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Research Report

Neighbourhood SME financing: Ukraine

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Ukraine

Neighbourhood SME financing

February 2016

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This report is based on a survey of the intermediaries conducted by the Economics Department of the European Investment Bank. Information about the market context draws on the EIB/EBRD/WB Enterprise Survey and the World Bank's Doing Business as well as national sources.

About the Economics Department of the EIB

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 35 economists and assistants, is headed by Debora Revoltella, Director of Economics.

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1 Summary

1.1 Economic and Financial Situation

- Ukraine is a lower middle income country with GDP per capita of \$3,050 in 2014 and unemployment of 10.5%. Agriculture and industry play an important role in the economy and country's exports. Ukraine is a major grain exporter, the world's 5th largest iron ore producer, and has substantial reserves of magnesium and coal.
- As conflict escalated in 2014, Ukraine's economic and financial situation deteriorated. The economic contraction was driven by a steep decline of production in the East and a more moderate recession in the rest of the country due to declining investment, economic uncertainty and disruption of trade with Russia. As a result, economy contracted by 6.8% in 2014. Current forecasts suggest a further decline of 9% in 2015.
- Deteriorating economic conditions led to pressure on the exchange rate and reserves. The hryvnia which stood as 8 UAH/USD at the end-2013 has depreciated to 26.9 UAH/USD as of Feb 22nd 2016. International reserves, which were virtually depleted at the end of February 2015, have been supported by international aid and recovered to USD 13.4bn in Jan 2016.
- These developments, in combination with deterioration in the position of Naftogaz, meant that it was difficult to control the fiscal deficit. The general government balance, excluding Naftogaz was 4.5% of GDP in 2014 and is estimated at 4.2% in 2015. The 2016 budget was approved in December, after a last-minute compromise, and remains in line with the IMF's deficit target of -3.7% of GDP. General government gross debt increased to an estimated 94% of GDP in 2015 compared to around 40% in 2013. The overall external debt of the economy reached 100% of GDP in 2014, and is expected to approach 150% in 2015.
- Inflationary accelerated due to exchange rate depreciation, increase of administered prices and high inflation expectations. Annual inflation peaked at 61% in April 2015 and the started to decelerate, reaching 52% in September 2015.
- Signs of economic stabilization appeared in spring 2015, with industrial production bottoming out, inflation moderating, international reserves recovering and the completion of negotiations on the external market debt restructuring.
- As a consequence of the recent economic downturn, small enterprises remain pessimistic about their production expectations. However, slowing growth of SME production and declining number of SMEs was already apparent since 2008. In addition to weak economic activity, the growth of SME sector is held back by number of weaknesses in regulatory and business environment.

1.2 Assessment of the Financial Sector

- The financial system is dominated by banks which account for about 95% of total financial assets. The banking sector consists of 126 licensed banks, out of which three are state-owned. The state plays a significant role in the sector. Foreign banks have a significant presence in the market with 38 banks having foreign ownership. However the share of Western banks declined in recent years, as they withdrew from the country due to their deleveraging strategies, more risk-averse approaches and weak growth prospects on the Ukrainian market.
- With the recent economic downturn and exchange rate depreciation, the financial sector came under significant pressure. Turbulence on FX market adversely affected banks with open foreign exchange positions and the ability of borrowers to service FX debt. In addition, deposit withdrawals in 2014 and early 2015 led to liquidity shortages and increased need for NBU liquidity provisions.

- The capital adequacy of the banking system deteriorated significantly during 2015 driven by the impact of currency depreciation on open positions coupled with rising NPLs and increased provisioning. As of May 2015, the official statistics for regulatory capital to risk-weighted assets stood at 7.7%. The recapitalization process is on-going requiring banks to restore capital adequacy ratios over the three-year period up to end-2018.
- Distress in the financial system highlighted the need for strengthening of banking sector governance and adoption of best practices in regulation. The National Bank of Ukraine has started to implement the program for the Development of Ukraine's Financial Sector till 2020.
- The non-bank financial sector is underdeveloped in Ukraine and accounts for approximately 5% of financial sector assets (mostly composed of insurance companies). Microfinance organizations are not present and there is no framework for setting up and operating microfinance institutions in the country. Therefore, demand for microfinance is mostly served by banks or credit unions.

1.3 Gaps in SME finance

- The SME segment is a large employer in the country. It accounts for about 70% of employees in registered business enterprises, with high concentration in industry, trade and agriculture. However, productivity is relatively low and the contribution to economic output lags behind. Access to financing is regarded to be as one of the biggest obstacles by the SME sector.
- Under current conditions, growth in SME credit is constrained by both demand and supply. Due to weak growth prospects, SMEs are abstaining from investments. In addition, large numbers of SMEs are discouraged from applying for credit due to high interest rates and the capacity of banks to extend credit is very limited.
- External financing of SMEs is mainly in the form of loans. SMEs have relatively good access to short-term local currency loans while foreign currency financing is restricted to those entities that have foreign currency earnings.
- Trade finance instruments are available on the market, mostly in the form of letters of credit, letters of guarantee and promissory notes. The leasing market is small. Private equity and venture capital are rarely available.
- The capacity of the banks to extend SME credit is constrained by the systemic factors of capital adequacy, asset quality and governance issues that are being addressed under the Central Bank's program for development up to 2020. In the short term, some banks have identified lack of local currency funding as a specific constraint on SME lending particularly for longer maturities.
- SME risk is an important constraint and all banks indicate some degree of difficulty for SMEs to post the necessary collateral, and provide business plans and transparent accounts. Guarantee schemes only partially address the problem, and there is also need for capacity building in SME planning and management processes.

2 The Macroeconomic Environment

2.1 Structure of the economy

Ukraine is a lower middle income country with GDP per capita of \$3,050 in 2014 and unemployment of 10.5%. Infrastructure is poor. Standards of healthcare, nutrition and life expectancy which declined after independence have been adversely affected by economic recession and political instability. The country ranking in the UN Human Development Index is 83rd out of 187 countries in the 2014 report. The failure of the economy to deliver improvements in living standards has been one of the underlying causes of political and social unrest. GDP per capita of USD 8,681 (in PPP terms) is 20% lower than it was in the years immediately after the breakup of the Soviet Union. The shadow economy plays an important part in overall economic activity with estimates of its share in GDP ranging from 30-60%.

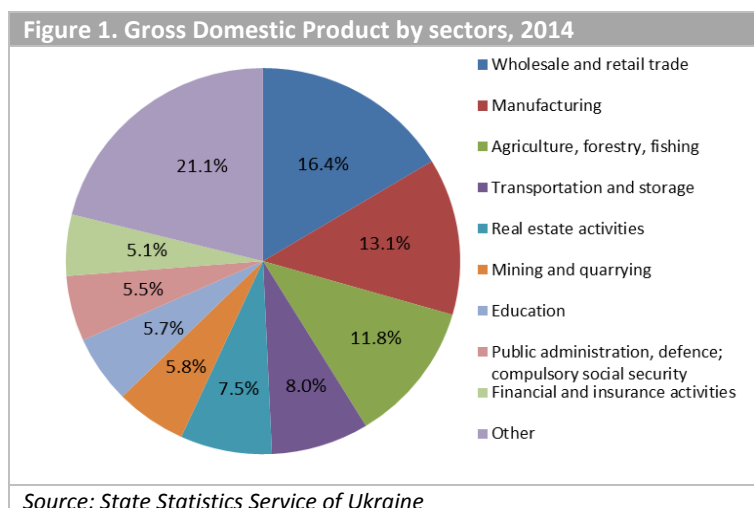
Ukraine is a major grain exporter. It is also the world's 5th largest iron ore producer, and has substantial reserves of magnesium and coal. Industry historically depended largely on Russian gas supplies. However, reverse flow capacity in pipeline connections with Hungary, Poland and Slovakia increased, which depending on demand and other market conditions, could cover some two thirds of Ukrainian import requirements. Exports are concentrated in relatively few sectors with high exposure to movements in the terms of trade. The steel industry in particular was successful in re-focusing on Asian markets after independence but remains vulnerable to movements in gas import tariffs and global steel prices.

2.2 Recent developments

Economic growth in Ukraine has been interrupted by deep recessions and the economy has failed to deliver consistent growth. Ukraine was hit by deeper recessions than the central and eastern European economies and was more vulnerable when the global crisis hit in 2009. The economy had eight consecutive years of negative growth in the early to mid-1990s, until it started to grow in 2000, reaching high 11% y-o-y economic growth in 2004. However, with the onset of 2008/2009 financial crisis, the economy declined by 15% in 2009. The growth recovered to 5.5% in 2011 but decelerated during 2012-2013 when it was hit by another shock.

The process of economic transition to a market-based economy had already slowed down prior to the crisis. Although Ukraine made good progress with transition in the early 1990s, particularly with price reforms and small-scale privatization, the process decelerated and only modest improvements have been made over the last decade. Moreover, the reforms that Ukraine managed to implement successfully did not have the anticipated impact on private sector development. Specific interest groups were able to influence the modalities of reform and were able to capture what were intended as more broad-based economic benefits.

With conflict escalating in early 2014, Ukraine's economic and financial situation has deteriorated markedly. The economic contraction was driven by a steep decline of production in the East and a



more moderate recession in the rest of the country due to declining investment, economic uncertainty and disruption of trade with Russia. Despite the loss of harvests in the eastern regions and Crimea, Ukraine collected a record grain harvest in 2014 and agriculture was the only sector registering growth. Overall, GDP declined by 6.8% in 2014. The main sectors in 2014 production were trade, manufacturing and agriculture, with respective shares of 16.4%, 13.1% and 11.8% in total GDP (see figure 1). Current forecasts

suggest a further decline of 9% in 2015 (IMF).

With the economic conditions deteriorating in 2014, the pressure on foreign exchange reserves intensified. The National Bank of Ukraine (NBU) tried to maintain its long-standing de-facto peg with interventions and capital controls. The NBU allowed some FX adjustments in early 2014, before stabilizing the exchange rate from April 2014. With mounting pressure on the exchange rate, interventions led to depletion of international reserves. Eventually, the NBU let hryvnia to float in February 2015. Overall, hryvnia depreciated from 8 UAH/USD at the end-2013 to 16 UAH/USD by the end of 2014 and lost another 50% during the first quarter of 2015. The new IMF program and international support, together with the Central Bank's measures have reduced the instability in the foreign exchange market and improved confidence. International reserves, which were virtually depleted at the end of February 2015, recovered to USD 10.2 bn on 1 July 2015 with aid inflows and placement of US guaranteed government bonds. Some of the administrative measures regulating the foreign exchange market were relaxed at the beginning of June.

In 2014, inflation rapidly accelerated due to sharp exchange rate depreciation, increase of administered prices and high inflation expectations. Annual inflation peaked at 61% in April 2015 and started to decelerate, reaching 52% in September 2015. Under these conditions the National Bank of Ukraine tightened monetary policy, with the policy rate reaching 30% in March 2015. As inflation stabilized, the NBU cut the policy rate in August and September 2015 to 22%.

Ukraine has been running current account deficits during the past ten years. The slowdown of the global economy contributed to the deepening of the current account deficit through lower steel exports, which is Ukraine's major export commodity. As a result, the current account deficit deteriorated from 2.2% of GDP in 2010 to 9.2% in 2013. Exchange rate depreciation in late 2014 and 2015 combined with weak domestic demand and low oil prices helped to reduce external imbalances. With imports falling more sharply than exports, current account deficit reduced to 4.7% of GDP in 2014 and continued to improve during the first half of 2015.

The general government deficit was adversely affected by the economic downturn and further deterioration in the position of Naftogaz. These developments led to an upward revision of the fiscal deficit for 2014 to 10.1% of GDP from 6.7% in 2013 (including the Naftogaz operational deficit). With poor revenue performance and increased spending needs, the government undertook several measures to curtail spending and increase tax revenues (e.g. broadening the VAT base). All in all, general government gross debt increased to 71% of GDP in 2014 compared to below around 40% in the previous years. The overall external debt of the economy reached 100% of GDP in 2014, up from 78% in 2013.

The IMF's four-year Extended Arrangement for USD 17.5 billion, approved in March 2015, replaced the previous Stand-By Arrangement. The new programme represents an additional USD 5.8 billion over and above the amounts committed and not disbursed under the previous arrangement. In August 2015 the IMF completed its First Review under the arrangement and approved USD 1.7 bn disbursement.

Ukraine reached agreement with private creditors on 27 August 2015 regarding restructuring USD 18 bn of sovereign and sovereign-guaranteed Eurobonds with a haircut of the principle by 20%. This will provide the country a debt relief of USD 3.6 bn. The debt deal also includes extension of the maturity of the remaining debt. The Eurobonds will be indexed to GDP, with no payments if real GDP growth is below 3% or nominal GDP drops below USD 125.4 bn. However, the Russia Eurobond maturing in December 2015 worth USD 3 bn was not included in the agreement.

2.3 Agriculture

Recent developments

Agriculture is an integral part of the Ukrainian economy. It accounts for 12% of gross domestic product and 17% of employment. The prominence of the Ukrainian agricultural sector is based on the high availability of fertile land. Ukraine is among the largest global producers of grains. The country has the world's largest producer of sunflower seeds (FAOstat, 2013). Ukraine is also the largest producer of honey in Europe, ranking third in the world. The honey export potential is showing positive trends¹. Export-oriented cereal and oilseed crops are mostly produced by larger farms. Approximately 45% of the agricultural output is produced by large-scale enterprises (OECD 2011).

Despite the economic decline in 2014, the agriculture sector registered 2.9% growth y-o-y and was the one of two sectors having a positive contribution (health and social work sector was the other one having rather humble positive contribution). Agriculture accounted for 10.2% of gross domestic product in 2014. Approximately 3.3 mln people are employed in the agriculture, forestry and fishing sector (17.2% of total employment). About 11% of registered SMEs are involved in this sector.

Signature of the Deep and Comprehensive Free Trade Area (DCFTA) agreement in June 2014 will further facilitate trade between the EU and Ukraine by tariff reductions and open new export destinations for producers. It will also require the country to harmonize standards and norms with those of the EU.

Financial needs

In addition to the need for structural reforms and regulatory changes, access to finance and working capital are important aspects given the current macroeconomic conditions. As of end-July, 2015, the amount of loans to non-financial corporations in Agriculture, forestry and fishing amounted to Hryvnia 54.8 bn (approx. USD 2.5 bn), making up 6.7% of total non-financial corporation portfolio. About 45% of these loans are disbursed in foreign currency. Half of these loans have original maturity of 1-5 year, while 39% was disbursed short term and the remaining 11% has the original maturity of over 5-years.

Despite the economic downturn and substantially decreased credit activity, agro business remains more active and so is the sector's demand for financing, especially for larger sized enterprises. The agriculture sector portfolio is expected to avoid further deterioration in 2015-2016, unlike other sectors. Given the structure of the country's agriculture sector, with export-oriented firms and pricing linked to global markets, the foreign exchange risks of those loans are relatively low.

Limited access to finance is one of the constraints for developing the agricultural sector. According to one of the IFC surveys (2011), 75% of firms indicated access to finance as a main constraint on further growth and investment. The study commissioned by the Development Facility of the European Fund for Southeast Europe (EFSE DF, 2011) estimated agrifinance gap of USD 8.7 bn in

¹ Ministry of Agrarian Policy and Food of Ukraine.

Ukraine. The access to financing is more constrained for smaller farms and village households. Large business groups have access to foreign debt and equity markets that enable them to avoid high local interest rates.

The major challenges in agro finance are related to high borrowing costs, lack of acceptable collateral, risk assessment issues, volatility, and financial literacy of borrowers. Development of value chain financing is another important aspect. The moratorium on selling agricultural land limits the availability of collateral. Currently leased land usage in agriculture is high.

3 Financial Sector Overview

3.1 Banking Sector

3.1.1 Structure

As of 1 July 2015, the banking sector of Ukraine consists of 126 banks with banking licences, out of which three are state-owned (including EIB's partners Ukreximbank and Oschadbank). The state plays a significant role in the sector, especially following the recapitalizations in 2009. The number of banks decreased during 2014-2015 as the National Bank of Ukraine (NBU) declared more than fifty banks insolvent (see table 1).

Table 1. Number of banks and ownership structure

	2007	2008	2009	2010	2011	2012	2013	2014	Jul-15	Jul-15**
Number of licensed banks	175	184	182	176	176	176*	180*	163*	137*	126*
<i>of which: with foreign capital</i>	47	53	51	55	53	53	49	51	40	38
<i>including with 100% foreign capital</i>	17	17	18	20	22	22	19	19	18	17
<i>Share of foreign capital in the authorized capital of banks, %</i>	35.0	36.7	35.8	40.6	41.9	39.5	34.0	32.5	30.9	31.6

Source: National Bank of Ukraine

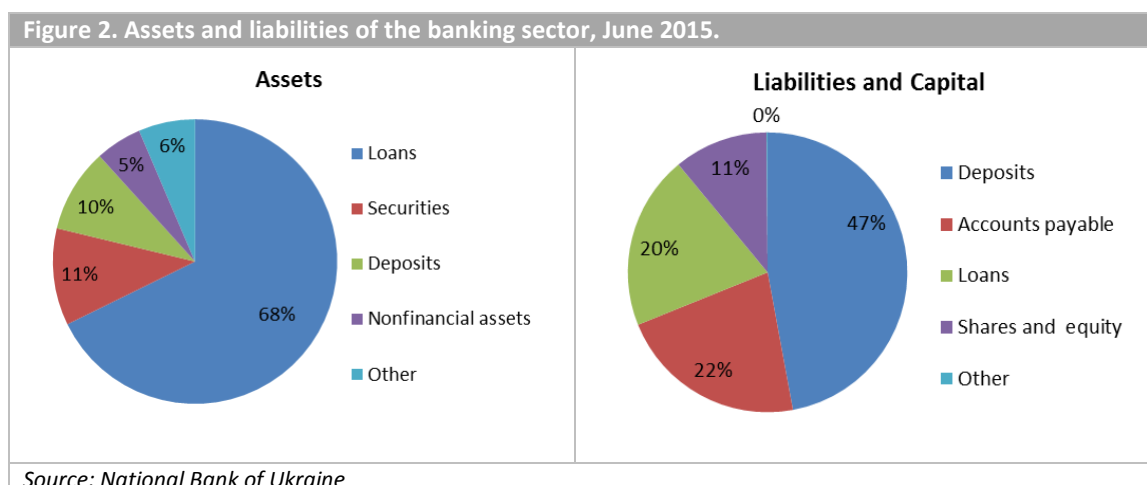
* Out of which one bank is licensed as a remedial bank

** Excluding insolvent banks

Foreign banks have a significant presence in the market with 38 banks having foreign ownership, 17 of which are 100% foreign owned. Banks with foreign ownership (including Russian as well as European companies) account for 32.9% of statutory capital. In addition, many of the systemically important banks are foreign owned and therefore support of the parent banks, including West European companies, has been regarded as important for the stability of the Ukrainian banking system. However, the European banks, which once had a market share of 40%, have scaled down as expectations of growth and profitability over the medium term have been downgraded and parent companies are reluctant to increase their exposure. The market share of West European banks in the Ukrainian banking sector halved in 2014 compared with 2008². The withdrawal of Western banks significantly reduced access to finance for SMEs, as those were the banks actively providing loans to the SME segment.

The top ten banks own 64.7% of the sector assets as of end-May 2015, and there is a long tail of small banks. Largest 25 banks of the system make up 86.6%. Loans account for 68% of bank assets. Liabilities and capital is mostly composed of deposits (47% of total liabilities and capital) (see figure 2).

² SEB sold its retail banking business, Sweden's Swedbank reduced retail operations, Dutch ING Bank exited retail banking, Renaissance Capital sold its retail banking unit, Dutch-controlled Home Credit Group was sold to Platinum Bank, and Germany's Commerzbank sold its Ukrainian unit, Bank Forum.



The current structure of the financial sector came about as a result of the extraordinarily rapid growth together with the entry of foreign banks over the period 2005-2008. The growth of credit was in the range 68% to 74% from 2006 to 2008. This credit expansion was supported by inflows of foreign capital and the net foreign liability of deposit money banks increased from around zero prior to 2005 to a peak of hryvnia 226.1 billion in 2008. In the corporate sector there was a concentration of lending in metal-related and construction enterprises. Foreign currency loans increased to a peak of 58% of total loans in 2008, and there was a widening mismatch of assets and liabilities.

3.1.2 Performance

With the recent economic downturn and exchange rate depreciation, the financial sector came under significant pressure. Turbulence on FX market adversely affected banks with open foreign exchange positions and the ability of borrowers to service FX debt. Distress in financial system highlighted the need of strengthening banking sector governance and adoption of best practices in regulation.

The banking sector liquidity risks increased due to deposit withdrawals throughout 2014 and the early 2015. During 2014 total deposits in national currency decreased by 13.7%, while foreign currency deposits were down by 37.2%. Funding problems due to declining deposits have been met by increased liquidity from the National Bank of Ukraine, foreign shareholders and also due to NBU limitations on withdrawals of FX deposits.

After withdrawals in 2014 and early 2015, domestic currency deposits stabilized and showed signs of recovery from April 2015. During the first 6 months of 2015, total deposits in domestic currency declined by 1.8%, but registered growth in m-o-m terms in Q2. The local currency deposit recovery was mainly driven by business deposits (5.6% increase during January-June 2015). Foreign currency deposits continued to decline during the first half of 2015, however the pace of outflows slowed. During the first 6 months of 2015 foreign currency deposits registered a decrease of 19.5%. NBU deposit controls imposed in early 2014 helped to moderate pressures on foreign currency withdrawals and capital outflows. The combination of exchange rate depreciation and erosion of confidence in the banks provided strong incentives to hold cash in foreign exchange and potentially compromised the liquidity position of banks where deposits were not fully matched by currency. The current framework of administrative measure on FX operations and deposit controls will be removed once the market uncertainty gradually declines and the financial conditions improve. Some of the restrictions were already relaxed in June. As the liquidity conditions improved in 2015, the NBU reduced liquidity support to banks.

The National Bank of Ukraine has started to implement the program for the Development of Ukraine's Financial Sector till 2020. The first stage of the program covers the banking sector clean-up that is already approaching completion. Other aspects of the program include: closer monitoring of

potentially weak institutions; capacity building of the deposit guarantee fund which will play a part in resolution of smaller banks; strengthened governance of resolved banks; and establishment of an institutional framework that promotes best practice in restructurings.

Since January 2014 through June 2015, the NBU declared 51 banks (21.8% of the system's total assets) insolvent, including two large banks. Out of these banks, 42 were liquidated and the rest put under temporary administration. The NBU continues to closely monitor and stress test asset quality in the banking sector.

3.1.3 Asset quality

The macroeconomic downturn and exchange rate depreciation during 2014-15 made the situation worse for the banking sector which had not yet recovered from the previous crisis. Exchange rate depreciation increased pressure on asset quality through unhedged borrowers, who did not have foreign currency income to service their FX loans. Now, there is a ban on disbursing FX loans to unhedged borrowers. However, the remaining stock of unhedged FX loans that were disbursed prior the ban (imposed by the National Bank of Ukraine in the fall of 2008) is still high in the system, particularly for mortgage loans. Banks have taken an active stance to address the FX borrowing issue. Restructuring has been ongoing on a voluntary basis, encouraged by the NBU. As a consequence, FX mortgage loans decreased from USD 3.6 bn at 1 January, 2015 to USD 2.4 bn by 1 August 2015.

Non-performing loans (NPLs), which had not recovered from the 2009 crisis, increased from 12.9% of total loans (under NBU definitions) at the end of 2013 to 19.0% by the end of 2014 and further to 24.1% in May 2015. The increase was driven by the new impaired loans, declining credit stock and valuation effects. However, the NBU's loan classification was changed in Dec 2012 resulting in a break in the series and the IMF has calculated an alternative series including substandard and doubtful loans as well as losses. On the basis of the IMF data NPLs to total loans reached 44.3% in May 2015.

Exposure to related-party lending represents another important issue to be addressed. Lax supervision over related-party lending in the past has supported the dominance of the banking sector by a few, locally-controlled business groups, which tended to distribute credit only within their groups. Reduction of related party exposure remains a priority. The new legal and regulatory framework has been developed to identify related-party loans in the banks. By the end of June, the top 10 banks submitted reports on related party lending that are now being examined by independent accounting firms. The next stage should entail unwinding the exposures that are above the limits. To further support this process, the authorities plan to establish a specialized unit that will oversee related party lending in all banks.

3.1.4 Capital adequacy

The capital adequacy of the banking system deteriorated significantly during 2015 driven by the impact of currency depreciation on open positions coupled with rising NPLs and increased provisioning. As of May 2015, the official statistics for regulatory capital to risk-weighted assets stood at 7.7%. One phase of recapitalization was implemented by end-June 2015 on the basis of the 2014 diagnostic studies. As a result, thirteen banks raised their capital by a total of UAH 45.6 bn (2.3% of GDP), while five did not and were resolved. Total fiscal cost of recapitalization remains at an estimated 9.5 percent of GDP, out of which 6.9 percent of GDP remain available for future needs³.

A new stage of diagnostics is now being carried out using March 2015 data to identify capital shortages as a result of losses associated with the recent macroeconomic shocks and the ongoing conflict. For the top ten banks the diagnostics were finalized in August 2015. The second stage of stress tests will continue through October for next 10 large banks. To this end, the largest 20 banks are set to submit credible recapitalization plans between August–October 2015 with clear

³ IMF First Review, August 2015.

commitments on future capital injections. At the initial stage the banks will be required to restore the capital adequacy ratios to 5% and then during the three-year period up to end-2018, they will be expected to restore the adequacy level to 10%.

3.1.5 Banking sector profitability

The profitability of the banking sector has been negative for three years since the 2008-09 financial crisis (as banks undertook successive rounds of restructuring) until it turned positive during 2012-2013. As the conflict with Russia intensified in 2014, adversely affecting country's economy, banking system profitability started to erode. Sharp currency depreciation at the beginning of 2015 further fuelled banking losses and the return on assets reached a low of -6.1% in June (see table 2). High recapitalization needs, eroded asset quality, loan restructurings and increased provisioning are all having negative impact on profitability. In the current environment the time it takes for the sector to return to profitability will greatly depend on resolution of the conflict and the economic recovery processes.

	2007	2008	2009	2010	2011	2012	2013	2014	Jun-15
Return on Assets, %	1.6	1.3	-4.5	-1.4	-0.6	0.5	0.2	-4.3	-6.1
Return on Equity %	13.8	10.5	-32.8	-9.8	-4.2	3.2	1.7	-35.0	-86.6

* Excluding insolvent banks
Source: National Bank of Ukraine

3.1.6 Trade Finance

Structure of Trade. Ukraine is an open economy that relies heavily on international trade. Exports of goods and services amounted to 49% of GDP in 2014, and imports 53% (World Bank, world development indicators). Merchandise trade accounts for the majority of international trade, standing at 82% of GDP. Primary commodities are an important component of Ukraine's international trade reflecting the country's relative advantage in heavy industry and agriculture. Mineral products make up 30% of imported goods, including imports of oil and gas. Other large contributors to the import bill are machinery and equipment (13%) and products of chemical and related industries (7%). As regards exports, metals and related products are the largest item with 28% of total exports, followed by agriculture (plant products) - 16%⁴. Ukraine's main trading partners are the EU and the CIS countries. Exports of iron and steel have been successfully redirected towards the growing Asian markets over recent years as demand from the more traditional European trading partners has declined. With the onset of crisis, weaker external demand and lower domestic earnings, the country's external trade has been declining.

Market developments. There are no mandatory reporting requirements for trade finance, and therefore no officially reported statistics. The following information is based on survey data reported in the European Trade Finance Yearbook 2013/14, EIB's own survey of the most active banks in trade finance and interviews with separate bank representatives.

Despite decreased external trade turnover, demand for trade finance instruments remains high, especially for larger scale SMEs and corporates. The recent introduction of administrative measures related to capital controls supported demand for TF activities, especially for letters of credit, letters of guarantee and promissory notes. (Exporters are obliged to sell 100% of their FX proceeds on domestic interbank FX market. Limits are set also for FX purchases). Commercial banks cooperate with a number of international financial corporations, such as IFC, EBRD and FMO, in trade finance facilities. However, with the increased country risks, the fees charged by the confirming banks abroad for issuing banks in Ukraine is high and constrains the TF market from further expansion.

Ukraine's trade relations with EU markets are expected to expand as a consequence of the Deep and Comprehensive Free Trade Area (DCFTA) agreement in June 2014. Demand for trade finance

⁴ Based on 2014 data. State Statistics Service of Ukraine.

instruments is expected to increase in parallel with trade deepening. Trade finance instruments supporting the access of Ukrainian companies to the EU markets could therefore have wider macroeconomic implications.

3.1.7 Regulation

Prudential regulation and supervision are the responsibility of the National Bank of Ukraine. Independence of the Central Bank is provided under the “Law on the National Bank of Ukraine” which prohibits interference of the legislative and executive bodies or their officials in the exercise of the functions and powers of the council or board of the NBU. To strengthen NBU’s institutional and policy-making independence, in line with IMF advice, the Parliament has passed amendments to the law that would enhance NBU’s ability regarding formulation and implementation of financial and monetary policies and support its financial autonomy.

Financial sector reform is a key component of the international support program for Ukraine and is integrated in the conditions of the recent IMF stand-by arrangement. The need to recapitalize the banking sector, overcome the critical crisis period and put the system on a sustainable path implies a far-reaching reform program addressing the key weaknesses in regulation and supervision of the sector. The program also addresses the structural reform agenda that includes measures to improve business climate in the country and strengthen governance. The reform of state owned enterprises is another important topic on the agenda. The IMF, World Bank and European Union have been working closely with the authorities on a reform agenda that will assist the country to tackle its financial system problems, fight corruption and improve judicial proceedings.

3.2 Non-bank financial institutions

The non-bank financial sector is underdeveloped in Ukraine. Non-bank financial institutions account for approximately 5% of financial sector assets, mostly composed of insurance companies. Microfinance is not developed and the microfinance segment is mostly served by banks or credit unions, though NGO’s are also present⁵. Leasing and factoring also account for negligible shares. The largest leasing and factoring companies are associated with large banks.

Non-bank financial institutions are regulated by the National Regulatory Commission for Financial Markets. The weak institutional and regulatory framework is holding back the sector’s development.

3.2.1 Credit unions

The overall size of the credit union segment is very small, relative to the financial system. As of Q2 2015, there were 588⁶ credit unions registered in the country with 775 thousand members. The total assets of credit unions amounted to approximately Eur 95 mln and capital of Eur 24 mln. The activities of credit unions have been declining since 2008. During the past seven years, the loan portfolio dropped to almost one third. Meanwhile, the number of members declined from 2.7 mln at end-2008 to 0.8 mln by the end of June 2015 and the assets dropped by more than 60%.

3.2.2 Leasing market

Leasing accounts for a negligible share in the financial system of Ukraine. The largest providers of leasing services are related to commercial banks in the country. According to the Ukrainian Union of Lessors’ leasing market survey of Q2 2014, the total value of leasing deals amounted to about 60 bn hryvnias (approx. Eur 2.5 bn or 3.5% of GDP).

⁵ HOPE International, a Christian faith-based non-profit organization, undertakes microfinance activities. With about 650 borrowers, the Hope Ukraine’s net loan portfolio amounts to mere 894 thousand USD, with average loans size of USD 1,340 as of September 2014.

⁶ National Bank of Ukraine.

4 The SME Segment

4.1.1 SME segment overview

The SME segment is an integral part of Ukrainian private sector. The MSME enterprises make up majority of registered enterprises, accounting for 99% of total (see table 3). Services industry is the main concentration area. More than one fourth of MSMEs are registered in trade sector. Agriculture accounts for 14%, followed by industry with 12%⁷. Small and medium sized firms in Ukraine are oriented on local markets and the share of enterprises participating in export activities is very modest (around 6%), however compares favourably to ENCA⁸ region average (around 4%)⁹.

	Micro	Small	Medium	Large
Industry	Share in total enterprises			
	81.8%	13.4%	4.7%	0.1%
	Distribution by economic activity			
Trade	28.7%	23.8%	19.2%	26.0%
Agriculture	13.8%	10.9%	16.3%	5.6%
Industry	10.3%	19.4%	30.0%	57.9%
Real estate activities	9.7%	6.0%	2.8%	0.4%
Professional, scientific, technical activities	9.6%	5.9%	4.4%	1.4%
Construction	8.8%	9.7%	5.9%	0.6%
Administrative and support services	4.1%	5.8%	5.5%	0.2%
Transportation & storage	4.0%	5.7%	7.1%	5.4%
Information and communication	4.0%	4.0%	2.3%	1.2%
Other	7.0%	8.8%	6.4%	1.2%
Total	100.0%	100.0%	100.0%	100.0%

Source: State Statistics Service of Ukraine

The SME segment is the main driver of private sector employment. It accounts for about 70% of employees in business enterprises with higher concentration in industry, trade and agriculture. The MSME segment accounts for approximately 60% of total turnover of enterprises (2014). As for the sectoral distribution of MSME turnover, almost half of it is in the wholesale and retail trade, followed by industry with 25% share and agriculture – 8%. Construction sector accounts for another 5%.

In addition to the above described MSMEs, Ukrainian economy has a very high concentration of individuals who are involved in entrepreneur activities. The number of such individuals are three times higher than that of MSME enterprises (as of 2013), but their turnover is only one tenth of the total MSME segment.

In 2012, the Government of Ukraine adopted new EU-aligned SME definitions (see table 4) using 2 criteria: average annual number of employees and average annual gross income from sales. Some banks also apply additional criterion on potential credit exposure.

Table 4. Official Definitions by Enterprise Size

Enterprise category	Average annual number of employees	Average annual gross income from sales
Micro	0-10	up to Eur 2 mln
Small	10-50	up to Eur 10 mln
Medium	51-250	up to Eur 50 mln
Large	>250	> Eur 50 mln

Source: Foreign Affairs, Trade and Development Canada

The Economics Department of the European Investment Bank has recently conducted a Bank Lending Survey among the financial institutions that are actively involved in disbursing credit to the SME segment. The survey collected information on lending conditions, availability of different financial products and credit extensions to corporates, particularly to SMEs. The survey included questions related to recent credit developments, demand and supply factors that affect credit growth, availability of various financial instruments, breakdown of loan portfolio by sectors/maturity/purpose and perception of credit conditions. Overall, six respondents provided information. It covers about one third of banking sector assets. Given that Ukraine has a high number of small banks that are oriented to specific business groups, the coverage of country's total SME portfolio is expected to be more considerable. Some of the key results of the survey are reported in the following sections of the report.

⁷ State Statistics Service of Ukraine. Business sector statistics does not cover banks, budgetary institutions, and informal activities.

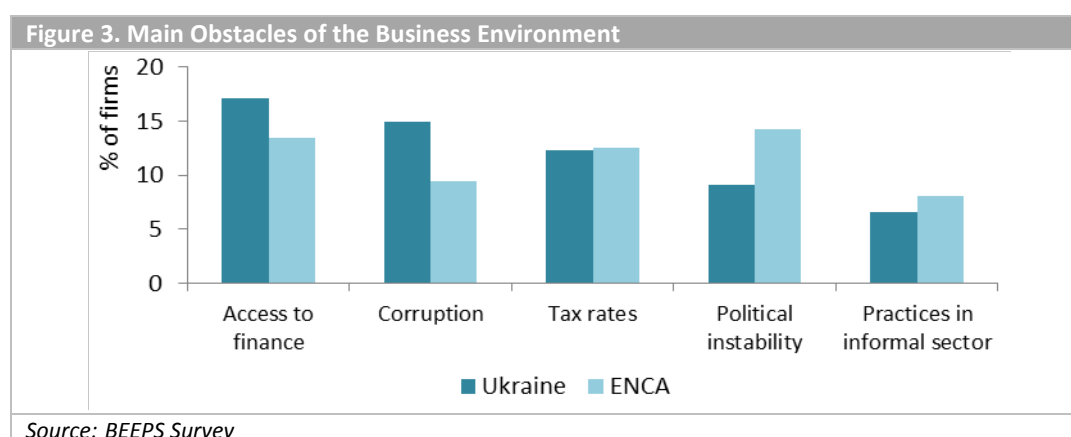
⁸ Includes countries: Armenia, Azerbaijan, Georgia, Moldova, Ukraine.

⁹ WB Enterprise surveys.

SME performance

MSME segment development is important for Ukrainian economy as it accounts for a significant share in the number of registered business enterprises and is a vital contributor to the job creation. However, SME performance has been weak in recent years. World Bank/EBRD¹⁰ survey data suggests that real annual sales growth slowed from 18.3% in 2008 to 2.6% in the 2013 survey. A similar negative trend is observed in employment growth and productivity. Various political, economic and institutional factors have prevented further expansion of the SME segment. As a consequence of the recent downturn, small enterprises remain pessimistic about their production expectations¹¹ (Q2, 2015). Both small and medium enterprises assess the financial and economic standing of their companies negatively.

The BEEPS¹² data indicates the main obstacles to doing business as perceived by SMEs (see figure 3). The most prominent constraints were access to finance, corruption, tax rates and political instability. Taking into account that this survey was conducted earlier in 2012-2013, the political stability issue has become even more severe since then. In addition, the recent survey of the National Bank of Ukraine reveals that small and medium enterprise production is hampered by macro conditions, such as exchange rate fluctuations, weak demand and high prices on energy and raw materials.



4.1.2 Access to finance

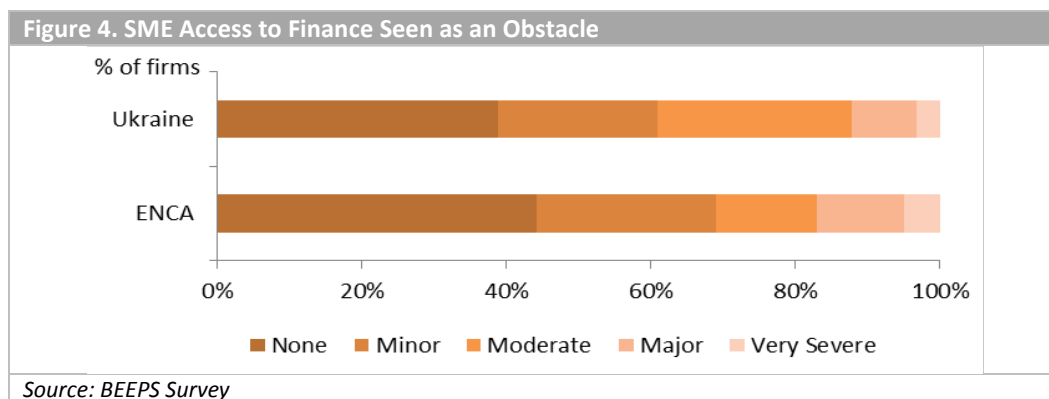
Although financial depth is quite high in Ukraine compared to its peers with credit to GDP ratio exceeding 60%, SMEs face limited opportunities to obtain loans. Almost 40% of SMEs find access to financing as a moderate, major or very severe obstacle to business operations (see figure 4). Domestic financing is important for SMEs as very low percentage of them is able to raise foreign capital: 87% of small firms and 82% of medium enterprises indicate that they do not attract foreign investment (NBU survey). More than 60% of SMEs claim to need a loan¹³. But only 15% of small firms and 22% of medium firms take advantage of bank loans or lines of credit, lagging behind peer countries. Large number of small and medium enterprises that need a loan (over 70%) get discouraged even before applying. SMEs identified high interest rates, excessive collateral requirements and complex procedures as the main discouraging factors. Overall, small and medium enterprises that are credit constrained (either discouraged or rejected) exceed 75% of the SMEs needing a credit line in Ukraine and the country scores worse than its peer countries.

¹⁰ 2013 Ukraine Enterprise Survey: Country Highlights.

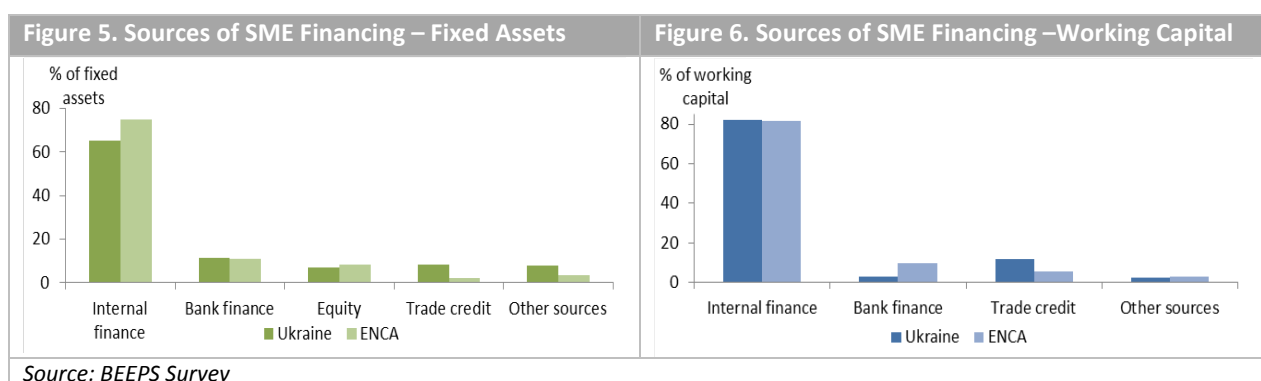
¹¹ National Bank of Ukraine, Business Outlook Survey.

¹² These results are derived from an in-house analysis of the World Bank/EBRD the Business Environment and Enterprise Performance Survey (BEEPS) database, whereby SMEs are defined as companies with less than 100 employees.

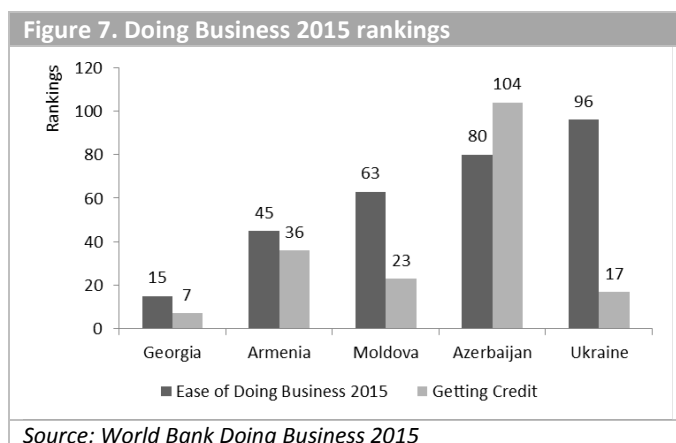
¹³ BEEPS



With limited access to external funding, SMEs rely heavily on internal sources of funding and retained earnings. For example, about 65% of investments in fixed assets and 80% of working capital are financed with internal resources (see Figures 5 and 6). Bank products are the second largest source to finance fixed assets.



4.1.3 The institutional and legal environment



The World Bank Doing Business indicators show a weak environment for SMEs and other private enterprises with an overall ranking of 96 out of 189 countries in the 2015 survey. In this respect, Ukraine performs poorly compared to other countries in the region (see figure 7). However, the country showed notable progress on improving from a ranking of 112 in 2014 and 140 in 2013. The advancement was supported by improved performance related to property registration, construction permits, financial sector regulations, thus making Ukraine

fastest improving country in 2014. Firms can also benefit from easier business registering procedures after the elimination of the requirement to provide minimum capital for company incorporation, notarization of incorporation documents, obtaining approval for a corporate seal, and registering with the statistics authority¹⁴. As a result, the number of procedures to start a business decreased from 10 to 6 with the time required of 21 days and costs of 1.2% of income per capita (Doing Business 2015). During past five years reforms related to taxation and property registration have also been carried out.

¹⁴ Ukraine: Opportunities and Challenges for Private Sector Development. The World Bank and International Financial Corporation.

Doing Business 2015 indicators show particular problems for businesses in getting electricity (rank 185th), dealing with trading across borders (154th) and resolving insolvency (142nd). New amendments have been adopted to strengthen creditor rights, reduce timeline, and promote rehabilitation that would support the improvement of business climate. In addition, financial sector players name problems with property rights and the legal/judicial system as significant constraints to SME development.

Ukraine performs well with regards to getting credit, ranking second in the ENCA region after Georgia. Nevertheless, further progress is necessary to eliminate remaining regulatory and institutional issues. A number of measures were implemented during recent years that support lending-borrowing processes through improved credit information system and legal rights. Particularly, Ukraine has expanded access to credit information by collecting data on firms from financial institutions. The coverage of individuals by private credit bureaus increased to 48% of adults in 2015 as opposed to only 28% in 2014. However, credit information system remains fragmented with no public credit registry or standardized sources for clients' credit history data. Overall, acquiring information related to new borrowers' identity, tax, bankruptcy and credit history represents a time-consuming process and the obtained information can often be not comprehensive. This process can also lead to delays and extra costs for credit approvals. In 2015, amendments to the law have been initiated concerning the establishment and maintenance of a credit register at the National Bank of Ukraine that would support reduction of credit risks for commercial banks by lowering asymmetric information problems.

Ukraine has shown considerable progress related to the property registration process, with Doing Business 2015 ranking improving to 59 from 88 in 2014. SMEs can benefit from less procedures, time and costs to acquire formal property rights that can facilitate provision of collateral. Now formal property registration process requires 7 procedures, 27 days and it costs about 2% of the property value. This process was supported by new laws and regulations of recent years related both to moveable and immovable collateral registration frameworks. For example, in 2012 a new Law on the Single State Register of Immovable Property was introduced providing banks with a reference to borrowers' property rights. In addition, a State Registry of Encumbrances over Movable Property was created.

Governmental support for the SME segment remains limited in Ukraine. Currently there are ongoing efforts to develop SME programmes on a state level. Some support programs exists at the local level and a number of programs are targeting to increase financial literacy in the SME community¹⁵.

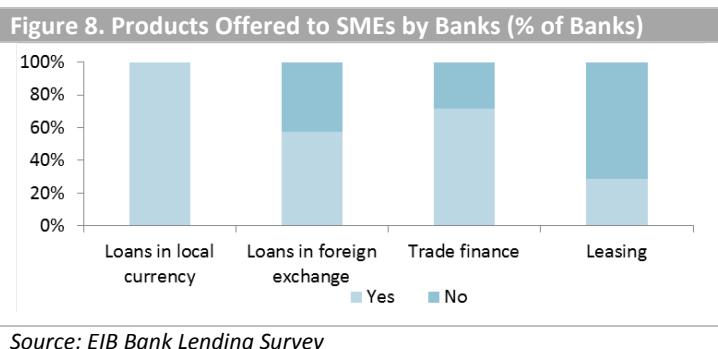
¹⁵ In 2014, the German-Ukrainian Fund (the "GUF") was established by the Cabinet of Ministers of Ukraine as represented by the Ministry of Finance, the NBU, and Kreditanstalt für Wiederaufbau ("KfW"). The fund intends to boost the competitiveness of Ukrainian small and medium enterprises by means of intermediated financings.

5 Financial Intermediaries in SME Financing

5.1 Banks

Products

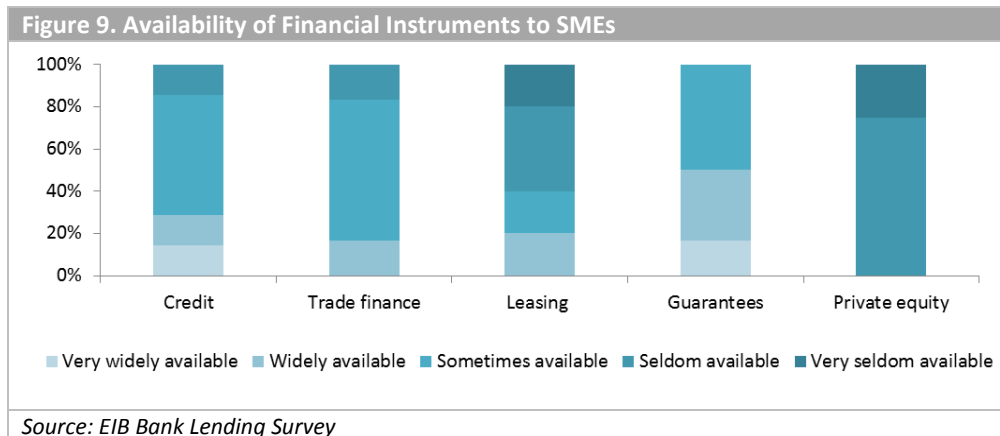
Banks are the main source of external financing for the private sector in Ukraine. All the EIB Bank Lending survey respondents indicated that they offer local currency loans to SMEs. Foreign currency loans or trade finance instruments are provided by a few of them, while leasing products are offered by less than one third (see figure 8).



Loans are the most extensively used financial instruments by the SME segment. Under the current macroeconomic conditions, overall financing remains tight. About 29% of respondent banks assess credit to be very widely/widely available and another 57% - sometimes available. The remaining 14% consider it as seldom available. Other instruments

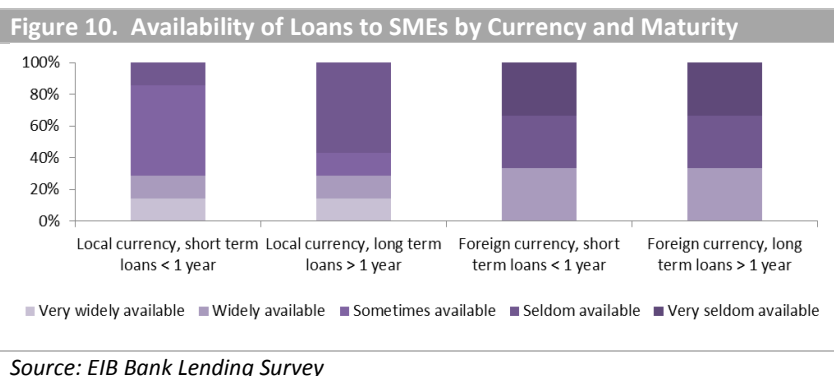
used by SMEs are guarantees and trade finance products. Leasing instruments are limited and the private equity market is very scarce with such products very seldom available (see figure 9).

Commercial banks provide loans both on a short-term basis, mostly for working capital, or long-term. For the SME segment (of the respondent banks), about one fourth of the portfolio is short-term (<1year). However, even longer-term loans (>1 year) are more concentrated at relatively short maturities. In 2013 BEEPS survey, small and medium firms indicated that original duration of their recent credit on average was about 20 months, below the ENCA average of over 30 months.



SMEs tend to use bank loans mostly for financing working capital needs, with the share of such loans reaching almost 70%. Considering current economic hurdles and difficult business environment, SMEs abstain from new investments and apply for credit to finance their ongoing operations. Examining the maturity structure of the banking sector total portfolio shows that it is also dominated by short-term loans: almost half of non-financial corporations' credit has a maturity below 1 year, while loans with maturity exceeding 5 years account for 15%.

Deteriorated macroeconomic conditions, increased funding needs of the banks and ongoing banking sector reformation processes resulted in tighter credit conditions in the country, inter alia for SMEs.



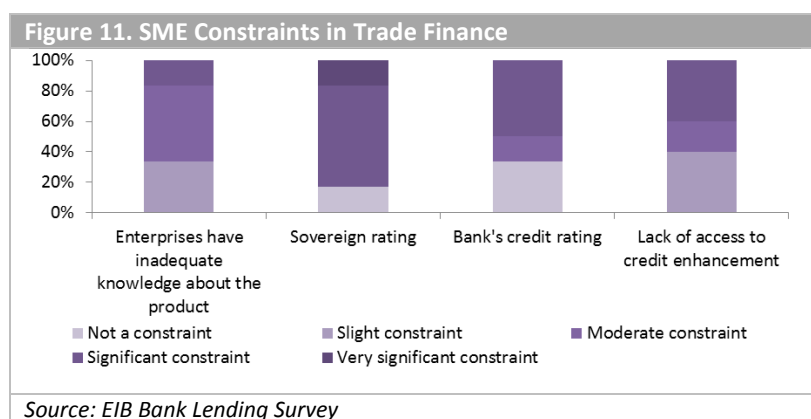
Short-term local currency loans are relatively available for small and medium firms, while securing a loan for longer maturity is hard (see figure 10). Foreign currency financing is even more limited for SMEs. According

to the National Bank of Ukraine regulations, only firms with foreign currency proceedings can be granted a loan in foreign currency. According to the Enterprise Surveys, about 6% of SMEs are involved in direct export activities. Therefore, the number of firms that qualify for an FX loan is very low. As a matter of fact, 95% of small firms and 86% of medium firms would be willing to get their next loan in local currency (NBU Business outlook survey).

Trade Finance. Trade finance (TF) has grown rapidly but remains a small part of overall credit portfolios, estimated at less than 10%. Moreover, there is considerable variation between banks, both in terms of their overall presence in trade finance and the specific products offered. Letters of guarantees and letters of credit are used most extensively.

Local banks are active in trade finance both directly and within the framework of foreign trade facilitation programmes. EBRD and the IFC provide programmes that strengthen the ability of local banks to provide trade finance and, in this way, improve the access of enterprises (including SMEs) to import and export markets. These trade programmes include guarantees to international confirming banks, which play an important role in reducing the political and commercial payment risks associated with international trade transactions undertaken by local banks. In addition they provide short-term loans to selected banks and factoring companies for on-lending to local exporters and importers.

Competition in the trade finance segment has increased in recent years and prices are responsive to changes in base rates and market conditions. However, with the elevated macroeconomic risks, the fees charged by confirming banks abroad remain high and this translates into higher domestic rates for TF products. Issuance of letters of guarantee and letters of credit are usually subject to collateral and risk rating of the customer. Risk-based charges are typically in the range 3% to 6% per annum of the transaction amount. Banks typically have a minimum fee per transaction, and some of the major players also earn fees for technical advice and services.



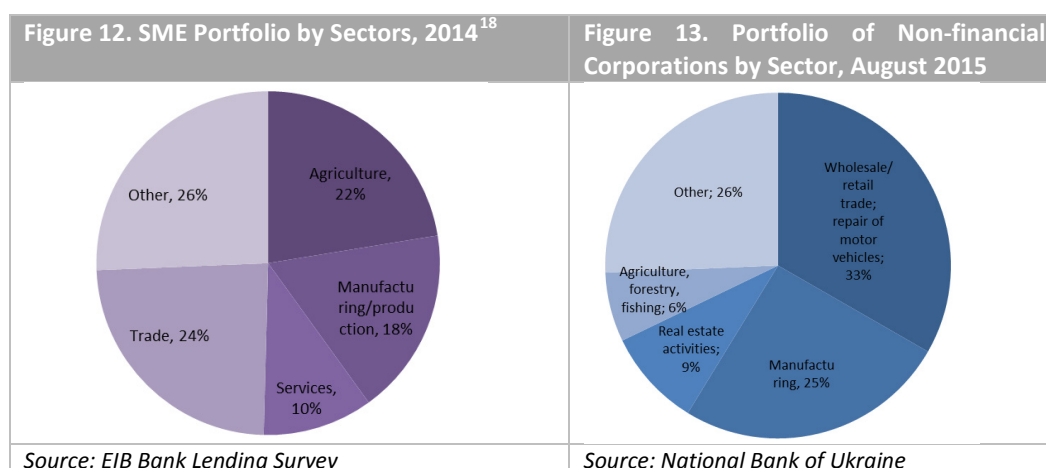
A number of factors constrain further expansion of trade finance for SMEs. Banks consider sovereign and own credit ratings as major obstacles (see figure 11). In addition, relatively poor awareness among many SMEs about the potential benefits of trade finance holds back the potential growth in demand for trade finance instruments.

Recent credit developments

Credit to the domestic economy has been following the downward trend since 2009 as both demand declined and banks tightened credit. The ratio of credit to GDP fell from a peak of 90% in 2009 (following a period of very rapid credit growth) to 70% in 2012 and remains depressed, standing at approximately 75% of GDP in mid-2015. This measure is inflated by the Hryvnia exchange rate depreciation, given that more than half of the bank portfolio is denominated in foreign currency. In real terms, credit to GDP shrank by about 30% by mid-2015 compared to the previous year. The respondent banks of EIB Bank Lending Survey reported SME portfolio reduction of 27%¹⁶ in Euro terms during 2014. The reduction of SME portfolios is primarily driven by demand-side (firm-related) factors. Many banks have capacity for lending, but due to eroded financial conditions of enterprises they refrain from disbursing loans.

The SMEs credit demand is expected to remain weak. According to the NBU Business outlook survey of Q2:2015, less than 25% of small firms and about 35% of medium enterprises are intending to take a loan, for working capital financing. As for the investment activity, 17%¹⁷ of small enterprises expect investment in equipment, machinery and instruments to decline, while medium enterprises anticipate it to remain largely unchanged.

The sectoral distribution shows that SME credit of the respondent banks in Ukraine is concentrated in trade, agriculture and manufacturing sectors, accounting for a cumulative 65% of the portfolio (see figure 12). Trade and manufacturing sectors account for significant shares in non-financial corporations' total portfolio as well (see figure 13). However, respondent banks are more active in financing SMEs involved in agricultural production.



Credit quality of SME portfolio. Credit quality of the SME segment deteriorated over 2013-2014. It is largely explained by macroeconomic and political developments that significantly reduced their earnings. However, the SME credit quality varies widely across respondents, with the average NPL ratio¹⁹ reaching 34% at the end of 2014. Credit quality deterioration can be observed for large enterprises as well.

Factors affecting credit growth

Subdued SME credit extensions reflects both bank and customer-related constraints. The current economic downturn has reduced SME activity, thus deteriorating their financial situation and ability to take on additional credit. The EIB bank lending survey confirmed that recent macro-political developments significantly affected credit to SMEs. From the macro and customer-related environment, banks consider tightening banking sector regulations, and both local and global

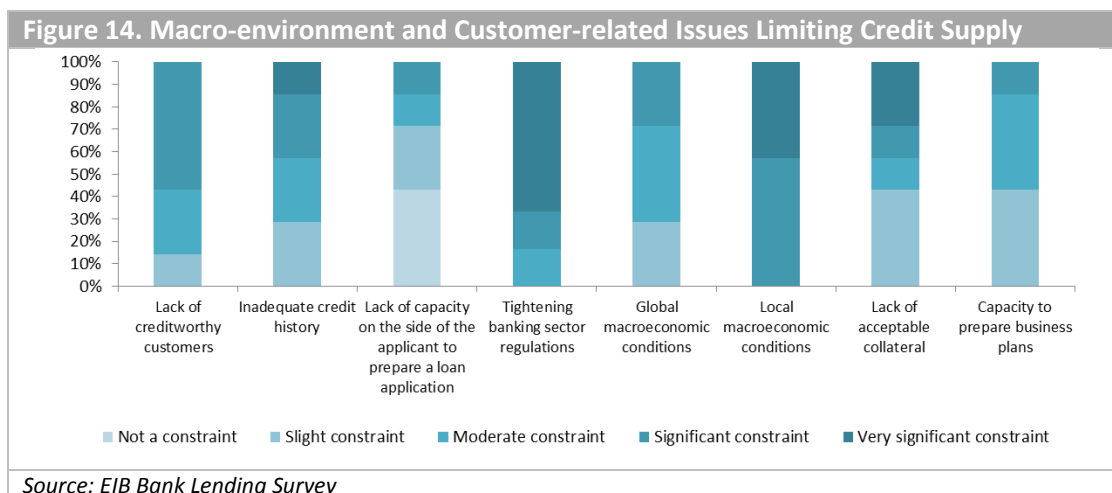
¹⁶ Survey responses covered about 25% of banking sector assets.

¹⁷ % of respondents expecting decline minus % of respondents expecting increase.

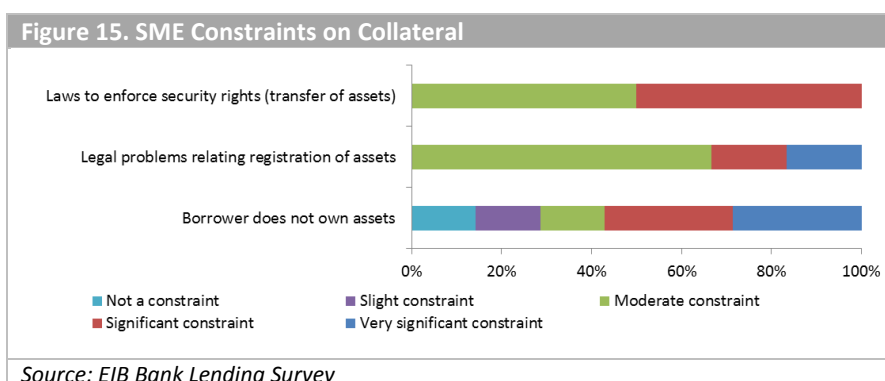
¹⁸ Survey responses covered about 25% of banking sector assets.

¹⁹ Weighted by respondents' SME loan portfolios.

macroeconomic conditions to be the most important constraints (see figure 14). Other issues relate to lack of creditworthy customers, inadequate credit history, and SMEs inability to present acceptable collateral. Some of these problems reflect weaknesses of regulatory and institutional environment, such as absence of organized credit registry or complicated procedures to acquire information on real estate from governmental entities. Lack of well-established credit information systems makes it hard for banks to assess the creditworthiness of borrowers. Furthermore, absence of reliable financial reporting is a concern for small and medium firms. Due to these asymmetric information problems, banks continue lending to existing clients and limit expansion to new enterprises.



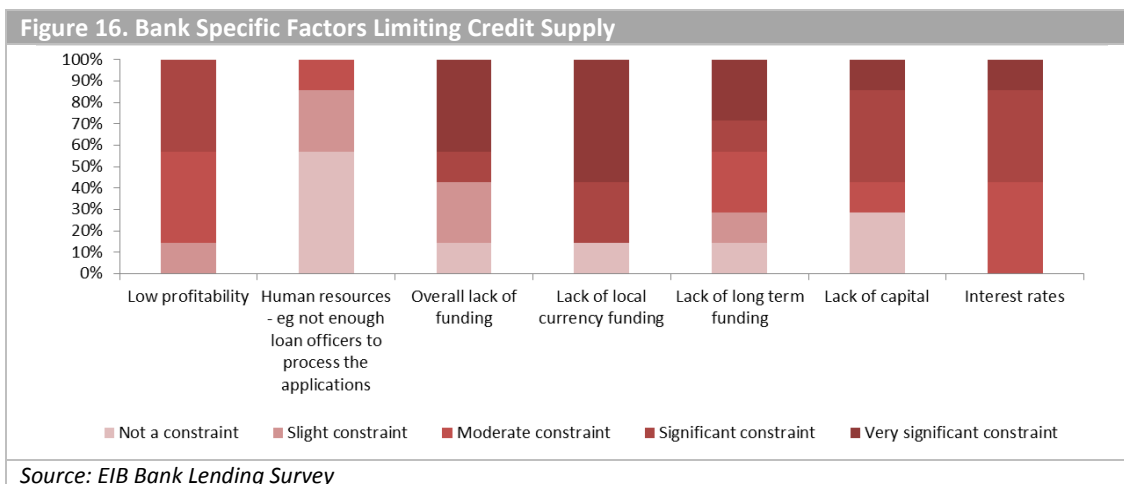
Collateral requirements. Inability to meet collateral requirements is one of the obstacles in obtaining credit for SMEs. More than half of the enterprises report collateral requirements exceeding 150% of loan amount. SMEs in Ukraine make use of both – moveable and immoveable property. Overall,



SMEs in Ukraine make better use of their movable property compared to other countries in the region. With the moratorium on agricultural land sales and its acceptance as collateral, SMEs in Ukraine have to rely more heavily on their moveable property,

especially in rural areas. Almost 60% of EIB Bank lending survey respondents rank lack of ownership of assets as a significant or very significant constraint for SMEs to present collateral (see figure 15). In addition to difficulties in presenting reliable collateral, institutional and legal environment shortcomings serve as an obstacle as mentioned above as well (for example, acquiring information on secured collateral remains problematic for banks in terms of timelines and costs).

Bank specific factors. Recent developments in the financial sector of Ukraine have been a significant constraint on SME credit. Local funding and liquidity conditions and difficulties in obtaining international funding have been problematic since the crisis in 2009 and were further exacerbated by the recent economic instability. Banks rank lack of local currency funding, high interest rates and low profitability of the SME segment to be the most disruptive factors. In addition, overall lack of funds, especially on long-term basis, and lack of capital represents a constraint (see figure 16).



Local currency funding. Access to local currency loans remains limited in the market, especially on longer term maturities due to the funding structure of the banks. A high share of deposits are in FX, deposit maturities are short and there is an absence of hedging instruments (for more details see the next section “funding of banks”). On the other hand, there are restrictions on FX lending. In 2009, National Bank of Ukraine has banned FX retail lending and FX lending to corporates without FX proceedings. Given the low share of exporting SMEs, they have to rely primarily on local currency loans from banks. Thus, access to SME financing has become even more difficult.

Interest rates. The combination of deposit outflows, local currency depreciation, inflation and tight monetary policy meant that nominal interest rates increased sharply. The NBU policy rate stood at 22% as of September 2015 and these high rates have also passed through to hryvnia deposits. Increased funding costs translated into interest rate hikes on local currency loans, reaching the levels at which it becomes a prohibitive factor. According to officially reported statistics of the National Bank of Ukraine, interest rates on national currency loans reached a peak of 24% in April. The rates seem to have moderated in the following months but remain high. Tight lending conditions are a disincentive for SMEs to raise additional funds through bank financing in a situation where demand for new investment projects is subdued. Therefore, most of the new loans are for the working capital financing and on a short term basis, to keep businesses operational.

Funding of banks

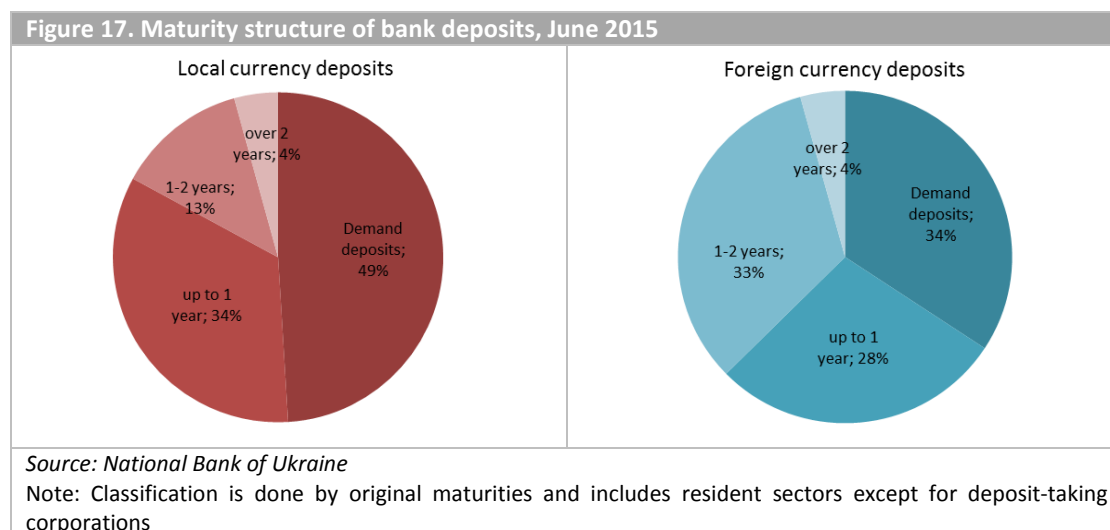
The funding structure of the sector differs across local banks, state-owned banks and foreign-owned banks. The presence of Western banks considerably increased after the so called Orange Revolution in 2005 and supported foreign capital inflow in the system. Foreign banks depended initially on parent capital and deposits to extend loans, while local banks relied more heavily on deposit funding. As for the state-owned banks, they could benefit from state capital. The share of Western banks significantly declined after the financial crisis 2008 due to their deleveraging strategies, more risk-averse approaches and weak growth prospects on the Ukrainian market. Recent developments led to capital and liquidity problems in the system (see chapter 3 for details). The recapitalization process is still ongoing and some banks are running on low capital levels, while the ones that could not meet NBU’s requirements were dissolved or put under temporary administration. On the other hand, banks with sufficient capital and liquidity are still taking a passive stance on credit due to elevated risks and lack of demand for credit from sound borrowers.

The liability structure of banks shows that almost half of assets are financed through deposits, 20% is accounted for loans and the share/equity makes up another 11%. High reliance on the deposit base made the sector vulnerable since the outbreak of crisis in 2014: the declining confidence was reflected in large deposit outflows from the system and banks faced liquidity and capital shortages. During 2014 total deposits in national currency decreased by 13.7%, while foreign currency deposits were down by 37.2%.

At the initial stage of deposit outflows banks were to some extent able to absorb part of the loss. However, with poor access to international markets it was necessary for the NBU to step in and the liquidity support provided was massive since early 2014. Against the recent signs of stabilizing funding conditions and easing liquidity, the reliance on NBU refinancing has decreased. However, the outstanding amount of NBU loans remains high for some domestic banks. By the end of June, 2015 the NBU claims on banks exceeded 110 bn of Ukrainian hryvnias or approximately 7% of 2014 GDP.

Fluctuations in the funding base significantly influenced banks' capabilities to extend credit, especially for banks with higher shares of retail deposits. Increased risk-aversion in the highly vulnerable environment further tightened credit conditions. Aside fluctuations in funding base, the maturity and currency structure of funding is essential in determining enterprises' accessibility to finance. Deposits, that are the main sources of financing local currency loans, are very limited: only half of the total deposits are denominated in hryvnias. FX resources are available both from local and foreign sources. Parent company funding for foreign-owned banks tightened as international banks revised their priorities. As FX hedging is not common due to prohibitively high costs, banks tended in the past to extend foreign currency loans to avoid FX risks. Given that a large share SMEs have local currency earnings, they do not qualify for FX loans. Therefore, lack of local currency funding translates into a severe constraint for SME credit portfolio expansion (for details see previous section).

In addition to being limited in nature, local currency funding is characterized by short term maturity. Overall, 83% of local currency deposits and 63% of foreign currency deposits are placed either on demand accounts or term deposits with a maturity up to 1 year, as of June 2015 (see figure 17). This significantly reduces banks' ability to extend long term loans, especially in local currency. Furthermore, government borrowing on local markets put upward pressure on yields.



To develop local financial markets and increase domestic currency accessibility, in July 2013 the Parliament of Ukraine adopted a law enabling IFIs to place Hryvnia-denominated local bonds. This enables IFIs to raise additional capital in local currency for various project financing.

5.2 Other financial intermediaries

Credit Unions

With no microfinance institutions on the market, credit unions are the main non-bank financial institutions serving the financial needs of small and medium enterprises. The role of credit unions is higher for rural areas and provinces. Credit unions lend to the members of the institution. The loan portfolio amounted to EUR 83 mln, as opposed to the banking sector portfolio (to residents) of EUR 44 bn. Roughly, one fifth of the loans are disbursed for small business and farming purposes and in

many cases credit unions can be the only source of funding for small farmers in rural areas. The funding is obtained through member investments and deposits. However, not all credit unions are allowed to accept deposits, and some rely on quasi-deposit instruments.

The ongoing economic and political problems, that have significantly reduced household earnings, are having a negative impact on the funding of the segment. The weak legislative and regulatory framework is another obstacle that the credit union market is facing in Ukraine.

Leasing

Leasing market is very small in Ukraine and availability of such products remains limited. The leasing market is characterised by longer maturities compared to the overall credit portfolio. Slightly more than half of the leases have durations between 5-10 years, while another 40% have maturity of 2-5 years. Contracts with maturity over 10 years are rare (less than 2% of total value). In 2014, the share of leasing with maturity over 5 years increased by about 10 p.p. compared to the year before. The leasing instruments are mostly used for financing transportation and agricultural equipment. Therefore, about 67% of the leasing market accounts for transport industry, while agriculture makes up about 17% (Q2 2014). Other sectors that use leasing instruments are construction (3%) and services (2%)²⁰. Approximately one fifth of SMEs have used leasing products to finance investment, scoring higher than peer countries (BEEPS).

The leasing companies are mainly funded through loans from banks and other companies (71%, Q2 2014) and through own funds (27%). The reliance of leasing companies on own capital has been increasing over the past years.

²⁰ Ukrainian Union of Lessors

6 Gaps in Financing

6.1 Gaps in the availability of financial products

- Under current macroeconomic conditions, credit extensions remain tight and banks' risk appetite is very low.
- SMEs generally have better access to short term working capital loans than long term investment finance. About one quarter of the SME portfolio is short-term (<1year) and longer-term loans (>1 year) are also concentrated at relatively short maturities. On average the original duration of SME credit is about 20 months, below the ENCA average of over 30 months.
- Foreign currency loans are more restricted. Under banking regulations, only firms with foreign currency revenue can be granted a loan in foreign currency and only about 6% of SMEs are involved in direct export activities.
- Trade finance is generally available and benefits from the support of IFI credit enhancement programs. However, it is constrained by the sovereign credit rating, banks' credit ratings and the low financial literacy and awareness of borrowers.
- Leasing is small but active with 20% of SMEs using finance leases primarily in transport and agriculture.
- SME guarantee schemes are used by three quarters of banks surveyed in Ukraine. Banks report administrative barriers and issues with transparency in relation to guarantee schemes.
- Private equity and venture capital are very rarely available. The nascent market was stalled by the economic downturn.

6.2 Constraints on the growth of SME finance

- Under current conditions, SME credit growth is constrained by both demand and supply. SMEs are not investing in the current economic conditions, and agriculture is the only bright spot. Agriculture accounts for 12% of gross domestic product and employs 3.3 mln people or 17% of the total workforce. About 14% of registered SMEs are involved in this sector. Overall, the number of SMEs that are discouraged from applying for credit is relatively high compared to other countries in the region.
- Funding has been severely constrained and the Central Bank had to provide massive liquidity in 2014 as deposits declined and Ukraine was cut off from international markets. However, liquidity conditions eased in 2015. The loan/deposit ratios of 1.5 in foreign currency and 1.3 in local currency indicate an aggregate funding deficit which suggests that as confidence returns there could be demand for external funding, though some banks have better access to deposits than others. Long term funding in local currency is particularly constrained.
- Capital constraints and tightening regulations are clearly a problem for many banks in Ukraine that are required to raise additional capital under the recapitalization program.
- The non-bank sector has a small share in the financial system of Ukraine. The microfinance segment is practically non-existent – there is no framework to set up microfinance institutions. To some extent, the role of microfinance institutions is absorbed by credit unions.
- Low banking sector profitability for a number of years has constrained the ability and incentive for Ukrainian banks to lend.
- SME risk is an important constraint for the intermediaries. All banks indicate some degree of difficulty for SMEs to post the necessary collateral, and provide business plans and

transparent accounts. SME risk is further exacerbated by problems with the business environment in Ukraine.

- The low level of financial literacy is constraining SMEs to make better use of financial products other than loans. Combined with the problems in business planning and reporting, the issue highlights the need for consultancy services to support capacity building in business planning/management processes and to enhance financial literacy.

References:

Presented analysis is based on a number of national, international and internal sources of data and information:

- Bank Lending Survey conducted by the European Investment Bank
- International Monetary Fund reports and databases
- Ministry of Agrarian Policy and Food of Ukraine
- Ministry of Economic Development and Trade of Ukraine
- National Bank of Ukraine (NBU) statistics and reports
- State Statistics Service of Ukraine
- Ukrainian Union of Lessors
- World Bank/EBRD The Business Environment and Enterprise Performance Survey (BEEPS) database and country reports; internal analysis of BEEPS database
- World Bank Doing Business Indicators
- World Bank and International Financial Corporation. Ukraine: Opportunities and Challenges for Private Sector Development.

Annex I Economic Data

Table 1. Macroeconomic indicators

UKRAINE - ECONOMIC DATA							
	2010	2011	2012	2013	2014	2010-2014 Average	2015 (Est)
SOCIAL INDICATORS							
Population (in millions)	45.6	45.5	45.2	40.5	42.8	43.9	42.7
Population Growth (%)	-0.4	-0.3	-0.5	-10.5	5.8	-1.2	-0.2
Unemployment rate (%)	8.1	7.9	7.5	7.3	9.3	8.0	11.5
NATIONAL ACCOUNTS							
Real GDP ⁽¹⁾ growth rate, %	0.3	5.5	0.2	0.0	-6.8	-0.2	-9.0
GNDY ⁽²⁾ , % GDP	--	--	--	--	--	--	--
GDP per capita, US\$	2,982.8	3,589.6	3,883.4	4,435.1	3,050.6	3,588.3	2,108.9
GDP in Bn US\$	136.0	163.2	175.7	179.6	130.7	157.0	90.1
Gross Investment, % GDP	17.0	18.3	17.7	15.1	11.5	15.9	9.5
Gross National Savings, % GNDY	--	--	--	--	--	--	--
FISCAL ACCOUNTS							
General Govt Balance, % GDP	-5.8	-2.8	-4.3	-4.8	-4.5	-4.4	-4.2
Gross General Govt Debt, % GDP	40.6	36.9	37.5	40.7	71.2	45.4	94.4
External Debt, % GDP	86.3	77.4	76.6	78.3	100.4	83.8	147.7
Debt Service Ratio, % of expt. goods, services & income	--	--	--	--	--	--	--
MONETARY ACCOUNTS							
CPI ⁽³⁾ Inflation, %	9.4	8.0	0.6	-0.3	12.1	5.9	50.0
Broad Money, % GDP	55.4	52.7	55.0	62.0	61.1	57.3	60.1
Credit to Private Sector, % GDP	78.4	71.1	69.6	73.5	76.3	73.8	--
Nominal Exchange rate (Nat cur/USD)	7.9	8.0	8.0	8.2	12.0	8.8	22.0
Nominal Exchange rate (Nat cur/EUR)	10.5	11.1	10.3	10.8	15.9	11.7	24.4
Appreciation (%) against the EUR	3.0	-5.3	7.3	-5.4	-47.0	-9.5	-53.4
Appreciation (%) against the USD	-1.9	-0.4	-0.3	-2.1	-47.0	-10.3	-83.3
BALANCE OF PAYMENTS ACCOUNTS							
Current Account Balance, % GDP	-2.2	-6.3	-8.1	-9.2	-4.7	-6.1	-1.7
Workers' Remittances, inflows, % GDP	4.8	4.8	4.8	5.3	5.6	5.0	--
Net FDI ⁽⁴⁾ , % GDP	--	--	--	--	--	--	--
Foreign Exchange Reserves, months of imports	--	--	--	--	--	--	--
Trade Openness ⁽⁵⁾	98.1	106.2	104.1	95.1	102.4	101.2	114.2
Market Share in the World Market, % world imports ⁽⁶⁾	0.3	0.4	0.4	0.3	--	0.4	--
Imports from EU-27 as Share of Total Imports (%)	31.5	31.2	31.0	35.1	--	32.2	--
Exports to EU-27 as Share of Total Exports (%)	25.5	26.3	24.9	26.5	--	25.8	--
Real Effective Exchange Rate (2000=100) ⁽⁷⁾	100.0	100.3	102.8	99.6	78.3	96.2	--
Terms of trade of goods and services ⁽⁸⁾	106.9	116.1	111.8	112.1	104.3	110.2	94.9
<p>(1) GDP : Gross Domestic Product (2) GNDY : Gross National Disposable Income = GDP + Net Income + Net Current transfers from abroad (3) CPI : Consumer Price Index - (4) FDI : Foreign Direct Investment (5) Trade openness = 100 * (exports + imports of goods and services) / GDP. (6) Market share in the world market = percentage of merchandise exports in total world imports. (7) REER: The real effective exchange rate. A decrease in REER represents an increase in competitiveness (real depreciation). (8) Terms of trade = export prices / import prices of goods and services. Source: IMF, WTO, European Commission (DG Trade), World Bank.</p>							
Governance Indicators 2014 (Percentile Rank)							
Voice and Accountability	Stability/No Violence	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption		
36.97	21.80	30.62	28.71	23.22	11.96		
<p>Voice and Accountability: the extent to which citizens of a country participate in the selection of governments. Stability and Absence of Violence: the likelihood that the government will be destabilized/overthrown by unconstitutional and/or violent means. Government Effectiveness: the quality of public service provision and of the bureaucracy as well as the government's commitment to policies. Regulatory Quality: the incidence of market-unfriendly policies, as well as burdens imposed by excessive regulation. Rule of Law: the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. Control of Corruption: the extent of corruption, conventionally defined as the exercise of public power for private gain. Source: World Bank.</p>							
Doing Business 2015 (ranking 1=best; 189=worst)							
Ease of Doing Business Rank	96	Getting Credit	17	Enforcing Contracts	43		
Starting a Business	76	Protecting Investors	109	Registering Property	59		
Dealing with Licenses	70	Paying Taxes	108	Resolving Insolvency	142		
Employing Workers	--	Trading Across Borders	154				
Source: World Bank							
SOVEREIGN RATINGS							
Moody's	Fitch	Standard & Poor's					
Caa3 / Stable	Caa2 / --	B3 / Stable					

Table 2. Financial Soundness indicators

	2014				2015		
	Mar.	Jun.	Sep.	Dec.	Mar.	Apr.	May
Ownership							
Number of banks, of which 1/	181	174	168	163	148	145	143
Private	174	167	161	156	141	138	136
Domestic	123	116	110	105	95	93	91
Foreign	51	51	51	51	46	45	45
Of which: 100% foreign-owned	19	19	19	19	19	19	19
State-owned	3	3	3	3	3	3	3
State-controlled (incl. bridge banks)	4	4	4	4	4	4	4
Foreign-owned banks' share in statutory capital	33.6	32.3	32.1	32.5	30.5	28.0	28.0
Concentration							
Share of assets of largest 10 banks	55.5	57.3	58.8	59.7	63.8	63.6	64.7
Share of assets of largest 25 banks	77.2	79.5	81.0	82.0	83.8	85.5	86.6
Number of bank with assets less than \$150 million	95	95	91	103	99	n.a.	n.a.
Capital Adequacy							
Regulatory capital to risk-weighted assets	14.8	15.9	16.0	15.6	8.4	7.8	7.7
Capital to total assets	12.8	12.6	12.3	12.4	6.5	6.1	6.0
Asset Quality							
Credit growth (year-over-year percent change) 2/	21.2	18.0	15.7	12.4	19.3	10.5	4.0
Credit at program exchange rate growth (year-over-year percent change) 2/	5.3	-0.6	-5.9	-15.6	-17.4	-17.5	-21.1
Credit to GDP ratio 2/	67.7	65.9	65.2	66.8	74.9	n.a.	n.a.
NPLs to total loans (NBU definition) 3/	13.3	14.6	16.7	19.0	24.7	25.5	24.1
NPLs to total loans (broader definition) 5/	26.1	27.7	30.6	32.0	39.7	43.7	44.3
NPLs net of provisions to capital (NBU definition) 3/	37.6	47.0	55.0	61.1	129.5	126.5	n.a.
NPLs net of provisions to capital (broader definition) 4/	100.2	142.5	153.8	163.9	367.2	388.0	n.a.
Specific provisions (percent of NPLs, NBU definition) 3/	79.4	72.3	71.1	76.7	80.1	n.a.	n.a.
Specific provisions (percent of total loans, NBU definition) 3/	13.8	13.7	15.6	19.1	26.1	n.a.	n.a.
Specific provisions (percent of NPLs, broader definition) 4/	...	34.6	36.1	42.6	48.8	48.8	n.a.
Foreign Exchange Rate Risk							
Loans in foreign currency to total loans 2/	41.6	42.9	44.2	46.4	55.3	52.4	51.9
Deposits in foreign currency to total deposits	43.4	42.2	41.2	45.6	53.2	49.9	49.1
Foreign currency loans to foreign currency deposits 2/	143.3	153.5	162.3	154.8	168.0	169.3	164.5
Net open FX position to regulatory capital (NBU definition) 5/	13.4	14.6	23.7	31.7	113.4	n.a.	n.a.
Net open FX position to regulatory capital (staff estimate) 5/	-18.3	-20.4	-20.9	-41.2	-97.2	n.a.	n.a.
Liquidity Risk							
Liquid assets to total assets	21.6	21.9	24.3	26.4	n.a.	n.a.	n.a.
Customer deposits to total loans to the economy	66.8	66.1	66.1	65.6	61.8	n.a.	n.a.
Earnings and Profitability							
Return on assets (after tax; end-of-period) 6/	-0.6	0.2	-1.1	-4.1	-22.3	-17.3	-12.4
Return on equity (after tax; end-of-period) 6/	-4.2	1.4	-7.9	-30.5	-285.9	-232.0	-168.1
Net interest margin to total assets	4.6	4.4	4.3	4.2	3.6	n.a.	n.a.
Interest rate spreads (percentage points; end-of-period)							
Between loans and deposits in domestic currency	7.4	4.5	6.2	6.9	10.8	8.4	8.1
Between loans and deposits in foreign currency	1.9	2.3	2.6	1.9	0.8	1.5	1.8
Between loans in domestic and foreign currency	11.4	8.4	7.5	8.4	16.2	15.0	14.0
Between deposits in domestic and foreign currency	5.9	6.2	3.8	3.3	6.1	8.0	7.7
Number of banks not complying with banking regulations							
Not meeting capital adequacy requirements for Tier I capital 7/	6	5	8	14	29	24	n.a.
Not meeting prudential regulations 7/	28	25	26	34	56	43	n.a.
Not meeting reserve requirements	37	27	33	34	29	26	n.a.

Sources: National Bank of Ukraine; and IMF staff estimates (for intra-quarter indicators where data available).

1/ Excludes banks under liquidation.

2/ Monetary statistics data.

3/ From December 2012, NBU changed loan classification, which resulted in the NPL series break.

4/ Includes NPLs that are classified as substandard, doubtful, and loss. From December 2012, estimated by staff using NPL data published by NBU according to new methodology, which resulted in series break.

5/ NBU definition did not take into account the effects of NBU Resolution 109, which

6/ Cumulative profits year-to-date, annualized.

7/ From 2015–2018, given the adverse exchange rate and losses in conflict areas, banks will be granted forbearance on meeting prudential requirements related to capital levels.

Table 3. Banking Sector Norms

	2008	2009	2010	2011	2012	2013	2014	01/08/2015
Minimum value of regulatory capital (UAH billion)	107.4	139.0	156.1	173.6	178.9	205.0	188.9	97.8
Regulatory capital adequacy ratio (no less than 10 percent)	13.1	18.3	20.3	18.5	18.1	18.3	15.6	8.0
Quick liquidity ratio (no less than 20 percent)	58.4	65.7	55.6	58.4	69.3	57.0	57.1	56.8
Current liquidity ratio (no less than 40 percent)	77.0	70.3	81.1	73.3	79.1	80.9	79.9	75.4
Short-term liquidity ratio (no less than 60 percent)	32.7	32.3	91.7	94.0	90.3	89.1	86.1	81.8
Maximum credit risk exposure per single counterparty / Regulatory capital (no more than 25 percent)	23.3	21.8	21.6	21.6	22.1	22.3	22.0	23.1
Total large credit risk exposure / Regulatory capital (no more than 800% of Regulatory capital)	170.7	165.3	159.7	163.5	172.9	172.1	250.0	675.1
Maximum credit exposure to single insider / Share Capital (no more than 5 percent)	1.6	1.2	0.8	0.5	0.4	0.4	0.1	Not Calculated
Maximum credit exposure to related parties (no more than 25 percent)*								20.3
Maximum aggregate credit exposure to all insiders / Share Capital (no more than 30 percent)	6.8	3.8	2.4	2.4	2.4	1.6	1.4	Not Calculated
Investment in securities issued by single entity / Reg. Capital (no more than 15 percent)	0.2	0.1	0.1	0.1	0.1	0.0	0.0	-
Total investment in securities / Reg. Capital (no more than 60 percent)	5.9	3.2	3.4	3.3	3.5	3.2	3.0	2.7

* Introduced by NBU Board Resolution No 361, dated June 8, 2015

Source: National Bank of Ukraine



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