Federal Ministry of Finance

Establishment of a Promotional Bank in Ukraine

Analysis and Recommendations

Final Report

Berlin Economics

Consultant:

BE Berlin Economics GmbH

Schillerstr. 59

10627 Berlin

Germany

Tel: +49 30 206 134 640

Fax: +49 30 206 134 649

service@berlin-economics.com

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Executive Summary

Ukraine faces important economic challenges. Regarding foreign trade, a more balanced relationship between exports and imports is required. There is an urgent need to increase exports, especially to destinations outside the CIS, as in the latter case significant trade barriers exist and many companies are not able to overcome such barriers. On the import side, energy is crucial. In particular, the country needs to reduce the gas bill from the Russian Federation by decreasing gas consumption, i.e. by increasing its very low energy efficiency. But also the economic structure of the country needs to be overhauled. The bias towards big business and old industry should be reduced by promoting small and medium-sized (SME) business as well as start-ups and innovation. Furthermore, regional development should be targeted more accurately.

The above mentioned challenges and the respective economic goals are widely accepted. However, as of today, the Ukrainian Government lacks effective instruments to pursue these goals in a decisive manner. The Government runs a number of support programmes and funds, but these are small in size, not always well targeted and there is a lack of coherence in the system. Foreign donors are eager to support the country, but in many cases they are discouraged by insufficient administrative absorption capacity. Thus, the current instruments to pursue economic goals and to implement apt pertaining programmes such as export promotion, energy efficiency, regional and SME development are not appropriate. There is a clear need to improve these instruments.

Against this background, the Ukrainian government is re-considering the possibility for the establishment of a promotional bank. A well-functioning promotional bank would without doubt make a strong contribution for pursuing and achieving economic goals. The bundling of experts and know-how in one financial institution would increase the managerial capacity, but also the transparency, efficiency and effectiveness of government support programmes. Also, it could increase the absorption capacity of foreign donor funds. Thus, the idea of establishing a promotional bank is in principle a good idea. However, there are two basic caveats attached. First, a promotional bank will only make things better, if it is well-designed and properly run. Otherwise, it could create more harm than good, as experienced in some countries where policy makers misused such institutions for different purposes. Thus, a proper institutional design is key for success. Second, founding a promotional bank requires significant amounts of money and time, while currently the government does not possess either of these resources in abundance.

The caveat of a proper institutional design can be dealt with by studying and adopting international best practice. In this respect we put forward a series of recommendations. First, the mandate of the bank should be clear and contain three elements: a broad and flexible definition of potential sectors to be promoted, since government priorities can change over time; a limitation of allowed activities, in order to avoid unfair competition with commercial banks; and provisions to ensure long-term financial sustainability, to make sure the bank is solvent under any circumstances. Second, corporate governance should be appropriate, secure long-term financial sustainability and restrict political influence. Policy makers should only define the general strategy and supervise its activities, but not interfere in single decisions and the day-to-day running of the bank. The Supervisory Board should consist of representatives from Government, Parliament (including opposition), National Bank, business associations and independent experts. Third, the bank needs to have an endogenous promotional potential, in order to ensure affordable loans to the promoted sectors of the economy. Financial privileges such as the exemption from the enterprise profit tax (EPT), an explicit state guarantee for its funding and the prohibition of profit disbursements or capital returns are to be recommended. Fourth, the promotional bank should be subject to the general banking regulation and supervision by the National Bank. Credit ratings by reputable agencies would certainly be an ideal complement to official supervision. Fifth, the subsidiarity principle needs to be followed strictly, in order to prevent a crowding-out of commercial banks. In this respect, we recommend basically on-lending via commercial banks, i.e. a second-tier structure.

The issue of the foundation of a promotional bank – the second caveat - is much more complicated. We recommend establishing a promotional bank via a special law, and not by a government decree, since such a decree can easily be changed by future governments. However, the question whether to establish a new or to use an existing state bank as a basis for a promotional bank is non-trivial. The establishment of a new bank would have certain advantages, but it would require significant amounts of money, time and human resources, all factors not readily available as of today in Ukraine. For this reason, the perspective for a new foundation does not look realistic in the short-term. Giving this limitation, the possibility of using and remodelling an established state bank for promotional purposes should be seriously considered. The state-owned bank Ukreximbank would be a natural candidate for this function, since it is well established and has experience in promotional activities and with international financial institutions. However, further research and consulting is needed to bring more light into possible schemes for establishing a promotional arm within Ukreximbank, which would at a later stage "grow out" and become a dedicated promotional bank, while the remaining Ukreximbank would then be a purely commercial bank.

To sum up, the country clearly needs better instruments to pursue its economic policy goals. In our view, a promotional bank could be a very strong instrument, with clear advantages vis-à-vis the existing promotional framework in Ukraine. This would also contribute to the creation of strong, good-governed state institutions, which are still lacking in the country. But a promotional bank makes only sense if it is well designed and policy makers play by the rules. By implementing our recommendations in this respect, some major risks can be avoided and the likelihood of a well-functioning bank will be significantly increased. However, one crucial question remains unanswered in this report: the question whether to establish a new institution or transform as basis of the promotional activities an existing state bank. To provide a final answer for this critical question, further research and discussion is needed, with participation of all relevant stakeholders.

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1. Introduction

International experience shows that national promotional[1] banks may be effective, efficient and targeted instruments to pursue specific goals of economic policy. In this regard, they can play an important role in the achievement of wider economic, ecological and social goals by facilitating e.g. SME development, innovation, export promotion, higher energy efficiency or investment in housing or infrastructure, especially social and economic infrastructure of municipalities. Promotional banks can also contribute to higher transparency and efficiency of government support programmes and subsidies, and can facilitate the financial cooperation with donor countries, thereby further increasing the availability of finance for different sectors. Furthermore, promotional banks can contribute through their operations to a better functioning of the national financial sector by enlarging and deepening of commercial banks` activities. Last they can help develop the local government bond market, since they typically refinance themselves through local bonds.

Seen against this background, it is only logical that the Government of Ukraine has voiced interest to establish a national promotional bank. However, promotional banks do not only entail opportunities, but also risks, as shown by international experience. Consequently, the future performance of the foreseen promotional bank will crucially depend on how it is designed, established and how it will be run.

The purpose of this report is to support the Government of Ukraine in its plans to establish a national promotional bank that supports the sustainable development of the national economy and follows best international practices. International, including German experience on this topic provides some valuable input into the current discussion in Ukraine.

This report is structured as follows: In the following chapter 2, we provide some general arguments on the necessity and the role of a possible Promotional Bank in supporting economic policy objectives. This discussion is accompanied by looking at specific international evidence. In chapter 3, we review the situation in Ukraine, including developments over the recent past. Chapter 4 is then devoted to the key issues relevant in establishing a national promotional bank in Ukraine. This relates to its mandate, governance issues, foundation, promotional potential, relationship with the commercial banking sector and with international financial institutions, to name the most important ones. For each issue, we discuss and assess the available options in Ukraine and provide clear policy recommendations, taking into account the concrete experience in different countries, i.e. international best practice.

[1] The terms „promotional bank“ and „development bank“ are frequently used in the relevant literature. We use the former term throughout the report.

2. Key Rationale for the Establishment of a National Promotional Bank

While there is no universal definition of a promotional bank (PB), it can be best defined as a government-owned bank that is tasked to address market failures in the financial system. Such failures may occur in different segments of the market, e.g. because the social benefits of certain projects are higher than their private (commercial) ones, information asymmetries typical for new and risky ventures as well as for small and medium-sized borrowers without collateral, or projects with typically very long amortization times (frequently found in energy efficiency projects).

Thus, promotional banks are created by policy in order to fulfil specific economic policy objectives. Supported by the government, such banks can provide long-term funding to the economy, as well as funding to particular borrower groups, regions or sectors not served well by private banks.

The role and rationale of the creation of PB in a market economy driven by (national and international) competition can be best understood in a wider cost-benefit approach:

- Benefits (Opportunities):
    - Promotion of politically desired economic developments,
    - correction of market failures,
    - efficient and transparent conduct of economic policy actions through a dedicated vehicle.
- Costs (Risks):
    - Misuse of a promotional bank by certain policymakers (i.e. influence of lobby groups),
    - neglect of sound banking practices due to political pressure
    - possible negative impact on wider financial system due to conflicts of interests in particular with commercial banks.

This short comparison of costs and benefits shows that the creation of a promotional bank creates opportunities, but also risks for the country. It is thus of crucial importance to identify in a consistent framework the key success factors and principles for successful promotional banks.

Many countries have established promotional banks to fulfil specific economic policy objectives. Worldwide, it is estimated that there are currently more than 500 respective institutions (Thorne, 2011). Figure 1 provides a selected overview of promotional banks in both developed and emerging economies.

Figure 1: Selected overview of promotional banks

Country	Bank	Established
Austria	Austria Wirtschaftsservice Gesellschaft mbH	1954
Brazil	Brazilian Development Bank	1952
Bulgaria	Bulgarian Development Bank	1999
China	China Development Bank	1994
Croatia	Croatian Bank for Reconstruction and Development	1992
Finland	Finnvera	1999
Germany	KfW/Kreditanstalt für Wiederaufbau	1948
Hungary	MFB Hungarian Development Bank Private Limited Company	2006
India	Industrial Development Bank of India	1964
Japan	Development Bank of Japan Inc.	1951 (established) 2008 (restructured)
Kazakhstan	Development Bank of Kazakhstan	2001
Korea	Korea Development Bank	1954
Russia	Vnesheconombank	1922 (established) 2002 (restructured)
South Africa	Development Bank of Southern Africa	1983
Spain	Instituto de Crédito Oficial	1971
Turkey	Industrial Development Bank of Turkey	1950

Source: Own research

In Annex A.1-A.3, we provide more detailed information on the activities of selected promotional banks, in particular German Kreditanstalt für Wiederaufbau (KfW), the Croatian Bank for Reconstruction and Development and Russia's Vnesheconombank (VEB).

As regards the overall performance of promotional banks, the international experience is very mixed. The banks established in certain industrial countries after World War II in order to finance the reconstruction of these economies (e.g. Germany, Japan) are generally considered to be successful. In contrast, many banks established in the 1970s and 80s in poorer countries often failed (Thorne, 2011). Reasons for these failures can be traced back to a lack of transparency, widespread mismanagement and corruption, inadequate prudential regulation and supervision, as well as the pursuit of political rather than promotional goals due to political interference.

It comes as no surprise that during the 1980s and 90s, a wide-scale wave of restructuring, closure and privatisation of promotional banks was undertaken as a result to these poor results. However, since the global financial crisis 2008/09, a renewed interest in the activities of promotional banks can be identified, as the main reasons for the crisis consisted apart from massive moral hazard of commercial banks in political, regulatory and market failures. Despite government-led efforts to stabilize private banks and capital markets, the lack of long-term finance and the need for countercyclical funding to mitigate the crisis' impact caused many countries to expand the role of their promotional banks. There have been many cases in both developed and emerging countries where promotional banks stepped up their activities to kick-start lending (see Rudolph, 2010, for individual country experience).

3. Review of Developments in Ukraine

3.1. Previous Attempts to Establish a Promotional Bank in Ukraine

1990s

In the 1990s, the Ukrainian Government was involved in project/development finance directly through budget grants, loans and budget-guaranteed loans. There existed also an innovation tax/duty (at 1% of net sales), which was channelled into the "State Innovation Fund (DIF)". The Fund issued cheap (or even interest-free) and relatively long-term loans for innovative projects. Many of the funded projects were risky or just fraudulent. Besides, large parts of the loans were issued to state-owned enterprises that were later privatized.

2000-2001: First draft law on the development bank

The Government abolished the innovation tax in 2000 and the Fund was restructured into the "Ukrainian State Innovation Company (UDIC)". UDIC was to continue funding innovation using DIF loan repayments and (as was hoped) project finance from IFIs, but on more market terms. These included co-financing requirements, shorter maturities and higher interest rates. The government also submitted to the Parliament[2] a draft law on the "Ukrainian State Bank for Reconstruction and Development". Main points of that draft law were:

- A 30% co-financing requirement
- Reinvestment of the profits
- Clients consist only of legal entities
- Main areas of activity : Development projects including structural changes and modernisation of industry, expansion of export capacity, residential construction
- Priorities for financing are determined by the Government
- CEO and supervisory board are appointed by the Government for five-year terms
- Mixed business model: First-tier bank but can use other banks as agents, funding from budget, private parties and IFIs, independent operationally but may conduct government-directed projects under state guarantee
- Subject to general banking legislation

Then President Kuchma designated this draft law as urgent for consideration but it subsequently failed to be passed in parliament.

2003-2006: UBRD vs. UBSR

UDIC continued to fund projects deemed innovative by government officials by providing loans or by providing equipment to companies through leasing operations. In 2003, the company suggested forming the "Ukrainian Bank for Reconstruction and Development (UBRD)" to expand its activities. The Government was supportive of this project.

[2] It seems that no other Government-sponsored draft laws on the topic were forwarded to the Parliament until 2013.

The plan was to establish a first-tier bank as quickly as possible, and expand its capital and lending capacity later. According to the business plan of the UBRD, its capital was to be expanded to UAH 200 m in 5 years by attracting foreign investors and budget funds. UBRD was created relatively swiftly by Government standards. It received a banking licence in March 2004, while the government resolution allowing the UDIC to create the UBRD was passed in May 2003. It was exempt from legislative provisions regarding state-owned banks, as it was not created directly by the government and three shares of the bank were owned by UBRD management. However, it didn't start operations until 2006. Almost all UBRD liquidity was tied up in deposits with another bank that was close to bankruptcy for several years.

Box 1: The Ukrainian Bank for Reconstruction and Development (UBRD)

The Ukrainian Bank for Reconstruction and Development was established under the resolution of the Cabinet of Ministers of Ukraine #655 from 05.05.2003 "Some aspects of the innovation infrastructure in Ukraine and activities of the State Innovation Company of Ukraine in 2003" and registered by the National Bank of Ukraine on 19.03.2004. The Ministry of Finance of Ukraine currently controls 99.9945% of the bank.

UBRD was created under the conventional banking law and started to function as a banking institution in 2006. Nowadays it is a small sized bank ranked as #179 out of 180 registered banks in Ukraine, having an equity of 118 million UAH and total assets of 129 million UAH (as of 31.12.2013).

In parallel, in 2003 the National Bank of Ukraine (NBU) and the management of the German-Ukrainian Fund (GUF[3]) floated the idea to expand the GUF into a "Ukrainian Bank for Promotion of Development (UBSR)". This idea was discussed between the Ukrainian and the German Governments, and a respective Draft law on the UBSR was prepared. Its main provisions were:

- UBSR is a second-tier institution that is allowed to do business only with banks
- It is focused on SME lending, project finance, innovation finance and the development of mortgage lending
- Initial capital endowment is provided by the NBU, the government, local authorities, local and foreign financial institutions
- Governance is based on general legislation for banks/corporations and statute of the banks
- Independent credit policy based on priority promotion programs
- No profit distributions allowed

Although the NBU had the right to introduce draft laws in the Parliament, the political climate made the passage of the law unlikely at the time. Despite the NBU losing the right to submit draft laws due to constitutional changes, there were renewed efforts to create the UBSR. A revised draft law was prepared as a result of discussions with a wide circle of stakeholders. The main points of the revised draft include:

[3] The GUF was founded in 1999 as a second-tier non-banking institution to provide financing to SMEs on a revolving basis.

- Second-tier bank
- No profit distribution
- Wide circle of founders (NBU, government, GUF, financial institutions, IFIs) was preserved
- Government guarantee on external borrowing
- UBSR acts as government agent on project finance from IFIs and on state development programs
- Maximum 25% share for shareholders other than NBU and government
- 1 UAH bn initial capital
- Governed by the supervisory council made up of three representatives from each shareholder
- Supervisory council is responsible for approving procedures of implementation of state programs (i.e. total exposure limit, terms of funding for banks and final borrowers, bank selection criteria)

However, this draft was never submitted to the Parliament. One factor may have been political developments at that time. A second, more relevant reasons in our view was the overall development of the banking sector in the country. The "Orange Revolution" opened up the country for foreign investments after 2004/05, and the banking sector was a prime recipient of such flows. Coupled with very soft global liquidity conditions, capital inflows (especially FDI and bank flows) into Ukraine accelerated. The FDI boom in the banking sector made the creation of a development bank a low priority for policymakers, and the discussion was put on hold.

2006-2008: Proposals for restructuring of Ukreximbank

In 2007, a Government audit found that UBRD didn't issue a single loan so far and UDIC functioned as a collecting company on old loans provided in 2005-2006[4] and suggested liquidating them. Nevertheless, UDIC was renamed as "State Innovation Financing Institution of Ukraine (DIFCU)" and the State Investment and Innovation Agency suggested expanding UBRR into a development bank as part of a draft "Capital Market Development Programme". However, these plans didn't make it into concept of the Programme finally approved by the Government.

In October 2006, the Government decided to explore turning the State Export-Import Bank of Ukraine (Ukreximbank) into a promotional bank with additional functions of an export credit agency (ECA). It was part of ongoing efforts to refocus Ukreximbank's role closer to more traditional ECA functions. In response to the Government decision, an initial concept was produced by the Ministry of Economy, but later another concept was prepared by an Inter-Ministry working group under active involvement of Ukreximbank. Despite consideration by the Government a year later, it was not approved as an official document.

[4] To be fair government audit report issued in 2005 on UBRD and UDIC activities in 2002-2004 reported gross mismanagement and several criminal cased were opened

During 2008-2009, the restructuring of Ukreximbank was considered further[5] but no final decision was reached until the global financial crisis hit the country.

2009: UBRD vs. UBSR again

In 2009, the Government decided not to pursue the Ukreximbank restructuring as it used Ukreximbank for quasi-fiscal operations and the restructuring was viewed as excessively complex. A working group headed by the Minister of Economy recommended creating the UBSR[6] on the basis of the UBRD as a state bank. In June 2009, the Government made the decision to go forward with the recommendation, but declined to approve an UAH 2 bn recapitalization for the UBRD. While management changes at the UBRD were implemented, the recapitalization was probably deferred until the next year given well-known fiscal difficulties in 2009. However the political change after Presidential elections in 2010 put the issue further on hold.

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

The discussion on a PB in Ukraine gained new attention in subsequent years. The formation of such a bank[7] was foreseen in "The state program of activation of economy for 2013-2014", approved by Resolution of the Cabinet of Ministers #187 from 27.02.2013. The program defined priority areas of economic development and key objectives of state policy in these areas. The creation of a PB to support the development of priority industries, conduct investments and innovative projects and attract long-term foreign investment in the national economy is one such objective aimed at improving competitiveness and the investment climate in Ukraine's economy.

As part of the Activation program, investment projects approved by the Ministry of Economic Development and Trade received state guarantees on commercial bank loans. According to the statements of government officials, the PB was expected to participate in the funding of these projects and the overall supply of long-term funding to investment projects in priority areas. Initial credit resources of up to UAH 10 bn were discussed.

On 18.10.2013, the Draft Law #3445 "On the State Development Bank of Ukraine" was registered in the Parliament of Ukraine[8]. According to it, the PB was to be established through reorganization of the existing UBRD. The budget of Ukraine for 2014 envisaged originally that the statutory capital of UBRD will be increased by 5 billion UAH through the issue of state bonds.

However, after the political change in early 2014, the initial plan was suspended. On 24.03.2014, the Parliament amended the state budget and removed any direct link to the

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[5] The work on Ukreximbank's reform was supported by technical assistance from the World Bank under the "Export Development Project 2".

[6] It's not clear if the same name for development bank as was used previously for GUF-based bank was a coincidence.

[7] The program uses the term "state development bank". We will continue to use the term "promotional bank" throughout the report.

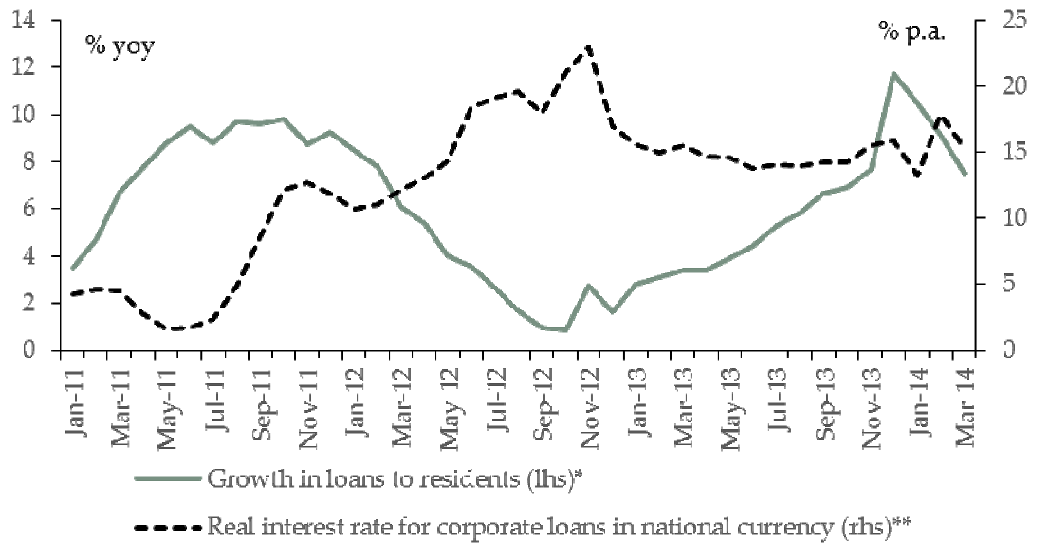
[8] See Annex B.1 for more information on this draft law.

allocation of 5 bn UAH to the UBRD. The funds can now be used to recapitalize any state-owned bank (in theory including UBRD).

3.2. Current Context: Global Financial Crisis and Recovery

In general, the global financial crisis of 2008/09 had a very strong negative impact on Ukraine's economy, in particular its banking sector. The economic recovery phase that started after the crisis at around 2010 was and continues to be very fragile, with many risks remaining, in particular in the banking sector, which is burdened by a very high share of non-performing loans (around 23% according to the IMF, if substandard loans are included). The whole period was complicated by a wrong economic policy mix, especially by pegging the exchange rate of the Hryvnia to the US dollar, and following a very loose fiscal policy. The result was a very weak credit activity, in part due to high interest rates, as the following Figure 2 shows:

Figure 2: Credit growth and cost of credit in Ukraine



Source: Own calculations based on NBU and Ukrstat data
** Loan volume adjusted for exchange rate changes by applying a fixed exchange rate of UAH 7.993 per USD to foreign currency loans; **Ex post real interest rate based on year-on-year CPI growth*

The current outlook for the banking sector is without doubt difficult. In a tense political and economic context, the authorities deserve much praise for arranging an impressive IMF-supported stabilisation programme, which has the stability of the financial sector as one of its main objectives. In the short run, an economic recession is inevitable, with significant downside risks to the economic outlook. However, the Government is very engaged to lay the foundations for a future recovery phase (e.g. of economic growth and an improvement of the social situation) in the medium- to longer term. In this respect, the revival of the idea of the creation of a PB can be important for successful structural reforms.

3.3. Review of Government Promotional programmes in Ukraine

Existing programmes and institutions

There is currently no coherent structure for government support of private investment projects. Investors that wish to receive support of investment projects may address the Ministry of Economic Development and Trade and/or the Ministry of Finance for subsidies, state guarantees and tax privileges. Ad-hoc decisions are taken and included in the annual budget, or a draft law is prepared on tax privileges. Sometimes, subsidies are part of a medium-term State program, but financing foreseen in the program does not guarantee annual funding.

There are also several (fully government-owned) state institutions with a mandate to provide funding to investment projects, but they have a rather marginal impact in terms of funds provided. These include the

- ″State Innovation Finance-Credit Institution″. Founded in 1991 as "Innovation Fund", it was reorganized in 2001 and renamed to the current name in 2007. It has an authorized capital of UAH 262 m.
- "State Investment Company" was allocated UAH 500 m for co-financing of investment projects in 2011 and was still spending them in 2012. The institution was responsible for the state's stake in UBRD in 2010-2013 until it was transferred to the Ministry of Finance. After UBRD was divested from the company, its authorized capital was reduced to UAH 349 m.
- ″Ukrainian Enterprise Support Fund″ used revolving funds and UAH 2 m in budget funds to issue UAH 10 m in microfinance loans in 2013. It is public law entity under State Regulatory Policy and Entrepreneurship Development Service without authorized capital.

The „State Agency for Investment and National Projects of Ukraine" has a larger budget (UAH 560 m in 2013) but it is involved mostly in technical assistance to private investment projects, being more focused on the implementation of "National projects" (for which the majority of its budget is spent on). It also manages the State investment company and the State innovation finance-credit institution.

Finally, there is law 5205-VI from 06.09.2012 „On stimulating investment activity in priority sectors of the economy to create new jobs ". Investment projects approved by the government and conforming to criteria foreseen in the law (minimum investment amount, jobs created, average wage of employees, inclusion in the list of priority sectors of economy) receive tax privileges and access to direct subsidies from the budget if they are appropriated in the budget. Priority industries include food manufacturing and storage, biofuels for import substitution, waste management and recycling, building and modernization of heating and water infrastructure, machine building including PCs, machinery and equipment, cars, transport infrastructure, building of tourist and recreational objects, import substitution in metallurgy.

Assessment of current funding from private and state sources

The established specialized state institutions had very limited capital from the beginning and haven't received meaningful state capital injections over the last several years. As a result, they operate mostly on a revolving basis and fund very few projects. Direct budget funding and ad-hoc government guarantees (excluding guarantees to Naftogaz and Ukravtodor) are also limited in size and don't provide consistent funding mechanism for state development priorities.

Private funding with long maturities is also rare. Bank loans with original maturity over 5 years accounted for only 14% of loans outstanding in March 2014. If we would exclude loans related to real estate (both on the buy and sell side) this figure would be much lower. Currently, average interest rates on corporate loans are around 18% in local currency and 10-11% in foreign currency. In the most recent enterprise survey by the NBU, an increasing share of companies (30%) reported also a tightening of lending conditions.

Advantages of a promotional bank

What are the advantages of a promotional bank in comparison with existing state programmes? We see the following advantages for the state:

- Different support programmes are conducted by different state institutions, as shown above. Experience shows that very often own interests by the different institutional players prevent the provision of efficient state support to the beneficiaries. A lack of cooperation, which might result in too low or too much support for certain clients is here to mention, as well as the lack of synergies in programme implementation. Bundling these programmes in one institution might reduce these deficits and lower the cost of support for the state.
- Bundling state support in one institution increases also its transparency. This helps also the Parliament, the public and foreign donors to monitor and control the usage of public funds. 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. These imperfections form the basis for targeted state financial support programmes that the bank can implement.
- A promotional bank has usually refinancing costs close to the sovereign level (see 4.4), which can be used to finance promotional activities rather cheaply. This implies that budget funds can be reduced, or even completely saved.

At the same time, there are additional advantages for the beneficiaries of such support programmes:

- The bundling of different programmes in one institution reduces search and information costs.
- Since the promotional bank will work closely together with the commercial banking system (see 4.6 for more information), the integration of state support into commercial financing (which is necessary for the beneficiary at a certain point anyway) is much smoother.

To sum up, a well-run promotional bank would as a minimum ensure a more orderly financing of state development priorities, while it is unlikely to compete with commercial banks in providing long-term funding.

4. Key Issues in the Establishment of a Promotional Bank in Ukraine

A sound institutional framework is absolutely critical for the successful performance of a PB, as empirical evidence forcefully demonstrates. In the following sub-chapters, we discuss the key elements of the institutional design of a promotional bank in Ukraine, and provide a number of respective recommendations.

4.1. Mandate

A PB must have a clear and sustainable mandate, which must be publicly disclosed in a transparent manner. The relevant literature (Rudolph, 2010) points to three key elements of such a mandate:

1. Determining the bank's target sectors

Here, a precise definition of the concrete objectives of the bank in the context of supporting the overall economic, social and ecological development in Ukraine must be undertaken. We propose to start with a potential very broad definition of target sectors, where specific market failures need to be addressed, in order to allow for certain flexibility over time. In our view, the following sectors shall be supported by the bank:

- **(M)SME development:** The lack of access to finance for mico, small and medium sized companies is often a key problem for their further development and associated job creation. Market failures due to asymmetric information or the lack of collateral lead to a situation where private commercial banks provide credit only at punitive conditions, or not at all. This implies that profitable investments from an economy-wide point of view are not being undertaken. A further strong case for MSME support is their positive impact on competition. Ukraine's economy is characterized by a relatively low degree of competition, and a dynamic MSME sector might change this in the medium term.
- **Facilitation of energy savings and environmental protection:** Market failures due to external effects exist in the energy sector as well. A further sector-specific problem is the low gas, heat and electricity tariffs for the population, which are significantly below their cost-recovery level. This, together with the absence of long-term financing at affordable rates, implies no incentives for implementing energy efficiency investments.
- **Export promotion:** Increasing and diversifying exports helps Ukraine to reduce its current account deficit, which had reached unsustainable levels and increase employment, which is of key importance in the current recession.
- **Infrastructure and housing investment:** Supporting infrastructure and housing investments is justified due to their public good characteristics, and the presence of external effects. As Ukraine's general infrastructure (e.g. transport, communication,

energy) as well as the housing stock is in a very poor shape, there are plenty of areas where the bank might provide long-term funding.

- **Municipal infrastructure investment:** In municipalities, the need for investments in different parts of the economic and social infrastructure (e.g. energy efficient and social housing, heat and water supply, waste and sewage disposal, road and public transport, school, kindergarten and further public buildings) is of particular relevance. By targeting municipal infrastructure investment with tailor-made financial products, a promotional bank can play a key role for a sustainable regional development and improving the countries overall growth potential.
- **Innovation finance:** The case of a market failure since private and overall economic returns on investments usually do not correspond is quite strong in innovative activities. Information asymmetries play an additional role. Innovative companies help to increase the competitiveness of the country and often contribute to high value-added exports.
- **Agricultural and rural development:** For agricultural enterprises in Ukraine, adequate access to short, medium and long term financing is of critical importance. Agriculture is becoming an increasingly capital intensive sector worldwide, but despite some recent progress, Ukraine's agricultural sector has not fully followed this trend. A promotional bank might provide targeted support for the sector, thereby facilitating investments in the rural sphere.
- **Investments into priority sectors of the economy:** The list of sectors given above is not exclusive, and shall be adjusted in a flexible manner according to political priorities.
- **Support of national target programmes:** The promotional bank might also play a role as a funding vehicle for specific national target programmes developed by the Government.
- **Measures for the promotion of education, social principles and standards:** Human capital is factor that plays an ever increasing role for the competitiveness of the economy in both national and international dimensions. The financing of the accumulation of human capital provided by higher education institutions (e.g. universities) can be also a perspective role for a promotional bank, as many external effects are present. The PB could also play an important role in strengthening advanced social principles and standards in partner banks.

2. Definition of relationship with private banks

A PB is meant to *complement* the activities of private banks in certain areas, not to *substitute* them. Due to their specific nature (state-owned, with respective funding advantages and further privileges), clear rules of the game need to be established. Otherwise, unfair competition might be the result, with associated crowding-out of private banks and a misallocation of capital[9].

3. Long-term financial sustainability

[9] We will return in sub-chapter 4.6 to this issue in more detail.

The mandate should require the goal of long-term financial sustainability, i.e. the conduct of promotional activities must be undertaken by an institution that is solvent under any circumstances. Otherwise, there is the risk that the bank – either under political pressure or due to the incompetency of the management – is permanently loss-making, because the financial conditions of their support programmes, or individual projects, are not adequate. This would force the government to cover these losses, and the need for frequent state support/recapitalizations would arise, which would damage the operations of the bank by increasing the political influence. The operational definition of this aspect of the mandate needs to be specified further, e.g. in form of requesting a minimum positive rate of return on capital. The concrete figure would need to be defined by the supervisory board.

Recommendation 1: The mandate of the promotional bank needs to be clear and sustainable, and should contain three elements: A broad and flexible definition of target sectors, the definition of the role of the PB in relation to private banks, and the goal of long-term financial sustainability.

4.2. Corporate Governance

It follows directly from the cost/benefit discussion in chapter 2 that high standards of corporate governance are of crucial importance for the performance and sustainability of the bank, as well as for the protection of the interests of taxpayers. This is key success factor for Ukraine, as the country is characterized as having a rather weak rule of law and low corporate governance standards. Relevant risks that need to be dealt with relate to political interference, and the lack of management/supervisory capacity.

Limiting political influence

The influence by policy makers shall be clearly limited to defining and supervising the general strategy, activity areas and operational guidelines of the bank. There must be no political influence on particular or day-to-day operations of the bank (i.e. lending decisions). In terms of the development of a transparent overall strategy, the following issues need to be integrated:

- **Promotion:** The scope of promotional activities to be conducted by the bank needs to be defined precisely. This sets the overall framework in which the bank can operate.
- **Efficiency:** The bank shall fulfill its (politically-) given mandate in a cost-efficient manner.
- **Solvency:** The goal of long-term financial sustainability (see 4.1) is important in this regard.
- **Clear and concise lending and investment policy:** Strategic decisions about promotional activities need to be translated into concrete and operational guidelines regarding the lending and investment policy conducted by the bank.
- **Effective banking supervision:** The bank shall fall under effective banking supervision (see 4.5 for more details).

How to ensure the necessary limitations on the political influence in practice? The key institution is the supervisory board, which should be created as a system of checks and balances. In our view, it should include representatives of the owners (i.e. the Government), but also further stakeholder circles with voting rights. These further members should include members of Parliament (representing also the opposition), the National Bank of Ukraine, business/SME associations, as well as distinguished independent experts.

An important task for the supervisory board is to constantly monitor the promotional activities of the bank, as interventions in financial markets are only justified as far as promotional objectives are concerned. This implies that an in-house analysis and research capacity is required for the bank in order to:

- **Identify market failures:** Only when there is a clear case for a market failure in a certain segment or area, which means private commercial banks are not engaged, there is a case for intervention by the promotional bank.
- **Develop promotional schemes:** Having identified such a market failure, the bank needs to address it by a special promotional programme or scheme.
- **Evaluate the schemes ex-post:** It is important to evaluate promotional programmes ex-post on a regular basis, to obtain more information regarding their effectiveness and efficiency. The results of this evaluation can be used to improve current and future programmes further.

If policymakers want to designate a new specific activity or role to the bank, two conditions must be fulfilled: This new role must be approved by the supervisory board, and the Government needs to carry all related risks/costs. This implies that any subsidies that are involved in such a scheme are funded directly and transparently by the budget, and the bank acts more like an agent for the Government in this case.

<u>Management</u>

A professional management in all spheres of the bank's activities is of utmost importance. This means that highly skilled professionals (in particular at the top management's level) are needed for running the bank, with corresponding implications for a competitive remuneration. The management must be able to decide autonomously on the day-to-day operations of the bank, supported by strong risk, control and information systems and models, which help the bank to judge, price and handle respective risks. Since the bank might be active in high-risk areas (e.g. innovation and start-up finance), the importance of an excellent risk controlling and management must be stressed.

At the same time, the management must be held accountable for the promotional and commercial results of the bank. This does not imply that the management shall act as a "profit maximizers" – the higher risks (due to lending to riskier sectors) and the higher operational expenditures (due to associated technical advice) in comparison to commercial banking imply a lower profitability. However, a reasonable return on assets/equity should be targeted and subsequently achieved.

In order to secure the operational independence of the promotional bank further, the following steps regarding the appointment of its management should be taken:

- Advertising managerial positions publicly;

- Proposals for the CEO post shall be made by a search committee, which includes independent members of the supervisory board (e.g. representatives of the association of banks, chamber of commerce and other independent institutions). The CEO should have a strong personality and high reputation in the banking community;
- Final decisions about managerial positions are to be taken by the supervisory board, not by the Government;
- Manager’s tenure should not overlap with the political election cycle;
- The Government cannot pass binding decisions regarding the promotional bank, only suggestions. However, if the Parliament changes e.g. the law regulating the activity of the bank, the Government needs to pass relevant implementing instructions to the bank.

Reporting and Information disclosure

Transparent financial reporting and disclosure standards allow for a better external monitoring of the bank’s activities by all stakeholders, and improves the accountability. This includes the media/population, which also help to limit the interference from political forces into the credit allocation.

Recommendation 2: High standards of corporate governance form the basis of the operational independence of the promotional bank, and thus must be laid down firmly in its founding documents. Key issues are the limitation of the political influence on the day-to-day activities of the bank, and the establishment of a professional management team. Transparent financial reporting and disclosure standards help stakeholders to monitor the bank and hold it accountable.

4.3. Foundation

When establishing a PB, different institutional settings are in principle possible. This can happen via a Special Law, or by a Governmental Directive. The guiding question for assessing different options is what is best as a prerequisite for safeguarding sufficient independence, orientation to public welfare, solvability and efficiency of the bank? In other words, how can the PB`s good governance be durably secured against abusive and detrimental influences of economic and political lobby-groups. In our opinion, a Special Law is highly preferable, as a non-Law foundation provides significantly lower barriers for damaging modifications and thus weaker autonomy and reputation. The Special Law should explicitly mention structural features and provide recommendations and restrictions on operational issues.

Another fundamental question is on what basis the PB is established, i.e. as a completely new institution, or on the basis of an existing suitable state bank. Whatever option will be realised, it should be done anyway relying on a Special Law. In our view, a (final) decision on this important issue warrants a further detailed investigation, as both variants carry substantial benefits and risks. However, some preliminary conclusions and recommendations can be made based on the analysis performed so far.

When establishing a completely new bank, a number of issues arise directly. The key question of bringing up the founding capital must be answered (To get a reliable assessment of the necessary amount for the initial capital amongst others a concrete business plan has to be drafted. However, around EUR 150 m could serve as a preliminary estimate for the minimum initial capitalization in our view). How can highly skilled professionals be recruited that will be tasked with establishing the bank? How long will it take until the bank can conduct its first promotional activities? Also, such an institution does not have a proven track-record of high market reputation, which usually takes a long time to build. Especially under current circumstances, waiting for a long time for the reputation to build up might be not feasible. Another issue that is relevant here is that Ukraine has a significant number of state banks with a mixed track record already, including five big commercial ones (with two of the top three banks in the country). This is a weak argument for yet another state bank.

If we thus consider the foundation on the basis of an existing state bank, the question is which bank should be chosen. Draft Law #3445 from 18.10.2013 proposed to take the Ukrainian Bank for Reconstruction and Development (UBRD) as the basis for the national promotional bank. We are skeptical of these plans, as in our view this bank in terms of capital, human resources and track record seems not to have the institutional potential to fulfil urgently needed promotional tasks any time soon.

The State Export-Import Bank of Ukraine (Ukreximbank[10]) might be a better choice to serve as the basis for a promotional bank, since it has a strong institutional basis with the associated experience, reputation and management capacity. A key reason for this is the established close collaboration with foreign donors as well as the presence on international capital markets over the last decades. The development of effective promotional activities in such a set-up can be done rather quickly. They could start e.g. in a dedicated department that is still formally and legally part of the bank in its current (commercial) form. However this promotional department as the nucleus of the later Promotional Bank should be ring-fenced from the "mother bank" in a certain way, e.g. it should have own decision structures and policy. The state and other stakeholders (see chapter 4.2) must play here an important role in strategic decisions, a fact that must be also accepted by the bank's management.

In the case of separating Ukreximbank into a commercial and a promotional arm, a further set of issues arises. The crucial challenge in this regard is of course the fact that Ukreximbank is currently a successful commercial bank that works directly with corporate and retail clients and competes with the other commercial banks in Ukraine. Turning part of the bank towards a promotional bank is a process that will take time, and is not without risks.[11] Since the bank is among the Top-3 in the country, it is of systemic importance. The significant share of retail deposits in its funding structure underlines the challenge to change it without creating unnecessary noise to any of its stakeholders, as any unfounded rumours might potentially result in a (system-wide) bank run. The same is true for its international bondholders, where certain covenants limit the options for transforming the bank. A further problem is also the fact that commercial banks, which should be natural partners for the (second-tier) promotional bank, will hesitate to cooperate with it due to direct competition with the

[10] See Annex A.4 for more information on the bank.

[11] The idea of transforming Ukreximbank is not new, but was discussed some years ago (see sub-chapter 3.1 for more details).

remaining commercial part of the bank. Furthermore the willingness and inner preparedness of the existing management and personnel to undergo such a transformation would be a crucial prerequisite for success. Lastly, the question of the allocation of capital for the individual units (commercial and promotional) must be addressed.

Without putting too much emphasis on operational details of the process of foundation, which need to be clarified in further research, it should in general follow a clear Road Map, which sets relevant objectives, tasks, milestones and a realistic time frame for its implementation. In further steps, the different state programmes described before (see chapter 3.3) can and should be also consolidated and integrated into the bank. This is not a short-term objective, as the process of establishment is complicated and complex enough, but an additional task for the medium term.

It should be also noted that the establishment of a promotional bank must be seen in the wider context of a broader strategic discussion about the general future of state-owned banks in Ukraine. Currently, there is a wide range of different mandates, levels of political influence, transparency and accountability and management capabilities, which explains the different operating performances of the state-owned banks.

Recommendation 3: We think that an establishment of the promotional bank based on a Special Law is highly preferable as opposed to a non-Law foundation, as the latter provides weaker autonomy and reputation. Regarding the establishment of the bank, further research is needed on the principle alternatives of a new institution, versus the transformation of an existing state bank like e.g. Ukreximbank, as different benefits and risks are associated with both variant.

4.4. Achieving the Promotional Potential

The operational independence of the PB must have a material (i.e. financial) basis, which can be called the "autonomous financial promotional potential". Otherwise, the PB is very dependent on budget money and the accompanying political influence and uncertainty.

How can such promotional potential be achieved? We see a number of features here:

- Initial capital endowment

The initial capital (in particular the paid-in part) provided by the Government must give the PB an excellent standing in terms of solvency on the national scale. Even private (but not profit-seeking) money could in principle be used to build up the capital of the bank. However, we suggest that a clear majority of the bank should stay in national (state) hands.

- Financial privileges

The government should provide certain privileges to the bank to support their activities. Here, tax exemptions are an instrument used often, in particular an exemption from the enterprise profit tax (EPT).

- Prohibition of capital returns

Apart from the initial capital endowment, a dynamic perspective requires the need for a gradual increase in the capital base to support an increase in lending. In order to allow for this gradual increase in the capital base in an autonomous manner, the owner shall formally refrain from distributing any profits in form of dividends, or other means of distribution. This gives the bank the potential to expand its role without frequent recourse to the state budget, which brings the frequently mentioned problems of political interference.

- Explicit state guarantee for funding

Apart from the equity contribution, the bank will also use debt-finance to fund its activities. Regarding the attraction of deposits, a special feature of promotional banks' funding is that such activities (both on the retail/corporate side) are usually prohibited. This leaves open direct funding by the Government (e.g. through direct lines of credit), funding by donors or wholesale funding as possible options. Regarding the latter two variants, the provision of a clear and transparent explicit state guarantee is advisable, as this lowers the cost of funding usually (almost) to the level of the sovereign borrowing costs.[12]

The features mentioned above help the operations of the PB in several respects, in particular in:

- Funding activities cheaply

The direct provision of sufficient equity by the state, and the attraction of debt funding at comparatively low costs (e.g. due to an explicit state guarantee on wholesale funding, or direct credit lines) helps the bank to fund its activities (i.e. lending) relatively cheap in comparison to private banks.

- Conducting promotional schemes at favorable conditions

The advantages due to lower funding costs mentioned in the last section imply that these gains can be partially passed on to the borrowers. The bank can thus offer its clients promotional schemes at favorable loan conditions.

- Covering costs and risks in an autonomous manner

While the PB's objective is not to maximise profits it should at least cover its cost and maintain the real value of its capital. Due to its funding advantage, and also taking into account that this gain is partially passed on to borrowers, the bank is able to cover its operational costs and the specific lending risks and be profitable. Generating profits is no contradiction to its development mandate but on the contrary, profits:

[12] It should be mentioned that there is a certain trade-off between the objective to obtain cheap funding (e.g. due to an explicit state guarantee) in order to conduct promotional activities, and the objective to operate under market discipline with the right incentives in place. In the latter situation, market funding without an explicit state guarantee might be an important credibility test for the bank's management. See sub-chapter 4.5 for more information.

- Increase the independence of the bank from budget transfers, thus increasing its economic and political autonomy;
- Increase equity through retained earnings;
- Provide a buffer for periods of financial crises;
- Provide the basis for autonomously financed (own) promotional programmes and interest subsidies;
- Improve the rating of the bank, increase its attractiveness as partner for IFIs and consequently reduce refinancing cost from capital markets.

Recommendation 4: Achieving the promotional potential is a material prerequisite for the independence from political interference and the long-term financial sustainability of the bank.

4.5. Regulation and Supervision

Inadequate regulation and supervision is seen by many observers (Thorne, 2011) as a major reason for the poor performance of a number of promotional banks in developing markets. The potential conflict of interest between the ownership role of the state, and the regulation and supervision of the bank's activities has contributed to these problems.

The PB should be subject to the prudential banking regulation and supervision by the relevant authorities, even though it is tasked with the fulfillment of promotional objectives, and reliant on wholesale/government (in contrast to deposit) funding. Since the PB is a leveraged financial institution, it poses certain systemic risks to financial stability, similar to other banks. Thus, there is no case for exemptions from the general banking regulation and supervision[13].

Banking supervision should take into account the specific features of a PB, though. This relates in particular to three main issues: the corporate governance framework, the sustainability of the business model and the quality of the management. By performing these tasks, the supervisory authorities protect also the state (i.e. the taxpayers) against potential credit risks and losses, as well as the overall competitive landscape in the financial sector. Furthermore, the bank should also adhere to relevant EU-standards to prevent money laundering and terrorist financing (i.e. compliance with the anti-money laundering (AML) Directive).

A wider interpretation of the issue of supervision relates to market supervision, which might be used to complement the functions performed by the official supervisor. Here, the issue of credit ratings obtained by rating agencies is to mention, as they might contain additional information[14] for stakeholders about the performance of the bank (in particular for the

[13] In particular, state audit chambers are not a substitute for general supervision, as these institutions usually lack the expertise to assess the risks related to the provisions of loans, i.e. banking risks (Rudolph, 2010).

[14] The rating will be based on two factors (Thorne, 2011): The sovereign credit rating and the intrinsic credit quality of the bank. The latter point is, among other things, a function of the institutional design factors discussed in this chapter.

owner, i.e. the state). In case the bank receives market funding, such a rating is of high relevance for the cost of funding. In turn, improving the rating (e.g. due to improved risk management) might directly lower the cost of funding for the bank.

Recommendation 5: The promotional bank shall fall under the general banking regulation and supervision. Official supervisors need to take into account the specific features of such a bank by focusing on the corporate governance framework, the sustainability of the business model and the quality of the management. Furthermore, market supervision (e.g. by obtaining a credit rating) might be an ideal complement to official supervision.

4.6. Relationship with the Commercial Banking Sector

As was mentioned in the beginning of this chapter, a clear definition of the mandate of the PB with respect to the activities of the commercial banking sector is needed. The main motivation for establishing such a bank is to complement the activities of (profit-oriented) commercial banks in those sectors or areas where private banks or markets do not fully work, and not to substitute them. The long-term goal of such activities is to develop the financial sector of Ukraine further, as this is a necessary condition for the overall economic and social advancement of the country.

This key principle of “subsidiarity” implies that no conflict of interests with commercial financing institutions shall arise, in particular no crowding out of private actors. How can subsidiary be achieved in practice? We see a number of approaches that help to optimize the potential for cooperation between a PB and the private banking sector:

- <u>On-lending mainly via private banks</u>

A typical safeguard to the problems mentioned above is the second-tier institutional structure of a PB (“bank behind the banks”). The bank thus does not work directly with clients, but uses the private banking system to channel its funds to the economy. The credit risks regarding the final client stays with the private bank.

The financial conditions of the promotional programmes, in which commercial banks participate, need to be set in such a way that they are compensated for any costs and risks, taking into account their respective benefits. At the same time, the programmes need to be targeted and structured in a way that they are easy to handle by commercial banks from an operational point of view, and can be integrated into their client relationships. Informational support and advice for commercial banks on these programmes are also important.

We are in principle supportive of such a second-tier approach in the context of Ukraine over the medium term. This helps also to mitigate possible fears by private banks that the promotional bank might “push” them out of certain market segments.

- <u>Clear limits on certain balance sheet operations</u>

In order not to get into the dangers of competing with private banks on unequal terms, specific operations on the asset and liability side shall be closely regulated.

This includes a ban on specific lending operations like the direct (or indirect) provision of (short-term) retail loans, which do not have an promotional character. This can be also extended to short-term corporate loans, for which there is usually a functioning private market. Limitations should be also placed on the funding side, with funding limited to equity and wholesale financial instruments (inclusive funding by government, other national PB or IFI). In particular, the PB shall not be allowed to take retail and/or corporate deposits, so that there is no direct competition with private banks[15]. Apart from competition issues, allowing deposit-taking activities would pose additional challenges in terms of management, transparency and supervision.

- Joint financing of projects together with private banks

The PB should always try to leverage the infrastructure and capacity of private banks via co-financing mechanisms. In order to stimulate private banks to enter a particular market or sector previously unserved, the PB needs to be willing to take comparatively more risk than a private bank. The PB might for example use the instrument of credit guarantees to encourage private banks into entering such transactions.

The issues raised above should be integrated into a strategy governing the relationship with private banks during the lending process. It is very important that this strategy is as transparent as possible, and openly communicated to all stakeholders. Otherwise, big risks to the performance of the PB and to that of private banks are looming, as the latter might fear they are being thrust aside and might not be willing to cooperate with the bank. These risks can relate to unclear and non-transparent eligibility criteria, too complicated procedures as well as political risks.

Recommendation 6: The promotional bank shall complement the activities of private banks, not substitute them. By following the key principle of "subsidiary" in its operations via different institutional mechanisms (second-tier structure, limits on certain balance sheet operations, and joint financing with private banks) the PB can avoid a potential negative crowding-out of private banks.

4.7. Relationship with International Financial Institutions

While promotional banks offer emerging and transition countries the opportunity to achieve certain policy objectives by addressing market failures in the domestic financial sector, they also provide an important link to the international environment. Typically, emerging and transition countries are reliant on foreign capital for their further development, both from private and public sources.

Foreign donors have been very active in Ukraine for many years in some of the key target sectors mentioned in sub-chapter 4.1. This support came through different instruments of financial and technical assistance, and involved dealing with a wide range of counterparts

[15] Likewise, the PB should not engage in securities' business on account of other persons or institutions.

from both the official and the private sector. Box 2 below provides a short overview of current activities by different international and bilateral donors in Ukraine.

Box 2: Overview of current donor activities in Ukraine (Financial assistance)

The most active donors supporting the economic development in Ukraine include the EBRD and the World Bank. In 2012 and in particular in 2013 they provided assistance mostly to private sector companies. EBRD, IFC and to lesser extent also the EIB signed over 30 projects that provided loans and equity (with heavy emphasis on loans) of over USD 1 bn to companies operating in Ukraine. The majority of the companies that received funding operated in the agribusiness, but there were also ongoing efforts to support local bank lending for SME development and energy efficiency purposes. These include:

- Second export development project and energy efficiency lines from the World Bank

- USD 100 m MSME lending framework, USD 50 m SME energy efficiency loan to Ukreximbank (approved in 2011), USD 100 m Ukraine Sustainable Energy Financing Facility from EBRD approved in 2012

- EIB SME credit lines signed with Unicreditbank, Prominvestbank, Ukreximbank and Oshschadbank in 2012/2013 for the total amount of USD 220 m

- German-Ukrainian fund partly funded by KfW had EUR 17 m in loans outstanding to banks for SME financing at the end of 2013

- Bilateral and smaller multilateral creditors also provided funding

- a number of energy efficiency initiatives funded by EU, Switzerland, NEFCO and other partners.

At the same time, the engagement with the public sector was less intensive, as most projects that are executed now were signed before 2012. The World Bank (as IBRD) signed its last large (>USD 10 m) project in Ukraine in 2012. In 2012/2013 EIB and EBRD funded several loans for the improvement of municipal infrastructure. EBRD funded several municipal district heating projects while EIB jointly with EBRD provided funding to complete the metro in Dnipropetrovsk.

In 2014, the engagement with international donors intensified significantly. Ukraine is currently in negotiations with the World Bank on a number of projects including a Development Policy Loan (DPL) of USD 750 m (with USD 100 m contribution from Japan) and a Second Municipal Infrastructure Project (USD 350 m). EBRD indicated that it will step up its investments in Ukraine to EUR 1 bn per year as compared to previous plans to spend EUR 0.55-0.75 bn annually. Significant part of this sum for 2014 is already committed. EIB also pledged to double its assistance to Ukraine with an project envelope of EUR 3 bn in 2014-2016.

In relation with the IMF-supported programme recently signed, additional official financing from IFIs and other sources is projected to amount to USD 6.4 bn in 2014; USD 5.4 bn in 2015 and USD 3.3 bn in 2016. The majority of this amount will come from the World Bank, EU, EBRD and EIB.

A well-run promotional bank with a high international reputation can in such a scenario serve as a single counterparty to the international donor community, streamlining and leveraging available financial assistance funds through its activities. Such a bank has in our view a number of strategic advantages over the status quo, in particular due to its mandate, a strong governance framework and the promotional potential.

At the same time, it should be noted that such a new promotional bank could be also perceived as a competitor by (large and powerful) IFIs active in Ukraine, as both institutions would compete in the provision of funds to Ukrainian entities. Especially in the starting phase, when the new institution needs to build up its reputation and credibility, it is very likely that there will be a wait-and-see approach taken by IFIs. However, one should also keep in mind that the network of Ukraine's development partners is very broad and diverse, and does not consist only of IFIs like the EBRD, the World Bank and IFC. Especially bilateral foreign development institutions might take a different approach and use the promotional bank as a efficient and effective vehicle to channel their funds to the economy.

Especially in the current economic situation, which is characterized by the need, but also the declared willingness[16] for substantial foreign support for Ukraine's future economic and social development, the creation of a promotional bank might create a huge opportunity to absorb and maximize the impact of such forthcoming development assistance.

Recommendation 7: The promotional bank might become a powerful vehicle to absorb and channel development assistance by the donor community, which is expected to increase rapidly in the near future, into the economy. Particular importance should be paid to bilateral/smaller development partners, for whom such an institution might be an ideal partner.

[16] According to our count, currently up to USD 37 bn are pledged by different countries and institutions for the next years, which is a significant increase over the recent past.

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Annex

A.1: Kreditanstalt für Wiederaufbau (KfW)

KfW was established on 18 November 1948. The bank is based on a special law ("Law Concerning Kreditanstalt für Wiederaufbau"). KfW is a public law institution („Anstalt des öffentlichen Rechts") . Its owners are the Federal Republic (80%) and the Federal States (20 %) of Germany. It enjoys a guarantee of the Federal Republic.

Today, KfW`s main activities are in the following areas:

- SME and start-up finance
- Risk capital, innovation, technical progress
- Housing
- Environmental and climate protection
- Infrastructure
- Municipal finance: Granting loans to territorial authorities ("Gebietskörperschaften") and special- purpose associations under public law ("öffentlich-rechtliche Zweckverbände")
- Measures for the promotion of education
- Development cooperation

Export and project finance activities in the interest of the German and European economy are carried out by a separate 100 % subsidiary without public support (KfW Ipex-Bank).

In the majority of its financing operations, KfW has to obey to the principle of subsidiarity, i.e. credit institutions or other financing institutions must be involved in the granting of financings. KfW funds itself mainly in the capital markets by issuance of debt securities.

Bodies of KfW are the Executive Board and the Supervisory Board. In the Supervisory Board are represented the owners (Federal Republic by 7 ministers, Federal States by 7 representatives appointed by the Federal Council), the Federal Parliament (7 deputies), the banking community, representatives of industry, municipalities, agriculture, crafts, trade, housing industry and the trade unions. The Supervisory Board is chaired alternatively by the Federal Minister of Finance or the Federal Minister of Economics and Technology. Decisions are adopted with the simple majority of the votes with each member having on vote.

The law on KfW stipulates that no distribution/disbursement of profits is allowed.

Figures & Facts 2013:

Balance sheet total EUR 464.8 bn., Promotional Volume EUR 72.5 bn., SME-financing EUR 22.6 bn., municipalities/infrastructure EUR 4.7 bn., KfW IPEX-Bank EUR 13.7 bn., KfW Development Bank EUR 5.3 bn.

A.2: Vnesheconombank (VEB)

The primary economic responsibilities of the VEB are the promotion of the competitiveness of the Russian economy, its diversification, encouragement of investment activity by providing investment, foreign economic, insurance and consultative support for projects in Russia and abroad including projects involving foreign capital. The financed projects should aim to develop infrastructure, innovations, special economic zones, environment protection, to provide support for exports of Russian goods and services as well as to support for small and medium-sized enterprises.

The precursor of today's Vnesheconombank was founded in 1922 shortly after the restoration of the Russian credit system as a joint stock bank with the name "Russian Commercial Bank". The bank was renamed and its activities extended twice in the Soviet era, in 1924 it became the Bank for Foreign Trade of the USSR (the USSR Vneshtorgbank) and in 1988 the Bank for Foreign Economic Affairs of the USSR (Vnesheconombank of the USSR). After the collapse of the Soviet Union it was restructured in 2002 by strengthening its role as a state-owned financial institution with the priority of supporting structural reforms. At the same time the extent of commercial activities was reduced. Since 2003 it is as State Trust Management Company responsible for investing pension funds. In 2007 the bank received with the Federal Law "On Bank for Development" a new legal basis and got its present form as a completely state-owned corporation called 'Bank for Development and Foreign Economic Affairs (Vnesheconombank). The reason for this last restructuring was from the government's point of view the necessity to create a development bank to support the Russian economic development based on the model of the German KfW. As a result of this strategy, the bank strengthened its cooperation with the regions substantially and became the key instrument of state investment policy.

The main promotional focus of the VEB is industry, which received 50.3% of total loans in the beginning of 2013, followed by infrastructural projects with 36.4% and the agro-industrial complex with 11%. The industrial share of industry is to continue to increase until 2015 to 58% according to the loan portfolio strategy. The sectoral priorities are aircraft construction and rocket and space complex, shipbuilding, electronic industry, nuclear industry including nuclear power engineering, transport, power and special mechanical engineering, smelting industry (manufacturing of special steels), timber processing industry, defence-industrial complex, agro-industrial complex, strategic computer technologies and software, information and communications systems, medical equipment and pharmaceutics. However, the VEB also offers financial support for affordable housing programs and support for single industry towns.

The VEB is governed by the Supervisory Board, which is headed by the Chairman of the Russian Government. The Supervisory Board is comprised of eight members and the Chairman. Members of the Supervisory Board are appointed by the Russian Government for a period of five years. Meetings of the Supervisory Board are called at least once per quarter.

The core principles are not to compete with commercial financial institutions (e.g. as eligibility condition projects should have a value of at least RUB 2 bn (ca. EUR 45 m), minimum loan size should be RUB 1 bn and the payback period should be no less than 5 years), break-even operation, giving preference for public private partnership projects and environmental responsibility.

The VEB has extensive international cooperation. It participates in the Long-Term Investors Club, Afrocom, the Russia-Brazil Business Council, the Russia-Bahrain Business Council and the Russian-Swedish Business Council and implements programs with international institutions including: financing of infrastructure projects in Russia jointly with the World Bank, target financing of energy-efficiency and resource-saving projects, the Russia-EU initiative "Partnership for Modernization" and the Northern Dimension Environmental Partnership.

Individual tasks of Vnesheconombank are divided on their subsidiaries, e.g. the SME Bank is financing the government programs for SME support and the Russian Agency for Export Credit and Investment Insurance supports industrial exports. Overall, the Vnesheconombank has 15 subsidiaries including representations in other countries and banks bailed out during the global financial crisis.

Figures & Facts 2013:

As of 31.12.2013, VEB's total assets stood at USD 101.3 bn, after USD 96.1 bn at the end of 2012. Loans to customers make up 56% of this amount. Among the loan portfolio, the majority of loans are commercial loans (43%) and project finance (38%). The portfolio is quite diversified across industries, and has increased its maturity over time. 68% of loans are above one year maturity; 58% of all loans are granted in national currency.

In terms of capital, the bank has a capital adequacy ratio (CAR) of 10.4%, which is above the minimum of 10% set by Supervisory Board. The bank has been profitable since 2009: In the first nine months of 2013, the return-on-equity (RoE) was 9.8%, while the return-on-average-assets (RoAA) was 1.9%. These developments are supported by a net interest margin (NIM) of between 3.2% and 3.4% over the last 3 years.
The long term foreign currency ratings are at par with the investment grade rating of the Russian sovereign: "BBB" (S&P), "BBB" (Fitch) and Baa1 (Moody's).

A.3: Croatian Bank for Reconstruction and Development (HBOR)

The objective of the Croatian Bank for Reconstruction and Development is promote the development of the Croatian economy by extending loans, insuring export transactions against political and commercial risks, issuing guarantees and providing business advice.

The HBOR was established in 1992 as "Croatian Credit Bank for Reconstruction" and is entirely owned by the Republic of Croatia. In 1995, the Bank was renamed "Croatian Bank for Reconstruction and Development". In March 2013 was the last change of the legal basis, which relates to the number of members of the HBOR Supervisory Board.

The promotional focus of the HBOR is financing the reconstruction and development of the Croatian economy, financing infrastructure, promoting exports, supporting the development of small and medium-sized enterprises, promoting environmental protection and insuring the exports of Croatian goods and services from non-marketable risks. Loan approvals for specific target groups show that the main lending activity in 2012 was focused on exports (33% of the loans), followed by industry (27%), SMEs (24%) and infrastructure (16%). Over half of these funds were for investment purposes (53%), while the rest was for working capital (47%).

In 2010, the HBOR group was formed. It consists of the HBOR, its direct subsidiary the "Hrvatsko kreditno osiguranje d.d." and its indirect subsidiary "Poslovni info servis d.o.o." The "Hrvatsko kreditno osiguranje d.d." insures company's foreign and domestic short-term receivables regarding shipments of goods and services and "Poslovni info servis d.o.o." provides analysis, credit risk assessment and information on creditworthiness.

The HBOR is led by the Management Board, which consists of three members, one of whom is the President of the Management Board. The Management Board conducts the business according to the Law on HBOR. Members of the Management Board are appointed by the Supervisory Board, which consists of ten members: six ministers in the Government of the Republic of Croatia, three members of the Croatian Parliament and the President of the Croatian Chamber of Economy. The President of the Supervisory Board (Minister of Finance), or in case of his/her absence, the Vice-President (Minister of Economy) has to summon a meeting of the Supervisory Board at least once in a half-year.

The HBOR supports the commercial banking sector, e.g. it makes project funds available to commercial banks, which, in turn, on-lend to eligible private sector exporters at market rates. HBOR maintains successful relations with international financial institutions, development banks, export credit agencies and commercial banks. It is a member in a series of associations (e.g. EAPB - The European Association of Public Banks, ELTI - European Association of Long-Term Investors, BACEE - Banking Association for Central and Eastern Europe), cooperates with all major International Financial Institutions (e.g. World Bank, EBRD, CEB - Council of Europe Development Bank, EIB - European Investment Bank) and signed co-operation agreements to facilitate access to information on export markets with financial institutions in over 40 countries. HBOR started its co-operation with EIB in 2001. So far, altogether eight finance contracts have been signed, totalling EUR 1.11 billion. By the raised funds, more than 1,800 projects have been financed and more than 7,100 new jobs created.

<u>Figures & Facts 2013:</u>

According to the Annual Report 2013 of the HBOR Group total assets stood at EUR 3.4 bn and gross loans at EUR 3.3 bn as of 31 December 2013. The credit ratings are at par with the Croatian sovereign at BB (S&P) and Ba1 (Moody`s).

A.4: State Export-Import Bank of Ukraine (Ukreximbank)

Ukreximbank was established as a state-owned company pursuant to Decree of the President of Ukraine No.29 on January 3, 1992. Since 2000, the bank is a joint-stock company (JSC) with 100% of shares owned by the state.

As indicated by its name, the main focus of Ukreximbank's operations was historically servicing various export-import transactions. Currently, Ukreximbank's customer base is diversified and includes some large industrial and state-owned enterprises. Ukreximbank is a full-service commercial bank, which goal is to support the real economy and SME-development. It accepts deposits from the public and makes loans, transfers payments in Ukraine and abroad, exchanges currencies, invests funds and provides cash and settlements, and other banking services to its customers. It is financing public and private investment projects, which focus on the development of sectors generating high value-added, e.g.:

- enterprises producing export - oriented and import - substituting products,

- attracting foreign loans in order to improve the performance of the Ukrainian economy (including, among other things, introduction of energy saving technologies),

- servicing foreign economic transactions of its customers

- acting as a financial agent of the Government of Ukraine for international commercial borrowings.

Additionally, it is acting as the sole financial agent of the Government of Ukraine with respect to foreign loans borrowed from IFIs or guaranteed by Ukraine.

The Bank has two subsidiaries, the leasing companies Ukreximleasing and Eximleasing LLC. Both subsidiary companies were established in order to include leasing services in the Bank's business and perform trade transactions.

In accordance with the "Law of Ukraine on Banks and Banking", the management bodies of Ukreximbank are the Supervisory Council and the Board. The supervisory council is appointed by the Verkhovna Rada of Ukraine, the President of Ukraine and the Cabinet of Ministers. The Supervisory Board appoints and resigns the Chairman of the Board and the other members upon the proposal of the Chairman.

Ukreximbank cooperates with international financial institutions and similar institutions, such as the World Bank, the EBRD, the European Investment Bank and IFC under programs for export development and international trade, SME development and energy efficiency. In 2012, Ukreximbank entered into a EUR 100 million loan agreement with the European Investment Bank (EIB). The agreement envisaged financing of projects implemented by small and medium-sized enterprises as well as energy-efficient and environmental projects. The EIB loan funds will be channeled through Ukreximbank to its customers.

<u>Figures & Facts 2013:</u>

At the end of 2013, Ukreximbank`s total assets stood at UAH 94.3 bn (USD 11.8 bn), which makes it the third biggest bank in Ukraine. Loans stood at UAH 42.3 bn (USD 5.3 bn) at the end of 2013. It has around 70 thousand corporate and around 1.44 million individual customers. The long-term foreign currency ratings are CCC (Fitch) and Caa3 (Moody`s).

B.1: The draft law “On the State Development Bank of Ukraine”

On 18.10.2013 the draft law #3445 "On the State Development Bank of Ukraine" was registered in the Verkhovna Rada, the Parliament of Ukraine. According to it, the PB will be established through reorganization of the existing “Ukrainian Bank for Reconstruction and Development” (UBRD).

The draft law was fast-tracked for consideration in the Parliament, as it was approved in the relevant committee in less than three weeks and was scheduled for plenary in another two weeks. It was not discussed due to recent political events.

According to the draft law, the PB should serve as a powerful investment platform for the national economy. Key provisions of the draft law include the main goals of the bank:

- medium and long-term lending to banks to support implementation of the national target programs that provide economic growth,
- medium and long-term lending to businesses executing investment projects and projects for economic and social development in the priority sectors of the national economy, including funding from the state budget,
- attraction of internal and external resources (including those attracted under the state guarantees) for the implementation of the national target programs,
- Cooperation with international and foreign financial institutions in the areas of fundraising and implementation of investment projects and projects for social and economic development.

Thus, the bank is planned to set up for the purpose of lending support for structural changes in the economy, development of the banking system, attraction of long-term local and foreign investments in priority sectors of Ukraine's economy, development of public-private partnerships and functioning as a financial agent of the Government of Ukraine.

According to the draft law, the bank will provide the following services:

- Attracting deposits (including those in foreign currency) from legal entities - investors which are used solely to finance the pre-defined investment and innovation projects to ensure the growth of the economy, including the co-financing jointly with the Bank,
- Opening and maintaining current and correspondent accounts (including those in foreign currency) of legal entities - borrowers and investors - participating in investment and innovative projects that provide economic growth,
- Placement of deposits (including those in foreign currency),
- Foreign currency transactions,
- Issue of its own securities and transactions with them,
- Provision of guarantees and warranties,
- Factoring,
- Leasing,
- Investments in the capital of legal entities,

- Attracting of medium and long-term financial resources at domestic and international markets,
- Settlement of banking transactions including international payments,
- Custodian services,
- Consultancy, informational services and other services.

In accordance with the provisions of the draft law, the bank is a specialized state-owned bank, with a special development bank license, which is not subject to the requirements of the National Bank of Ukraine on the mandatory economic ratios and norms on open currency positions and mandatory reserves. Also the bank will not be the participant of the Deposit Guarantee Fund.

The founder of the bank is the state represented by the Cabinet of Ministers of Ukraine. Its creation does not require approval of the Antimonopoly Committee of Ukraine. Governing bodies of the Development Bank will be the Supervisory Council and the Board, and functions of the operational control for the Supervisory Council will be performed by the internal audit. The Supervisory Council is composed from officials from Ministry of Economic Development and Trade and Ministry of Finance (3 and 4 representatives, respectively). It is envisaged that the activities of the bank have to be open and transparent by introducing obligatory annual audits done by external auditors.

Funding of the bank is supposed to come through direct financing from the state budget, through exchange of its shares for governmental bonds, as well as through international financial institutions. State guarantees can be used for fundraising purposes at domestic and international financial markets. According to the draft law, the bank will be prohibited from accepting deposits and issuing loans to consumers.