

Establishment of a Promotional Bank in Ukraine

Key Recommendations

- **Expert Workshop** -

Towards the Establishment of a Promotional Bank in Ukraine

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I. Motivation

- Several (failed) attempts to establish a promotional bank in Ukraine in the past – why bringing up this topic right now?
- Ukraine faces enormous economic and political challenges
- The international community has pledged significant financial support to Ukraine's government to overcome these challenges
- In this context, the old idea of establishing a promotional bank deserves a fresh consideration, as this might be an important instrument to absorb the expected financial support
- Also domestic reasons why such a bank might be an improvement over the current status quo of state support to the economy

II. Status Quo: Existing State Support Programmes

State institutions providing funding to investment projects

- “State Innovation Finance-Credit Institution”
- “State Investment Company”
- “Ukrainian Enterprise Support Fund”
- “State Agency for Investment and National Projects of Ukraine”
- Additionally: Investment projects approved by the government can receive tax privileges and access to direct subsidies if appropriated in the budget (Law 5205-VI from 06.09.2012)

Assessment:

- No coherent structure for government support of private investment projects; investors may address Ministries for subsidies, state guarantees and tax privileges;
- Lack of cooperation between different institutions, weak implementation and inefficient outcomes; decisions are taken ad-hoc
- State institutions have limited capital; operate mostly on a revolving basis and fund very few projects - lack of private funding at long maturities cannot be compensated

III. Vision for a Change

How can the status quo be changed?

Bundling different support programmes conducted by different state institutions in one institution (PB) can lead to benefits for both the state and the beneficiaries:

State

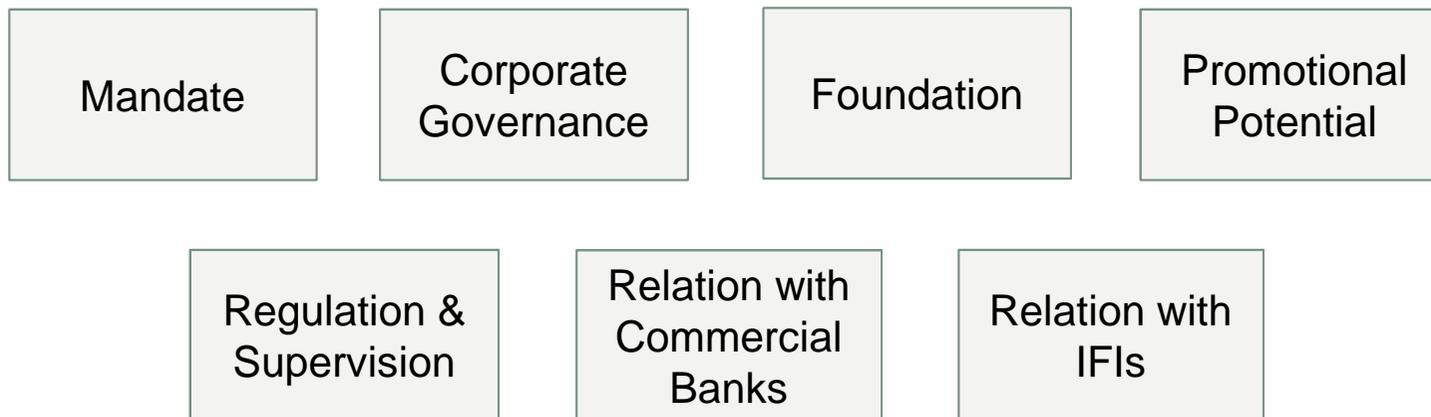
- PB might reduce the deficits in terms of cooperation, implementation and outcomes and thus lower the overall cost of support for the state
- Bundling state support in one institution increases transparency, politically-motivated support of certain beneficiaries becomes more difficult
- A well-managed promotional bank is in a better situation than a non-financial state institution to assess imperfections in private financial markets
- Budget funds can be reduced, since PB has usually refinancing costs close to the sovereign level

Beneficiaries

- Dealing with one institution reduces search and information costs
- Integration of state support into commercial financing is much smoother

IV. How to establish a Promotional Bank: Key issues

- Sound institutional framework absolutely critical for a successful performance
- Discussion and recommendations regarding the key elements of the institutional design of a promotional bank in Ukraine:



Mandate

Mandate	Mandate of PB needs to be clear and sustainable and should contain 3 elements:
Corporate Governance	<ol style="list-style-type: none">1. <u>Determining the bank`s target sectors</u>: Broad and flexible definition of potential sectors is needed2. <u>Definition of relationship with private banks</u>: To avoid unfair competition PB must <i>complement</i> the activities of private banks in certain areas, not <i>substitute</i> them3. <u>Long-term financial sustainability</u>: PB must solvent under any circumstances during its conduct of promotional activities
Foundation	
Promotional Potential	
Regulation & Supervision	
Relation with Commercial Banks	
Relation with IFIs	

Corporate Governance

Mandate	High standards of corporate governance:
Corporate Governance	<u>Limiting political influence</u> <ul style="list-style-type: none">• Only defining and supervising the general strategy, activity areas and operational guidelines• Supervisory Board: Representatives of the Government, Parliament (representing also the opposition), the National Bank of Ukraine, business associations, independent experts
Foundation	
Promotional Potential	<u>Management</u> <ul style="list-style-type: none">• Proposals for the CEO by a search committee, which includes independent members of the supervisory board• Advertising managerial positions publicly• Final decisions about managerial positions by the supervisory board, not by Government• Manager's tenure should not overlap with the political election cycle
Regulation & Supervision	
Relation with Commercial Banks	
Relation with IFIs	<u>Reporting and information disclosure</u> <ul style="list-style-type: none">• Transparent financial reporting allows for a better external monitoring, improves accountability and limits political interference

Foundation

Mandate
Corporate Governance
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Promotional Potential
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Relation with IFIs

- Establishment via a Special Law strongly preferred
- Basic question: Foundation of a new bank, or restructuring of an existing bank?
- In our view, restructuring of an existing bank is preferable to setting up a new institution:
 - It takes a long time to build up the necessary market reputation
 - Ukraine has a significant number of state banks with a mixed track record, very weak argument for yet another state bank
- Our view: The State Export-Import Bank of Ukraine (Ukreximbank) is the best candidate for such a restructuring, with the longer term vision of creating a powerful second-tier institution that is actively engaged in promotional activities

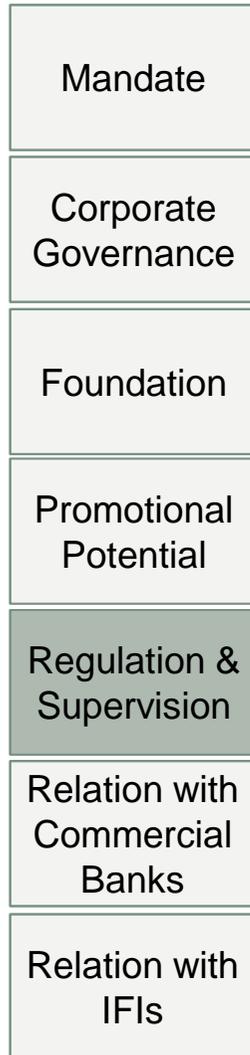
Promotional Potential

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Which instruments can be used to achieve the promotional potential?

- Initial capital endowment. Initial capital provided by the Government must give PB an excellent standing in terms of solvency. However, since the current fiscal situation is very difficult, emphasis must be also put on other instruments
- Financial privileges. Exemption from the enterprise profit tax (EPT)
- Explicit state guarantee for funding. Provision of an explicit state guarantee by the Ukrainian government to lower the cost of funding (almost) to the level of the sovereign
- Prohibition of capital returns. In order to allow for a gradual increase in the capital base, the Government shall formally refrain from capital returns (e.g. dividends)

Regulation and Supervision



- The PB should be subject to the general banking regulation and supervision by the National Bank, taking into account its specific features:
 - the corporate governance framework,
 - the sustainability of the business model
 - quality of the management
- Credit ratings by reputable rating agencies are an ideal complement to official supervision, and might provide additional information to stakeholders

Relationship with the Commercial Banking Sector

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Corporate Governance
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How to implement the “subsidiarity” principle into practice, and prevent a crowding-out of private banks:

On-lending via private banks (second-tier structure)

- PB shall use the private banking system to channel its funds to the economy

Clear limits on certain balance sheet operations

- Asset side: No provision of retail loans; eventually also short-term corporate loans
- Funding side: No retail and/or corporate deposits

Joint financing of projects together with private banks

- PB leverages the infrastructure and capacity of private banks via co-financing mechanisms
- PB might for example use the instrument of credit guarantees to encourage private banks to take on new risks

Relationship with IFIs and bilateral donors

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- PBs address market failures in the domestic financial sector and provide an important link to IFIs and bilateral donors
- Different institutions and donors have recently declared a substantial increase in financial assistance to Ukraine in order to improve the current economic situation
- A PB with a high international reputation can serve as a single counterparty to the international donor community and might be able to absorb and maximise the impact of such assistance
- PB has strategic advantages over the status quo, in particular due to its mandate, strong governance framework and promotional potential
- This might be especially important for smaller (e.g. bilateral) donors

Thank You!

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Annex: Previous Attempts to establish a Promotional Bank in Ukraine

2000-2001: First draft law on the development bank

- Law on the “Ukrainian State Bank for Reconstruction and Development” failed to be passed in parliament

2003-2006: UBRD vs. UBSR

- “Ukrainian Bank for Reconstruction and Development (UBRD)” started operations in 2006
- In parallel, in 2003 the National Bank of Ukraine (NBU) and the German-Ukrainian Fund (GUF) worked on the idea to expand the GUF into a “Ukrainian Bank for Promotion of Development (UBSR)”,
- Implementation was not possible for political and economic reasons

2006-2008: Proposals for restructuring of Ukreximbank

- Ideas to turn State Export-Import Bank of Ukraine (Ukreximbank) into a promotional bank with additional functions of an export credit agency, but no official document was approved

2009: UBRD vs. UBSR again

- Government suggested to create the UBSR on the basis of the UBRD, but recapitalisation of UAH 2 bn was not approved

2010-2014: UBRD to be reorganised into the State Development Bank of Ukraine

- Draft Law #3445 "On the State Development Bank of Ukraine"