can only be a long-term goal, for which the banking system is not yet ready at the level of EU standards.

In **Moldova** only a small minority of respondents felt that the transposition of European legislation was being done correctly on time, although representative of the regulatory authorities argued that there had been a colossal effort, especially in relation to Basle principles for the banking sector. It was felt that opinions on this question had been distorted as a result of the major bank fraud of 2014, while the implementation of these reforms came with a great delay. Reform of the Deposit Insurance scheme had been accepted with some reluctance by the banks. The insurance sector remains "totally unprepared" for requirements of new regulations.

In **Georgia** it was considered that for the banking sector the adoption of legislation is proceeding smoothly with no real obstacles. Introduction of Basle principles is already advanced. By 2020 all requirements of the DCFTA in the banking sector will have been met. Deposit Insurance has been provided for ahead of schedule. As for the insurance sector there are 6-7 year transitional period for implementation. Solvency I was already introduced in 2016, but introduction of Solvency II is most challenging, among others, with inadequacy of supporting services such as actuaries. Georgia already introduced regulations related to motor vehicle insurance (civil liability) covering only foreign registered vehicles and full implementation is lagging behind.

Question no 2: Implementation. *Are the financial institutions implementing the new legislation…*

a. *well, or*
b. *with some difficulty, or*
c. *with big problems?*

In **Ukraine** implementation by financial institutions mirrors that already reported for the legislative process. The banking system is seen as doing reasonably well, although complaining about various difficulties. There were complaints about unfair competition for private sector banks, due to the practices of state-owned banks, with further complaints by the correctly supervised banks over unfair competition from non-bank suppliers of financial services. Implementation in the insurance sector and in other non-banking financial services is highly problematic, with very poor performance of the supervisory authorities.

In **Moldova** a large majority of respondents reported that financial institutions experience difficulties in implementing European legislation. The transfer of information from the central bank to market participants was being helped by various technical assistance projects. The situation was most inadequate in the non-banking financial sector, with little advance in the capital market and insurance sectors in recent years. Here it would be advisable to avoid imposing too sophisticated mechanisms.

In **Georgia** almost all banks have international and institutional investors and follow internationally recognised practice. Implementation of EU regulations in the banking sector is proceeding smoothly on time without significant problems. There is permanent and continuing cooperation between financial institutions and regulator ensuring effective implementation of financial regulations. Deposit insurance is going ahead in the banking sector, albeit after initial opposition. Extension of the system to other depository institutions has to come later. As already reported above, implementation of Solvency II encounters problems, notably with inadequate market capitalisation the insurance sector and supporting services. Georgia undertakes relevant measures to join Green Card system, which is also essential for the effective implementation of insurance directive.

Question no 3: Bank failures/frauds. *Would the whole package of measures, if implemented well, prevent major banking failures/crises of the type observed for example in Moldova and Ukraine in the recent past….*

a. definitely prevent, or
b. only help prevent, or
c. not really cover these kinds of disorder?

Ukrainian participants felt that full implantation of EU legislation will help prevent bank fraud, but will not be a 'silver bullet' protecting against all threats to the correct functioning of financial institutions. Similarly in **Moldova** if the whole package of DCFTA measures had been in place the 2014 bank fraud might well have been prevented, the causes of which are well known: violation of credit procedures, poor corporate governance and money laundering practices. However there have been other factors at play, not linked to banking legislation, including the functioning of the judiciary and political disputes. For **Georgia**, in the opinion of both official and private sector participants, the banking system is trusted by the population and has not suffered by bank failures. New regulatory requirements may further reduce the risk of bank fraud, but also make access to credit more difficult.

Question no 4: Updating. *A major new piece of EU legislation in 2018 has been the so-called MiFID II, which is highly complex regulatory system aiming mainly at sophisticated financial instruments of the type that caused the 2008 global financial crisis. There is a presumption in the DCFTA that the Annexes should be updated for new EU legislation. What are the views of the authorities and financial institutions on the case for executing this update…*

a. yes, promptly, or
b. only with a long delay of years, allowing first for experience in the EU, or
c. not at all since it is unsuitable for own financial markets?

For **Ukraine** participants noted that MiFID II is much more complicated than MiFID I, but it is needed to ensures better protection of all stakeholders. Ukraine has been legislating some parts of MiFID II, but lobbyists in the Rada have prevented three attempts to adopt a basic law for compliance with MiFID II. Officials believe that Ukraine has enough time to fulfill all MiFID obligations by 2023, and that it makes no sense to align on old and outdated regulations.

Moldovan participants felt on the one hand that their authorities should be aligning on the newest European regulations, rather than old ones, but on the other hand that the most complex regulations are ahead of the realities and requirements of the Moldovan financial sector.

For **Georgia** implementation of MiFID II is considered challenging for its more complex requirements, for which the financial sector is not sufficiently developed. EU member states only started implementing MiFID II in 2018, and it would be important to have information on their experiences in this regard. The authorities are undertaking a gap analysis to get a clear picture of what would need to be done.

Question No 5: 'Full internal market treatment'. *These provisions appear only in the Ukraine DCFTA, setting out detailed and exacting procedures for gaining this status for financial services. Do the Ukrainian authorities and/or financial institutions favour going ahead with this provision?*

Ukrainian participants felt that that the country should progress with the "full internal market treatment" objective. The only disputed point was the desirable speed of the changes – prompt or gradual.

Overall conclusions:

For all three countries there is an important distinction to be made between the banking sector on the one hand, and on the other hand the non-banking financial institutions and the insurance sector. Basic bank regulation according the Basle principles proceeds reasonably well in **Ukraine**, or smoothly in **Georgia**, but with reservations expressed in **Moldova.** The major bank frauds/failures in recent years in **Moldova and Ukraine** might have been prevented if the European regulations had been properly in place. However for the non-banking financial institutions and especially the insurance sector there are widespread problems in capacity to implement regulations, or needs to take more time. In **Moldova and Georgia**, the new MiFID legislation is seen as going beyond the needs and capacities of the current state of financial markets, or at least for more time to see how this new directive is implemented in the EU itself. On the contrary, in **Ukraine,** the MIFID II is deemed necessary for the financial sector, although currently the adoption of its provisions remains slow.