INPUT PAPER
NO. 4

STOCKHOLM INSTITUTE OF TRANSITION ECONOMICS

SCEEUS STOCKHOLM CENTRE FOR EASTERN EUROPEAN STUDIES

Stockholm Conference on Private Sector Engagement in Ukraine's Recovery and Reconstruction

Combining Silos - Joint Roles for Public and Private Participants in Ukraine's Recovery

Christopher Collie[1]

Developing a broad investor base in Ukraine will require private players to help solve problems that are typically addressed by the official sector. In turn, official sector organisations should take a unified and entrepreneurial approach to private sector engagement.

Ukraine's recovery will require very large volumes of private investment to meet the reconstruction and recovery needs that the official sector cannot cover. Major problems need to be solved to enable private funding to flow at scale. Aside from the obvious issues of the timeline and trajectory of the war, key bottlenecks include country risk concerns on rule of law, governance and corruption, limited investor familiarity with Ukraine preventing rigorous risk appraisal, and a lack of sufficient first-loss capital.

This note considers three areas where the private and official sectors could cooperate to address risk while pursuing their respective goals, and which could form part of a strategy for developing Ukraine's investor base:

- accelerating country risk reduction by involving potential investors in existing reform processes and adding impetus to reform implementation
- enabling sharper risk assessment and helping drive broader adoption by centralising official sector data
- obtaining risk-mitigating private impact finance as a complement to official sources of concessional capital

Private interest in post-war recovery investment appears to be significant if the problems can be solved. Investors will vary in the level of comfort they require regarding these problems.

1 Chris Collie is Principal Legal Counsel at the European Stability Mechanism (Luxembourg), member of the board of Luxembourg-Ukraine Chamber of Commerce, and a Trustee at the Centre for Effective Dispute Resolution (London). Views are strictly personal and do not necessarily reflect the opinions or positions of the organisations with which the author is affiliated.

Some investors, referred to as early adopters in this discussion note, are already convinced of the benefits of participating in Ukraine's recovery and would be ready to make allocations if sufficient first-loss financing can be secured.

But for most of the investment community Ukraine remains an unfamiliar and very risky market. Overall recovery investment is a niche proposition despite the opportunities. Investors may largely expect the problems to be solved by the official sector: governments and IFIs will deal with reforms and provide concessional first-loss capital, and then private funding can follow.

The scale and urgency of the problems warrant a different approach in Ukraine. Solutions will likely be more effective, and come sooner, if investors become active participants early in the problem-solving process. This may be an unfamiliar posture for investors and asset managers and place an additional burden on them, but feedback loops and critical mass effects mean that they can expect to be rewarded for taking an active role.

The official sector would need to strategically initiate and facilitate this involvement. EU/G7 authorities, IFIs/DFIs, and Ukrainian counterparts, would need to find ways to interface with the investment community in a unified and strategic way. The diversity of those institutions and their operations means that achieving such coordination may be challenging for them, but the benefit of attracting private finance sooner and in higher amounts should justify the work.

Accelerating Country Risk Reduction - Add Impetus to Rule of Law and Governance Reforms

The extent of private involvement in Ukraine's recovery, as well as the multiplier effect of investment, will be directly proportional to the quality of rule of law and governance in Ukraine. Weak rule of law will keep many investors away entirely, and those who do participate will require elevated returns that may not be obtainable without significant concessional capital. This requires accelerated progress in justice system reforms and further support for internationals and domestic agencies working on corruption and fraud.

Rule of law reforms must be accompanied by improved governance, transparency and market confidence. The size of Ukraine's state-owned corporate sector and its presence in many competitive industries makes it either the biggest opportunity, or the biggest obstacle, for improved investor confidence in transparent governance and market functioning.

Improved governance at state-owned corporates, in particular in relation to inefficiency and corruption, tends to receive less attention than other rule of law reforms. A critical and very visible step would be for Ukraine to create a new central holding company established along OECD lines, with full ownership of the state's corporate shareholdings and a mandate to manage them on a commercial basis. Addressing governance issues in state-owned corporates could have a transformational effect on the way that business is done in Ukraine and provide a very concrete reform that Ukraine could point to as evidence of its intentions on governance and transparency.

The problem is that reforms of the justice system and the state-owned sectors are always notoriously difficult. If legislated and implemented effectively they can entirely shift a market's risk/reward proposition, but this can take a generation and Ukraine's recovery does not have that time. Every available resource should therefore be mustered to add impetus to the reform effort. While reforms are a political issue and are primarily the responsibility of the official sector, it is likely to materially increase the pace and scope of reforms if private investors become involved in an appropriate way.

The EU and G7 authorities and IFIs/DFIs which are involved in rule of law reforms could partner to create a forum for early adopters and potential investors to detail their concerns on rule of law, corruption and transparency issues. This could also help assess the level of funding that would become available if those (and other) concerns were addressed. The forum could include a dedicated channel with Ukrainian authorities to add impetus to the reform process. Information should flow both ways, providing details of reform efforts and ongoing problems back to investors and helping them assess progress and risks.

Enabling Sharper Risk Assessment - Create a More Informed Potential Investor Base by Centralising and Communicating Data

A key bottleneck for broadening the investor base is that non-specialist investors are unfamiliar with Ukraine risk. This problem is compounded by stereotypes. It is further compounded by the difficulty of understanding what the official sector and Ukrainian authorities are doing to prepare for recovery (whether in terms of reconstruction or reforms), and what the level of progress is.

These bottlenecks may discourage potential investors from considering Ukraine recovery investment on the basis that developing a rigorous outlook and risk appraisal is simply too hard.

Official sector organisations and government authorities could try to address this by making it easier for investors to access publicly available information describing the goals and progress of their programmes and activities. This could take the form of a portal centralising information on the current and planned activities of international financial institutions and development banks involved in Ukraine. It could also centralise information from those and other institutions (such as EU and international government organisations and NGOs) relating to rule of law, transparency, and EU accession.

Such a portal could also include publicly available commercial data, for example in relation to the experience of previous financing to Ukrainian financial intermediaries, or the performance of initial recovery investment vehicles once they are deployed.

Mitigating Risk - Impact Finance as a Complement to Official Sector Concessional Capital

Early private financing structures will require concessional first-loss capital that is typically provided by the official sector. Private impact finance may offer a way to scale beyond the volumes that will be made available from donors and IFIs/DFIs. The impact finance sector has grown significantly in recent years and is now estimated to exceed USD 1 trillion. Private concessional capital would most obviously be useful in blended investment structures. It could also expand the balance sheet capacity of complementary instruments like the existing DFI-financed war and political risk insurance and foreign exchange hedging tools.

Obtaining impact finance would require thoroughly worked-up theories of change around a specific impact objective. This work may need to be initiated by return-focussed investors or asset managers who need concessional financing in order to make investment structures viable. As they may not be deeply experienced in impact finance, the work could be done together with IFIs/DFIs and impact structuring experts.

A difficulty for return-focussed investors would be that their investment strategies would need to align with the chosen impact case, and be compatible with fee structures. However, in the Ukraine recovery context these should not necessarily conflict. Meeting impact objectives may increase expected returns. Blended funds leveraging private impact finance with associated impact evaluation may even provide a point of differentiation at the fund distribution and marketing stage that helps justify the work of putting them together.

Impact objectives and theories of change could include improving institutional quality and rule of law (for example by linking deployment of funding to the achievement of rule of law metrics, together with high governance criteria at asset level), green transition (relatively straightforward given Ukraine's reconstruction plans) or perhaps simply assisting reconstruction by enabling initial structures to get off the ground, which in turn would provide data and examples that other investors can follow.

The bespoke character of impact financing may limit the scalability of this approach for meeting risk capital needs over the medium term. However, if early investment vehicles achieve the aims of both return- and impact-focussed investors, further impact capital on more standardised terms might become easier to attract. This may be especially the case due to the strength of the impact narrative in Ukraine: clear additionality given the enabling effect of first-loss impact funding, and an ample pipeline of reconstruction and recovery projects with a clear human benefit.

Who Should Go First?

Driving broad-based private investment in Ukrainian reconstruction and recovery substantially involves the creation of a new market. That market is unlikely to emerge spontaneously from the private sector. The process will therefore need to be led by a coordinated group of IFIs, DFIs and Ukrainian authorities. Those institutions could consider developing a joint private sector strategy that would identify the early adopters who are ready to invest, use the potential availability of funding to add impetus to reforms and to motivate impact investors whose involvement will enable pilot instruments to be launched, then use the data from those first examples to validate recovery investment and create familiarity and momentum in the broader investment community.