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## **Improving SME Access to Finance in Ukraine**

Ivan Koriakin, Robert Kirchner

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## Improving SME Access to Finance in Ukraine

### Executive Summary

In Ukraine, the development of small and medium-sized enterprises (SMEs) can contribute to a more diversified and open economic structure, and act as an engine for employment generation. At the same time, many factors hinder this sector from realizing its full potential. One of these factors is access to finance, where SMEs appear to be especially credit-constrained due to their higher risk profiles. Indeed, access to finance is mentioned in surveys about Ukrainian SMEs consistently among the top three business constraints.

How large is this problem in quantitative terms? In this paper, we attempt to quantify the SME financing gap based on estimated demand and existing supply of capital. This analysis yields the following results:

Type of finance	Demand	Supply	Financing gap	In % of demand
Equity, EUR m	6,668.53	5,794.92	873.61	13%
Debt, EUR m	20,005.58	11,585.02	8,420.57	42%
<b>Total, EUR m</b>	<b>26,674.11</b>	<b>17,379.93</b>	<b>9,294.18</b>	<b>35%</b>

The main part of the resulting **financing gap of EUR 9.3 bn** is in debt finance (EUR 8.4 bn). This raises for policymakers the immediate question what can be done to close this gap over time.

We think that **loan guarantee funds**, which do not exist in Ukraine to date, are an appropriate instrument to stimulate SME lending by banks. As they do not interfere with commercial principles, they are a non-distortive response to the constraints discussed. However, it will be important to monitor and assess their functioning over time in order to make them as efficient as possible. In the **banking sector**, more efforts should be directed to attract SME credit lines by International Financial Institutions, e.g. also directed towards SME in the Eastern regions, where we estimate a need of **more than EUR 100 m** due to the conflict. Furthermore, these lines should be committed in local currency, in order to remove a possible currency mismatch. As the far-reaching reforms in the banking sector in terms of the legal and regulatory framework gain traction, a gradual improvement of bank lending from its own funding base should support SME access to finance in the future.

Further work should be done in parallel in the **non-banking sector**, whose size is still relatively small. Nevertheless, in order to support innovative and IT companies, which are growing rapidly in Ukraine, a new financial infrastructure involving venture capital and business angel financing, or more generally private equity, must be developed.

Finally, more efforts to promote **financial literacy** must be made. Only if current and potential SMEs (including private entrepreneurs) have the necessary skills and knowledge on business planning, accountancy issues, etc. will this translate into formal demand for external debt and equity.

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## 1. Introduction

For transition economies like Ukraine, it is crucial to move away from a growth model based on large enterprises towards a more diversified and open economic structure. Small and medium-sized enterprises (SMEs) can facilitate this shift from mass production to a more diverse, demand-driven and market-oriented supply of products, being well-positioned to react quickly to changing market conditions, introduce product and market innovation and challenge inefficient elements. SMEs can act in Ukraine as an engine for employment generation and sustained growth; offer a significant opportunity for economic recovery in the short term and increased resilience over the medium to long term. The signing of the bilateral Association Agreement with the EU in 2014, including the Deep and Comprehensive Free Trade Areas (DCFTA) creates new opportunities for greater economic integration and trade. This historical event will have a positive impetus for development of business in Ukraine in general and for SMEs in particular.

This paper looks at one particular aspect of SME policy in Ukraine in more detail, which is access to finance. The recently published OECD SME Policy Index “Eastern partner Countries 2016” provides a comprehensive analysis of SME policy in the country, and mentions this area as a key challenge where progress is needed<sup>1</sup>. SMEs appear to be especially credit-constrained due to their higher risk profiles. Indeed, access to finance is mentioned in surveys about Ukrainian SMEs consistently among the top three business constraints<sup>2</sup>. Improving SME access to finance would also go hand-in-hand with the efforts of the authorities to clean-up the banking system, where about a third of all banks were removed from the market by the regulator due to breaches of regulatory norms.

The paper is structured as follows: In the next chapter, we provide a short overview of the SME sector in Ukraine. This covers its role in the national economy, the SME financing gap, an overview and assessment of existing instruments and the impact of the current crisis. Chapter then 3 deals with improving SME access to finance and provides respective recommendations on how the government can stimulate access to finance. This relates to the expansion of SME classic bank finance, broadening the use of financing instruments and a list of priorities to start with.

## 2. Present Situation of SMEs and SME Finance

### 2.1 SMEs in Ukraine and their Role in the Economy

Since 2012, the definition of SMEs in Ukraine is identical to that of the EU, except an optional criterion of total balance sheet<sup>3</sup>. Article 55 of the Economic Code of Ukraine<sup>4</sup> provides the following explanation:

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<sup>1</sup> See Annex 5.1 for a more comprehensive analysis of all OECD SME policy factors.

<sup>2</sup> See EBRD (2015) “Business Environment and Enterprise Performance Survey, BEEPS V.

<sup>3</sup> The European Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

<sup>4</sup> <http://zakon2.rada.gov.ua/laws/show/436-15/page2>

**Table 1**

## Definition of SMEs in Ukraine

Economic unit	Definition
Micro company/private entrepreneur (PE)	Headcount <= 10, annual turnover <= EUR 2 m
Small company/private entrepreneur (PE)	Headcount 10-50, annual turnover EUR 2-10 m
Medium company/private entrepreneur (PE)	Headcount 50-250, annual turnover EUR 10-50 m

Source: *Economic Code of Ukraine*

Unfortunately, Ukraine lacks some of the SME statistics that exist in the EU. The European Commission has a special portal for SMEs<sup>5</sup> and provides an SME performance review<sup>6</sup> for all EU countries and also for some countries associated with the EU (Serbia, Moldova, etc.), but not for Ukraine.

The number of SMEs in Ukraine is substantial; however, exact figures are published only for legal entities and private individuals (PEs) on an annual basis. As for legal entities, official statistics show the following<sup>7</sup>:

**Table 2**

## Number of SMEs in Ukraine

Economic unit	Number (as of 31 December 2014) <sup>8</sup>	Share of total number of companies
Micro company	278,922	81.8%
Small company	45,676	13.4%
Medium company	15,906	4.7%
<b>Total</b>	<b>340,504</b>	<b>99.9%</b>

Source: *State Statistics Service of Ukraine*

<sup>5</sup> <http://ec.europa.eu/growth/smes>

<sup>6</sup> [http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/index\\_en.htm](http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/index_en.htm)

<sup>7</sup> [https://ukrstat.org/uk/operativ/operativ2013/fin/kp\\_reg/kp\\_reg\\_u/kp\\_reg\\_u\\_2014.htm](https://ukrstat.org/uk/operativ/operativ2013/fin/kp_reg/kp_reg_u/kp_reg_u_2014.htm)

<sup>8</sup> Excluding the Autonomous Republic of Crimea, Sevastopol and the conflict area in Eastern Ukraine.

The number of private entrepreneurs is also provided by the State Statistics Service of Ukraine<sup>9</sup>:

**Table 3**

Number of private entrepreneurs

Economic unit	Number (as of 31 December 2014) <sup>10</sup>	Share of total number of PEs
Micro PEs	1,580,965	99.4%
Small PEs	9,483	0.6%
Medium PEs	712	0.0%
<b>Total</b>	<b>1,591,160</b>	<b>100%</b>

Source: State Statistics Service of Ukraine

Despite not having exact data<sup>11</sup>, we believe that the total number of economic units which fall under the definition of SMEs in Ukraine is around **2.0 million**.

Apart from the total number of enterprises, the role of SMEs in the national economy can be described by the number of employed persons, the volume of sales and the share of GDP in comparison with selected EU-28 countries<sup>12,13,14</sup>:

**Table 4**

Role of SMEs in the national economy

SME's share of	Ukraine	Slovakia	Poland	Germany	EU-28
Enterprises	<b>99.9%</b>	99.9%	99.8%	99.5%	99.8%
Employment	<b>75.5%</b>	71.2%	69.0%	60.9%	66.9%
Sales	<b>60.4%</b>	62.7%	51.0%	53.8%	57.9%

Source: State Statistics Service of Ukraine, Eurostat

In Ukraine, the SME's share in the number of enterprises, employment and sales are comparable to those of the EU countries shown above. Quite a small input of SMEs to the state budget (UAH 6.9 bn out of UAH 410 bn of all taxes, or 1.7% in 2014, and 10.9 bn UAH in 2015)<sup>15,16</sup> is due to the existence

<sup>9</sup> [http://www.ukrstat.gov.ua/operativ/operativ2014/fin/osp/osp\\_reg/ksg\\_reg/ksg\\_reg\\_u\\_14.htm](http://www.ukrstat.gov.ua/operativ/operativ2014/fin/osp/osp_reg/ksg_reg/ksg_reg_u_14.htm)

<sup>10</sup> Excluding the Autonomous Republic of Crimea, Sevastopol and the conflict area in Eastern Ukraine.

<sup>11</sup> There might be further SMEs in the form of farmers, (consumer) cooperatives, companies organised by NGOs, etc.

<sup>12</sup> From BE's study "Towards a modern SME policy in Ukraine" published in 2014 at <http://www.berlin-economics.com/en/publications/others>

<sup>13</sup> <http://www.international.gc.ca/development-developpement/partners-partenaires/calls-appels/ukraine-sme-pme-bg.aspx?lang=eng>

<sup>14</sup> [http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/index\\_en.htm#interactive-sme-database](http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/index_en.htm#interactive-sme-database)

<sup>15</sup> <http://www.minfin.gov.ua/news/view/podatкова-reforma-fakty-i-tsyfry?category=bjudzhet&subcategory=dohidna-politika>

<sup>16</sup> <http://news.finance.ua/ru/news/-/367503/stalo-izvestno-skolko-uproshhentsy-zaplatili-edinogo-naloga-za-proshlyj-god>

of the simplified taxation regime (STR) covering both companies and private entrepreneurs with annual sales less than UAH 20 m<sup>17</sup>:

**Table 5**

Input of SMEs to the state budget

Annual sales	Number of STR taxpayers, thousand	Share of number of STR taxpayers	Single tax paid, UAH m	Share of single tax paid
Less than UAH 1 m	1,275.6	98.03%	4,524.8	65.54%
UAH 1-5 m	24.9	1.91%	2,026.7	29.35%
UAH 5-20 m	0.7	0.06%	352.8	5.11%
<b>Total</b>	<b>1,301.2</b>	<b>100%</b>	<b>6,904.4</b>	<b>100%</b>

Source: Ministry of Finance of Ukraine

## 2.2 SME Finance: Demand, Supply and the Financing Gap

Before discussing the SME financing gap, i.e. the gap between estimated demand and supply, it is useful to consider the “Access to Finance” component of the previously mentioned OECD SME Policy Index further. This component has been evaluated as follows<sup>18</sup>:

**Table 6**

Access to finance for SMEs

#	Policy factor	Score	Gap to 5.00, %
6	Access to finance for SMEs	3.22	36%
6.1	Legal and regulatory framework	3.70	26%
	Creditor rights	3.85	23%
	Register	3.49	30%
	Credit information bureau	4.31	14%
	Banking regulations	3.50	30%
	Stock market	3.00	40%
6.2	Bank financing	2.06	59%
	Banking statistics	2.32	54%
	Credit guarantee schemes	1.67	67%
6.3	Non-bank financing	3.54	29%
	Microfinance	3.00	40%

<sup>17</sup> Starting from 1 January 2016 this limit has been reduced to UAH 5 m.

<sup>18</sup> Gaps are marked in the following way: 0-33% as green, 34-66% as yellow, 67-100% as red

	Saving and loan associations (SLAs)	3.67	27%
	Leasing	3.50	30%
	Factoring	4.00	20%
6.4	Venture capital	1.38	72%
	Legal framework	1.45	71%
	Design and implementation	1.49	70%
	Monitoring and evaluation	1.00	80%
6.5	Financial literacy	3.29	34%
	Design and implementation	3.86	23%
	Monitoring and evaluation	1.00	80%
	<b>Overall score</b>	<b>3.22</b>	<b>36%</b>

Source: OECD SME Policy Index

The legal and regulatory framework, as well as non-bank financing is among the areas where Ukraine has achieved the most progress. Bank financing and financial literacy are moderately scored and require further efforts. Venture capital is the least developed sector.

For the purpose of estimating SME demand for financing, we use an assumption that they are able to raise and service certain amounts of debt and equity in relation to their size. A debt-to-equity ratio assumption of 75%:25% is used to estimate average demand for each type of SME.

The demand is based on the assumption that all participants are fully aware of such financing. However, we assume that only up to 25% of them would be interested and willing to invest and require finance (with lower probabilities for private entrepreneurs), while the rest would use their own funds and have no intention to raise any external financing, or temporarily do not operate.

As a result, we estimate total potential demand for finance of **EUR 26.7 bn**.

**Table 7**

SME demand for financing

Economic unit	Number	Average equity (per one), EUR m	Average debt (per one), EUR m	Probability of taking SME financing	Total demand for equity, EUR m	Total demand for debt, EUR m	Total demand, EUR m
Micro company	278,922	0.01	0.03	25%	697.31	2,091.92	2,789.22
Small company	45,676	0.1	0.3	25%	1,141.90	3,425.70	4,567.60
Medium company	15,906	0.5	1.5	25%	1,988.25	5,964.75	7,953.00
Micro PEs	1,580,965	0.01	0.03	10%	1,580.97	4,742.90	6,323.86
Small PEs	9,483	0.1	0.3	15%	142.25	426.74	568.98
Medium PEs	712	0.5	1.5	20%	71.20	213.60	284.80

Farmers	38,850	0.1	0.3	25%	971.25	2,913.75	3,885.00
Other SMEs	30,165	0.01	0.03	25%	75.41	226.24	301.65
<b>Total</b>	<b>2,000,679</b>	-	-	-	<b>6,668.53</b>	<b>20,005.58</b>	<b>26,674.11</b>

Source: State Statistics Service of Ukraine, own estimation

The major source of equity is represented by own funds of SMEs while the major source of debt is provided by loans from Ukrainian banks, which are predominantly short-term. Currently, SME credit lines by IFIs<sup>19</sup> arranged through Ukrainian partner banks and leasing seem to be the only sources of medium and long-term debt. SME loan guarantee schemes are not available.

**Table 8**

SME supply of financing

Type of Financing	Supply of equity, EUR m	Supply of debt, EUR m
Loans from Ukrainian banks <sup>20,21</sup>	-	10,167.26
SME credit lines by IFIs arranged through partner Ukrainian banks <sup>22</sup>	-	1,000.00
Loan guarantee schemes	-	-
Leasing and factoring companies <sup>23</sup>	-	392.35
Credit unions <sup>24</sup>	-	25.41
Own equity <sup>25</sup>	5,483.92	-
Equity funds <sup>26</sup>	200.00	-
Startup financing <sup>27</sup>	111.00	-
<b>Total supply</b>	<b>5,794.92</b>	<b>11,585.02</b>

Source: National Bank of Ukraine, National Commission for State Regulation of Financial Services Markets

<sup>19</sup> International Financial Institutions (IFIs) such as EBRD, EIB, IFC, KfW, USAID, NEFCO, etc.

<sup>20</sup> Excluding SME credit lines arranged through partner Ukrainian banks.

<sup>21</sup> [http://bank.gov.ua/control/uk/publish/article?art\\_id=36807&cat\\_id=36798](http://bank.gov.ua/control/uk/publish/article?art_id=36807&cat_id=36798), calculated as 33% of total credit portfolio to legal entities is provided to SMEs (as of 31 October 2015)

<sup>22</sup> Including Energy Efficiency/Renewable Energy (EE/RE) financing.

<sup>23</sup> <http://nfp.gov.ua/content/stan-i-rozvitok-finansovih.html>, calculated as 25% of total portfolio of leasing and factoring companies to legal entities is provided to SMEs (as of 30 September 2015)

<sup>24</sup> <http://nfp.gov.ua/content/stan-i-rozvitok-kreditnih-spilok.html>, calculated as 33% of total portfolio of credit unions is provided to SMEs (as of 30 September 2015)

<sup>25</sup> <http://ukrstat.gov.ua> (Chapter 'Activities of enterprises'), calculated as 15% of total equity of Ukrainian enterprises (as of 31 December 2014)

<sup>26</sup> [http://www.horizoncapital.com.ua/sites/default/files/press/in\\_press/pdf/article\\_percis\\_4-dec2010-jan2011\\_ukrainian\\_private\\_equity\\_market\\_interview\\_natalie\\_jaresko-original.pdf](http://www.horizoncapital.com.ua/sites/default/files/press/in_press/pdf/article_percis_4-dec2010-jan2011_ukrainian_private_equity_market_interview_natalie_jaresko-original.pdf)

<sup>27</sup> The IT sector has represented major investments in 2014-2015 (<http://ain.ua/2015/12/28/624155>, <http://forbes.ua/business/1408447-investicii-v-it-glavnoye-sobytiya-uhodyashchego-goda>)

Comparing demand and supply figures, we can identify a **financing gap of EUR 9.3 bn**, where 42% of demand is needed in debt financing and 13% of demand in equity financing:

**Table 9**

Financing gap

Type of finance	Demand	Supply	Financing gap	In % of demand
Equity, EUR m	6,668.53	5,794.92	873.61	13%
Debt, EUR m	20,005.58	11,585.02	8,420.57	42%
<b>Total, EUR m</b>	<b>26,674.11</b>	<b>17,379.93</b>	<b>9,294.18</b>	<b>35%</b>

Source: Own estimation

### 2.3 Existing financing instruments: strengths and weaknesses

In Ukraine there are several financing instruments for SMEs, and debt instruments are more developed than equity ones. Strengths and weaknesses of them are described below:

**Table 10**

Strengths and weaknesses of existing SME financing instruments

Financing instruments	Strengths	Weaknesses
Loans from Ukrainian banks	Most accessible instrument, provided in local currency	Predominantly short-term, high interest rate, often require hard collateral
SME credit lines by IFIs arranged through Ukrainian partner banks	Medium and long-term loans, often accompanied by technical assistance	Hard currency loans <sup>28</sup>
Leasing and factoring companies	For leasing: medium and long-term, leased object used as a security  For factoring: accounts receivable used as a security, could be revolving	For leasing: Own contribution up to 50% required  For factoring: short-term financing, could be recourse
Credit unions	Unsecured	Low capacity, small amount, high interest rate, individuals only
Own equity	Permanent risk capital	Difficult to raise, if urgently needed

<sup>28</sup> Anton Usov of EBRD: „SMEs should be our priority regardless of the financial or political situation... But in recent years it has been difficult to lend to the small and medium-sized business sector for various reasons. One of those is that we are limited in the currency of loans we provide, and local businesses in Ukraine need long-term loans in the local currency, which is the Hryvnia. Unfortunately, now we don't have the technical ability to provide lending in Hryvnia. ... We are trying to push that forward as much as we can. There are certain pieces of legislation that allow us to issue bonds in domestic currency and use these resources to lend to companies in Ukraine, including small businesses“ (<http://euukrainecoop.com/2015/01/29/ebrd>)

Equity funds	Permanent or temporary risk capital, often medium or long term	Low capacity, difficult to access
Start-up financing	Good appetite for innovative projects from global companies and funds	Low capacity, mostly in IT sector, investments often made outside Ukraine

Source: Own research

#### 2.4 Impact of the current economic crisis and displacement of people

After stagnation in 2013, Ukraine's real GDP contracted by 6.8% in 2014 and fell by a further estimated 11.0% in 2015. End-of-period inflation was 0.5% in 2013, 24.9% in 2014 and 43.3% in 2015. The Hryvnia depreciated from around 8 against the US-Dollar in the end of 2013 to 24 in the end of 2015. The number of commercial banks reduced from 180 in the end of 2013 to 120 in the end of 2015.

Under these circumstances, Ukrainian SMEs suffered from loss of business, a contraction of credit and high interest rates. All existing drawbacks of SME development in Ukraine have thus been aggravated by the severe economic downturn and the crisis in the banking sector and led to a further tightening of lending standards.

As a result of the military conflict in the East, the United Nations High Commissioner for Refugees (UNHCR) has counted 1,438,000 internally displaced persons (IDPs) from Crimea and Eastern Donbas<sup>29</sup>. Entrepreneurs from these regions often lost their assets and had to re-launch their business at new places. According to our calculations financing of **EUR 109 m** is required to support those SMEs which had to relocate to other regions of Ukraine:

**Table 11**

Estimation of financial needs for SMEs affected by the conflict in the East

	Whole Ukraine	Share of total population	Estimated number of IDPs and displaced SMEs	Demand for financing per one SME, EUR m	Probability of taking financing	Demand for financing, EUR m
Population	42,619,835		1,438,000			
Number of PEs	1,591,160	3.73%	53,686	0.01	15%	80.53
Number of SMEs	340,504	0.80%	11,489	0.01	25%	28.72
<b>Total</b>						<b>109.25</b>

Source: State Statistics Service of Ukraine, UNHCR, own estimation

<sup>29</sup><http://unhcr.org.ua/en/who-we-help/internally-displaced-people>; <http://internal-displacement.org/europe-the-caucasus-and-central-asia/ukraine/figures-analysis>.

### 3. Improving Access of SMEs to Finance: Recommendations

#### 3.1 Expanding Coverage through the Banking Sector

Loans from Ukrainian banks will continue to be a primary source of financing for Ukrainian SMEs, in line with international and regional trends. However, the national banking sector will need a few years to recover from the current crisis, to strengthen and start servicing their needs. In particular, a sustainable and longer-term local currency funding base is needed to facilitate the issuance of longer-term local currency loans to SMEs. The joint efforts by the Government and the National Bank towards macroeconomic stabilization are an important first step in that direction. Now, improving the legal and regulatory framework in the financial sector (e.g. strengthening creditor's rights and improving the registry of movable assets that can be used as collateral) must be the main focus of the authorities.

In the meantime, the provision of funding by International Financial Institutions (IFIs) to partner banks in Ukraine for SME on-lending is of great importance, especially for longer maturities. The initiation of a **new financing package of EUR 500 m** (including EUR 109 m for SMEs of IDPs as identified in 2.4 above) would fall into this category.

Credit lines by IFIs arranged through Ukrainian partner banks proved in general to be successful in recent years due to the implementation of many joint projects supporting SMEs, except in cases where banks owned by Ukrainian shareholders went bankrupt. Very often, such credit lines are accompanied by technical assistance components helping to transfer skills to both partner banks and SMEs. An unresolved issue with IFI support, which has already been mentioned, is the currency nature of these funding lines, which are usually in foreign currency, and which creates currency mismatches. Here, existing plans to switch to local currency funding in the future need to be implemented.

A list of potential partner Banks for cooperation with IFIs in SME Finance, which can be found in Annex 4.2, includes financially strong banks, often owned by international groups.

#### 3.2 Expanding Financing Instruments

##### i. Loan guarantee funds

In many countries, governments have established loan guarantee schemes aiming to help SMEs to secure loans from banks. Loan guarantee schemes are often provided by the state to encourage bank lending to viable businesses which cannot meet standard requirements due to lack of collateral and/or a proven track record. They can play a catalysing role in emerging economies where the SME financing gap is generally wider than in developed economies.<sup>30</sup> The funds can guarantee up to 100% of the loan amount, but normally this is limited to 50-75%, to co-share the risk of the borrower's default with the bank in order to set the right incentives for project selection and monitoring.

Well-structured support systems are an appropriate and non-distortive response to the constraints mentioned above. However, it is important to align them with commercial principles and to monitor and evaluate them on a permanent and systematic basis, in order to reach the right target group.

So far, in Ukraine no general SME loan guarantee programmes have been put in place<sup>31</sup>. The forthcoming EU SURE Loan Guarantee Facility of EUR 40 m will be the first important step in this direction. More information on the EU SURE project can be found in Annex 4.3. Sectoral (e.g. agricultural) loan guarantee schemes can be also arranged based on international best practices<sup>32</sup>.

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<sup>30</sup> [http://www.eib.org/attachments/efs/viwig\\_credit\\_guarantee\\_schemes\\_report\\_en.pdf](http://www.eib.org/attachments/efs/viwig_credit_guarantee_schemes_report_en.pdf)

<sup>31</sup> [http://www.eib.org/attachments/efs/econ\\_report\\_psf\\_and\\_the\\_role\\_of\\_rbi\\_ukraine\\_en.pdf](http://www.eib.org/attachments/efs/econ_report_psf_and_the_role_of_rbi_ukraine_en.pdf)

<sup>32</sup> <http://www.oecd.org/countries/ukraine/UkraineCGSAGribusiness.pdf>

ii. Non-bank instruments like leasing, factoring and credit unions

In Ukraine, there are 293 leasing companies and 267 non-financial companies (mostly suppliers) who can provide leasing services, predominantly for transport and agriculture, as well as 378 factoring companies<sup>33</sup>. There are also 589 credit unions, uniting 751.7 thousand members and providing relationship-based microfinancing<sup>34,35</sup>.

Similar to banks, these institutions suffered from non-performing loans and the loss of capital in recent years. Even though their role in credit support for SMEs is small (compared to bank loans, around 3.9% and 0.2%, respectively) it is nevertheless important. They help to diversify financing sources and risks. These instruments will return to growth when the macroeconomic situation improves.

iii. Sectoral instruments like warehouse receipts

Warehouse receipt (WHR) financing represents a sectoral instrument typical for agriculture. It is a collateralized commodity transaction, in which the crop serves as a security for the loan. Warehouse receipts help to ensure post-harvest finance for working capital needs. For a proper functioning of this instrument, it is crucial to establish a legal and institutional framework.

The EBRD has already implemented WHR programmes in Bulgaria, Slovakia, Lithuania, Kazakhstan, Croatia, Romania and Serbia. In January 2002, a Memorandum of Understanding between the Government of Ukraine and the EBRD was signed whereby the parties expressed intentions to co-operate in the implementation of a viable WHR system. On 4 July 2002 the Law 'On Grain and Market of Grain in Ukraine' was passed by the Parliament of Ukraine.<sup>36</sup> However, major unresolved issues related to the certification of grain and elevators, and the activities of the guarantee fund for the grain warehouse receipts prevent this instrument from being used for many years.<sup>37</sup> Only recently, that is in summer 2015, a pilot project in Ukraine issued the first crop receipts for pre-harvest financing. Experts estimate that in the medium term crop receipts would be able to provide at least USD 1.5 billion of additional liquidity for producers, while the long-term potential could be even greater<sup>38</sup>.

iv. Venture capital, business angel financing

New financing instruments have not been common to Ukrainian SMEs, which rely mostly on their own capital and traditional bank loans. However, the current economic crisis has also forced the population and businesses to create new opportunities and embrace change.

Despite the country's weak investment climate, George Soros established in 2015 the Ukrainian Redevelopment Fund, committing to invest USD 1 bn to support the development of the Ukrainian economy. The first transaction of his fund was a purchase of a stake in Ukrainian software developer

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<sup>33</sup> <http://nfp.gov.ua/content/stan-i-rozvitok-finansovih.html> (as of 30 September 2015)

<sup>34</sup> <http://nfp.gov.ua/content/stan-i-rozvitok-kreditnih-spilok.html> (as of 30 September 2015)

<sup>35</sup> The average loan amount is up to 500 EUR.

<sup>36</sup> <http://www.ebrd.com/documents/evaluation/2004-warehouse-receipt-programmeagricultural-commodities-financing-programme.pdf>

<sup>37</sup> <http://www.volkovpartners.com/s/en/home/comments/600>

<sup>38</sup> <http://www.eastagri.org/news/index.asp?id=559>

Ciklum Holding Ltd.<sup>39</sup> Further promising areas are energy efficiency and agriculture, and what is more relevant for our purposes, providing investment support for IDPs: “The purpose of such investments is to stimulate IDPs to open small and medium enterprises. We are studying the opportunity to invest into them.”<sup>40</sup>

Business angel financing is booming due to the attractive position of Ukraine at the global IT and online services market. Ukrainian universities educate about 16,000 high-quality IT specialists annually. Thanks to that, Ukraine is considered as the most attractive European market for hiring talented freelancers, and the fourth biggest market in the world in terms of their earnings<sup>41</sup>. The most popular technical skills are web development, mobile application development and software development.<sup>42</sup>

### 3.3 Immediate priorities to start with

In the following table, we provide a list of measures that could improve SME access to finance in the short term.

**Table 12**

Immediate priorities that could improve SME access to finance in the short term

#	Subject <sup>43</sup>	What to do	How to do
1	Loans to SMEs	Adopt legal and regulatory reforms and consider credit guarantees to improve access to finance	Cooperate with IFIs and governmental agencies on further improvements in the legal and regulatory framework  Coordinate with EU SURE a Loan Guarantee Facility of 40 m EUR  Initiate a specialised loan guarantee scheme for farmers  Resolve issues related to warehouse receipts
2	Loans to SMEs	Address the current decline in lending to SMEs	Initiate a financing package of EUR 500 m for SMEs (including EUR 109 m for SMEs of IDPs) from IFIs to channel through partner banks as identified in 3.1 above.
3	Loans to SMEs	Work towards a regulatory framework that facilitates banks'	Cooperate with IFIs and governmental agencies for clearing all barriers to provide

<sup>39</sup> <http://www.bloomberg.com/news/articles/2015-11-18/billionaire-george-soros-invests-in-ukraine-software-developer>

<sup>40</sup> <http://m.nv.ua/publications/soros-rassmatrivaet-vozmozhnost-investirovat-v-ukrainu-29781.html>

<sup>41</sup> Estimated at USD 60 m in 2014.

<sup>42</sup> <http://forbes.ua/opinions/1406741-rastushchij-rynok-frilansa-v-ukraine-globalnaya-tendenciya-ili-mestnyj-fenomen>

<sup>43</sup> These subjects coincide with recommendations of OECD SME Policy Index “Eastern partner Countries 2016” (<http://www.oecd.org/countries/ukraine/sme-policy-index-eastern-partner-countries-2016-9789264246249-en.htm>)

	access to longer term and local currency funding and promote competition in the banking sector to encourage banks to offer more competitive rates and reach out to new segments	loans to partner banks for further on-lending to SMEs in Hryvnias <sup>44,45</sup>
4	Non-bank financial products and services	Support viable alternatives to bank financing by putting in place adequate legal frameworks for the provision of non-bank financial products and services
		Initiate a Ukrainian SME private equity fund of EUR 25 m <sup>46</sup> . Use experience of British programmes of Business Finance Partnership (BFP), Start-up Loans Scheme, Business Angel Co-Investment Fund, Enterprise Capital Funds Programme, etc. <sup>47</sup> Cooperate with business associations representing leasing, factoring, credit unions venture capital and business angel financing to improve the legal and regulatory framework.
5	Education and training	Promote financial literacy among the public and build financial management and business planning skills among small business owners
		Enhance financial skills of SMEs by training entrepreneurs in how to raise financing: cooperation with banks and investors, basics of finance, business planning, financial projections, etc.  Train SME how to raise alternative financing such as leasing, factoring, credit unions, venture capital, business angel financing, etc.

Source: Own research

<sup>44</sup> EBRD, IFC and NEFCO have been granted the right to use Hryvnia to fund projects – see NBU’s press release at [http://bank.gov.ua/control/en/publish/printable\\_article;jsessionid=4D83EAA35BE0E356A6CB9B61B8FAFFA5?art\\_id=2263213&showTitle=true](http://bank.gov.ua/control/en/publish/printable_article;jsessionid=4D83EAA35BE0E356A6CB9B61B8FAFFA5?art_id=2263213&showTitle=true).

<sup>45</sup> So far, the EBRD has funded in Ukraine only 0.02% of their EUR 9.2 bn portfolio in local currency, compared to 1.81% in Armenia and 36.8% in Russia – see at <http://www.ebrd.com/documents/treasury/local-currency-financing-presentation.pdf>

<sup>46</sup> See a business idea at <http://documents.mx/documents/ukrainian-sme-private-equity-fund.html>

<sup>47</sup> <https://www.gov.uk/government/publications/2010-to-2015-government-policy-business-enterprise/2010-to-2015-government-policy-business-enterprise>

## 4. Annex

### 4.1 The OECD SME Policy Index on Ukraine

The recently published OECD SME Policy Index “Eastern partner Countries 2016”<sup>48,49</sup> has outlined that fostering SMEs has nowadays become even more important. This is due to significant deterioration of macroeconomic conditions since 2012 when the report was issued first. Falling commodity prices and a slowdown in foreign trade have resulted in significant currency depreciation, rising inflationary pressures and a credit contraction which has damaged national output.

The potential of SMEs in Ukraine has still to be discovered. Despite making up 99% of all firms, they account for 75% of all employment and 60% of sales. According to the study, Ukraine has got the following SME Policy Index scores<sup>50</sup>:

**Table 13**

OECD SME Policy Index on Ukraine

#	Policy factor	Score	Gap to 5.00, %
1	Create an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded	2.25	55%
2	Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance	2.05	59%
3	Design rules according to the “think small first” principle	2.45	51%
4	Make public administration responsive to SMEs	3.81	24%
5	Adapt public policy tools to SME needs	2.29	54%
6	Facilitate SME access to finance and develop a legal framework and business environment supportive of timely payments in commercial transactions	3.22	36%
7	Help SMEs to benefit more from the opportunities offered by the Single Market	4.34	13%
8	Promote the upgrading of skills and all forms of innovation	2.21	56%
9	Enable SMEs to turn environmental changes into opportunities	1.22	76%
10	Encourage and support SMEs to benefit from growth markets	1.63	67%
<b>Overall score</b>		<b>2.55</b>	<b>49%</b>

Source: OECD SME Policy Index

<sup>48</sup> <http://www.oecd.org/countries/ukraine/sme-policy-index-eastern-partner-countries-2016-9789264246249-en.htm>

<sup>49</sup> Eastern Partnership Countries include Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

<sup>50</sup> Gaps are marked in the following way: 0-33% as green, 34-66% as yellow, 67-100% as red.

## 4.2 Potential Partner Banks for Cooperation with IFIs in SME Finance

**Table 14**

Potential Partner Banks for Cooperation with IFIs in SME Finance

Bank	Shareholder Structure	Market Share by Assets <sup>51</sup>	Market Share by Loans <sup>51</sup>	Equity, EUR m <sup>51</sup>	Number of branches <sup>52</sup>	Experience with IFIs (if yes - donor and product)
Group of the largest banks						
Ukreximbank	State - 100%	11.13%	7.48%	270	102	Yes (WB, IFC, KfW, EBRD, GCPF, EIB) - EE/RE loans, SME loans
Raiffeisen Bank Aval	Raiffeisen Bank International (Austria) - 96.45%	4.18%	3.37%	159	595	Yes (EBRD) – SME loans
Ukrsibbank	BNP Paribas S.A. (France) - 84.996%	3.02%	2.55%	77	455	Yes (EBRD) – SME loans
First Ukrainian International Bank	Rinat Akhmetov (Ukraine) - 99.9%	2.85%	3.37%	168	157	No
OTP Bank	OTP Bank Plc. (Hungary) - 100%	1.83%	1.98%	54	83	No
Group of large banks						
Credit Agricole	Credit Agricole S.A. (France) - 99,996%	1.74%	1.78%	61	168	No
Megabank	Victor Subbotin (Ukraine) – 60.89%, EBRD (UK) – 15.00%, KfW (Germany) – 15.00%, IFC (US) – 6.01%	0.68%	0.89%	34	170	Yes (EBRD, IFC, KfW, GGF, GUF, OPIC, NEFCO) - EE microloans, EE SME Agri loans

<sup>51</sup> As of 1 October 2015

<sup>52</sup> As of 1 January 2016

Kredobank	PKO Bank S.A. (Poland) – 99.57%	0.65%	0.51%	41	108	No
Group of mid-sized banks						
ProCredit Bank	ProCredit Holding AG (Germany) – 60.87%, KfW (Germany)) – 39.13%	0.54%	0.63%	26	27	Yes (EBRD, KfW, IFC, GUF) - EE microloans, SME loans
Pravex Bank	Intesa San Paolo S.p.A. (Italy) – 100%	0.34%	0.24%	50	139	No
Piraeus Bank	Piraeus Bank S.A. (Greece) – 99.99%	0.25%	0.18%	17	17	No
Idea Bank	Getin Holding S.A. (Poland) – 99.34%	0.21%	0.29%	12	82	No
Group of small banks						
Bank Lviv	Margeir Petursson (Iceland) – 99.88%	0.10%	0.12%	7	24	Yes (EBRD, NEFCO) - EE microloans

Source: National Bank of Ukraine, own research

#### 4.3 EU SURE (Support to Ukraine to Re-launch the Economy)

In 2015, the EU announced a new package of aid for Ukrainian SMEs. The initiative EU SURE (EU Support to Ukraine to Re-launch the Economy) will be implemented in 2016-2020. It is part of the EUR 110 m package of EU Special Measures for Ukraine and includes a Technical Cooperation Facility of EUR 15 m to provide advice on legal approximation with the EU, capacity building and infrastructural support in priority areas covered by the EU-Ukraine Association Agreement, and a loan guarantee facility of EUR 40 m.

EU SURE is to be implemented by International Technical Assistance, EBRD and EIB and targets the Ministry of Economic Development and Trade, SMEs and business support organizations. EU SURE will support the development of SMEs across the Ukrainian regions and contribute to the re-launch of the Ukrainian economy to create growth and employment. This also includes the conflict affected areas and neighboring regions actively participating in the re-integration of internally displaced persons (IDPs).

At the national level, EU SURE will provide technical assistance and policy advice to complete the ongoing SMEs deregulation and the national and regional economic development strategies, and to

create a web info portal for SMEs; it will also include a contribution to the participation of Ukraine in EU programmes related to private sector development (Horizon 2020).

At regional level, EU SURE will provide business advice and entrepreneurial skills for SMEs, through a network of Business Support Centres (BSC) run in cooperation with EBRD. The BSC will help improve the competitiveness of the SME sector by connecting local small businesses to a network of local consultants and international industry experts. Business advice will be tailored according to the size of the company and the complexity of the challenges. BSC will also advise SMEs on how to access to financing and how to adapt to and benefit from the establishment of the DCFTA between the EU and Ukraine.

EU SURE will cover at least 15 regions across Ukraine. Targeted economic sectors will depend on the economic profile of the region and activities should aim but not be limited to the following key sectors: agriculture, innovation, improvement of provision of public services and infrastructures, energy efficiency and green economy.

EU SURE will also facilitate the access to finance by exploiting the synergies between the business advice services provided by the Business Support Centres and a complementary Loan Guarantee Facility worth EUR 40 m and run in cooperation with EIB. This loan facility will provide local commercial banks with an effective risk management tool to increase their capacity to absorb increased funding demand from SMEs.

### **List of recent Policy Studies**

- Implications of an economic detachment of the rebel-held area, by Ricardo Giucci, Robert Kirchner, Vitaliy Kravchuk, David Saha and Georg Zachmann, Policy Study PS/01/2015

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- Promoting clusters to foster industrial development. Key features and benefits of the cluster approach, by Bjoern Vogler, David Saha, Policy Briefing PB/12/2015

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